State of California
Franchise Tax Board

SUMMARY OF FEDERAL INCOME TAX CHANGES-1986

Laws Affected
Personal Income Tax
Bank & Corporation Tax

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

FEDERAL INCOME TAX CHANGES

1986

Prepared by the Staff of the

FRANCHISE TAX BOARD

State of California

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Members of the Board:

State Controller
Chairman, State Board of Equalization
Director of Finance

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EXECUTIVE SUMMARY

During 1986 the following laws, which revised the Internal Revenue Code, were passed by Congress and signed by the President:

1. CONSOLIDATED OMNIBUS BUDGET RECONCILIATION ACT OF 1985, Public Law 99-272 (signed April 7, 1986)

2. OMNIBUS BUDGET RECONCILIATION ACT OF 1986, Public Law 99-509 (signed October 21, 1986)

3. TAX REFORM ACT OF 1986, Public Law 99-514 (signed October 22, 1986)

This report explains the federal income tax changes enacted during 1986, with a discussion of current California law and estimates of the fiscal impact to the State of California from conforming to the federal changes.

REVENUE IMPACTS: All revenue estimates included in this report are based upon the tax rates existing under current law. If the California tax rates (or tax brackets) are changed, there would be corresponding changes in the revenue estimates for the individual items included in this report. For additional information, see the Summary of State Revenue Estimates beginning on Page 2100.

Overview

On October 22, 1986, President Reagan signed the Tax Reform Act of 1986, an Act so broad in scope that it virtually rewrites the entire body of federal law (Internal Revenue Code) relating to the taxation of income for individuals and corporations.

This act is especially important to the State of California, since a substantial portion of state tax law is patterned after, and closely conforms to the Internal Revenue Code. Each year the California Legislature is required by statute to review federal changes enacted during the prior year and make decisions on whether or not to change California law in a similar manner.

In contrast to the Tax Reform Act of 1986, the two Omnibus Budget Reconciliation Acts are of minor consequence.

Tax Policy Summary

Due to the comprehensive nature of the federal changes, there will be many tax policy issues before the state Legislature during 1987. It is anticipated that there will be a great deal of interest not only in the 1986 changes, but also in re-examining many of the pre-existing differences between state and federal law.

The scope of this report is generally limited to the 1986 changes, although some of the revenue estimates for conformity to federal changes include the elimination of any pre-existing difference with regard to the specific item.

Specific Issues

The following overview of specific issues which may be considered for conformity follows the format of the Personal Income Tax Return, although many of the issues also affect Banks and Corporations.

Line 16

Business Income (or Loss). Significant changes include the areas of: allowance of net operating loss carrybacks and carryforwards; accelerated methods of depreciation; current expensing of certain business assets; limitation of meal and entertainment expenses to 80% of actual expenses; limitations on use of the cash method of accounting; uniform capitalization rules for valuing inventory; accelerated reporting of income under long-term contracts; elimination of bad debt reserves for nonfinancial entities; and denial of the installment method of reporting income for revolving credit accounts, sales of publically traded securities, and certain installment receivables.

Line 17

Capital Gains (and Losses). Capital gains are no longer partially excluded, but are taxed as ordinary income under the new federal law.

Line 20

Fully Taxable Pensions and Annuities. A significant conformity issue in this area is the elimination of the three year basis recovery rule.

Line 21

Rents, Royalties, and Partnerships. Significant changes include the areas of: limitations on losses from passive investments; the extension of "at-risk" rules to real estate; capitalization of intangible drilling costs and exploration and development costs; and new limitations on percentage depletion of hard minerals.

Line 22 — Farm Income (or Loss). Many of the issues for business also apply to farming. In addition, the new federal law places new limitations on prepaid and preproduction expenses of farmers.

Lines 29-42 — Adjustments to Income. Significant changes include the areas of: taxation of unemployment benefits and the deduction of contributions to an Individual Retirement Plan (IRA), and the amount of allowable deductions to other pension plans.

Line 47 — Itemized Deductions. Significant changes include the areas of: elimination of the deduction of state and local sales taxes; reduction of the amount allowed as a deduction for medical expenses; denial of a deduction for personal interest expense (other than home mortgages); and limitation of miscellaneous deductions (tax preparation fees, unreimbursed employee business expenses, investment expenses, professional journals, etc.) to the amount exceeding two percent of adjusted gross income.

Line 51 — Computation of Tax. Significant changes include the areas of: increasing the threshold of taxation (standard deduction and personal exemptions); number of tax rates and tax brackets; and repeal of the income averaging provisions.

Line 52 — Personal and Dependent Exemptions. The new federal law generally increases the amount of the deduction for personal and dependent exemption deductions.

Line 71 — Credits Against the Tax. Significant changes have been made to the earned income credit (similar to California's low income credit), the credit for incremental research and development expenses (no state counterpart), and the targeted jobs credit (similar, but different provisions).

Line 73 — Minimum Tax. The new federal law makes substantial changes to both the alternative minimum tax for individuals and the corporate minimum tax.

Corporate Provisions — The following issues effect corporate taxpayers, but not individuals:

Bank and Corporation Tax Rates. The new federal law reduces the marginal tax rates, although the total tax is increased as a result of changes in the definition of taxable income.

Liquidating Distributions. The "General Utilities Doctrine" is repealed and gain or loss will generally be recognized by a corporation upon a liquidating sale of its assets or upon a distribution of its property in complete liquidation.

NOL Trafficking. The new law significantly curtails the deduction of net operating losses following a significant change in ownership of the corporation.

Real Estate Investment Trusts (REIT). The new federal law modifies qualification requirements, asset and income requirements, the definition of rents and interest, and imposes a 10% tax on prohibited transactions.

Real Estate Mortgage Investment Conduit (REMIC). A brand new pass-through vehicle is created for entities which issue multiple classes of investor interests backed by a pool of mortgages. The REMIC is intended to be the exclusive vehicle for issuing multiple class mortgage backed securities.

Admin. Provisions

Significant changes include the areas of: the imposition of penalties; requirements for filing information returns; increasing the requirement (from 80% to 90%) of estimated tax payments by individuals; and establishment of separate interest rates for underpayments and overpayments.

Additional Information

Additional information regarding this report (or additional copies) may be obtained from Dan Converse, Legislative Services Bureau, P.O. Box 1468, Sacramento, CA 95807-1468. Telephone: (916) 369-4331.

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TITLE I

INDIVIDUAL INCOME TAX PROVISIONS

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Title IA1: Individual Income Tax Revisions

ACTION: REDUCE TAX RATES FOR INDIVIDUALS

Act Section 101 Conference Report Page 1

Form 540 Line No. 51 Form 100 Line No. N/A

BACKGROUND

California tax rates are substantially lower than under federal law. In recent years, the California tax has been approximately twenty percent (20%) of the federal tax on the same amount of income.

CURRENT CALIFORNIA LAW (Sec. 17041)

California rates range from one percent (1%) to eleven percent (11%) of taxable income (adjusted gross income, minus the zero bracket amount and excess itemized deductions) in increments of one percent (1%). The income levels at which tax rates begin to be imposed vary according to filing status:

TAX BRACKETS FOR 1986 TAXABLE INCOME

Tax Rate	Single or Separate	Joint	Head of Household	Joint Custody	Estates & Trusts
1 %	$ 1,710	$ 3,420	$ 3,420	$ 1,710	$ 0
2 %	5,210	10,420	10,410	7,810	3,490
3 %	7,810	15,620	13,890	10,420	6,110
4 %	10,420	20,840	16,530	13,890	8,710
5 %	13,080	26,160	19,150	16,530	11,360
6 %	15,710	31,420	21,780	19,150	13,980
7 %	18,330	36,660	24,410	21,780	16,630
8 %	20,930	41,860	27,020	24,410	19,220
9 %	23,560	47,120	29,630	27,020	21,850
10 %	26,180	52,360	32,260	29,630	24,460
11 %	28,790	57,580	34,880	34,880	27,090

NEW FEDERAL LAW (Sec. 1)

H.R. 3838 replaces the current 14-bracket tax rate schedule, which has rates ranging from 11 to 50 percent, with a five-bracket schedule for 1987 and a two-bracket schedule for 1988 and later years:

TAX BRACKETS FOR 1987 TAXABLE INCOME

The income levels at which tax rates begin to apply for 1987 are as follows:

Tax Rate	Single	Separate	Joint	Head of Household	Estates & Trusts
11 %	$ 0	$ 0	$ 0	$ 0	$ 0
15 %	1,800	1,500	3,000	2,500	500
28 %	16,800	14,000	28,000	23,000	4,700
35 %	27,000	22,500	45,000	38,000	7,550
38.5%	54,000	45,000	90,000	80,000	15,150

TAX BRACKETS FOR 1988 TAXABLE INCOME

The income levels at which tax rates begin to apply for 1988 are as follows:

Tax Rate	Single	Separate	Joint	Head of Household	Estates & Trusts
15 %	$ 0	$ 0	$ 0	$ 0	$ 0
28 %	17,850	14,875	29,750	23,900	5,000

For 1988 and later years, the benefit of the 15 percent tax bracket is phased out for higher income individuals and families. The phaseout is accomplished by imposing a 5 percent surcharge on taxable income between $71,900 and $149,250 for joint returns, between $43,150 and $89,560 for single individuals, between $35,950 and $74,625 for separate returns of married persons, between $61,650 and $123,790 for heads of household, and between $13,000 and $26,000 for estates and trusts. The surcharge produces the effective marginal tax rate of 33 percent.

For joint returns, the 15 percent tax bracket on the first $29,750 of taxable income saves $3,867.50 in taxes, compared to imposing a 28 percent rate on that income. A five percent surcharge on the $77,350 of taxable income between $71,900 and $149,250 will recapture the $3,867.50. Thus, a taxpayer with $149,250 of taxable income will pay $41,790 in tax, which is 28 percent of $149,250.

For 1987, there is no phaseout of the benefits of the lower tax brackets.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The new rates begin, in effect, on July 1, 1987. The full impact of the new rates will be first applied to taxable years beginning on or after January 1, 1988.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Not directly applicable. The new federal tax rates reflect federal tax policy which takes into account desired redistributional tax shifts between income groups and the availability of additional revenues from corporate taxpayers. California's existing tax rate structure reflects a degree of progressivity and incidence that has differed from federal law. New tax rates can be developed after tax policy decisions have been made relating to the expansion/contraction of the income tax base together with any objectives regarding the maintenance of or changes to the existing distribution of tax burdens.

ACTION: INCREASE STANDARD DEDUCTION FOR INDIVIDUALS

Act Section 102	Conference Report Page 5
Form 540 Line No. 47	Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17073)

The term "standard deduction" was replaced by "zero bracket amount" as part of 1983 federal conformity legislation. The California system is the same as the Federal system although the amounts are different. For 1986, the zero bracket amount for a single person or married filing separately was $1,710, and $3,420 for a married couple filing jointly, head of household, or surviving spouse. Under the zero bracket system, the taxpayer gets the benefit of the zero bracket amount automatically through the tax rate schedule and does not claim it as a deduction from income. If the taxpayer has itemized deductions that are greater than the zero bracket amount, the excess is allowed as a deduction from income.

NEW FEDERAL LAW (Sec. 63)

The standard deduction replaces the zero bracket amount. Effective January 1, 1988, the standard deduction amounts will be as follows:

Joint Returns and Surviving Spouses	$5,000
Heads of Households	$4,400
Single Individuals	$3,000
Married Filing Separately	$2,500

Standard deductions would be adjusted annually beginning in 1989. The inflation adjustment factor would reflect the amount of inflation for the fiscal year ending August 31.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The new standard deduction amounts begin in 1988. The standard deduction in 1987 is the same amount that would have applied under current law; i.e., $3,760 for joint returns and surviving spouses; $2,540 for heads of households and single individuals; and $1,880 for married individuals filing separately.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Whether or not the State adopts Federal standard deduction amounts will depend on deliberate tax policy decisions relating to the expansion/contraction of the income tax base together with any objectives regarding the maintenance for changes to the existing distribution of tax burdens.

Based on a simulation run by the Department tax model for the 1987 taxable year, if California were to adopt the 1988 standard deduction amounts (discounted one year to 1987 levels), the revenue loss would amount to $282 million under PITL.

The significantly larger standard deduction amounts would result in approximately 432,000 taxpayers shifting from "itemizers" to non-itemizers. The non-itemizers would realize an average tax savings of $37. Taxpayers having an AGI in excess of $50,000 would receive the largest tax savings, an average of $105. Itemizers would receive no additional tax savings.

TAX POLICY ISSUES

In 1983, California repealed the standard deduction and adopted a zero tax bracket in conform to the federal structure. Although conforming to the federal structure, California did not conform to the dollar value of the federal zero brackets, but used the values of the existing standard deduction which was being repealed. Changing the dollar values was not considered at that time, since all the changes were required to be only structural and non-substantive.

It is appropriate at this time to consider whether or not there is any valid reason for the use of different dollar values for state purposes.

ACTION: REPEALS PERSONAL EXEMPTIONS FOR THE AGED AND BLIND AND CREATES AN ADDITIONAL STANDARD DEDUCTION FOR THEM

Act Section 102 | Conference Report Page 5

Form 540 Line No. 8 | Form 100 Line No. N/A

BACKGROUND

Both California and Federal law allow credits for the elderly who meet certain qualifications. The State credit is limited to 50% of the Federal credit. California also allows a $1,000 income exclusion for elderly whose AGI is under $25,000. This exclusion is reduced by $.50 for each dollar in excess of $25,000. Federal law allows an additional personal exemption of $1,000 for a taxpayer who has reached the age of 65 or is blind before the close of his taxable year.

CURRENT CALIFORNIA LAW (Sec. 17052.9, 17054 and 17134)

Currently, there is no additional standard deduction (zero bracket amount) allowed for either the blind or elderly. An additional personal exemption credit ($14) is allowed for taxpayers who are blind, but there is no additional personal exemption credit based upon age.

NEW FEDERAL LAW (Sec. 63)

HR 3838 repeals the current law additional personal exemptions of $1,000 for the blind and elderly beginning in 1987 and replaces this with an additional standard deduction. This standard deduction amount of $600 is allowed for an elderly or blind individual who is married ($1,200 if both). An additional standard deduction amount of $750 is allowed for an unmarried individual who is elderly or blind ($1,500 if both). Beginning in 1989, the standard deduction amounts for the elderly or blind will be indexed for inflation.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The additional standard deduction for the blind or elderly will become effective January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Two conformity positions are considered in this analysis. The first position (a) would add the extra standard deduction for the elderly and blind, and retain California's existing personal exemption credit for the blind and exclusion for the elderly.

The second position (b) would add the extra standard deduction for the elderly and blind, but repeal the State provisions for the blind and elderly.

The estimated revenue effects of the two conformity positions are as follows:

	1987-88	1988-89
	(in millions)	
(a) Extra Standard Deduction Without Repeal	$22 loss	$23 loss
(b) Extra Standard Deductions With Repeal	$11 gain	$12 gain

The estimates for (a) were derived from the Department's tax model with the extra standard deduction imputed to all returns and then proportionately reduced to reflect the blind and elderly population on the basis of Federal SOI (Statistics of Income) data for blind and elderly returns relative to the total of all Federal returns.

The estimates for (b) reflect the combined revenue effect of (a), and revenue gains from the repeal of blind credits ($300,000 for 1987) and the $1,000 elderly exclusion ($33 million for 1987). The net revenue gain was increased 9 percent for the 1988 estimate. The revenue estimate for the repeal of the credit for the blind was obtained from the tax model. The estimate on the repeal of the exclusion for the elderly was derived from Federal SOI data on the income distribution of the elderly and the frequency of joint returns where each spouse is at least 65 years old. Prorating the data to California results in an estimated 1.2 million state returns filed by the elderly, of which 70 percent qualify for the current state exclusion.

Title IA3: Individual Income Tax Provisions

ACTION: INCREASES PERSONAL AND DEPENDENT EXEMPTIONS AND REPEALS THE EXEMPTIONS FOR AGE AND BLINDNESS.

Act Section 103 Conference Report Page 7

Form 540 Line No. 7 Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17054)

California law is similar to federal law in that it provides for personal and dependent exemptions and special exemption for blindness. However, California law does not allow an additional exemption for the elderly. Under California law, exemptions are expressed in the form of tax credits, rather than deductions from income. The credits reduce the tax, but are not refundable. Since 1979, the credits have been indexed annually based on percentage changes in the California Consumer Price Index. The indexed exemption credits for 1986 are:

Single or married filing separate	$43
Married filing joint or surviving spouse. . . .	$86
Head of household	$86
Joint custody Head of Household	$65
Dependent, Blind, or Student.	$14
Estate	$10
Trust	$1

As under federal law, a personal exemption is allowed an individual filing on his or her own return even if that individual is also claimed as a dependent on another taxpayer's return. Unlike federal law, the value of the dependent and blind exemptions is much smaller than the personal exemption.

NEW FEDERAL LAW (Sec. 1 and 151)

H.R. 3838 increases the personal exemption for each taxpayer, the taxpayer's spouse, and each eligible dependent to $1,900 for 1987, $1,950 for 1988, and $2,000 for 1989. Beginning in 1990, the $2,000 personal exemption amount will be adjusted for inflation. H.R. 3838 repeals the additional exemption for an elderly or blind individual.

H.R. 3838 does not allow a personal exemption to be claimed on the return of a taxpayer who is eligible to be claimed as a dependent on another taxpayer's return (e.g., the return of a child who is eligible to be claimed as a dependent on the return of his or her parents).

H.R. 3838 adds a new provisions which, above specified levels of income, reduces the tax benefit of personal and dependent exemption deduction to zero. This is accomplished by imposing an additional tax equal to 5 percent of that portion of taxable income which exceeds the specified levels of income. For 1988, the phase-outs begin at the following levels of income:

FILING STATUS	TAXABLE INCOME
Married filing joint & surviving spouse	$149,250
Head of Household	$123,790
Single	$89,560
Married filing separate	$113,300

EFFECTIVE DATE OF FEDERAL PROVISIONS

Repeal of the additional exemption for the blind or elderly as well as the new rules regarding dependents will become effective in 1987. The phase-out of the personal and dependent exemptions, above certain levels of income, is not effective until 1988.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Any "conformity" estimates in this area depend on decisions reached with regard to those policy issues discussed below.

For example, if California were to replace its personal and dependent credits with the federal personal and dependent exemption deductions, the net revenue loss for the 1987 taxable year would exceed $800 million.

TAX POLICY ISSUES

California law is significantly different from federal law in that personal and dependent exemptions are expressed in terms of credits against the tax rather than as deductions from taxable income. Under California law, an equal tax benefit is provided to all persons within a particular filing status (such as married filing joint) without regard to level of income

Under old federal law, the value of the exemption deduction is inversely related to taxable income; i.e., low income persons receives a tax benefit of $119 (11% of $ 1,080) and high income persons receive a tax benefit of $540 (50% of $ 1,080).

Under new federal law, low income persons will receive tax benefit of $300 (15% of $2,000); high income persons will not receive any tax benefit at all; and middle income taxpayers will receive a benefit of $ 0.00 to $300, depending upon their level of income.

Should California abandon its tax credits in favor of a deduction from income, as under federal law?

Should California phase-out its personal and dependent exemptions (whether a credit or a deduction) for persons with high levels of income?

What are the appropriate dollar values (whether credit or deduction) for the personal and dependent exemptions allowed by California?

Title IA4: Individual Income Tax Provisions

ACTION: INDEXING OF TAX RATE BRACKETS, PERSONAL EXEMPTIONS, AND STANDARD DEDUCITONS

Act Section 101 | Conference Report Page 10

Form 540 Line No. 47, 51, 52 | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17041, 17054, 17054.5, 17069)

In order to compensate for inflation, the rate brackets, the zero bracket amount, the low-income credit income brackets, and the personal exemption credits are revised annually under a system of "indexing". Indexing of tax brackets is based on the amount of change in the California Consumer Price Index from June of the prior year to June of the current year. After adjustment for the CCPI change, tax brackets, low-income credit income brackets, and zero bracket amount are rounded to the nearest ten dollars (same as federal).

Indexing of personal and dependent credits reflects the cumulative CPI change from June, 1983 to June of the current year. These credits are rounded to the nearest one dollar.

When indexing began in 1978, the adjustment was based on the excess of the change over 3 % per year. Beginning in 1980, the adjustment is based on the full amount of the change.

NEW FEDERAL LAW (Sec. 1)

Inflation adjustments to the rate brackets will continue as under present federal law except (1) inflation will be measured by 12-month periods ending August 31 rather than September 30 and (2) tax rate brackets, standard deductions (including the additional standard deduction amounts for the blind or elderly), and personal exemption amounts are to be rounded down to the nearest multiple of $50 rather than $10.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provisions with respect to the 12-month measuring period for inflation and rounding down to the nearest multiple of $50 are effective January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The new federal indexing provision which allows for much larger roundings effects was developed within the framework of significantly larger bracket points, standard deduction, and personal exemption amounts than under current California law. The revenue impact of indexing depends on the extent to which, if any, California elects to conform to the underlying indexed provisions above.

Title IA5: Individual Income Tax Provisions

ACTION: REPEALS THE TWO-EARNER DEDUCTION

Act Section 131 | Conference Report Page 10

Form 540 Line No. N/A | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17024.5(b)(16))

California does not allow a special two-earner wage deduction. The rationale for the two-earner deduction does not apply to California, since under state law the tax rate schedule for single persons corresponds directly to the income splitting provisions for married couples.

NEW FEDERAL LAW (Sec. 221)

This act repeals the deduction for two-earner married couples.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The repeal of the deduction is effective for taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Not applicable since California does not have a comparable two-earner deduction. However, the PEG (Policy Economics Group) has estimated an annual $2 million revenue gain to California from federal repeal. This revenue gain is due to the use of federal Adjusted Gross Income (AGI) for California tax purposes regarding deductions for medical purposes and casualty losses. According to PEG, the net effect of a larger federal AGI for certain taxpayers claiming these deductions results in a revenue gain to California.

Title IA6: Individual Income Tax Provisions

ACTION: REPEAL OF INCOME AVERAGING

Act Section 141 Conference Report Page 11

Form 540 Line No. 51 Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 18241)

The purpose of income averaging is to provide tax relief for certain taxpayers with fluctuating income. All taxpayers are eligible except (1) those who have not been full-time residents during the current and preceding four years and (2) certain taxpayers who have not been completely self-supporting. Generally taxpayers will get tax relief if their income for the current taxable year is $3,000 greater than 133 1/3% of the average income for the preceding four years. Important differences between Federal law and California law are that under Federal law (1) the base period is three years instead of four, and (2) the percentage of average income which must be exceeded is 140% instead of 133 1/3%.

NEW FEDERAL LAW (Sec. None)

H.R. 3838 repeals this provision.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The repeal of income averaging becomes effective January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on a simulation run by the Department's tax model, conformity would result in a revenue gain in the $174 million range for the 1987-88 fiscal year. The estimate for the 1988-89 fiscal year would amount to $187 million based on the national growth rate of 7.7% for this provision as projected by the JCT. These gains would result under the PIT law.

The tax model shows that for the 1987 taxable year, 3.8% of taxpayers (478,000) would be affected by this provision. The average tax increase for these taxpayers would range from $34 for the $5,000-$10,000 AGI class to $1,496 for AGI's over $100,000. The largest percentage increase in tax liability (9.6%) would be for the $100,000 and over AGI class.

ACTION: INCREASES EARNED INCOME CREDIT

Act Section 111 | Conference Report Page 12

Form 540 Line No. 70 | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17069)

California has not adopted the federal earned income credit. California law provides relief to low income households through a special low income credit which, unlike the federal credit, does not require a qualifying dependent.

NEW FEDERAL LAW (Sec. 32)

Under the Act, the rate of the earned income credit is increased from 11 percent of the first $5,000 of earned income to 14 percent of the first $5,714. The maximum allowable amount of earned income credit is increased from $550 to $800.

Formerly this credit was phased down by 12 3/9 percent of adjusted gross income (AGI) or earned income (whichever is greater) which exceeded $6,500. For the 1987 tax year this credit will be phased down by 10 percent of AGI or earned income (whichever is greater) in excess of $6,500. for the 1988 tax year the phase down will be 10 percent of AGI or earned income (whichever is greater) in excess of $9,000. In addition, the new law provides for automatic consumer price index-based inflation adjustments of (1) the earned income eligible for the credit and (2) the income level at which the phase out begins.

Treasury regulations will require employers to notify employees whose wages are not subject to withholding that they may be eligible for the refundable earned income credit. However, the requirement does not apply to wages which are exempt from withholding under IRC Section 3402(n) i.e., college or high school summer employment.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Beginning for taxable years after December 31, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

California has not conformed to the federal earned income credit. Tax relief to low income households is provided through a special low income credit. The substitution of the earned income credit for the existing low income credit would have revenue consequences. The magnitude of this impact depends on the relative size of the state credit. Since the earned income credit requires a qualifying dependent, many taxpayers now benefitting from the existing state credit would not qualify for the earned income credit.

Title IC1: Individual Income Tax Provisions

ACTION: INCLUDE ALL UNEMPLOYMENT COMPENSATION BENEFITS IN GROSS INCOME

Act Section 121 | Conference Report Page 14

Form 540 Line No. 12 | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17083)

California has not conformed to federal law, which includes all or part of unemployment compensation in gross income when an income threshold is exceeded. Under California law, no portion of unemployment compensation is taxable.

OLD FEDERAL LAW (Sec. 85)

Current federal law provides a limited exclusion for unemployment compensation benefits, which ceases to operate when an income threshold is exceeded. (The income threshold is $18,000 for married individuals filing a joint return, $12,000 for unmarried taxpayers, and zero for married taxpayers filing separately.) When the income threshold is exceeded, unemployment compensation benefits are included in gross income, limited to the lesser of (1) one half of the amount exceeding the income threshold, or (2) the full amount of the unemployment compensation benefits received.

NEW FEDERAL LAW (Sec. 85)

In consideration of the fact that unemployment compensation benefits are wage replacement payments, which would be fully taxable if received as wages, new federal law includes the full amount of unemployment compensation benefits in gross income.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applies to all amounts received on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

According to the latest federal Statistics of Income quarterly publication, unemployment insurance payments partially included in federal adjusted gross income (AGI) in 1984 for 498,300 California filers totaled $696.6 million. The state revenue gain for 1987 if California taxed these payments would be $35 million under an assumed five percent marginal tax rate and no growth in reported payments.

Regarding the partially excluded payments, the Policy Economics Group (PEG) has not specifically estimated this provision. PEG's overall proration share for California of items estimated is 4.1 percent. Applying this proration to the national estimates prepared by the Joint Committee on Taxation (JCT) indicates that the relative fiscal impact under state conformity would be revenue gains in the $31 million range for 1987-88. However, due to California's enlarged low income credit (AB 66, Ch. 1461, Stats. 1985) which effectively increases the threshold of taxation, state revenue gains from taxing these payments (formerly excluded under federal law) would be closer to $20 million.

Adding the two segments together (partially included and partially excluded) results in an overall revenue gain of $55 million for 1987-88 and the same level for 1988-89.

TAX POLICY ISSUES

Unemployment compensation is a replacement for salary or wages, which if they had been received, would have been fully taxable.

ACTION: <u>LIMIT EXCLUSION FOR SCHOLARSHIPS AND FELLOWSHIPS</u>

Act Section 123 | Conference Report Page 14

Form 540 Line No. 12 | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17131)

California conforms to federal law, which generally provides that an amount received as a scholarship or fellowship grant shall be excluded from gross income. The exclusion also applies to amounts received to cover the costs of travel, research, clerical help, equipment, services, and accommodations that are incidental to the scholarship or fellowship. To a limited extent, a taxpayer may exclude certain athletic scholarships, and certain amounts received where the recipient may be required to perform future service as a federal employee.

In addition, California conforms to the federal provision which allows an exclusion from gross income for the amount of any qualified tuition reduction, to students engaged in teaching or research activities who are employees of exempt educational institutions.

NEW FEDERAL LAW (Sec. 117)

The exclusion for scholarship or fellowship grants would be limited to degree candidates, for amounts used for tuition, books, supplies and equipment, and course related fees. Amounts paid for room, board, or incidental expenses would not be excluded from gross income.

The exclusion for amounts received as a grant or tuition reduction that represent payment for teaching, research or other services, required as a condition of receiving the grant, or to certain federal grants where the recipient is required to perform future services as a federal employee, are repealed.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applies to taxable years beginning on or after January 1, 1987, except that prior law continues to apply to scholarships and fellowships granted before August 17,1986. In case of a grant after August 16, 1986, and before January 1, 1987, prior law applies only to amounts received during 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Policy Economic Group (PEG) did not supply a specific estimate for this provision. However, PEG's estimates for all provisions indicate that an appropriate proration figure for California relative to the nation is 4.1 percent. This proration percentage was applied to the national estimates prepared by the Joint Committee on Taxation and the relative fiscal impact under state conformity would be revenue gains in the $3 million range for 1987-88 and in the $5 million range for 1988-89. These revenue gains would occur under the Personal Income Tax Law.

ACTION: LIMIT EXCLUSION FOR PRIZES AND AWARDS

Act Section 122 — Conference Report Page 17

Form 540 Line No. 12 — Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17081, 24446)

California has conformed to federal law, which generally requires that prizes and awards must be included in gross income. An exclusion from income is provided for prizes and awards received for achievements in charity, the arts, and the sciences. This exclusion is contingent upon two conditions: (1) the recipient must not specifically apply for the prize or award, and (2) the recipient must not be required to render services in exchange for receipt of the prize or award.

NEW FEDERAL LAW (Sec. 74, 102, 274)

The exclusion for scientific (etc.) achievement awards is repealed, except where the award is donated to a tax exempt charity or to a governmental unit. If such donation or assignment is made, the prize or award is not included in the recipient's gross income, and no charitable deduction can be claimed by the winner or payor.

Employee awards of tangible, personal property received for length of service, or safety achievement, are excludable from gross income for income tax purposes, and are deductible by the employer. However, the aggregate cost of length of service and safety awards made to the same employee may not exceed $1,600 for qualified plan awards and $400 for non-qualified plan awards.

To the extent that the new exclusion does not apply, all prizes and awards by employers to employees are includable in the gross income of the employee and are not deductible by the employer.

An employee award is excludable from wages for employment tax purposes, and from the social security benefit base to the same extent that it is excludable from gross income.

EFFECTIVE DATE OF FEDERAL PROVISIONS

These provisions are effective for awards made on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Policy Economic Group (PEG) did not provide an estimate for this provision. However, PEG's estimate for all provisions indicate that an appropriate proration figure for California relative to the nation is 4.1%. This proration percentage was applied to the national estimates prepared by the Joint Committee on Taxation and the relative fiscal impact under state conformity would be revenue losses in the $2 million range for 1987-88 and in the $3 million range for 1988-89. These revenue losses would occur under the Personal Income Tax Law.

Title ID1: Individual Income Tax Provisions

ACTION: DISALLOWANCE OF DEDUCTION FOR STATE AND LOCAL SALES TAXES

Act Section 134 | Conference Report Page 20

Form 540 Line No. 47 | Form 100 Line No. G-17

CURRENT CALIFORNIA LAW (Sec. 17052.13, 17220, 23612, 24345)

California law has been in conformity with prior federal law only with respect to the deduction of sales taxes paid. California does not allow a deduction for sales or use tax paid or incurred in connection with the purchase of qualified property for which a tax credit is claimed pursuant to a Section 17052.13 election (enterprise zone property acquisitions).

NEW FEDERAL LAW (Sec. 164)

The act eliminates the deduction for state and local general sales taxes paid. However, the act also provides for the capitalization of sale taxes, which are not otherwise deductible in the following manner:

(1) taxes incurred in the acquisition of property used in a trade or business are to be considered as part of the cost of acquisition, and

(2) taxes incurred in the disposition of property used in a trade or business will be used to reduce the amount realized on the disposition.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on a simulation run for California by the Policy Economics Group (PEG) the revenue gain under conformity at 1986 levels of income from disallowance of the sales tax deduction would be in the $244 million range. Equivalent estimates for 1987-88 and 1988-89 fiscal years would amount to $256 million and $269 million respectively based on national growth rates for this provision as projected by the Joint Committee on Taxation (JCT).

PEG's simulation shows that at 1986 levels of income 34 percent of California taxpayers (4 million) would be affected by this provision. Average tax increases would range from $6 for the $5,000-$10,000 adjusted gross income (AGI) class to $251 for the over $200,000 AGI class.

Based on a proration of the Joint Committee on Taxation's estimate for the nation, the revenue gain under the Bank and Corporation Tax Law due to capitalization, rather than expensing of sales taxes, would be in the $13 million range for 1987-88 and in the $11 million range for 1988-89. A proration factor of 4 percent was used which represents the general relationship between California's corporate tax collections and federal tax collections over the past few years.

Title ID3: Individual Income Tax Provisions

ACTION: <u>INCREASE THE FLOOR FOR MEDICAL EXPENSE DEDUCTIONS FROM 5 TO 7.5 PERCENT OF ADJUSTED GROSS INCOME</u>

Act Section 133 — Conference Report Page 21

Form 540 Line No. 47 — Form 100 Line No. N/A

<u>CURRENT CALIFORNIA LAW (Sec. 17210)</u>

California law conforms to Federal law. Deductions are permitted for medical and dental expenses (not reimbursed by insurance) of the taxpayer, spouse, and dependents to the extent that such expenses exceed 5 percent of federal adjusted gross income. Some examples of valid deductions include medicines and prescription drugs; examinations by doctors, dentists, eye doctors, psychiatrists, chiropractors; x-ray and lab services; hospital and nursing home care; dentures, hearing aids, and eyeglasses; lodging and mileage expenses while away from home to receive medical treatment; and ambulance costs.

<u>NEW FEDERAL LAW (Sec. 213)</u>

The floor under the itemized medical expense deduction is increased from 5 percent to 7.5 percent of the taxpayer's adjusted gross income. The conference report reaffirms that certain expenses incurred to adapt a residence for the physically handicapped are eligible for the medical expense deduction such as the construction of entrance ramps and widening of doorways.

<u>EFFECTIVE DATE OF FEDERAL PROVISIONS</u>

The change to the floor of the medical expense deduction is effective January 1, 1987.

<u>REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW</u>

Based on a simulation run for California by the Policy Economic Group (PEG) the revenue gain under conformity at 1986 levels of income would be in the $50 million range. Equivalent estimates for 1987-88 and 1988-89 fiscal years would amount to $56 million range and $63 million range respectively based on national growth rates for this provision projected by the Joint Committee on Taxation.

The PEG simulation shows that at 1986 levels of income 10 percent of taxpayers (1.2 million) would be affected by this provision. Average tax increases would range from $7 for the $5,000-$10,000 adjusted gross income (AGI) class to $773 for the over $200,000 AGI class.

Title ID4: Individual Income Tax Provisions

ACTION: REPEAL OF ITEMIZED DEDUCTION FOR ADOPTION EXPENSES

Act Section 135 | Conference Report Page 22

Form 540 Line No. 47 | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17201, 17211)

California law has been in general conformity with federal law regarding deductions for adoption expenses associated with the "special needs child". However, California law limits the deduction to $1,000 per taxable year ($500 married, filing separately) rather than $1,500 per child as under federal law.

Unlike federal law, California also allows a deduction for similar expenses incurred in adopting a child other than a "special needs child" to the extent such expenses exceed 3 percent of state A.G.I. This provision is also subject to the $1,000 maximum deduction.

NEW FEDERAL LAW (Sec. 222)

Repeals the deduction for adoption expenses.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applies to adoption expenses paid after December 31, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Joint committee on Taxation estimates revenue gains for the nation of $5-$6 million annually. Based on this projected low level of impact for the nation with consideration to differences between state and federal law, conformity would result in minor revenue gains annually of probably less than $200,000.

Tax Policy Issues

Although the federal income tax provision is repealed, the Act also amends the Adoption Assistance Program in Title IV-E of the Social Security Act to provide matching funds for adoption expenses of a "child with special needs" who has been placed for adoption in accordance with state and local laws. The California provisions which would be affected by the change in the Social Security Act are found in Sections 16115-16123 of the Welfare and Institution Code under the chapter heading "Aid For Adoption of Children". This chapter provides for county paid Adoption Assistance Program benefits to qualified families adopting special needs children.

Title ID5: Individual Income Tax Provisions

ACTION: ALLOWS DEDUCTIONS FOR EXPENSES ALLOCABLE TO CERTAIN TAX-EXEMPT INCOME

Act Section 144 Conference Report Page 23

Form 540 Line No. 47 Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17270, 17280)

California law generally conforms to federal law with respect to the principle of denying deductions for expenses related to income which is exempt from tax.

Although there is no provision in state law dealing specifically with the deductions for ministers and military personnel, the Franchise Tax Board has generally allowed deductions, as has the Internal Revenue Service, for mortgage interest or real property taxes paid or incurred with respect to personal residence by (1) a minister with a parsonage allowance that is excludable from gross income, or (2) a member of a military service with excludable subsistence, quarters, or other housing allowance.

NEW FEDERAL LAW (Sec. 265 (6))

A specific provision is added to the Internal Revenue Code to ensure that ministers and military personnel may continue to deduct mortgage interest and real property taxes without regard to their receipt of tax-exempt housing allowances.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision applies for taxable years beginning before, on, or after December 31, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No additional revenue losses would result from this provision which codifies existing practice.

TAX POLICY ISSUES

This provision was enacted in response to an IRS ruling (Rev. Ruling 83-3, 1983-1 CB72) which disallowed mortgage interest and property tax deductions allowable to a ministers parsonage allowance. The ruling applied effective July 1, 1983, subject to transitional relief (extended through 1986) for ministers owning homes before 1983. In order to ensure the prior policy of allowing the deductions to ministers with parsonage allowance (and military personnel with housing allowances) this provision was given retroactive effect.

Title IE1a: Individual Income Tax Provisions

ACTION: REDUCE MEAL EXPENSE DEDUCTION

Act Section 142 — Conference Report Page 24

Form 540 Line No. 16 — Form 100 Line No. 6-26

CURRENT CALIFORNIA LAW (Sec. 17201, 24343)

California conforms to federal law, which generally allows a deduction for food and beverage expenses at a restaurant or hotel when consumed in an atmosphere conducive to business. Discussion of business before, during, or after the meal is not specifically required if the meal and/or beverages are consumed for business and not social purposes, as in the case of a prospective customer.

NEW FEDERAL LAW (Sec. 274)

(1) Reduces the amount of otherwise deductible expenses to 80 percent of such amount;

(2) increases the requirements for deduction of meal expenses to conform with the general requirements for the entertainment expense deduction. Specifically, the meal expense must be directly related to or associated with the active conduct of the taxpayer's trade or business, and business must be discussed during or directly before or after the meal, and

(3) the taxpayer, or an employee of the taxpayer, must be present at the furnishing of the food or beverages.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Taxable or income years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The following revenue estimates are composite estimates based on a proration of national estimates prepared by the Joint Committee on Taxation (JCT) combining I-E1a Meal Expenses, I-E1b Entertainment Expenses, I-E1c Travel Expenses and I-E1d Convention Travel Expenses. The relative fiscal impact under state conformity is revenue gains in the $38 million range for 1987-88 and $46 million range for 1988-89. These revenue gains would occur under the Personal Income Tax Law. The proration to California used (4.1%) reflects Policy Economic Group (PEG) conformity estimates for California compared to national estimates for those provisions analyzed. The PEG has not specifically estimated this provision.

Based on a proration of the JCT estimate for the nation, the revenue gain under the Bank and Corporation Tax Law would be in the $45 million range for 1987-88 and in the $51 million range for 1988-89. A proration factor of 4 percent was used which represents the general relationship between California's corporate tax collections and federal corporate tax collections over the past few years.

ACTION: LIMIT THE DEDUCTION FOR ENTERTAINMENT EXPENSE OTHER THAN FOR MEALS

Act Section 142 Conference Report Page 27

Form 540 Line No. 16 Form 100 Line No. 6-26

CURRENT CALIFORNIA LAW (Sec. 17201, 24444)

California law generally conforms to federal provisions, pertaining to the deductibility of entertainment expenses, including the purchase of tickets and the rental of a "luxury skybox." The cost of tickets purchased may be deducted without regard to face value. There are no restrictions in the case where the ticket costs more than its face value because, for example, it was purchased from a a ticket agent or "scalper."

Under current law, the only limitation placed on the expense deduction for rental of a luxury skybox, or the cost of box seats or season tickets, is that the expense incurred must meet either the "directly related" test or the "associated with" test for business expenses. The expense must be ordinary and necessary for the active conduct of the trade or business.

NEW FEDERAL LAW (Sec. 162, 274)

The deduction of entertainment expenses is generally reduced to 80 percent of the amount otherwise allowable. However, the following items will be allowed full deductibility :

- amounts treated as compensation,
- reimbursed expenses,
- amounts directly related to attendance at a meeting or convention of a business league, chamber of commerce, etc.,
- items made available to the general public,
- goods or services (including facilities) which are sold to a customer,
- tickets to a sporting event conducted to raise money for charitable purposes.

The deduction for tickets is limited to 80 percent of face value. An exception to this provision applies where a premium is added to the cost of sports tickets for charitable fund raising events, in which case the amount of the premium is deductible.

The deduction for the cost of renting a luxury skybox at a sports arena , if used for more than one event, is also limited to 80 percent of the cost of non luxury box seat tickets. However, this cost differential disallowance will be phased in over a two year period.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Taxable or income years beginning on or after January 1, 1987. The limitation on skyboxes is phased in over two years, with one-third of the deduction disallowed in 1987, two-thirds disallowed in 1988, and the full amount disallowed in 1989 and subsequent years.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No relevant state tax data is available to estimate this provision.

The Joint Committee on Taxation has included this item in its impact estimate of I-E1a (Meal Expenses). It is not possible, however, to isolate this item; therefore the revenue gain for this particular provision is indeterminable.

ACTION: LIMIT OR REPEAL THE DEDUCTION FOR TRAVEL EXPENSES

Act Section 142 Conference Report Page 29

Form 540 Line No. 16, 47 Form 100 Line No. 26

CURRENT CALIFORNIA LAW (Sec. 17201, 17242, 24343)

California generally conforms to federal law, which allows a deduction for travel expenses incurred with respect to employment, a trade or business, and certain services for a charitable organization. The business expense deduction is limited with respect to travel expenses attributable to conventions held on cruise ships or luxury liners, to $2,000 per taxpayer per year. The deduction is denied, in this case, if the vessel is not registered in the United States, or if it stops at ports of call outside the United States and its possessions.

Travel expenses incurred for educational purposes may be allowed as a business expense if (a) the travel maintains or improves existing employment skills, or is required by the taxpayer's employer, and (b) the travel is directly related to the taxpayer's job duties.

The travel expense deduction for charitable travel includes the cost of transportation and lodging, and is treated in the same manner as a charitable contribution.

NEW FEDERAL LAW (Sec. 170, 274)

A deduction for travel, itself, as a form of education is no longer allowed. However, taxpayers may continue to deduct educational travel expenses incurred when travel is a necessary component of a business deduction that relates to education (for example, when the claimant must travel to a location in order to obtain an educational benefit available only at that location).

The deduction for the cost of lodging as a charitable contribution is limited to instances where the travel possesses no significant element of personal pleasure, recreation, or vacation.

For luxury water travel, the daily deduction cannot exceed twice the highest per diem amount for travel in the U.S. generally allowed to employees of the executive branch of the federal government. This daily figure is multiplied by the number of days the taxpayer was engaged in luxury water travel.

If the expenses of luxury water travel include separately stated amounts for meal or entertainment expenses, these are subject, under the percentage reduction rule, to be reduced by 20 percent prior to application of the per diem limitation.

The general rules for luxury water travel do not apply when the taxpayer attends a convention, seminar, meeting, etc., that is held on board a cruise ship. In this case, the deduction for expenses is limited to $2,000 per taxpayer per year, as under current law, and is denied entirely if the vessel is not registered in the United States, or if it stops at ports of call outside the United States and its possessions.

EFFECTIVE DATE OF FEDERAL PROVISIONS

These provisions are effective for taxable or income years beginning on or after 1/1/87.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No relevant state tax data is available to estimate this provision.

The Joint Committee on Taxation has included this item in its impact estimate of I-E1a Meal Expenses. It is not possible, however, to isolate this item; therefore the revenue gain for this particular provision is indeterminable.

ACTION: DENY DEDUCTION FOR TRAVEL EXPENSE TO ATTEND NONBUSINESS CONVENTIONS

Act Section 142 | Conference Report Page 30

Form 540 Line No. 47 | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17201, 24343)

California conforms to federal law, which generally allows a deduction for expenses incurred in attending nonbusiness conventions, meetings, seminars, etc., if the expenses are incurred in conjunction with the production of income (for example, attending a seminar relating to financial or tax planning). Also allowed are expenses incurred while attending a convention, meeting, or seminar relating to the taxpayer's trade or business.

NEW FEDERAL LAW (Sec. 274)

A deduction is denied for expenses incurred in attending a convention, meeting, seminar, etc., unless they are ordinary and necessary, and incurred as expenses which directly relate to the taxpayer's trade or business. Expenses incurred in attending a convention, etc., relating only to the production of income are no longer deductible.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No relevant state tax data is available to estimate this provision.

The Joint Committee on Taxation has included this item in its impact estimate of item I-E1a (Meal Expenses). It is not possible, however, to isolate this item; therefore the revenue gain for this particular provision is indeterminable.

ACTION: LIMIT AND RECLASSIFY CERTAIN ADJUSTMENTS TO GROSS INCOME

Act Section 132 | Conference Report Page 32

Form 540 Line No. 29, 30 | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW

Employee Business Expenses (Sec. 17072)

California conforms to federal law in providing for the deductibility of certain employee business expenses from gross income ("above the line" expenses). Generally, employee business expenses can only be claimed as miscellaneous itemized deductions. An exception is made for four types of employee business expenses above the line, thereby making the deduction available for non itemizers: (1) certain expenses paid by an employee and reimbursed by the employer, (2) employee travel expenses incurred while away from home, (3) employee transportation expenses incurred while on business, and (4) business expenses of taxpayers who are employed as outside salespersons.

Moving Expenses (Sec. 17277)

California is generally in conformity with federal law treating moving expenses as an adjustment to income when incurred in connection with a change in principal place of work. Both laws have a minimum distance requirement and a $3,000 limitation on the deduction of moving expenses, however, California limits the deduction where an individual moves into or out of California. In those cases, a deduction is allowed only if an amount received as reimbursement is included in income and the deduction is limited to the smaller of the reimbursement or actual expenses.

Miscellaneous Itemized Deductions (Sec. 17072)

California conforms to federal law which allows, as an itemized deduction, expenses for (1) unreimbursed employee business expenses, (2) expenses related to investment activities, (3) tax preparation fees, (4) gambling and hobby losses up to the amount of gambling or hobby income, (5) adoption expenses, and certain less common expenses. Additionally, California allows a deduction for certain expenditures related to the handicapped and/or elderly.

NEW FEDERAL LAW (Sec. 62 and 67)

Employee Business Expenses

Currently available unreimbursed employee business expenses including those "passed through" from certain pass through entities other than estates, nongrantor trusts, cooperatives, and REITS), are to be allowed only as itemized deductions and are subject to a floor of two percent of the taxpayer's adjusted gross income. A new above-the-line deduction for business expense is made available to certain performing artists having more than one employer during the taxable year, whose allowable expenses in performing such services exceed 10 percent of wages for the services, and whose adjusted gross income does not exceed $16,000.

Moving Expenses

The moving expense deduction is changed from an adjustment to income to an itemized deduction not subject to the floor of two percent of adjusted gross income that applies to other employee business expenses and certain miscellaneous deductions.

Miscellaneous Itemized Deductions

Miscellaneous itemized deductions not specifically allowed under other provisions of the code may be deducted to the extent that such expenses exceed two percent of adjusted gross income. The following miscellaneous expenses are not subject to the two percent floor and may be deducted in full:

(1) Impairment related work expenses;

(2) Estate taxes;

(3) Deductions related to short sales of personal property;

(4) "Claim of right" adjustments;

(5) Certain terminated annuity payments;

(6) Amortizable bond premiums;

(7) Deductions related to cooperative housing corporations; and

(8) Gambling losses to the extent of gambling winnings

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provisions are effective for taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The following revenue estimate is a composite estimate based on a simulation run for California by the Policy Economic Group (PEG) combining I-E2a Employee Business Expense, I-E2b Home Office Expenses and I-2c Hobby Losses. The revenue gains under conformity at 1986 levels of income would be in the $210 million range. Equivalent estimates for 1987-88 and 1988-89 would amount to $225 million and $240 million respectively based on growth rates for the nation projected by the Joint Committee on Taxation.

The PEG simulation shows that at 1986 levels of income, 35% of taxpayers (4.1 million) would be affected by this provision. Average tax increases would range from $17 for the $15,000-$20,000 adjusted gross income (AGI) class to $375 for the $200,000 and over AGI class.

TAX POLICY ISSUES

In several other provisions which interact with adjusted gross income (AGI), California can specifically refer to AGI as required to be shown on the federal tax return. This eliminates computational differences in areas where the two laws are otherwise conformed. The new floor for the above expenses (2 percent of AGI) is a candidate for reference to federal AGI in order to eliminate computational differences.

ACTION: INCREASE RESTRICTIONS ON BUSINESS USE OF HOME EXPENSE DEDUCTION

Act Section 143 | Conference Report Page 35

Form 540 Line No. 47 | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17201)

California conforms to federal law which generally allows a deduction for expenses attributable to business use of the home (for rent, depreciation, and repairs for example). Allowance of the deduction for business use of the home is contingent upon several restrictions. The deduction is only allowed for a part of the home used exclusively and regularly as either the principal place of business, or as a place of business to meet patients, clients, or customers. For an employee, the use of the home must be for the convenience of the employer.

Employees may claim the deduction above the line, as an employee business expense deducted from gross income, but only if the employee receives employer reimbursement for home office expenses.

Individuals who are self employed may deduct above the line, on the Business Income or Loss Schedule, the business portion of expenses relating to operating the home. Expenses may be deducted for any portion of the home that is used exclusively and regularly as either the taxpayer's principal place of business, or as a place of business to meet customers, clients, or patients. It is further stipulated that the deduction for self employment expenses cannot exceed the taxpayer's gross income from the business. Costs incurred in excess of the limitation cannot be carried over and used as deductions in other taxable years.

The general business use requirements for home office expenses need not be met when the taxpayer rents part of his or her home (renting a room to a lodger, for example). Under current law, this exception also applies where an employer leases a portion of an employee's home.

NEW FEDERAL LAW (Sec. 280A)

The deduction for business-use-of-home expenses is limited to the taxpayers net income from the business (gross income less deductions for business related expenses). Excess home office deduction amounts may be carried forward to later years. The deduction carried forward will be subject to the income limitations that will prevail in those years.

The 1986 Act denies the home office deduction in situations where the employee rents home space to the employer. Thus, the only expenses that are deductible are those which are allowable in the absence of any business use (mortgage interest, real estate taxes, etc.).

EFFECTIVE DATE OF FEDERAL PROVISIONS

Taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No relevant state tax data is available to estimate this provision.

The Policy Economic Group has included this item in its state impact estimate of I-E2a Employee Business and miscellaneous expenses. It is not possible, however, to isolate this item from their data base; therefore, the revenue effect for this particular provision is indeterminable.

ACTION: INCREASE RESTRICTIONS ON DEDUCTION FOR HOBBY LOSS EXPENSE

Act Section 143 Conference Report Page 35

Form 540 Line No. 47 Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17201)

California conforms to federal law, which allows expenses attributable to activities not engaged in for profit (i.e., "hobby losses") to be deducted as miscellaneous itemized deductions, but only up to the amount of income received from the hobby activity.

A "hobby loss" is not allowed to offset income from any other source. An activity is presumed to be engaged in for profit if it is profitable in 2 out 5 consecutive years, or 2 out of 7 consecutive years for horse breeding, training, showing or racing.

NEW FEDERAL LAW (Sec. 183)

For activities consisting primarily of horse racing, training, showing, or breeding, current law rules apply. For all other activities the presumption that an activity is engaged in for profit (i.e., is not a hobby) applies only if the activity is profitable for three out of five consecutive years.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No relevant state tax data is available to estimate this provision.

The Policy Economic Group has included this item in its state impact estiamte of I-E2a Employee Business and miscellaneous expenses. It is not possible, however, to isolate this item from their data base; therefore, the revenue effect for this particular provision is indeterminable.

ACTION: REPEAL THE POLITICAL CONTRIBUTIONS CREDIT

Act Section 112 Conference Report Page 37

Form 540 Line No. 47 Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17245)

California law provides an itemized deduction for political contributions. An individual taxpayer may deduct up to $100 and a married couple filing a joint return may deduct up to $200 a year.

California does not conform to federal law regarding the provision of a political contribution tax credit.

CURRENT FEDERAL LAW (Sec. None)

Individual taxpayers may claim a nonrefundable tax credit equal to one-half of the amount of their contributions to political candidates and certain political organizations. The credit may not exceed $50 per individual, or $100 for a married couple filing a joint return.

NEW FEDERAL LAW (Sec. 24)

The Political Contributions Credit is repealed.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on a simulation run by the Department's tax model, repeal of California's political contribution deduction would result in a revenue gain in the $2.4 million range for the 1987 taxable year. Equivalent estimates for 1987-88 and 1988-89 fiscal year would amount to gains of $2.5 million and $2.6 million respectively based on national growth rates for this provision projected by the JCT (4.0%). These revenue gains would occur under the PITL.

The tax model shows that for the 1987 taxable year, 313,700 taxpayers would be affected by this provision. Average tax increases for those affected would range from less than $1 for taxpayers whose adjusted gross income (AGI) is $10,000 or less, to close to $13 for those whose AGI is $100,000 and above.

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TITLE II

CAPITAL COST PROVISIONS

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Title IIA1a: Capital Cost Provisions

ACTION: ESTABLISH NEW COST RECOVERY CLASSES FOR ACCELERATED DEPRECIATION OF ASSETS

Act Section 201 — Conference Report Page 38

Form 540 Line No. 16 — Form 100 Line No. G-21

BACKGROUND

Depreciation of assets is computed by first determining the estimated useful life of the asset and then selecting a permitted depreciation method. The methods include "straight line" (equal amounts each year of the assets useful life) and "declining balance" (original cost less accumulated depreciation multiplied by 150 or 200 percent of the straight line yearly rate). These general rules were required until 1971 when Congress enacted the Class Life Asset Depreciation Range (ADR) System to which California generally conformed. The ADR System is based on establishing lives for assets based on broad industry classes. The purpose of this is to keep conflict over individual useful lives at a minimum.

A taxpayer using the ADR System does not have to justify asset replacement or retirement policies. A depreciation period selected for an asset cannot be changed by either the taxpayer or the government during the remaining period of use of the asset. The election to use the ADR System is an annual one. If made, it applies to all tangible personal property and real property placed in service in the trade or business during the year of election.

As part of the 1981 Economic Recovery Tax Act (ERTA), Congress established a new Accelerated Cost Recovery System (ACRS) which was required to be used for all assets placed in service after December 31, 1980. Each asset was placed within one of six recovery classes based upon its midpoint life in the ADR System. Under ACRS, recovery deductions are determined by applying a statutory percentage to an asset's original cost. Thus, under ACRS a taxpayer does not estimate useful life nor select a depreciation method but merely determines which statutory recovery class contains the asset and uses the statutory recovery percentage for that class to determine the deduction. The rate is determined for each recovery class as follows:

- o 3 year class - Method is 150 percent declining balance, switching to straight line, over 3 years.
- o 5 year class - Method is 150 percent declining balance, switching to straight line, over 5 years.

- o 10 year class - Method is 150 percent declining balance, switching to straight line, over 10 years.

- o 15 year public utility class - Method is 150 percent declining balance, switching to straight line, over 15 years.

- o 15 year real property class - Method is 200 percent declining balance, switching to straight line, over 15 years.

- o 19 year real property class - Method is 175 percent declining balance, switching to straight line, over 19 years.

<u>CURRENT CALIFORNIA LAW (Sec. 17201, 17250, 17250.5, 24349, 24349.5, & 24354.1)</u>

California has not generally conformed to the federal ACRS rules for depreciation. California law is based on the ADR System that remains in effect for federal purposes for assets placed in service prior to 1981. However, California does not conform to that portion of the ADR System which, for federal purposes, allows the useful life to be up to 20% shorter or longer than the mid-point of each ADR guideline life. This means that the useful life for California purposes must be the mid-point of the ADR guideline life.

California does allow the use of the ACRS rules for computing depreciation on certain new residential rental property constructed in California between July 1, 1985 and June 30, 1988. However, for qualified property which is not low-income rental property the class life is 18 years rather than 19 years required under federal law.

<u>NEW FEDERAL LAW (Sec. 168, 280F, 312, 7701)</u>

The new federal provision modifies the ACRS for property placed in service after December 31, 1986, except for property covered by transition rules. The cost of property placed in service after July 31, 1986, and before January 1, 1987, which is not transition-rule property, may, at the election of the taxpayer, be covered under the modified rules.

The new federal law does all of the following:

- o Provides more accelerated depreciation for the revised three-year, five-year and ten-year classes,

- o Reclassifies certain assets according to their present class-life (or ADR midpoints) and

- o Creates new 7, 20, 27.5 and 31.5 year-classes.

Depreciation methods for each ACRS class are provided instead of statutory tables. Eligible personal property and certain real property can be assigned a 7, or 20-year class, along with the current 3, 5, 10 or 15 year class.

The depreciation method applicable to certain classes of property is as follows:

- o <u>3, 5, 7 and 10 year classes.</u>

  Method is 200 percent declining balance switching to straight line, over 3, 5, 7 or 10 years.

- o <u>15 and 20 year class.</u>

  Method is 150 percent declining balance, switching to straight line, over 15 or 20 years.

- o <u>27.5 and 31.5 year real property class.</u>

  Method is straight line.

Property class additions and exclusions to current and new classes are as follows:

Class-Year	Additions	Exclusions	ADR Midpoint
3	No change.	research and experimentation property, automobiles and light-trucks	4 years or less (no change)
5	light trucks, automobiles, qualified technological equipment, computer-based telephone central office switching equipment, geo-thermal, ocean thermal, solar and wind energy properties, small power production facilities.	no longer used for the class property not included in any other class	more than 4 years and less than 10 years (no change)
7	New class established for class property not included in any other class and adding single-purpose agricultural or horticultural structures and property with no ADRS midpoint and not classified elsewhere.	N/A	10 years and less than 16
10	No change	Single-purpose agricultural or horticultural structures or property with no ADR midpoint.	16 years and less than 20 years. (Changed from 18 years and less

			than 25)
15	municipal wastewater treatment plants, telephone distribution plant, comparable equipment used for the two-way exchange of voice and data communication.	No change.	20 years and less than 25 years. (Changed from more than 25 years)
20	municipal sewers	section 1250 property with an ADR midpoint of 27.5 years and more.	25 years and more.
27.5	residential rental property, manufactured homes that are residential rental property, escalators and elevators.	N/A	27.5 years and more.
31.5	non-residential real-property, section 1250 real property which is not residential rental property that does not have an ADR midpoint or whose midpoint is 27.5 years or more.	N/A	27.5 years and more.

New ADR midpoints have been established for the following assets:

Asset	New ADR Midpoint	Old ADR Midpoint
Semiconductor manufacturing equipment	5	6
Computer-based telephone central office switching equipment and related equipment	9.5	18
Single-purpose agricultural and horticultural structure, as specified	15	10
Telephone distribution plant, as specified	24	35
Municipal water-waste treatment plants	25	10

Classifications under the ADR system occasionally are made on the basis of regulated accounts. All assets described in these accounts are to be included, without regard to the fact that the taxpayer owning the described assets may not be subject to any regulatory authority.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applies to property placed in service on or after January 1, 1987. For property placed in service between July 31, 1986, and January 1, 1987, the taxpayer may elect to come under the new provisions. There are also extensive transitional rules, including many exceptions for specific projects.

This act also provides numerous transitional rules.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

If California were to repeal its existing depreciation structure and conform to the new federal depreciation system, the revenue effect is estimated as follows (in millions):

	1987-88	1988-89
PITL	$- 33	$- 30
BCTL	- 312	- 301
Total Losses	$- 345	$- 331

These estimates take into account:

(1) Differences between existing California depreciation and ACRS (ERTA '81 & TEFRA '82) as analyzed for AB 1463 (1985-86 R.S.) and aged to 1987 levels.

(2) The current state provisions allowing ACRS for residential rental property and enterprise zone investments.

(3) Differences between ACRS and the new CCRS (capital cost recovery system) depreciation structure.

(4) The increase in state preference tax revenues from more accelerated depreciation deductions under conformity.

After the effects of adopting ACRS were evaluated, prorations of national estimates for CCRS were applied to arrive at the net impacts shown above for the first two years under conformity. Due to the high level of complexity and interactions involved in developing such estimates that necessarily have to allow for the great diversity in types of depreciable assets, the estimates should be considered approximate order of magnitudes only. The principal factor contributing to net revenue losses over the shorter term are the larger deductions generally for machinery and equipment. The smaller depreciation deductions for real property will have a more significant lessening effect on revenue losses over the long term.

Title IIA1b: Capital Cost Provisions

ACTION: REDUCE DEDUCTION LIMITATIONS FOR LUXURY AUTOMOBILES

Act Section 000 | Conference Report Page 0000

Form 540 Line No. 16 | Form 100 Line No. G-21

CURRENT CALIFORNIA LAW (Sec. 17201, 17255 & 24349.1)

California is conformed to the federal limitation on the yearly deduction for depreciation of an automobile. The ADR midpoint life of automobiles is 3 years while for federal purposes they were included in the ACRS 3 year recovery class. Depreciation cannot exceed $3,200 in the first year and $4,800 for each succeeding year. After the mandatory three year recovery period has been exhausted, any remaining basis of the automobile may be deducted as a business expense (provided that more than 50 % of the automobiles use was business related) at a maximum annual rate of $4,800. If less than 100 % of the automobiles use was business related, then the annual rate is reduced to reflect the actual business use.

Property that is used less than 50 % in a trade or business in any taxable year will be subject to the depreciation rules under the straight line method over the earnings and profits life for such property.

NEW FEDERAL LAW (Sec. 280F)

The new federal law extends the useful life to 5 years and reduces the depreciation deductions for luxury automobiles to:

- $2,560 for the first year
- $4,100 for the second
- $2,450 for the third year
- $1,475 for each succeeding taxable year within the 5 years

Additionally, the maximum annual expense rate beginning in the sixth year is decreased from $4,800 to $1,475.

Property that is used less than 50 percent in a trade or business in any taxable year will be subject to the depreciation rules under the alternate cost recovery system. (straight-line depreciation over five years)

EFFECTIVE DATE OF FEDERAL PROVISIONS

This act applies to property placed in service on or after January 1, 1987. This act also provides numerous transitional rules.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Revenue gains from conforming to this federal depreciation change only is unknown. The larger issue of total conformity to the new federal depreciation system is provided in the analysis of II-A1a Cost Recovery Classes.

ACTION: AUTHORITY GIVEN TO TREASURY TO ADJUST CLASS LIVES FOR ACCELERATED DEPRECIATION OF ASSETS

Act Section 201 | Conference Report Page 41

Form 540 Line No. 16 | Form 100 Line No. G-21

CURRENT CALIFORNIA LAW (Sec. 17201, 17250, 17250.5, 24349, 24349.5, & 24354.1)

California has not generally conformed to the federal ACRS rules for depreciation. California does allow the use of the ACRS rules for computing depreciation on certain new residential rental property constructed in California between July 1, 1985 and June 30, 1988. However, for qualified property which is not low-income rental property the class life is 18 years rather than 19 years required under federal law.

California law is based on the ADR System that remains in effect for federal purposes for assets placed in service prior to 1981. However, California does not conform to that portion of the ADR System which, for federal purposes, allows the useful life to be up to 20% shorter or longer than the mid-point of each ADR guideline life. This means that the useful life for California purposes must be the mid-point of the ADR guideline life.

NEW FEDERAL LAW (Sec. 167 (m))

Through this act the Secretary of the United States Treasury will monitor and analyze all depreciable assets, except residential rental property or non-residential real property. The Secretary may:

- prescribe new class lives for any property
- modify any assigned property
- prescribe a class life for any property which does not have a class life

The Secretary, in determining the modified or prescribed class life changes, will take into consideration the anticipated useful life, and the devaluation over time of the property to industry or other groups.

Once the Secretary has prescribed or modified an asset's class life, the new class life will be used to determine the recovery period of the asset. This asset will be subject to depreciation under the alternate cost recovery system.

The Secretary may not generally modify property that has a class life and has been placed in service before January 1, 1992. However, in the case of certain specified property placed in service before January 1, 1992, the Secretary may shorten (but not lengthen) the property's class life.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applies to property placed in service on or after January 1, 1987; property placed in service after July 31, 1986, for which the taxpayer elects to apply the new provisions; and transitional property.

This act also provides numerous transitional rules.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

This item is included in the impact estimate of II-A1a (2100) Cost Recovery Classes which relates to total conformity to the new depreciation system. It is not possible to isolate this item; therefore the revenue effect for this particular provision is indeterminable.

Title IIA2a: Capital Cost Provisions

ACTION: EXPANDS THE ALTERNATIVE COST RECOVERY SYSTEM FOR PROPERTY FOR NON U.S. AND CERTAIN OTHER PROPERTY

Act Section 201 Conference Report Page 48

Form 540 Line No. 16 Form 100 Line No. 6-21

CURRENT CALIFORNIA LAW (Sec. 17201, 17250, 17250.5, 24349, 24349.5, & 24354.1)

California has not generally conformed to the federal ACRS rules for depreciation. California allows the use of the ACRS rules for computing depreciation on certain new residential rental property constructed in California between July 1, 1985 and June 30, 1988. However, for qualified property which is not low-income rental property the class life is 18 years rather than 19 years required under federal law.

California law is based on the ADR System that remains in effect for federal purposes for assets placed in service prior to 1981. However, California does not conform to that portion of the ADR System which, for federal purposes, allows the useful life to be up to 20% shorter or longer than the mid-point of each ADR guideline life. This means that the useful life for California purposes must be the mid-point of the ADR guideline life.

California makes no distinction between property used inside and outside of the United States or property produced abroad.

CURRENT FEDERAL LAW (Sec. 168)

Under ACRS a different depreciation method can be elected instead of the prescribed method. This elective method uses the straight-line method of depreciation and the half-year convention and applies to personal property, but not to real property. The half-year convention treats all assets placed in service during the tax year as if they had been placed in service at the midpoint of the tax year. This means that only half the full annual deduction will be allowable in the first and last tax years.

The elective method may be of benefit to taxpayers when the taxpayer has not had a substantial increase in income for the tax year, does not expect any in the near future, and does not need to depreciate the property at an accelerated rate. Under this method a taxpayer can elect to depreciate using a longer recovery period to save the deduction for years in which it can be used to off-set income taxable in higher brackets. The following table shows the available elective recovery periods:

Types of Property	Recovery Periods Which may be Elected
3-year property	ADR class life, 5 or 12 years
5-year property	ADR class life, 12 or 25 years
10-year property	ADR class life, 25 or 35 years
15-year public utility property	ADR class life, 35 or 45 years
19-year real property or low income housing	35 or 45 years

A taxpayer who elects this method for a specific class of personal property must elect the same recovery method and period for any property of the same class placed in service during the tax year. However, a different election may be made for property in a different class. Election of this method is irrevocable without IRS consent. The election for real property is made on a property-by-property basis.

Current federal law requires tax-exempt-use property, as specified, to be depreciated using the straight-line method of depreciation (without salvage value) over a longer recovery period. The recovery period is:

- the greater of 40 years or 125% of the lease term using a mid-month convention, for 19 year real property or low income housing, or

- the greater of the property's ADR class life (12 years if no ADR class life) or 125% of the lease term, for other recovery property.

No investment credit is available if personal property is used by a "tax-exempt entity."

Additionally, current federal law allows the President to disallow the investment tax credit for property completed abroad or predominantly of foreign origin, if the country in which it originated maintains non-tariff trade restrictions or engages in discriminatory acts unjustifiably restricting U.S. commerce. The investment tax credit uses the ACRS method of depreciation in the computation of the credit. However, the President is not allowed to disallow accelerated depreciation for property completed abroad or predominantly of foreign origin.

NEW FEDERAL LAW (Sec. 168)

The new federal alternative cost recovery system uses straight-line recovery, no salvage value and extends the recovery periods.

The federal changes relative to the following subjects are discussed separately:

1. Other uses of the alternative cost recovery system.

2. Property used predominantly outside the United States.

3. Tax-exempt-use property.

4. Tax-exempt-bond-financed property.

5. Property imported from a foreign country for which an Executive Order is in effect due to non-tariff trade restrictions or other discriminatory acts.

6. Property for which the taxpayer is electing the alternate ACRS method.

1) Other uses of the alternative cost recovery system:

Corporations are limited to a specific recovery period for specific property in computing earnings and profits for the determination of the dividend distribution. For example in computing the depreciation of business equipment, a truck used in a trade or business that meets the requirements for depreciation has a 5 year class life and would be recovered over 5 years using the straight-line method of depreciation. Under the old federal law the truck would have a 3 year class life with an optional recovery period of 5 or 12 years.

Depreciation under the alternative minimum tax must be computed using the alternate cost recovery system. If the taxpayer made the election to have the modified ACRS rules apply to property placed in service after July 1, 1986 but before 1987 the alternative minimum tax for 1986 must use the new alternative cost recovery system to compute the tax preference. The cost of property other than real property is recovered, for purposes of the minimum tax, using the 150 percent declining balance method switching to straight line method, over the established class lives. The cost of real property and other property for which the elected or required straight-line method is used for regular tax purposes is recovered using the straight-line method for minimum tax purposes.

All luxury automobiles as well as listed property, such as computers and airplanes, which are used 50 percent or less for business purposes must use the alternate cost recovery system.

2) <u>Property Predominantly Used Outside the U.S.</u>:

Any satellite or other spacecraft held by a United States person launched from within the United States is not considered foreign property.

3) <u>Tax-Exempt-Use Property</u>:

Basically, current tax-exempt entity leasing rules are retained under the alternate cost recovery system.

4) <u>Tax-Exempt-Bond-Financed Property</u>:

If property is financed with tax-exempt bonds then that property or portion of property must use the alternate system. Any portion of the property not financed by tax-exempt bonds is recovered using the regular accelerated system. The tax-exempt financed portion of the asset's costs will be allocated to property in the order first placed in service. A specific rule has been provided to allow low-income residential rental property to have a 27.5 year class life, which is the same as under the regular system.

A refunding obligation issued only to refund a pre-March 2, 1986, obligation to finance property placed in service after 1986 is generally treated as a new issue and the taxpayer must use the alternative ACRS depreciation method for the costs that are unrecovered on the date of the refunding issue.

If a change of the recovery period is required because of a refunding issue only the remaining unrecovered cost of the property is required to be recovered under the alternate system. In this way no retroactive adjustments to ACRS deductions previously claimed will be required when a pre-March 2, 1986 bond issue is refunded, as specified.

5) <u>Property Imported From A Foreign Country</u>:

With the repeal of the investment tax credit, under this act the President may by Executive order deny the alternate ACRS method of depreciation to property completed abroad and predominantly of foreign origin. This authority is limited to assets that are ordered after the date of the Executive order and are subject to the alternate cost recovery system.

6) <u>Taxpayer Electing the Alternate Method</u>:

A taxpayer may irrevocably elect to apply the alternative ACRS method to any class of property in any class year. For residential rental property and non-residential real property, the election may be made on a property by property basis.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This act shall apply to property placed in service on or after January 1, 1987 in tax years ending after that date.

A taxpayer may elect to have these provisions apply to any property placed in service after July 31, 1986 and before January 1, 1987.

This provision does not apply to:

- o property which is constructed, reconstructed or acquired by the taxpayer pursuant to a written contract which was binding on March 1, 1986, if $1,000,000 or 5% of the cost of such property has been incurred or committed by March 1, 1986,

- o an equipped building or plant facility if construction has commenced as of March 1, 1986, pursuant to a written specific plan and more than one-half of the cost of such building has been incurred or committed by that dateif the class life is at least 7 years and the property is placed in service before a specified date.

The alternative cost recovery system will apply to property that is financed with tax-exempt bonds which is placed in service on or after January 1, 1987, to the extent the property is financed by the proceeds of an obligation (including a refunding obligation) issued after March 1, 1986. Affirmative commitment exceptions are provided.

This act also provides numerous transitional rules.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

This item is included in the impact estimate of II-A1a (2100) Cost Recovery Classes which relates to total conformity to the new depreciation system. It is not possible to isolate this item; therefore the revenue effect for this particular provision is indeterminable.

Title IIA4: Capital Cost Provisions

ACTION: APPLICATION OF ACCOUNTING CONVENTION FOR DEPRECIATION OF ASSETS

Act Section 201 | Conference Report Page 45

Form 540 Line No. 16 | Form 100 Line No. 6-21

CURRENT CALIFORNIA LAW (Sec. 17250, 24349.5)

California has not generally conformed to the federal ACRS (Accelerated Cost Recovery System) rules for depreciation. California law is based on the ADRS (Asset Depreciation Range System) that remains in effect for federal purposes for assets placed in service prior to 1981. However, California does not conform to that portion of the ADR System which, for federal purposes, allows the useful life to be up to 20% shorter or longer than the mid-point of each ADR guideline life. This means that the useful life for California purposes must be the mid-point of the ADR guideline life.

California does allow the use of the ACRs rules for computing depreciation on certain new residential rental property constructed in California between July 1, 1985 and June 30, 1988. However, for qualified property which is not low-income rental property the class life is 18 years rather than 19 years required under federal law.

In computing the ADR, both California and federal law allows the taxpayer to use the half year convention or the modified half-year convention for certain types of property. (The convention is one of three components used to determine the depreciation deduction for tangible property.) The half-year convention allows half of the year's depreciation on all assets placed in service during the first year. The modified half-year convention allows a full year's depreciation for assets first placed in service in the first six months of the year but assets first placed in service in the last six months of the year are allowed no depreciation. The convention elected for the tax year applies to both item and multiple-asset-vintage accounts and must be used for all eligible assets placed in service in that year. However, other conventions may be elected for another ADR year.

For eligible residential rental property, a mid-month convention applies. The depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month. Further, property disposed of by a taxpayer at any time during a month is treated as having been disposed of in the middle of the month.

NEW FEDERAL LAW (Sec. 168(d))

The act eliminates the current statutory schedules for personal property which reflect a half year convention.

With the elimination of the statutory schedules, language has been provided to apply the half-year convention for all property placed in service or disposed of within the taxable year. This property is treated as placed in service or disposed of at the midpoint of such taxable year. In the case of a taxable year less than 12 months, property is treated as being in service for half the number of months in such taxable year.

If more than 40 percent of a taxpayer's property is placed in service during the last three months of the taxable year a mid-quarter convention must be used. The mid-quarter convention treats all property placed in service during any quarter of a taxable year as placed in service on the midpoint of such quarter. Where the taxpayer is a member of an affiliated group, all members are treated as one taxpayer for the 40 percent determination. For taxable years in which property is placed in service, all property is used to determine the 40 percent; however, the mid-quarter convention applies only to tangible property. This does not apply to nonresidential real property or residential rental property.

Additionally, the mid-month convention has been expanded to include low-income housing.

EFFECTIVE DATE OF FEDERAL PROVISIONS

These provisions apply generally to property placed in service on or after January 1, 1987 for taxable years ending after December 31, 1986. The taxpayer may elect to apply these rules to property placed in service between August 1, 1986 and the end of 1986.

This act also provides numerous transitional rules.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

This item is included in the impact estimate of II-A1a cost Recovery Classes which relates to total conformity to the new depreciation system. It is not possible to isolate this item; therefore the revenue effect for this particular provision is indeterminable.

Title IIA5: Capital Cost Provisions

ACTION: ELIMINATES THE RECAPTURE OF DEPRECIATION ON THE DISPOSITION OF REAL PROPERTY

Act Section 201(d) Conference Report Page 47

Form 540 Line No. 18 Form 100 Line No. 6-9

CURRENT CALIFORNIA LAW (Sec. 18151, 18173)

California generally conforms to federal law regarding the recapture of excess depreciation as ordinary income, on the disposition of an asset. The amount recaptured depends on the type of property, the method of depreciation used, and the period during which depreciation has been deducted. One of the types of property subject to this treatment is real property. For real property, gain on disposition is treated as ordinary income to the extent that the depreciation taken exceeds straight-line depreciation. California applies these treatments to Personal Income Tax Law; however, Bank and Corporation Tax Law does not have these recapture provisions.

California law contains some differences from the Federal rules, including the following:

- o Recapture rules do not apply to certain residential property (two or more units) where construction commenced after 1982, provided substantially similar provisions are operative in Federal law (to be effective through 1987).

- o California substitutes different dates for various dates in the Federal law.

In applying the same California and Federal recapture provisions, the amount of recapture may be different because of the differences in amounts deducted in prior years.

NEW FEDERAL LAW (Sec. 1250)

Under the new federal law, real property (Section 1250 property) will be subject to the straight-line method of depreciation, thereby making unnecessary the recapture of depreciation on the disposition of assets placed in service on or after January 1, 1987.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This act applies to property placed in service on and after January 1, 1987, in taxable years ending after such date.

This act shall not apply to:

- o any property which is constructed, reconstructed, or acquired by the taxpayer pursuant to a written contract which was binding on March 1, 1986,
- o property which is constructed or reconstructed by the taxpayer if:
- o the lessor of $1,000,000, or 5 percent of the cost of such property has been incurred or committed by March 1, 1986, and
- o the construction or reconstruction of such property began by such date, or
- o an equipped building or plant facility if construction has commenced as of March 1, 1986, pursuant to a written specific plan and more than one-half of the cost of such equipped building or facility has been incurred or committed by such date.

This act also provides numerous transitional rules.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

This item is included in the impact estimate of II-A1a Cost Recovery Classes which relates to total conformity to the new depreciation system. It is not possible to isolate this item; therefore the revenue effect for this particular provision is indeterminable.

Title IIA6: Capital Cost Provisions

ACTION: MODIFIES LEASE TERM FOR DEPRECIATION OF LEASEHOLD IMPROVEMENTS AND ACQUISITION COSTS

Act Section 201(a) — Conference Report Page 48

Form 540 Line No. 16 — Form 100 Line No. 6-21

CURRENT CALIFORNIA LAW (Sec. 17201, 17250, 17250.5, 24349, and 24349.5)

California has not generally conformed to the federal ACRS rules for depreciation. California does allow the use of the ACRS rules for computing depreciation on certain new residential rental property constructed in California between July 1, 1985 and June 30, 1988. However, for qualified property which is not low-income rental property the class life is 18 years rather than 19 years required under federal law.

California law is based on the ADR System that remains in effect for federal purposes for assets placed in service prior to 1981. However, California does not conform to that portion of the ADR System which, for federal purposes, allows the useful life to be up to 20% shorter or longer than the mid-point of each ADR guideline life. This means that the useful life for California purposes must be the mid-point of the ADR guideline life.

California recovers the cost of leasehold improvements over the shorter of the property's ADR System recovery period or the portion of the lease term remaining on the date the improvements were made. As a general rule, unless the lease has been renewed or the facts show with reasonable certainty that the lease will be renewed, the cost or other basis of the lease, or the cost of improvements, is spread only over the number of years the lease has to run, without taking into account any right of renewal. The renewal periods are not included if the unexpired lease period accounts for 60% or more of the useful life of the improvement. In amortizing costs of acquiring a lease, the renewal periods are not included if 75% or more of the cost is attributable to the unexpired lease period. If however, the lease has been renewed or there is a reasonable certainty that the option to renew will be exercised, the renewal periods are taken into account, despite the fact that the 60% and 75% tests are met. Where facts show with reasonable certainty that the lease will be renewed, the lease term shall, beginning with the taxable year in which the lease will be renewed, include the renewal period.

NEW FEDERAL LAW (Sec. 168, 178)

The new federal law generally requires the term of the lease to include all renewal options as well as any period for which the the parties reasonably expect the lease to be renewed in determining the amortization period for lease acquisition costs. The costs of improvements made to leased property by the leasee are to be recovered under the modified ACRS rules without regard to the lease term. Thus, the cost of improvements are recovered over the applicable recovery period. If, at the end of the lease, the taxpayer does not retain the improvement, gain or loss will be recognized by reference to the adjusted basis of the improvement at the termination of the lease.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Generally, this act applies to property placed in service on or after January 1, 1987. For property placed in service between July 31, 1986 and January 1, 1987, the taxpayer may elect the new provisions.

This act also provides numerous transitional rules.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

This item is included in the impact estimate of II-A1a Cost Recovery Classes which relates to total conformity to the new depreciation system. It is not possible to isolate this item; therefore the revenue effect for this particular provision is indeterminable.

Title IIA7: Capital Cost Provisions

ACTION: MODIFIES THE AGGREGATE CEILINGS FOR EXPENSING QUALIFIED PROPERTY.

Act Section 202(b) Conference Report Page 48

Form 540 Line No. 16 Form 100 Line No. G-21

CURRENT CALIFORNIA LAW (Sec. 17024.5(b)(13), 17252, 17252.5, 17265, 24356.2, and 24356.3)

California does not conform to federal law with respect to a taxpayer electing to treat all or part of the aggregate cost of qualifying property used in a trade or business as a currently deductible expense not to exceed $5,000 for 1986 or 1987, $7,500 for 1988 or 1989; $10,000 for 1990 and thereafter, in-lieu of ACRS.

However, California does allow the following:

1. Additional first-year depreciation on acquired assets equal to 20 percent of the cost of the asset, with a maximum in each year of $10,000 ($20,000 for husband and wife filing jointly). If the additional first-year depreciation is taken on any selected asset, the basis of the asset for depreciation purposes is reduced by the first-year depreciation taken.

2. A taxpayer may elect to treat the cost of any recovery property that is tangible personal property exclusively used in a trade or business conducted in an enterprise zone as an expense not chargeable to the capital account in the year in which the property is first placed in service. Any amounts deducted with respect to expensed property that ceases to be used in an enterprise zone within two years after being placed in service must be included in income for that year. The aggregate cost that can be taken into account for expense treatment can not exceed $5,000 for taxable or income year of designation of the enterprise zone; $5,000 for the first year thereafter; $7,500 for second and third years thereafter; and $10,000 for each succeeding year. Taxpayers who elect this expense treatment may not take the additional first-year depreciation with respect to the same property.

3. A taxpayer who conducts a qualified business in a program area can elect to treat 40 percent of the cost of property used as an integral part of the qualified business and certain machinery or parts used as specified, as an expense that is not chargeable to the

capital account. The deduction is allowed for taxable or income years in which property is first placed in service. The aggregate cost for any taxable or income year may not exceed; $100,000 in the year of designation and the first year thereafter; $75,000 in the second and third years after the year of designation; and $50,000 in each subsequent year. A taxpayer who elects this 40 percent expensing may not claim additional first-year depreciation with respect to the same property. Any amount expensed with respect to property that ceases to be qualified property at any time before the close of the second taxable year after the property is placed in service must be included in income in that year.

NEW FEDERAL LAW (Sec. 179)

The new federal law eliminates the existing expensing ceiling of $5,000 which was scheduled to increase to $7,500 beginning in 1988 and 1989, and to $10,000 after 1989. The new ceiling is established at $10,000 for each year if the cost of qualified property placed in service during the year and used in the active conduct of a trade or business is $200,000 or less. The $10,000 ceiling is reduced dollar for dollar by the amount of the cost which exceeds $200,000. For example, if a taxpayer bought qualified tangible personal property for $205,000 in a year, the amount over $200,000 ($5,000), is subtracted from the $10,000 ceiling. The taxpayer is then allowed to expense only $5,000 that year. Married individuals filing separate returns are treated as one taxpayer for determining the amount expensed and the total amount of the investment in the qualified property. Thus the ceiling on a separate return of a married person is $5,000 rather than $10,000.

In addition, the total cost of property that may be expensed for any taxable year cannot exceed the total amount of taxable income derived by the taxpayer from the active conduct of a trade or business during the taxable year. Costs that are disallowed under this rule are carried over to the next year and added to the amount allowable as a deduction for that year. Recapture will take place whenever an asset is converted to nonbusiness use instead of only during the first two years after the asset was placed in services.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This act applies to property placed in service on and after January 1, 1987.

This act also provides numerous transitional rules.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Revenue losses from conformity to larger expensing deductions are unknown. The larger issue of total conformity to the new federal depreciation system is analyzed in II-A1a Cost Recovery Classes.

Title IIA8: Capital Cost Provisions

ACTION: EXPANSION OF MASS ASSET VINTAGE ACCOUNTS

Act Section 201	Conference Report Page 49
Form 540 Line No. 16	Form 100 Line No. G-21

CURRENT CALIFORNIA LAW (Sec. 17201, 17250.5, 24349 and 24349.5)

Under the Asset Depreciation Range (ADR) system which is used in California for all assets, except certain residential rental property, and which is used for federal purposes for assets placed in service before 1981, a taxpayer must establish "vintage accounts". A "vintage account" is an account containing eligible property first placed in service by the taxpayer during the taxable year. The "vintage" of an account refers to the taxable year during which the eligible property in the account is first placed in service by the taxpayer. Such an account will consist of an asset, or group of assets, within a single asset guideline class. Any number of vintage accounts of a taxable year may be established. More than one account of the same vintage may be established for different assets of the same asset guideline class.

Certain kinds of assets are not permitted in the same vintage account. Vintage accounts that are kept separate are as follows:

- o New and used assets
- o Personal property assets subject to the elective 10 percent salvage reduction compared to assets not subject to the election
- o Personal property and residential or nonresidential rental property
- o Property for which the election of additional first year depreciation was made and property on which that election was not made.

A complex "depreciation reserve" method is used to account for dispositions of individual assets within vintage accounts. When this "depreciation reserve" exceeds the original basis of the remaining assets in the account the excess is recaptured as ordinary income and for federal purposes the investment credit is recaptured. In order to compute the recapture all accounts of the same vintage in the same asset guideline class for which the taxpayer has selected the same depreciation period and adopted the same depreciation method are treated as a single multiple asset vintage account.

Under the Accelerated Cost Recovery System (ACRS) which for federal purposes is used for assets placed in service after 1980 and for California purposes is used for certain residential property a taxpayer may elect to account for "mass assets" in the same mass asset account as though such assets were a single asset. A "mass asset" means a mass or group of individual items:

- o not necessarily homogenous,
- o each of which is minor in value relative to the total value of such mass or group,
- o numerous in quantity,
- o usually accounted for only on a total dollar or quantity basis,
- o with respect to which separate identification is impractical,
- o with the same present class life, and
- o placed in service in the same taxable year.

Upon disposition of individual assets within the mass asset account, all proceeds are recaptured as ordinary income up to the total unadjusted basis in the account and for federal purposes the investment credit is recaptured.

According to the committee reports the limitation on the type of assets which may be included in mass asset accounts is limited, primarily because of concern about the mechanics of recapturing the investment tax credits.

NEW FEDERAL LAW (Sec. 168)

With the repeal of the investment tax credit, the question of recapture of that credit is no longer of concern. The act permits taxpayers, under regulations, to maintain one or more general asset accounts for any property for which ACRS applies. Generally all proceeds realized on any disposition of property in a general asset account must be recaptured as ordinary income.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision applies to property placed in service on or after January 1, 1987. However a taxpayer may elect (as prescribed by the Secretary of the Treasury or his delegate) to have this provision apply to any property placed in service after July 1, 1986 and before January 1, 1987.

This act also provides numerous transitional rules.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

This item is included in the impact estimate of II-A1a Cost Recovery Classes which relates to total conformity to the new depreciation system. It is not possible to isolate this item; therefore the revenue effect for this particular provision is not determinable.

Title IIA9: Capital Cost Provisions

ACTION: CHANGES IN THE TREATMENT OF PUBLIC UTILITY PROPERTY

Act Section 201, 203 Conference Report Page 50

Form 540 Line No. 16 Form 100 Line No. G-21

CURRENT CALIFORNIA LAW (Sec. 17250)

California has not generally conformed to the federal ACRS rules for depreciation. California does allow the use of the ACRS rules for computing depreciation on certain new residential rental property constructed in California between July 1, 1985 and June 30, 1988. However, for qualified property which is not low-income rental property the class life is 18 years rather than 19 years required under federal law.

California law is based on the ADR System that remains in effect for federal purposes for assets placed in service prior to 1981. However, California does not conform to that portion of the ADR System which, for federal purposes, allows the useful life to be up to 20% shorter or longer than the mid-point of each ADR guideline life. This means that the useful life for California purposes must be the mid-point of the ADR guideline life.

California does not conform to federal with respect to the special provisions for regulated public utilities. Under the Bank and Corporation Tax law public utilities are allowed normal depreciation deductions subject to the mid-point of the ADR guideline life.

CURRENT FEDERAL LAW (Sec. 168)

Public utility property, as specified, is not considered recovery property unless the regulated utility uses the normalization method of accounting for rate-making purposes. Under the normalization method a public utility calculates it's tax expense for rate-making purposes using the same depreciation method, and at least as long a depreciation period used to compute it's depreciation expense for rate-making purposes. Any deferral of taxes achieved by applying the accelerated cost recovery rules for tax purposes rather than the method just described must be credited to a reserve account maintained by the utility. The benefits derived by applying the accelerated cost recovery rules cannot be passed through to the regulated public utility's customers by reducing the rates, but instead are accrued for the utilities use.

If a regulated public utility does not apply the normalization method of accounting, then for tax purposes property is depreciated in the same manner as it is depreciated for rate-making purposes.

NEW FEDERAL LAW (Sec. 168)

As with prior law, the new system makes special provisions for public utility property. Most public utility property has a longer class life and is in the 15 or 20 year 150 % declining-balance classes. The rules requiring normalization of the tax benefits in setting rates charged to customers are retained and expanded to cover unregulated public utilities. In addition, special rules are provided that require regulated utilities to normalize any excess deferred-tax reserves resulting from rate reduction. These rules for deferred taxes apply to recovery allowances taken on assets placed in service before 1987. The normalization of the deferred taxes must be coordinated with normalization of the accelerated cost recovery allowances. Failure to coordinate the provisions will preclude the utility from using the new system.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This act applies to property placed in service on and after January 1, 1987, in taxable years ending after such date.

This act shall not apply to:

- property constructed, reconstructed, or acquired by the taxpayer pursuant to a written contract binding on March 1, 1986,

- property in which the binding contract of March 1, 1986 has committed or already incurred the lesser of $1,000,000 or 5 %, and the construction began by March, 1, 1986,

- an equipped building or plant facility if construction has commenced as of March 1, 1986, pursuant to a written plan and more than one-half of the cost has been incurred or committed by such date,

- projects licensed or certified before March 2, 1986, by the Federal Energy Regulatory Commission (FERC),

- hydroelectric projects of less than megawatts if an application was filed with FERC before March 2, 1986.

- specifically described property qualifying under any one of the 142 special transitional rules.

This act also provides numerous transitional rules

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

This item is included in the impact estimate of II-A1a Cost Recovery Classes which relates to total conformity to the new depreciation system. It is not possible to isolate this item; therefore the revenue effect for this particular provision is indeterminable.

Title IIA11: Capital Cost Provisions

ACTION: REPEAL FINANCE LEASE PROVISIONS

Act Section 201 | Conference Report Page 51

Form 540 Line No. 16 | Form 100 Line No. G-21

CURRENT CALIFORNIA LAW (No provision)

California does not conform to federal provisions with respect to finance leases.

CURRENT FEDERAL LAW (168)(f)(8)

Under current federal law whether a transaction is a lease or a purchase for income tax purposes is important in determining who is entitled to the investment tax credit and to deductions for business expenses.

Rules for determining lease versus purchase have not been written in the tax code, but have evolved over the years through a series of court rulings and Revenue Rulings issued by the Internal Revenue Service.

TERRA (1982) added new rules to the Internal Revenue Code which were to become effective after December 31, 1983. The Tax Reform Act of 1984, however, postponed the effective dates until December 31, 1987.

NEW FEDERAL LAW (No provision)

The new federal law repeals the finance lease provisions.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The federal provisions are repealed prior to becoming effective.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Not applicable. California has not adopted federal finance lease rulings.

Title IIC1: Capital Cost Provisions

ACTION: REDUCES AND EXTENDS THE INCREMENTAL RESEARCH CREDIT FOR THREE YEARS

Act Section 231 — Conference Report Page 68

Form 540 Line No. 71 — Form 100 Line No. 18

CURRENT CALIFORNIA LAW (None)

California has no provision, comparable to federal law, allowing a tax credit for certain increases in research and experimental expenses.

OLD FEDERAL LAW (Sec. 30)

In addition to IRC Section 174 which allows a deduction for research and experimental expenditure, this section allows a credit in an amount equal to 25% of the current tax year's "qualified research expenditures" which exceed the average qualified research expenditures incurred in the prior three years.

"Qualified research expenditures" eligible for this credit consist of

(1) in-house expenditures incurred by the taxpayer for research wages and supplies used in research, plus certain amounts paid for research use of laboratory equipment, computers, or other personal property;

(2) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf; and

(3) if the taxpayer is a corporation, 65 percent of the taxpayer's expenditures (including grants or contributions) pursuant to a written research agreement for basic research to be performed by universities or certain scientific research organizations.

This credit is limited to the current year's tax liability. However, excess credits can be carried forward for 15 years and back for 3 years.

This credit expired December 31, 1985.

NEW FEDERAL LAW (Sec. 41)

Extends the incremental research credit for three years, through December 31, 1988, and reduces the eligible credit to 20 percent. The definition of allowable expenditures and research activities are significantly tightened. The emphasis of the credit is targeted on research which is technological in nature and conducted either for the purpose of new product development or to improve the function performance or quality of an existing product. Expenditures paid for the use of computers are allowable; however, expenditures for all other leased research equipment will be ineligible for the credit. Qualifying expenditures for basic university research are increased from 65 percent to 100 percent of the amount exceeding the sum of

(a) the greater of two fixed research floors, plus

(b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed based period as adjusted for inflation. In addition, this credit is now subject to the general business credit limitation.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Taxable years beginning on or after January 1, 1986, except that the modifications relating to the university and qualified scientific organization basic research credit are effective for taxable years beginning on or after January 1, 1987.

This credit sunsets December 31, 1988.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on a proration of national estimates prepared by the Joint Committee on Taxation, the relative fiscal impact under conformity would be revenue losses in the $9 million range for 1987-88 and $7 million range for 1988-89 under the Personal Income Tax Law and in the $88 million and $62 million ranges, respectively, under the Bank and Corporation Tax Law. These estimates assume that only research expenses incurred in California would qualify.

The Personal Income Tax proration of 12.5 percent represents California personal income relative to the nation as projected for 1987 reduced by an assumed factor of 10 percent to allow for research in California only. The Bank and Corporation Tax Law proration (8%) represents the relative share of federal gross receipts reported by both nonapportioning and apportioning California filers adjusted by the average apportionment factor of the latter group of corporate filers.

Title IIC2: Capital Cost Provisions

ACTION: <u>EXPANDS THE DEFINITION OF QUALIFIED RESEARCH CONTRIBUTIONS OF SCIENTIFIC PROPERTY</u>

Act Section 231(f) Conference Report Page 76

Form 540 Line No. N/A Form 100 Line No. G-19

<u>CURRENT CALIFORNIA LAW (Sec. 24357.8, 24357.9, and 24358)</u>

California and federal law both allow a contribution deduction for the donation of scientific equipment by corporations to institutions of higher education however many differences exist between the two laws..

The major differences for California law are as follows:

1) The contributed property does not have to be constructed by the taxpayer.

2) The scientific equipment or apparatus may be used, in addition to the permitted uses under federal law, in research training in <u>applied sciences</u> or for <u>instructional purposes</u>.

3) The institution of higher education must be located in California.

4) California limits the deduction for the contribution to 5 percent of the corporation's net income while the federal limit is 10 percent of adjusted gross income.

California goes one-step further in the contribution deduction for scientific equipment, as specified. Computer software and ancillary or test equipment if contributed to institutions of higher education in California can also be deducted.

<u>NEW FEDERAL LAW (Sec. 170 (e)(4)(i))</u>

The new federal provision expands eligible donees to include certain tax-exempt scientific research organizations. The 10 percent limit on the amount of the credit would not change.

<u>EFFECTIVE DATE OF FEDERAL PROVISIONS</u>

This act applies to taxable years beginning on or after January 1, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No specific national estimate was made by the Joint Committee on Taxation for this particular item indicating a very minor impact for the nation.

The existing state deduction is scheduled to expire on January 1, 1988. No data is available on revenue losses from the existing state deduction which is broader in scope than the federal provision since it includes computer software and ancillary test equipment, but narrower in application since the donee must be a California institution of higher education. Revenue losses from an extension of the existing State deduction with tax-exempt scientific research organizations added as eligible donees are indeterminable but, based on the low level of impact for the nation, state revenue losses would also be minor.

POLICY CONSIDERATIONS

California allows contribution deductions for scientific equipment as well as software, and ancillary or test equipment, as specified. If California considers conforming to the inclusion of certain tax-exempt scientific research organizations as eligible donees of scientific equipment then it should consider whether or not these organizations should also entitle the donor to a deduction for the donation of software and ancillary or test equipment.

Title IID1: Capital Cost Provisions

ACTION: REPEAL OF 5-YEAR AMORTIZATION OF TRADEMARK AND TRADE NAME EXPENDITURES

Act Section 241 | Conference Report Page 78

Form 540 Line No. 16 | Form 100 Line No. G-20

CURRENT CALIFORNIA LAW (17201, 24368.1)

California law conforms to federal law with respect to the tax treatment of trademark or trade name expenses. These expenses may, at the election of the taxpayer, be amortized over a period of at least 60 months. Consideration paid to acquire an existing trademark or trade name is not eligible for amortization.

NEW FEDERAL LAW (177, Repealed)

The election to amortize trademark and trade name expenses is repealed, thereby requiring these expenditures to be capitalized and recovered only on the disposition of the asset.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective for expenditures paid or incurred after December 31, 1986, except that present federal law will continue to apply to expenditures incurred in the following cases:

(1) A binding written contract has been entered into as of March 1, 1986.

(2) Development, protection, expansion, registration or defense of trademarks or trade names commenced as of March 1, 1986 (if $1 million or 5 percent of the cost, whichever is less, has been incurred or committed by that date); provided in each case the trademark or trade name is placed in service before January 1, 1988.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on the Joint Committee on Taxation's estimated low level of impact for the nation, conformity would result in minor revenue gains under the Personal Income Tax Law and Bank and Corporation Tax Law. Revenue gains under the Personal Income Tax Law would be in the $200,000 range for 1987-88 and in the $300,000 range for 1988-89. Revenue gains under the Bank and Corporation Tax Law would be in the $400,000 range for 1987-88 and in the $700,000 range for 1988-89. The Personal Income Tax proration of national estimates to California (4.1%) reflects the Policy Economics Group (PEG) state estimate relative to the nation for those provisions analyzed, however, PEG has not specifically estimated this provision. The Bank and Corporation Tax Law proration (4%) represents the general relationship between California's corporate tax collections and federal corporate collections tax over the past few years.

Title IID3: Capital Cost Provisions

ACTION: REPEAL OF THE DEDUCTION FOR RAILROAD GRADING AND TUNNEL BORES

Act Section 242 Conference Report Page 79

Form 540 Line No. N/A Form 100 Line No. G-21

BACKGROUND

The term "railroad grading and tunnel bores" means all improvements resulting from excavations (including tunneling) construction of embankments, clearings, diversions of roads and streams, and sodding of slopes. Also any work necessary to construct, reconstruct alter, protect, improve, replace or restore a roadbed or right-of-way for railroad track. If expenditures for improvements as described above are incurred with respect to an existing roadbed or right-of-way such expenditures are also eligible.

CURRENT CALIFORNIA LAW (Sec. 17250)

California Personal Income Tax Law specifically does not conform to the federal provision which allows a domestic railroad common carrier to elect to amortize (over 50 years) expenses with respect to railroad grading and tunnel bores and the Bank and Corporation Tax Law contains no provision which would allow such an election. Thus, for California purposes, these expenses are required to be capitalized as part of the cost of the land and recovered on disposition of the asset.

NEW FEDERAL LAW (Sec. 185)

The act repeals the amortization election regarding "railroad grading and tunnel bores."

EFFECTIVE DATE OF FEDERAL PROVISIONS

This repeal generally applies to expenses paid or incurred on or after January 1, 1987. A transitional rule allows the present law election to be made for certain contracts and construction using a March 1, 1986 qualification date as long as the improvements are placed in service before January 1, 1988.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

California did not conform previously to the federal provision allowing amortization of expenses of railroad tunnels and bores, consequently, there is no revenue effect from the federal repeal.

Title IID4: Capital Cost Provisions

ACTION: <u>RETROACTIVELY MODIFIES MOTOR CARRIER OPERATING AUTHORITY PROVISIONS</u>

Act Section 243 | Conference Report Page 80

Form 540 Line No. 16 | Form 100 Line No: G-21

BACKGROUND

Generally no deduction is allowed for a decline in value of property absent a sale or other disposition. Due to the federal government's deregulation of the trucking industry, motor carrier operating authorities (certificates or permits) suffered a decrease in value. In the Economic Recovery Tax Act (ERTA) of 1981, a non-code provision retroactively allowed the amortization (over a 60 month period) of the basis of these motor carrier operating authorities beginning in the 1980 tax return.

CURRENT CALIFORNIA LAW

California has never conformed to the federal non-code provision which allows taxpayers, for taxable years ending after June 30, 1980, to deduct their adjusted basis in motor carrier operating authorities. The federal deduction must be taken ratably over a 60-month period. The 60-month period begins July 1980 (or, if later, the month in which acquired) or, at the taxpayer's election, the taxpayers first taxable year beginning after July 1, 1980.

For California purposes the basis of these operating authorities is recovered only on sale or other disposition.

NEW FEDERAL LAW (ERTA Sec. 266)

This act retroactively changes:

- The term "motor carrier operating authority" to include a bus operating authority and a freight forwarder operating authority. (Freight forwarder operating authority provisions are contingent upon deregulation of that industry and must be held at the beginning of the 60 month amortization period.)

- The dates to be used for bus operating authorities to November 19, 1982 from July 1, 1980,

- The 60-month amortization period beginning date for bus operating authorities to November 1982 from July 1980.

o The 60 month amortization period beginning date for freight forwarder operating authorities to the beginning of 1987 or if later the deregulation month.

EFFECTIVE DATE OF FEDERAL PROVISIONS

With regard to the change relating to bus operating authorities, this act applies to taxable years beginning on or after November 19, 1982 and, if a refund or credit of any overpayment of tax resulting from this act is prevented (due to the expiration of the statute of limitations) at any time on or before one year after October 22, 1986, then the refund or credit of the overpayment may be allowed if the claim is filed on or before 18 months after October 22, 1986.

This act, with regard to the freight forwarder operating authority provisions, applies to taxable years ending after the beginning of the month of deregulation.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

A conformity estimate is not appropriate since California has not conformed previously to this special amortization provision and to do so now would involve the state prohibition pertaining to "gifts of public money".

Title IID5: Capital Cost Provisions

ACTION: EXTEND PROVISION ALLOWING EXPENSING OF COSTS FOR REMOVAL OF ARCHITECTURAL BARRIERS

Act Section 244 — Conference Report Page 81

Form 540 Line No. 47 — Form 100 Line No. G-26

CURRENT CALIFORNIA LAW (Sec. 17262, 24383)

California law is very similar to federal law with respect to the provisions allowing expensing of costs for removal of architectural barriers to accommodate elderly or handicapped persons. California, however, made the deduction permanent in 1984, while the federal provision was scheduled to expire on December 31, 1985. California allows a deduction for the cost of remodeling the taxpayer's residence as well as the taxpayer's trade or business. The California definition of deductible expenses is somewhat broader than the federal.

California allows a deduction for capital expenses incurred in repairing or remodeling any building, facility, or transportation vehicle owned or leased by the taxpayer in order to permit handicapped or elderly individuals to enter or leave the building, facility, or transportation vehicle; to increase their access, or to allow more effective use of such facilities. The maximum deduction is $35,000, and must be taken in the taxable year in which the expense in incurred. If not connected with a trade or business the expense may be claimed as an itemized deduction.

NEW FEDERAL LAW (Sec. 190)

The election to deduct qualifying expenditures for the removal of architectural and transportation barriers, rather than capitalizing the expenses, is made permanent.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective for taxable and income years beginning on or after January 1, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Since California has previously made the deduction permanent, the primary revenue impact from this provision to conform to federal law would be attributed to disallowing the current deduction for nonbusiness reason (private). There is no state data available to determine the revenue gains that would occur but they would probably be minor.

Title IIE1: Capital Cost Provisions

ACTION: REDUCES THE TAX CREDIT FOR REHABILITATION EXPENSES

Act Section 251 | Conference Report Page 82

Form 540 Line No. N/A | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (N/A)

California does not conform to federal law with respect to allowing a tax credit for rehabilitation expenses.

The rehabilitation component of the federal investment tax credit allowed a credit of 15 percent for nonresidential buildings at least 30 years old, 20 percent for nonresidential buildings at least 40 years old, and 25 percent for certified historic structures.

NEW FEDERAL LAW (Sec. 190)

The new law replaces the three-tier rehabilitation credit with a two-tier credit for qualified rehabilitation expenses. The Act provides a 20 percent credit for the rehabilitation of certified historic structures and a 10 percent credit for the rehabilitation of buildings, other than historic structures, originally placed in service before 1936.

As under prior law, the new credit for the rehabilitation of historic structures applies to both residential and nonresidential buildings, while the new credit for the rehabilitation of buildings (other than historic structures) only applies to nonresidential buildings.

Prior law provisions that determine whether rehabilitation expenditures qualify for the credit generally have been retained. An expenditure is not eligible for the credit unless the taxpayer elects to recover the rehabilitation costs using the straight-line method of depreciation. A lessee's expenditures don't qualify for the credit unless the remaining lease term, on the date the rehabilitation is completed, is at least as long as the applicable recovery period (31 1/2 years for nonresidential property, 27 1/2 years for residential property).

External-walls requirement: The new law significantly modifies the external walls requirement. The prior provision that required 75 percent of the existing external walls to be retained in place as external walls has been deleted, and replaced by the prior law alternate test. This test requires the retention in place of (1) at least 75 percent of the existing external walls, including at least 50 percent as external walls, as well as (2) at least 75 percent of the building's internal structural framework. So a completely gutted building cannot qualify for the rehabilitation credit. A building's internal structural framework generally includes all load-bearing internal walls and any other internal structural supports, including the columns, girders, beams, trusses, spandrels, and all other members that are essential to the building's stability. Although the external walls requirement is waived for historic structures, the Secretary of the Interior is expected to continue generally to deny certification to rehabilitation where less than 75 percent of external walls are not retained in place.

Basis reduction: The new law deleted the prior law provision that required a basis reduction for only 50 percent of the credit for certified historic structures. So, a full adjustment is required for both the 10 percent and 20 percent rehabilitation credits.

EFFECTIVE DATE OF FEDERAL PROVISIONS

In general, the new rules are effective for property placed in service after December 31, 1986. Special transition rules apply to:

- Property placed in service as rehabilitation property before January 1, 1994, if the rehabilitation was completed under a written contract binding on March 1, 1986.

- Rehabilitation of property (including any leasehold interest) acquired before March 2, 1986 or acquired on or after that date, if (1) the rehabilitation was completed under a written contract binding on March 1, 1986, and a historic certification application was submitted to the Department of the Interior (or its designee) before March 2, 1986, or (2) the lesser of $1,000,000 or 5 percent of the rehabilitation cost was incurred before March 2, 1986, or is required to be incurred under a written contract binding on March 1, 1986.

  There are additional transition rules for specific projects.

  Property covered by the transition rules is eligible for a 25 percent credit (historic rehabilitation), 13 percent credit (nonresidential buildings at least 40 years old), or 10 percent credit (for nonresidential buildings at least 30 years old). However, a full basis adjustment is required even if the project is covered by the transition rules. There are special credit rules for certain specific projects.

A rehabilitation project covered by the transition rules is exempted from the new law's longer writeoff period for real estate. Transition property can be depreciated (using straight line) over a 19-year recovery period, even if placed in service after December 31, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

A conformity estimate is not appropriate since California has not previously conformed to adopt this rehabilitation tax credit.

Title IIE3: Capital Cost Provisions

ACTION: ESTABLISHES LOW-INCOME HOUSING CREDITS

Act Section 252 | Conference Report Page N/A

Form 540 Line No. N/A | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (N/A)

Neither California nor federal law allowed a tax credit for construction or rehabilitation of low-income housing.

NEW FEDERAL LAW (Sec. 42)

New federal law establishes the following credits:

- o new construction and rehabilitation,
- o new construction and rehabilitation financed with tax-exempt bonds or similar federal subsidies, and
- o cost of acquiring existing housing.

The following is a description of the new credits:

- o New construction and rehabilitation. A new credit of up to 9 percent is allowed each year over a 10-year period. The credit is taken on expenses for new construction and rehabilitation of each qualifying low-income housing unit. To qualify for the credit, expenses must exceed $2,000 per low-income unit. The credit rate is equivalent to a credit with the present value of 70 percent.

- o New construction and rehabilitation financed with tax-exempt bonds or similar federal subsidies. A maximum credit of 4 percent each year for 10 years is allowed on the construction and rehabilitation financed with tax-exempt bonds or similar federal subsidies, such as Farm Housing Administration (FmHA) loans. These expenses must also exceed $2,000 per low-income unit to qualify for the credit. The credit rate is equivalent to a credit with a present value of 30 percent.

- o Cost of acquiring existing housing. There is also a credit for acquiring each low-income housing unit. The maximum credit is 4 percent each year over a 10-year period on the cost of acquiring each low-income housing unit. To qualify for the credit, the property must not have been placed in service within the previous 10 years. If the low-income housing project is financed at least in part by the federal government, the Treasury Secretary may under certain conditions waive the 10-year requirement. This credit will be granted even when there is no rehabilitation.

Low-income rental housing tax credits can be issued by each state in an amount equal to $1.25 per state resident. Qualified housing expenditures that are not financed with tax-exempt bond proceeds must receive credit authority from the state. Expenditures from tax-exempt bond financing that qualify for the credit receive the credit without reducing a state's credit authority. No separate volume limitation is applied to low-income rental housing tax credits for these projects because tax-exempt bonds for multifamily rental housing are already limited under state volume limitations.

States must reserve at least 10 percent of their credit authority for projects that are developed by certain nonprofit organizations that foster low-income housing.

To receive the credit:

- o At least 20 percent of units in a project must be occupied by individuals having incomes of 50 percent or less of area median income, adjusted for family size; or

- o At least 40 percent of units in project must be occupied by irdividuals having incomes of 60 percent or less of area median income, adjusted for family size.

Income limits may be adjusted for areas with unusually low family income or high housing costs relative to family income. The gross rent charged to tenants in units eligible for the credit may not be more than 30 percent of the qualifying income for a family of its size. Gross rent includes the cost of utilities, other than telephone. Once a project qualifies for the credit it must continue to satisfy the eligibility requirements for a 15-year period. If it doesn't, prior credits will be recaptured.

All rental units must be suitable for occupancy. They will not qualify for the credit if they are used on a transient basis. Thus, hotels, dormitories, hospitals, nursing homes, lifecare facilities, and retirement homes will not qualify. Single room occupancy housing used on a nontransient basis will qualify even though such housing may provide eating, cooking, and sanitation facilities on a shared basis.

The basis of the housing project with respect to which the housing credits are allowed must be reduced by any rehabilitation credits. However, the project's basis for depreciation is not reduced by the housing credits claimed.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This act applies to property placed in service after 1986 (other than property grandfathered under the depreciation rules) and before 1990. Property placed in service after 1989 may qualify for the credit if expenditures of 10 percent or more of the reasonably expected costs are incurred before January 1, 1989, and the property is placed in service before January 1, 1991. Special transitional rules also apply.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on a proration of national estimates prepared by the Joint Committee on Taxation, the relative fiscal impacts state conformity to the new federal low-income rental housing tax credit would be revenue losses in the $36 million range for 1987-88 and the $79 million range for 1988-89. These revenue losses would occur under the Personal Income Tax Law. The proration to California (12.5 percent) reflects California personal income relative to the nation, as projected for 1987. A reduction of 10 percent was used to allow for some credits that would exceed state tax liabilities.

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TITLE III

CAPITAL GAINS AND LOSSES

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Title IIIA: Capital Gains and Losses

ACTION: REPEAL THE NET CAPITAL GAIN DEDUCTION

Act Section 301 — Conference Report Page 105

Form 540 Line No. 17 — Form 100 Line No. N/A

BACKGROUND

California was generally conformed to federal law, with respect to short-term and long-term gains from the sale or exchange of capital assets, until 1971 when California added a mid-term holding period for taxable years beginning on or after January 1, 1972. Subsequently, California also added special rules for small business stock and nonproductive assets sold or exchanged in taxable years beginning on or after January 1, 1982.

All assets are generally considered to be "capital assets", except business property held for sale (inventory), depreciable business property, business accounts receivable, and copyrights or compositions.

CURRENT CALIFORNIA LAW (Sec. 18162.5)

California law provides that all of the gain from the sale of a capital asset is includible in gross income for assets held less than one year; sixty-five percent (65%) for assets held more than one year, but less than five years; and fifty percent (50%) for assets held more than five years.

Gains from the sale or exchange of qualified small business stock are excluded in full if held for more than three years.

Gains from certain nonproductive assets falling in the mid-term holding period (one to five years) are includible at a rate of seventy percent (70%) rather than sixty-five percent (65%).

NEW FEDERAL LAW (Sec. 1202)

The act repeals the net capital gain deduction (sixty percent of long-term gains). Thus, capital gains will be fully included in gross income with no deductions or exclusions.

The act also provides that the tax on capital gains shall not exceed twenty-eight percent (28%), an amount equivalent to the highest regular marginal tax rate imposed by this act. The effect of this provision is to limit the tax on capital gains in the event that marginal tax rates are increased at some future date.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The new federal law applies to capital assets sold or exchanged in taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Many taxpayers will respond to Federal changes beginning in 1987 by realizing capital gains prior to the effective date of the change or deferring sales to subsequent years. The magnitude of additional revenues for 1986 is conjectural, but may be significant. Over the longer run, however, taxpayers would not be able to reduce capital gains realizations as much as in the short-term.

The Department of Finance is preparing a budget estimate on the anticipated increase in Personal Income Tax revenues for 1986 due to accelerated sales of capital assets.

Although this estimate for 1986 is not yet available, a behavioral estimate of the potential revenue loss for 1987 is still provided which reflects a 25 percent reduction to the existing base-line projection of total capital gains for 1987. This 25 percent downward adjustment allows for both accelerated sales in 1986 and deferrals to subsequent tax years. A tax model run for 1987 indicates this loss to be in the $520 million range.

If California were to conform to Federal law by eliminating the long-term and mid-term exclusions on capital gains against the diminished tax base and increasing the limitation on the deduction of net capital losses from $1,000 to $3,000, it would recapture the behavioral revenue loss above and produce a net revenue gain in the $2 million range for 1987. The basis for the revenue estimate is the Department's tax model.

TAX POLICY ISSUES

1. The basic question is whether or not California wants to conform to the new federal law with respect to including the entire amount of capital gain in gross income rather than allowing a deduction or exclusion.

If the answer to the first issue is "yes", these additional issues are applicable:

2. Federal law is retaining its existing structure for short-term and long-term gains, even though both will be fully included in gross income. This facilitates any future change to differential treatment. The issue for California is whether to retain its current structure (changing all percentages to 100%) or repeal its structure and conform to federal law.

3. California (but not federal) law provides that gain from certain small business stock is excluded from gross income in full, if the stock has been held for more than three years. Does California wish to retain this unique provision or conform to federal law by repealing this provision.

Title IIIC: Capital Gains and Losses

ACTION: <u>LIBERALIZATION OF INCENTIVE STOCK OPTION RULES</u>

Act Section 321 | Conference Report Page 107

Form 540 Line No. 17 | Form 100 Line No. N/A

<u>BACKGROUND</u>

An incentive stock option (ISO) is an option received by an employee to purchase the employer's stock, the value of which is not subject to tax upon receipt or exercise, but is taxed as a capital gain at a later date when the stock is sold or exchanged.

No deduction is allowed to be taken by the employer at any time.

<u>CURRENT CALIFORNIA LAW (Sec. 17501, 17514, 24621, 24622)</u>

California is conformed to federal law which generally requires that to be treated as an ISO, (1) the term of the option must not exceed ten (10) years, (2) the option price cannot be less than the fair market value on the date of the option, (3) the option cannot be transferred, except by inheritance, (4) options must be exercised in the order granted, and (5) options granted during the current year cannot exceed $100,000 per employee (including carryover of unused limit). Other rules also apply.

For 1982 and 1983, California did not allow ISO treatment for options granted before January 1, 1982. Beginning with the 1984 taxable year, however, California allows ISO treatment for stock options granted on or after January 1, 1976, but not exercised prior to January 1, 1984.

<u>NEW FEDERAL LAW (Sec. 422A)</u>

The Act repeals the requirement that incentive stock options must be exercised in the order granted. The act also changes the focus of the $100,000 annual limitation so that it applies not to <u>options granted</u> during the current calendar year, but to <u>options first exercisable</u> in any calendar year.

The $100,000 limitation continues to be computed on the fair market value at the time granted and includes all options under all plans of the employer corporation (including parent and subsidiary corporations). The carryover of unused limits is repealed, since it pertained to the granting of options, rather than exercise.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applies to options granted on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Joint Committee on Taxation estimates a revenue loss for the nation of less than $5 million annually. Based on this projected low level of impact for the nation, conformity would result in a minor revenue loss annually in the $200,000 range.

Title IIID2: Capital Gains and Losses

ACTION: <u>REVISE YEAR-END RULES FOR QUALIFIED COVERED CALLS</u>

Act Section 331 | Conference Report Page 108

Form 540 Line No. 17 | Form 100 Line No. N/A

BACKGROUND

Tax straddles occur when a taxpayer holds personal property and contracts to buy or sell personal property at a future date.

A "call" is an option to purchase stock at a given price within a specified period of time.

A "covered call" is where the grantor of the "call" already holds the stock for which the call option was granted.

To be classified as a "qualified covered call", the option period must exceed 30 days and certain other requirements must be satisfied.

CURRENT CALIFORNIA LAW (Sec. 18031)

California Personal Income Tax Law is generally conformed to federal law which reduces the <u>loss on disposition of an option</u> in a straddle position by the amount of any unrecognized gain in an offsetting position on stock, unless the unrecognized gain on stock is offset by a "qualified covered call", and the <u>stock is held for at least 30 days</u> after disposition of the option.

If the situation is reversed, i.e., there is a <u>loss on disposition of stock</u> offset by an unrecognized gain on an option, no reduction of the loss is required.

NEW FEDERAL LAW (Sec. 1092)

The Tax Reform Act of 1986 extends the limitation on losses on straddle positions to include <u>loss on disposition of stock</u>, where the stock loss is offset by an unrecognized gain on an option, unless the unrecognized gain is offset by a "qualified covered call" and the <u>option is held for at least 30 days after sale of the stock</u>.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applies to positions established on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No relevant state tax data is available to estimate this provision. The Joint Committee on Taxation has included this item with the "Mark-to-Market System" and the "Hedging Exception" into the "straddles" category (IIID) and projected a revenue gain for the nation of less than $5 million annually. Based on this projected low level of impact for the nation, conformity would result in minor revenue gains annually in the $200,000 range.

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TITLE IV

AGRICULTURE, TIMBER, ENERGY, AND NATURAL RESOURCES

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Title IVA1: Agriculture, Timber, Energy, and Natural Resources

ACTION: LIMIT THE EXPENSING OF SOIL AND WATER CONSERVATION EXPENDITURES AND RESTRICT THE DEFINITION OF QUALIFIED EXPENSES

Act Section 401 Conference Report Page 110

Form 540 Line No. 22 Form 100 Line No. G-26

CURRENT CALIFORNIA LAW (Sec. 17201 and 24369)

California has conformed its law to the federal law regarding soil and water conservation expenses. Current law allows taxpayers engaged in the business of farming to deduct expenses made for the prevention of erosion of land used in farming. Deductible expenses include amounts paid for items such as grading, terracing and contour furrowing, construction of drainage ditches, irrigation ditches, dams, ponds and the planting of wind breaks. Also, assessments levied by soil or water conservation drainage districts are deductible to the extent those expenditures would constitute deductible expenditures if paid directly by the taxpayer. Expenses to acquire depreciable assets are not eligible for expensing under this provision. The deduction is limited in any one year to 25 percent of the taxpayer's gross income from farming. Any excess may be carried over to succeeding years.

NEW FEDERAL LAW (Sec. 175)

This provision of the act limits soil and water conservation expenditures for the expensing election to those consistent with a conservation plan (if any) approved by the Soil Conservation Service of the Department of Agriculture or, in the absence of a plan, a plan of a comparable state conservation agency. Expenditures in connection with draining or filling of wetlands or preparing land for installation or operation of a center pivot irrigation system are not eligible for the deduction.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision applies to expenditures paid or incurred after December 31, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on a proration of national estimates prepared by the Joint Committee on Taxation (JCT), the relative fiscal impact from state conformity would be a Personal Income Tax revenue gain in the $1 million range for 1987-88 and 1988-89. The proration to California's (4.1 percent) reflects the Policy Economic Group

(PEG) California estimates relative to the nation for those provisions analyzed. The PEG has not specifically estimated this provision.

Based on a proration of the JCT's estimate for the nation, the revenue gain under the Bank and Corporation Tax Law from conformity would be in the $500,000 range for 1987-88 and 1988-89. A proration factor of 4 percent was used which represents the general relationship between California's corporate tax collections and federal tax collections over the past few years.

Title IVA1c: Agriculture, Timber, Energy, and Natural Resources

ACTION: REPEAL THE DEDUCTION FOR LAND CLEARING EXPENDITURES

Act Section 402 Conference Report Page 111

Form 540 Line No. 22 Form 100 Line No. G-26

CURRENT CALIFORNIA LAW (Sec. 17201)

California Personal Income Tax Law has conformed with current federal law which allows a taxpayer engaged in the business of farming to deduct expenses paid or incurred during the taxable year for the clearing of land for purpose of making the land suitable for farming. These expenses must not be added to the basis of land. The deduction may not exceed the lesser of $5000 or 25 percent of taxable income derived by the taxpayer from farming.

The Bank and Corporation Tax Law does not contain this special expensing provision and therefore such expenses must be capitalized as part of the basis of the land.

NEW FEDERAL LAW (Sec. 182)

This provision of the act repeals the election to expense land clearing expenditures. However, routine brush clearing and other ordinary maintenance on land already used in farming continue to be currently deductible.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective for expenditures paid or incurred after December 31, 1985.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

A departmental estimate prepared for the 1987-88 Tax Expenditure Report on all agricultural expensing provisions is a revenue loss in the $3 million range under the Personal Income Tax Law.

It is not expected that land clearing expensing comprises more than one-fourth (25 percent) of this total impact. Revenue gains, therefore, under conformity are estimated to be in the $750,000 range annually.

Title IVA2: Agriculture, Timber, Energy, and Natural Resources

ACTION: CHANGE COMPUTATION OF GAINS OR LOSSES ON DISPOSITIONS OF CONVERTED WETLANDS AND HIGHLY ERODIBLE CROPLANDS

Act Section 403 — Conference Report Page 111

Form 540 Line No. 16 — Form 100 Line No. G-9

CURRENT CALIFORNIA LAW (Sec. 18151 and 18169)

There is no current federal or California law which specifically uses the terms "converted wetlands" and "highly erodible croplands." However, gains and losses from dispositions of such land used in a trade or business would be combined with gains and losses from dispositions of other trade or business property. If gains exceed the losses the gain is taxed as a capital gain. If losses exceed gains the net losses are ordinary losses. Generally the taxability of a capital gains for Personal Income Tax Law are:

1. 100 percent if the asset has been held less than one year,

2. 65 percent if the asset has been held more than one year but not more than five years, and

3. 50 percent if the asset has been held more than five years.

For Bank and Corporation Tax Law all gains and losses from the sale or other disposition of an asset are taken into income in full.

NEW FEDERAL LAW (Sec. 1257)

The act provides that gain on the disposition of wetlands or highly erodible cropland (as defined in Section 1201 (4) and (6) of the Food Security Act of 1985 (16 U.S.C. 3801 (4) and (6)), converted to farming use, or used for farming purposes following conversion, is treated as ordinary income. Any loss on the disposition of such property is treated as long term capital loss.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective for dispositions of converted wetlands or highly erodible cropland first used for farming after March 1, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Joint Committee on Taxation (JCT) estimates a revenue gain for the nation of less than $5 million annually. Based on this projected low level of impact for the nation, conformity would result in minor revenue gains annually under the Personal Income Tax Law of less than $200,000.

Since on the corporate side these gains or losses are treated as ordinary income or loss, conformity is not directly applicable under the Bank and Corporation Tax Law.

Title IVA3: Agriculture, Timber, Energy, and Natural Resources

ACTION: EXTENDS ELIGIBILITY FOR A DEDUCTION FOR COSTS INCURRED AFTER LOSS OR DAMAGE DUE TO FREEZING, ETC.

Act Section 803 | Conference Report Page 112

Form 540 Line No. 22 | Form 100 Line No. G-26

CURRENT CALIFORNIA LAW (Sec. 17201, 17261, 24343 & 24422.5)

California has substantively conformed to federal law and regulations. Generally, the costs of putting an asset into production must be capitalized. However, certain farmers may elect to use the cash method of accounting when the accrual method would otherwise be required. These farmers may elect to deduct preproductive period expenses. "Preproductive period expenses" means any amount which is attributable to the preproductive period of any crops, animals or any other property having a crop or yield. For property having a useful life of more than one year and which will have more than one crop or yield, the preproductive period is the period before the disposition of the first marketable crop or yield. For any other property the preproductive period is the period before the property is disposed of.

Deduction of preproductive period expenses is not available to corporations, or partnerships with one or more corporate partners that are engaged in farming. These taxpayers must report preproductive period expenses on an accrual basis. Exceptions

are for certain family owned corporations and corporations whose gross receipts for each prior taxable year after 1976, for California purposes (1975 for federal purposes), does not exceed $1 million. There are special rules for citrus and almond groves.

California law and federal law are the same in allowing the taxpayer who owned the citrus or almond grove to deduct costs incurred after loss or damage due to freezing, etc. if the same taxpayer replants the same property. California law extends this provision to taxpayers who own other fruit or nut groves or vineyards.

NEW FEDERAL LAW (Sec. 263A)

The act provides that preproductive period costs incurred in the business of farming may be deducted currently, at the election of the taxpayer, if the following certain conditions are met; (1) the farmers must be ones who are not currently required to use an accrual method of accounting, (2) the farmers are not a corporation, partnership or tax shelter and (3) the plant or animal has a preproductive period of two years or less.

Replanting and maintenance costs of a grove, orchard or vineyard in the U.S. incurred for plants bearing a human-edible crop which were lost or damaged because of freezing, drought, pests or casualty are deductible as current expenses even though the replanting does not take place on the same property. This means costs incurred at a different location in the U.S. for replanting of the same type of crop are deductible as an expense. Additionally the deduction is allowed if, (1) a taxpayer who owned the property and has an equity interest of more than 50 percent and (2) the person claiming the deduction owns part of the remaining equity interest and materially participates in the replanting, cultivating, maintenance or development of the property.

Farming, for the purpose of the election to deduct preproductive period costs, includes the trade or business of producing livestock, operating a nursery or sod farm or the raising or harvesting of trees bearing fruit, nuts or other crops as well as agricultural crops. Farming, for this purpose does not include the raising, harvesting or growing of ornamental evergreen trees that are more than six years old when cut. Also, as a special rule for citrus and almond growers, the election to expense costs does not apply to the planting, cultivation, maintenance or development of any citrus or almond grove (or part thereof) and which is incurred before the close of the fourth taxable year beginning with the year the trees were planted. The portion of a citrus or almond grove planted in one taxable year shall be treated separately from the portion of the grove planted in another taxable year.

Amounts expensed which would have been capitalized are to be recaptured.

Once the election is made it may be revoked only with the consent of the Internal Revenue Services.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The effective date of the election provision, unless the Internal Revenue Service otherwise consents, is for the taxpayer's first taxable year which begins after December 31, 1986 and during which the taxpayer engages in a farming business.

The provision relating to replanting of a grove, orchard or vineyard are effective for costs incurred on or after October 22, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on a proration of national estimates prepared by the Joint Committee on Taxation (JCT), the relative fiscal impact under state conformity would be Personal Income Tax (PIT) revenue gains in the $7 million range for 1987-88 and $6 million range for 1988-89. The proration to California's 4.1 percent reflects the Policy Economic Group (PEG) estimates for California relative to the nation for those provisions analyzed. PEG has not specifically estimated this provision.

Based on a proration of the JCT's estimate for the nation, revenue gains under the Bank and Corporation Tax Law would be in the $3 million range for 1987-88 and $2 million range for 1988-89. A proration factor of 4 percent was used which represents the relationship between California's corporate tax collections and federal corporate tax collections over the past few years.

Revenue gains occur because, (1) the new uniform cost-capitalization rules require a broad range of previously expensed costs to be allocated and capitalized to production activities, and (2) those farmers not on the accrual method of accounting and not part of a farming syndicate can elect to deduct preproductive costs currently but must recapture these costs as ordinary income on disposition of the product at a gain, and additionally must use straight-line depreciation on all farm assets placed in service.

Title IVA4: Agricultural, Timber, Energy and Natural Resources

ACTION: <u>LIMITS DEDUCTIBILITY OF PREPAYMENTS OF FARMING EXPENSES</u>

Act Section 404 — Conference Report Page 114

Form 540 Line No. 22 — Form 100 Line No. G-26

<u>CURRENT CALIFORNIA LAW (Sec. 17551)</u>

California law has conformed by reference to federal law regarding the nondeductibility of prepaid farming expenses for farming syndicates. A farming syndicate is a partnership or other noncorporate farming business if interests have been offered for sale under the securities law or 35 percent or more of the losses are allocable to limited partners. Farming syndicates are not allowed to deduct any amount paid for feed, seed or other similar supplies prior to the year in which the supplies are used or consumed. Other farmers (not including timber growers) are generally permitted to use the cash method of accounting, so that feed, seed or other similar supplies are deductible in the year paid for, whether or not they are used or consumed in that year.

<u>NEW FEDERAL LAW (Sec. 464)</u>

The act provides that both farmers using the cash method of accounting and farm syndicates may not deduct amounts paid for unconsumed feed, seed, fertilizer or other supplies to the extent such prepayments exceed 50 percent of the total deductible farming expenses excluding prepaid supplies. Such expenses may be deducted only in the year in which they are actually used or consumed. This new rule is in addition to the rules of current law relating to expenses of farming syndicate.

Two exceptions to the 50-percent test are provided. If either of the exceptions is met, prepaid supplies will continue to be deductible, even though the prepaid expenses are greater than 50 percent of the non-prepaid expenses for that year. The first exception applies if a farm-related taxpayer satisfies the 50-percent test on the basis of the three preceding taxable years. For purposes of this exception, the total prepaid farm supplies for the three preceding taxable years must be less than 50 percent of the total deductible farming expenses other than prepaid farm supplies for the same three-year period. The second exception applies if a farm-related taxpayer fails to satisfy the 50-percent test due to a change in business operations directly attributable to extraordinary circumstances. The term "farm-related taxpayer" includes any person whose principal residence is on a farm or whose principal occupation is farming, or any individual who is a member of the family of such a person.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision of the act applies to amounts paid or incurred after March 1, 1986, in taxable years beginning after that date.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on a proration of national estimates prepared by the Joint Committee on Taxation (JCT), the relative fiscal impact from state conformity would be revenue gains in the $1.2 million range for 1987-88 and $400,000 range for 1988-89. This revenue effect would occur under the Personal Income Tax Law. The proration to California (4.1 percent) reflects the Policy Economic Group (PEG) California estimates relative to the nation for those provisions analyzed. The PEG has not specifically estimated this provision.

ACTION: ALLOWS CERTAIN FARMERS TO EXCLUDE INCOME ARISING FROM THE DISCHARGE OF INDEBTEDNESS INCURRED IN THE FARM BUSINESS

Act Section 405	Conference Report Page 115
Form 540 Line No. 22	Form 100 Line No. G-10

CURRENT CALIFORNIA LAW (Sec. 17131 and 24307)

Current California Law conforms generally to federal law regarding the treatment of discharge of indebtedness income. A solvent taxpayer receiving income from the discharge of qualified business indebtedness is permitted to exclude that income if the taxpayer elects to reduce the basis in depreciable property. If the amount of the discharge of indebtedness exceeds a solvent taxpayer's available basis, the taxpayer recognizes income in the amount of the excess.

An insolvent taxpayer (the amount of liabilities exceeds the value of assets) is allowed to exclude the income from discharge of indebtedness to the extent of the insolvency. The basis of property is reduced by the excluded income with certain limitations and if the excluded income cannot be fully absorbed by these adjustments, tax is forgiven on the excess amount.

NEW FEDERAL LAW (Sec. 108 & 1017)

This act provides that the income arising from the discharge of indebtedness owed by a qualifying solvent individual engaged in farming to an unrelated lender will be treated as though the farmer was insolvent, and thus the farmer is allowed to exclude from income the discharge of indebtedness. The debt must have been incurred in the trade or business of farming or be a farm business debt secured by farmland or farm equipment used in the trade or business of farming. Additionally, a taxpayer is eligible for this relief only if 50 percent or more of the taxpayer's average annual gross receipts for the preceding three taxable years was derived from farming. The amount of the discharge of indebtedness which is excluded from the gross income is required to be applied to reduce basis in the same manner as in the case of an insolvent taxpayer.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision of the act applies to discharge of indebtedness occurring after April 9, 1986 in taxable years ending after that date.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on a proration of national estimates prepared by the Joint Committee on Taxation (JCT), the relative fiscal impact under state conformity would be revenue losses in the $400,000 range for 1987-88 and $300,000 range for 1988-89. This revenue effect would be under the Personal Income Tax Law. The proration to California (4.1 percent) reflects the Policy Economics Group (PEG) estimates California relative to the nation for those provisions analyzed. The PEG has not specifically estimated this provision.

Title IVB3: Agriculture, Timber, Energy and Natural Resources

ACTION: INCREASES CAPITAL GAINS RATE FOR TIMBER AND ALLOWS REVOCATION OF ELECTION

Act Section 311 — **Conference Report Page 118**

Form 540 Line No. 17 — **Form 100 Line No. G-9**

CURRENT CALIFORNIA LAW (Sec. 17711)

California Personal Income Tax Law (PITL) has conformed to federal law in that income received on account of a retained economic interest in timber qualifies for capital gain treatment at the election of the taxpayer where the timber is held for six months before disposition using the state capital gain holding periods and rates of exclusion.

Owners of timber (or a contract right to cut timber) may elect to treat the cutting of timber as a sale or exchange qualifying for capital gains treatment. To qualify the timber (or contract right) must be held for six months prior to cutting. If the taxpayer makes this election, the election cannot be revoked unless the Franchise Tax Board permits the revocation based on a showing of undue hardship.

California Bank and Corporation Tax Law (B&CTL) does not conform to this provision of the federal law. California B&CTL applies no special rates to capital gains.

NEW FEDERAL LAW (Sec. 1201; Act Sec. 311)

The act repeals preferential treatment for long term capital gains. Thus, the advantage to making this election has, to that extent, been eliminated.

If an election was made in a taxable year beginning before January 1, 1987 to treat the cutting of timber as a sale or exchange qualifying for capital gains treatment, that election may now be revoked on a one time basis by the taxpayer without the permission of the Secretary of the Treasury. Any revocation of an election made in accordance with this provision will not be considered in determining whether a future election to treat the cutting of timber as a sale or exchange by the taxpayer is allowed. If a taxpayer revokes an election without consent in accordance with this provision, and thereafter makes an election to treat the cutting of timber as a sale or exchange, any future revocations will require the permission of the Secretary of the Treasury.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective for taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The department has estimated previously for the 1987-88 Tax Expenditure Report to be included in the Governor's Budget Summary 1987-88 that the revenue loss to the state from the special capital gain treatment of timber income is in the $5 million range annually. The repeal of capital gain timber treatment therefore, would result in revenue gains of $5 million annually under the Personal Income Tax Law.

Title IVC1a: Agriculture, Timber, Energy and Natural Resources

ACTION: <u>REDUCED INTANGIBLE DRILLING COSTS WHICH MAY BE EXPENSED</u>

Act Section 411 | Conference Report Page 120

Form 540 Line No. N/A | Form 100 Line No. G-26

<u>CURRENT CALIFORNIA LAW (Sec. 23401 and 24423)</u>

California Bank and Corporation Tax Law (B&CTL) does not conform to federal law regarding the reduction of the deduction for intangible drilling costs (IDCs) of oil, gas and geothermal wells. For federal purposes, integrated producers may expense 80 percent of the IDCs and must amortize the remaining 20 percent over 36 months. California B&CTL allows a taxpayer to fully expense the IDCs of oil, gas and geothermal wells.

California has not conformed to the treatment of IDCs as an item of tax preference for corporations. For federal purposes, IDCs are a corporate preference item to the extent of the amount of "excess IDCs" over the taxpayer's net income from oil, gas and geothermal properties for the tax year. "Excess IDCs" means the excess of the deduction for the IDCs over the allowable deduction had the costs been capitalized and amortized over 120 months, or, at the taxpayer's election, deducted as cost depletion.

<u>NEW FEDERAL LAW (Sec. 291)</u>

The act provides that if IDCs are expensed, integrated producers may only expense 70 percent of the costs and must amortize the remaining 30 percent over 60 months.

<u>EFFECTIVE DATE OF FEDERAL PROVISIONS</u>

The provision applies to costs paid or incurred after December 31, 1986.

<u>REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW</u>

Revenue gains under the Bank and Corporation Tax Law from conforming to the federal expensing provision are estimated to be in the $25 million range for 1987-88 and in the $27 million range for 1988-89. These gains are based on federal tax expenditure estimates on intangible drilling expensing prorated to California and adjusted to allow for California's current allowance of 100 percent expensing compared with the former federal allowance of 80 percent.

Title IVC2b: Agriculture, Timber, Energy and Natural Resources

ACTION: DENIES PERCENTAGE DEPLETION FOR LEASE BONUSES AND ADVANCE ROYALTIES IN CONNECTION WITH OIL, GAS OR GEOTHERMAL PROPERTY

Act Section 412 | Conference Report Page 122

Form 540 Line No. 21 | Form 100 Line No. 6-22

CURRENT CALIFORNIA LAW (Sec. 17686 and 24832)

California law conforms to federal law generally in allowing percentage depletion with respect to oil, gas and geothermal wells. In Commissioner v Engle, 464 U.S. 206 (1984), the U.S. Supreme Court held that taxpayers were entitled to percentage depletion for lease bonuses or advance royalty payments during the productive life of the lease. California also follows that rule.

NEW FEDERAL LAW (Sec. 613A)

The act denies percentage depletion for lease bonuses, advance royalties, or other payments made without regard to actual production from an oil, gas or geothermal property.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective for amounts received or accrued after August 16, 1986 in taxable years ending after that date.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The following conformity estimates are composite estimates based on a proration of national estimates prepared by the Joint Committee on Taxation (JCT), combining IVC2 Depletion Bonuses and Royalties and IVC3 Expansion Recapture of Previous Drilling costs.

The relative fiscal impact under state conformity would be revenue gains in the $2 million range for 1987-88 and 1988-89. This impact would occur under the Personal Income Tax Law. No meaningful impact is expected under the Bank and Corporation Tax Law. The proration to California's (4.1 percent) reflects California estimates relative to the nation for those provisions analyzed. The Policy Economic Group (PEG) has not specifically estimated this provision.

Title IVC3: Agriculture, Timber, Energy and Natural Resources

ACTION: EXPANDS RECAPTURE OF PREVIOUSLY EXPENSED INTANGIBLE DRILLING COSTS AND DEPLETION

Act Section 413 — Conference Report Page 122

Form 540 Line No. 18 — Form 100 Line No. 8-9

CURRENT CALIFORNIA LAW (Sec. 18151 and 18175)

California's Personal Income Tax Law has conformed to the federal law as to the recapture as ordinary income of intangible drilling costs (IDCs) expensed and the recognition of that gain even when other provisions would otherwise have made the gain nontaxable (such as the like-kind exchange rules). If oil, gas or geothermal property is disposed of after December 31, 1975 the IDCs previously taken are recaptured. The amount which becomes ordinary income, if there is a gain in the disposition, is the amount expensed in excess of the amount which would have been deducted if the IDC had been capitalized and recovered through depletion.

The Bank and Corporation Tax Law is not conformed to this recapture provision. For California all of the gain is included in net income of the corporation however, the provisions which allow gain to be unrecognized (such as corporate liquidations) would make this gain nontaxable in those situations.

Depletion which reduced the adjusted basis of the property is not an item subject to recapture upon disposition of the property.

NEW FEDERAL LAW (Sec. 1254)

This provision of the act requires recapture as ordinary income of depletion which reduced basis, as well as expensed IDCs. It also increases the amount of IDCs that are subject to recapture.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is applicable to any disposition of property which is placed in service by the taxpayer after December 31, 1986. However, an exception is made for any disposition of property placed in service after December 31, 1986, if the property was acquired pursuant to a binding written contract which was entered into before September 26, 1985.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Joint Committee on Taxation (JCT) has included this item in its impact estimate of IVC2 Depletion Bonuses Royalties. The relative fiscal impact under state conformity is indeterminable, since isolating this item provision is not possible.

Title IVD1: Agriculture, Timber, Energy and Natural Resources

ACTION: REDUCE THE DEDUCTION FOR EXPLORATION AND DEVELOPMENT COSTS

Act Section 411 Conference Report Page 124

Form 540 Line No. 21 Form 100 Line No. G-26

CURRENT CALIFORNIA LAW (Sec. 17690, 17689.5, 24836, and 24837.5)

California and federal law, are substantially the same, (although federal law was not incorporated in California law by reference) and allow exploration and development costs associated with mines and other hard mineral deposits to be deducted currently, or capitalized, at the election of the taxpayer. In general, exploration (but not development) costs which have been deducted currently either (1) are applied to reduce depletion deductions, or (2) at the taxpayers election, are recaptured in income once the mine begins production, and then recovered as a depletable expense. However, under federal law only 80 percent of hard mineral exploration and development costs may be currently expensed, by a corporation, and 20 percent must be amortized. California did not conform to this restriction and thereby, allows the deduction in full.

NEW FEDERAL LAW (Sec. 291)

The act increases, from 20 percent to 30 percent, the amount of otherwise deductible mining and development costs that corporations must capitalize. Moreover, these costs must now be amortized ratably over a 60 month (5 year) period instead of being written off under the schedule that was in prior law.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision applies to costs paid or incurred after December 31, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on a proration of the Joint Committee on Taxation (JCT) estimates for the nation, adjusted to reflect California's existing allowance of a 100 percent deduction, revenue gains under the Bank and Corporation Tax Law from this provision would be in the $4 million range for 1987-88 and $3 million for 1988-89. A proration factor of 4 percent was used which represents the general relationship between California's corporate tax collections and federal tax collections over the past few years.

The impact under the Personal Income Tax Law is expected to be minimal.

Title IVD2: Agriculture, Timber, Energy and Natural Resources

ACTION: <u>REDUCE CORPORATE PERCENTAGE DEPLETION DEDUCTION ON COAL AND IRON ORE</u>

Act Section 411 Conference Report Page 125

Form 540 Line No. N/A Form 100 Line No. 6-22

<u>CURRENT CALIFORNIA LAW (Sec. 24831 and 24833)</u>

California conforms to federal law to the extent that it allows a deduction for percentage depletion on coal and iron ore. However, California does not conform to the federal requirement that percentage depletion of coal or iron ore in excess of adjusted basis (determined without regard to the depletion deduction for that year) be reduced by 15 percent.

<u>NEW FEDERAL LAW (Sec. 291 and 611-613)</u>

The act requires that the percentage depletion deduction for coal or iron ore in excess of adjusted basis be reduced by 20 percent.

<u>EFFECTIVE DATE OF FEDERAL PROVISIONS</u>

Effective for taxable years beginning on or after January 1, 1987.

<u>REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW</u>

Based on a proration of the Joint Committee on Taxation (JCT) estimates for the nation, revenue gains under the Bank and Corporation Tax Law from this provision would be in the $2.6 million range for 1987-88 and in the $2.4 million range for 1988-89. A proration factor of 4 percent was used which represents the general relationship between California's corporate tax collections and federal tax collections over the past few years. In addition to the above proration factor of 4 percent, a multiplying factor of 4 was applied to the original Joint Committee on Taxation estimates. This was done to balance the differences in percentage depletion deductions between California law which does not reduce percentage depletion deductions by any percentage and federal law which increased its reductions from 15 percent to 20 percent.

Title IVD3: Agriculture, Timber, Energy and Natural Resources

ACTION: EXPANDS LAW RULES REGARDING THE RECAPTURE ON THE DISPOSITION OF MINING PROPERTY

Act Section 413 | Conference Report Page 126

Form 540 Line No. N/A | Form 100 Line No. 8-26

CURRENT CALIFORNIA LAW (Sec. 17689.5, 24836 and 24837.5)

California has conformed to federal law regarding the recapture of mining exploration expenses upon the disposition of the mining property. Adjusted exploration expenses (generally amounts expensed in excess of the amounts that would have been deducted if the costs had been capitalized) are recaptured as ordinary income upon disposition of a mining property and are recognized as income notwithstanding any nonrecognition provision.

NEW FEDERAL LAW (Sec. 1254)

The act provides that on a disposition the taxpayer must recapture the lesser of (1) amounts deducted as expenses rather than added to basis, plus depletion deductions that reduced basis or (2) the amount realized (for a sale, exchange, or involuntary conversion) or the fair market value (for any other disposition) minus the properties adjusted basis.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision of the act applies to dispositions of property first placed in service after December 31, 1986. However, it does not apply to property placed in service after December 31, 1986, if it was acquired pursuant to a binding written contract entered into before September 26, 1985.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

This estimate is included in the prorated revenue estimate for Title IVD1 Deduction for Exploration and Development Costs.

Title IVD4: Agriculture, Timber, Energy and Natural Resources

ACTION: <u>PERCENTAGE DEPLETION ALLOWED FOR COAL AND IRON ORE ROYALTIES</u>

Act Section 311 | Conference Report Page 126

Form 540 Line No. 21 | Form 100 Line No. 8-22

<u>CURRENT CALIFORNIA LAW (Sec. 17681, 24835)</u>

Current California law does not conform to federal law which allows capital gain treatment rather than percentage depletion with respect to the disposal of coal or iron ore with a retained economic interest.

California only allows depletion deductions with respect to coal and iron ore and has no provision which would allow capital gain treatment for either corporate or noncorporate taxpayers.

<u>NEW FEDERAL LAW (Sec. 631)</u>

The new federal law provides that coal and domestic iron ore royalties are eligible for percentage depletion for any taxable year in which long term capital gains are subject to tax at the same rate as ordinary income. (Income from coal and domestic iron ore royalties will be treated as ordinary income pursuant to the general repeal of capital gains for individuals and corporations.)

<u>EFFECTIVE DATE OF FEDERAL PROVISIONS</u>

This provision applies to taxable years beginning on or after January 1, 1987.

<u>REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW</u>

No state revenue impact would result from this federal change. Current state law treats all gains under the Bank and Corporation Tax Law as ordinary income, allowing percentage depletion to be applied against royalty income.

The next page of this report is page 500.

TITLE V

TAX SHELTERS; INTEREST EXPENSE

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Title VA: Tax Shelters; Interest Expense

ACTION: EXTENDS AT-RISK RULES TO REAL ESTATE ACTIVITIES

Act Section 503 | Conference Report Page 134

Form 540 Line No. 16 | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17551)

California is generally conformed to federal law which imposes an at-risk limitation on the deduction of losses from business and income-producing activities for individuals and certain types of corporations which California does not recognize.

The at-risk rule is designed to prevent a taxpayer from deducting losses in excess of the amount the taxpayer has "at-risk" in the activity. The amount at risk is generally limited to (1) the sum of the taxpayer's cash contributions to the activity, (2) the adjusted basis of other property contributed to the activity, and (3) amounts borrowed for use in the activity, if the taxpayer has personal liability for repayment or has pledged security for repayment. This amount is increased each year by the taxpayer's share of income and decreased by the share of losses and withdrawals from the activity.

The at-risk rules apply to all business activities except real estate holdings and equipment leasing by closely-held corporations.

NEW FEDERAL LAW (Sec. 465)

The present at-risk rules are extended to the activity of holding real property, with an exception for real estate losses to the effect that certain qualified nonrecourse financing is treated as an amount at risk, provided that, in the case of nonrecourse financing from related persons, the terms of the loan are commercially reasonable and on substantially the same terms as loans involving unrelated persons.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision applies to property placed in service on and after January 1, 1987 and for losses attributable to an interest in a partnership or S corporation or other pass-through entity acquired on or after January 1, 1987.

DIRECT STATE BUDGET EFFECTS FROM FEDERAL CHANGE

Since taxpayers' decisions regarding real estate investments will be governed by the change in federal law, revenue effects will occur whether or not California actually conforms. These effects are estimated below.

Based on a proration of national estimates prepared by the Joint Committee on Taxation (JCT), the relative fiscal impact for California would be revenue gains in the $2 million range for 1986-87, in the $8 million range for 1987-88 and in the $15 million range for 1988-89 under the Personal Income Tax Law. The proration to California (4.4%) reflects the Policy Economics Group (PEG) state estimate relative to the nation for the passive loss provision. PEG has not specifically estimated the at-risk provision.

Based on the JCT's corporate estimates for the nation, the revenue loss under the Bank and Corporation Tax Law would be in the $3 million range for 1986-87, in the $8 million range for 1987-88 and in the $13 million range for 1988-89. A proration factor of 4 percent was used which represents the general relationship between California's corporate tax collections and federal tax collections over the past few years. The corporate impact reflects an anticipated higher degree of corporate investments in real estate ventures following the decline in individual participation due to the extension of the at-risk limitation.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Since in some cases taxpayers will be denied deductions at the federal level but not at the state level unless California actually conforms, there will also be revenue gains directly attributable to the conformity issue. The magnitude of these revenue gains is indeterminable, but if it amounts to 20% of the direct budget effects, revenue gains under the PITL from conformity would be in the $400,000 range for 1986-87, in the $1.6 million range for 1987-88, and in the $3 million range for 1988-89.

Title VB: Tax Shelters; Interest Expense

ACTION: LIMITS DEDUCTION OF LOSSES AND ALLOWANCE OF CREDITS FROM PASSIVE ACTIVITIES

Act Section 501 | Conference Report Page 137

Form 540 Line No. 16 | Form 100 Line No. G-10

CURRENT CALIFORNIA LAW (None)

In general, under both state and federal law, individuals, estates, and trusts may use deductions or tax credits from passive investment activity to offset income from other sources. Some exceptions to this general rule apply. For example, net capital loss deductions against ordinary income are limited to $1,000 per year ($3,000 under federal law). With respect to a partnership, the amount of loss that may be allowed to a partner is generally limited to the amount of the adjusted basis of his/her interest in the partnership (the at risk rule).

NEW FEDERAL LAW (Sec. 469)

Deductions attributed to passive trade or business activities, to the extent they exceed income from all such passive activities, generally cannot be deducted against other, nonpassive income. Credits from passive activities generally are limited to the tax attributable to passive activities. Accordingly, losses and credits from a passive activity, including expenses such as interest associated with acquiring an interest in the passive activity, can be applied only against income from that passive activity or other passive activities and not against salary or other income for services or against portfolio income, such as interest, dividends, royalties, gains from the sale of investment property. Unapplied losses can be carried forward and applied against passive income in subsequent years. Unapplied losses from an activity are allowed in full when the taxpayer disposes of his entire interest in the activity. However, a taxpayer is not treated as having disposed of an interest in a passive activity if he transfers it to a related party. To the extent that any loss recognized upon disposition is a capital loss, it is limited to the amount of capital gains plus $3,000 (for individuals). The remainder of the capital loss is carried forward and allowed in subsequent years subject to the capital loss limitation rules.

A passive activity is any activity which involves the conduct of any trade or business, and in which the taxpayer does not materially participate. If a taxpayer does not materially participate in the activity, a determination that involves several factors dealing with regular, continuous, and substantial participation in the business operation, the activity is considered "passive" for that particular taxpayer. Since a limited partner generally is precluded from participating in the partnership's business affairs, this activity is considered intrinsically passive. Income received by an individual from the performance of personal services with respect to a passive activity is not treated as income from a passive activity.

A passive activity excludes a working interest in oil and gas property where the taxpayer's form of ownership does not limit liability.

Passive loss provisions apply to individuals, estates, trusts, and personal service corporations. It also applies, in modified form, to closely held corporations that are subject to the at-risk rules (generally where five or fewer individuals own more than 50% of the stock). Regarding personal service corporations, the passive loss rule does not apply to a corporation where the employee-owners together own less than 10%, by value, of the corporation's stock.

Portfolio income (interest, dividends, royalties, gains from disposition of investments) is not treated as income from a passive activity and, therefore, passive losses and credits cannot be applied against it. Interest deductions attributable to passive activities are subject to the passive loss rule but are not subject to the investment interest limitation.

Regarding rental real estate activities, a taxpayer (excluding trusts) is allowed to deduct passive losses against other nonpassive income up to $25,000 annually (and credits in a deduction equivalent sense) if the taxpayer actively participates (i.e. has 10% or more interest in the activity). The $25,000 allowance is phased out ratably as the taxpayer's AGI (excluding passive losses, IRA contributions, and taxable social security benefits) increases from $100,000 to $150,000. The amount of the $25,000 allowance and the AGI phase-out range are halved in cases where married taxpayers file separately. However, the $25,000 allowance is reduced to zero in cases where married taxpayers filing separately lived together during any part of the year. In the case of an estate of a decedent taxpayer, the estate is deemed to actively participate for an additional two years after the death of the taxpayer.

Rehabilitation and low income housing credits can be taken under the $25,000 allowance (in a deduction equivalent sense) against nonpassive income without regard to whether the taxpayer actively participates. The phase-out range would be increased to between $200,000 and $250,000 for the rehabilitation and low income housing credits. The low income housing credit exception applies only to property placed in service before 1990 unless the property is placed in service before 1991 and 10% or more of the total project costs are incurred before 1989.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is fully effective with investments occurring after October 22, 1986 (the date of enactment). A phase-in rule applies to investments made on or before October 22, 1986. The amount disallowed would be 35% for 1987, 60% for 1988, 80% for 1989, 90% for 1990, and 100% for 1991 and thereafter. In general, in order to qualify for the transition rule, the interest acquired must be in an activity which has commenced by October 22, 1986. However, phase-in treatment applies (1) if the taxpayer has entered into a binding contract effective on or before the date of conference action (August 16, 1986) to acquire the business assets, or (2) where construction of business property has begun on or before the conference action date. The applicable phase-in percentage applies to the passive loss remaining after any portion of such loss is applied under the $25,000 offset provision.

DIRECT STATE BUDGET IMPACT FROM FEDERAL CHANGE

Since taxpayer behavior in this area will be governed by the change in federal law, revenue effects at the state level will occur whether or not California actually conforms. The magnitude of the state budget impact will generally correspond to the estimates below.

Based on a proration of national estimates prepared by the Joint Committee on Taxation (JCT), the relative fiscal impact under the state Personal Income Tax Law would be revenue gains in the $50 million range for 1986-87, $180 million range for 1987-88 and $300 million range for 1988-89. The proration to California (4.4%) reflects the Policy Economic Group (PEG) state estimate on this provision relative to the nation. The PEG estimate cannot be used directly since it reflects fully phased-in effects.

Based on the JCT's estimates for the nation, the revenue loss under the state Bank & Corporation Tax Law would be in the $17 million range for 1986-87, $60 million range for 1987-88 and in the $105 million range for 1988-89. A proration factor of 4 percent was used which represents the general relationship between California's corporate tax collections and federal corporate tax collections over the past few years. The corporate impact reflects an anticipated higher degree of corporate participation in "passive" business ventures as a result of the decline in individual tax-sheltering due to passive loss limitations.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Since in some cases taxpayers will not respond to the new federal rules appropriately to avoid losing federal deductions, deductions denied at the federal level will continue under state law unless California actually conforms. To this extent, therefore, a conformity estimate that reflects additional revenues under the PITL is appropriate. The size of this impact due to conformity is speculative but would most likely represent a small percentage of the direct state budget estimates given above. If 10 percent is the assumed impact, revenue gains under the PITL from conformity would be in the $20 million range for 1987-88, and in the $30 million range for 1988-89.

ACTION: LIMITS THE NONBUSINESS INTEREST DEDUCTION FOR INDIVIDUALS

Act Section 511 | Conference Report Page 151

Form 540 Line No. 47 | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17201)

California law is generally conformed to federal law in allowing the deduction of all interest expenses. Under both state and federal law, investment interest is deductible only to the extent of the sum of $10,000 ($5,000 for married persons filing separately), plus the amount net investment income. Amounts disallowed under this limitation are carried forward and treated as investment interest in succeeding tax years.

NEW FEDERAL LAW (Sec. 163)

Taxpayers other than corporations are limited in the amount they can deduct for interest on debt incurred for property held for investment. The deduction is limited to the amount of net investment income which is defined as the excess of net investment income over investment expenses. Investment interest subject to the limitation includes all interest (except consumer interest and qualified residence interest) on debt not incurred in a person's active trade or business.

Personal interest is no longer deductible. Personal interest is defined as interest on any debt, other than (1) interest on debt incurred or carried in connection with the taxpayer's trade or business or investment activity, (2) qualified residence interest, (3) interest taken into account in computing the taxpayer's income or loss from passive activities for the year, or (4) interest payable on certain estate tax deficiencies.

Qualified residence interest is deductible and is defined as interest on debt secured by the taxpayer's principal or second residence, provided the debt does not exceed the lesser of 1) the fair market value of such residences, or 2) the sum of the taxpayer's basis, the cost of any improvements, and the amount of any debts secured by the property, incurred after August 16, 1986 to pay for medical or educational expenses.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provisions are generally effective for taxable years beginning on or after January 1, 1987, but are phased in over a five-year period. During the phase-in period, the amount of interest disallowed under the provision is limited to 35 percent in taxable years beginning in 1987, 60 percent in taxable years beginning in 1988, 80 percent in taxable years beginning in 1989, 90 percent in taxable years beginning in 1990 and 100 percent in taxable years beginning in 1991 and thereafter.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The relative fiscal impact under state conformity is revenue gains in the $185 million range for 1987-88 and in the $257 million range for 1988-89. These revenue gains would occur under the Personal Income Tax Law. The basis for the state estimates is the national estimates prepared by the Joint Committee on Taxation prorated to California by a 4.1 percent factor. This factor reflects the PEG conformity estimate for California on this provision relative to their rational estimate for the same provision. The PEG estimate itself cannot be directly used since it reflects fully phased-in effects.

The next page of this report is page 600.

TITLE VI

CORPORATE TAXATION

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Title VI: Corporate Taxation

ACTION: <u>REDUCE CORPORATE TAX RATES</u>

Act Section 601 Conference Report Page 158

Form 540 Line No. N/A Form 100 Line No. 47

<u>CURRENT CALIFORNIA LAW (Sec. 23151, 23186, 23181, 23400, and 23401)</u>

Every corporation subject to the California Franchise Tax, including banks and financial corporations, pays annually the greater of a minimum tax of $200 or a tax measured by its income.

- o General corporations--

  For income years ending in 1983 and later, the tax rate is 9.6 percent.

- o Bank and financial corporations--

  Tax rates were established for the 1980 through 1984 income years by SB 882 (Ch. 324 Stats. 1986) as follows:

  1) 1980 and 1981 is 11.6%

  2) 1982 and 1983 is 10.907%

  3) 1984 is 10.930%

  For income years ending in 1985 and thereafter, the rate is determined by the Franchise Tax Board by formula based on the amount of personal property taxes and business license taxes paid by nonfinancial corporations compared to their incomes. The rate may not exceed 12%.

<u>NEW FEDERAL LAW (Sec. 11)</u>

Under the act, corporation income is subject to tax under a graduated bracket rate structure that has been reduced from five brackets to three, as follows:

Taxable Income	New Federal Rate	Old Federal Rates
$50,000 or less	15%	15-18%
Over $50,000 but not over $75,000	25%	30%
Over $75,000	34%	40-46%

An additional 5 percent tax is imposed on income between $100,000 and $335,000 (not to exceed $11,750).

EFFECTIVE DATE OF FEDERAL PROVISIONS

The new rate structure is effective for taxable years beginning on or after July 1, 1987. Taxable years that include July 1, 1987, are subject to blended rates under the rules of existing law.

TAX POLICY ISSUES

Any reductions in the corporate tax rates should take into consideration that California's corporate tax rates were developed:

- o within a tax structure that is fundamentally different than the structure at the federal level, and
- o within the California Constitutional mandate that the State have a year-end balanced budget.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The development of revenue estimates depends on the extent to which existing appropriate tax rates are modified by legislative action. Therefore, no revenue estimates can be provided at this time.

Title VIC: Corporate Taxation

ACTION: <u>REDUCE THE DIVIDEND RECEIVED DEDUCTION</u>

Act Section 611 — Conference Report Page 161

Form 540 Line No. N/A — Form 100 Line Nos. B-37, B-38

<u>CURRENT CALIFORNIA LAW (Sec. 24402, 24410 & 24411)</u>

California does not conform to federal law because of fundamental differences in the two systems in determining what income is subject to tax.

The California law excludes from taxable income dividends which are paid out of income and which have been subject to either franchise tax, corporation income tax or gross premium tax imposed on insurance companies by part 7 (commencing with Section 12001) of the Revenue Taxation Code in the hands of the paying corporation.

As to every corporation which has income from sources within and without California, the Franchise Tax Board makes a computation each year, after the return is filed, to determine the percentage of the dividends paid during the year which is deductible by recipient corporations. In making this computation, a formula is used, allocating within and without the State certain items, such as Federal income tax, which affect earnings and profits but which do not affect the income taxable for California tax purposes. The office of the Franchise Tax Board supplies a copy of this formula, and gives information regarding the latest known percentage of dividends deductible in individual cases, upon request.

This differs from federal law which generally allows a deduction of 85 percent of dividends received from taxable domestic corporations.

For federal and state law, the intent of these provisions is to avoid double taxation of corporation income at the corporate level.

<u>NEW FEDERAL LAW (Sec. 243-246A)</u>

The act reduces the 85 percent dividend received deduction to 80 percent.

<u>EFFECTIVE DATE OF FEDERAL PROVISIONS</u>

The provision is effective for dividends received or accrued on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

In using a unitary apportionment method of determining its corporate tax base, which has recently been modified by SB 85 (Chapter 660, Stats. 1986), California has a fundamentally different corporate tax structure with its own unique treatment of both foreign and domestic source dividends. The federal dividend provision, therefore, is not directly applicable to California and conformity to this item cannot be achieved without significant changes in the fundamental structure of the Bank and Corporation Tax Law. Accordingly, no revenue estimate has been developed for this item.

ACTION: REPEAL THE DIVIDEND EXCLUSION FOR INDIVIDUALS

Act Section 612 | Conference Report Page 162

Form 540 Line No. 14 | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17144)

California law specifically denies application of the federal provision which grants the $100 exclusion to individual shareholders receiving dividends.

NEW FEDERAL LAW (Sec. 116)

The act repeals the dividend exclusion of $100 for individuals.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision is effective for taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No revenue impact. New federal law conforms to existing California treatment.

Title VIE: Corporate Taxation

ACTION: AMEND THE PROVISION OF THE LAW RELATING TO EXTRAORDINARY DIVIDENDS

Act Section 614 | Conference Report Page 163

Form 540 Line No. N/A | Form 100 Line No. G-4

CURRENT CALIFORNIA LAW (Sec. 24966)

Under current California law, dividends received by a corporation are deducted from gross income to the extent that they are paid out of income subject to the Bank and Corporation Tax Law or gross premiums tax on insurance companies.

An extraordinary dividend is one whose amount equals or exceeds 10 percent of taxpayer's adjusted basis in the stock (5 percent in the case of preferred stock).

When stock is sold or or otherwise disposed of before it has been held for more than a year, the basis of the stock that has paid an extraordinary dividend must be reduced by the nontaxable portion of the dividend. Also, any nontaxable portion of the dividend that is in excess of the stock basis is treated as a gain from the sale or exchange of stock.

In general, a distribution in redemption of stock which does not result in a meaningful reduction in the shareholder's proportionate interest in the distributing corporation is considered to be essentially equivalent to a dividend and is treated as a dividend for tax purposes. However, apart from certain cases in which a shareholder's interest is completely terminated or is reduced by more than 20 percent, present law is unclear regarding what constitutes a meaningful reduction in interest. In addition, distributions in partial liquidation of the distributing corporation are not considered dividends if the recipient is a noncorporate shareholder.

NEW FEDERAL LAW (Sec. 1059)

The act requires the basis of stock held by a corporation must be reduced (but not below zero) by the untaxed portion of extraordinary dividends received by the corporation if the stock has not been held for more than two years before the date the dividend is declared agreed to, or announced - whichever date is earliest. A distribution that would otherwise constitute an extraordinary dividend under the two-year rule described above will not be considered extraordinary if the distributee has held the stock for the entire period the distributing corporation (and any predecessor corporation) has been in existence. The basis reduction is required only to figure gain or loss on disposition.

If the aggregate nontaxable portions of extraordinary dividends exceed the shareholders basis, the excess is treated as gain from a sale or exchange at the time of disposition.

For purposes of determining whether a dividend is extraordinary, there is now an alternative provision which permits a taxpayer to measure the dividend by reference to the fair market value of the stock rather than its basis on the date before the ex-dividend date.

The act also provides for a different treatment of dividends on certain qualifying preferred stock. Qualified dividends paid on preferred stock will not trigger basis reduction and the other rules for extraordinary dividends unless the corporate taxpayer's actual rate of return on the stock exceeds 15 percent. However, if the actual rate of return is less than 15 percent and the taxpayer sells the stock before holding it for more than five years, a portion of the dividend is treated as an extraordinary dividend, but that portion is limited by the extent to which the actual rate of return exceeds the stated rate of return.

A preferred dividend qualifies for this exception if (1) the underlying stock provides for fixed preferred dividends payable at least annually, and (2) the dividends are not in arrears when the taxpayer acquires the stock.

"Actual rate of return" is defined as the rate of return for the period the taxpayer holds the stock, computed by taking into account total dividends received during that period and using the lower of (1) the taxpayer's adjusted basis in the stock or (2) the stock's liquidation preference (excluding any dividend arrearages). The "stated rate of return" is the annual rate of dividend payable expressed as a percentage of the lesser of adjusted basis or liquidation preference.

In addition, the term "extraordinary dividend" is expanded to include any distribution, without regard to the holding period for the stock or the relative size of the distribution, to a corporate shareholder in partial liquidation of the distributing corporation and any redemption of stock that is non-pro rata.

Except as provided in regulations, the act does not apply to distributions between members of an affiliated group filing consolidated returns and to distributions that constitute qualifying dividends within the meaning of 243(b)(1).

EFFECTIVE DATE OF FEDERAL PROVISIONS

The act is generally effective for dividends declared after July 18, 1986. Distributions constituting extraordinary dividends by virtue of being a distribution in partial liquidation or a non-pro rata distribution are subject to the provision only if announced or declared after October 22, 1986.

For purposes of the pre-existing rules for aggregation of dividends, dividends declared after July 18, 1986, are not aggregated with dividends declared on or before that date.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

This provision interacts with the dividends received deduction which has been excluded as a conformity issue due to California's fundamentally different corporate tax structure. Accordingly, no revenue estimate has been developed for this provision.

Title VIG: Corporation Taxation

ACTION: DENY A DEDUCTION FOR PAYMENTS RELATING TO REDEMPTION OF STOCK

Act Section 613 Conference Report Page 168

Form 540 Line No. N/A Form 100 Line No. 6-26

CURRENT CALIFORNIA LAW (Sec. 17270 & 24343)

California has conformed to federal law when an expense may be deductible from gross income if it is "ordinary and necessary" and incurred during the taxable year in carrying on a trade or business. However, the cost of acquiring any asset whose life extends substantially beyond the close of the taxable year is considered to be a capital expenditure and is not currently deductible.

The purchase of stock, including the repurchase by an issuing corporation of its own stock, is generally treated as a capital transaction, that does not give rise to a current deduction. The Supreme Court has held that the capitalization requirement extends to expenses such as legal, brokerage, and accounting fees incident to an acquisition of stock.

Some authority exists for the proposition that in certain extraordinary circumstances, amounts paid by a corporation to repurchase its stock may be fully deductible in the year paid. The validity of this authority (Five Star Manufacturing Co. v. Commissioner, 355 F.2nd 724), however, has been questioned.

NEW FEDERAL LAW (Sec. 162)

The act denies a deduction for any amount paid or incurred by a corporation in connection with the redemption of its stock.

The provision will not apply to (1) interest deductions allowable under section 163, (2) amounts constituting dividends within the meaning of 561, and (3) deductible expenses incurred by a regulated investment company which issues only stock which is redeemable upon the demand of its shareholders.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision is effective for amounts paid or incurred on or after March 1, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on a proration of the Joint Committee on Taxation's estimates for the nation, revenue gains under the Bank and

Corporation Tax Law would be in the $150,000 range annually. A proration factor of 4% was used which represents the general relationship between California's corporate tax collections and federal tax collections over the past few years.

Title VIH: Corporate Taxation

ACTION: REVISE THE THE RULES FOR CARRYOVERS OF NET OPERATING LOSSES AND TAX CREDITS

Act Section 621 Conference Report Page 170

Form 540 Line No. N/A Form 100 Line No. 6-26

BACKGROUND

Before the 1954 Internal Revenue Code enacted Sections 381-383, case law determined in general that net operating loss deductions were only allowed to the corporations sustaining the loss with certain exceptions. The 1954 Internal Revenue Code provided statutory rules to permit or require carryovers of various items to the successor corporation which results in the successor corporation stepping into the "tax shoes" of its predecessor.

The 1954 Internal Revenue Code generally allows net operating losses of a predecessor corporation to be used as a carryover against taxable income of the successor corporation where the assets of the predecessor were acquired in a tax-free acquisition or in an acquisition in which gain is only partially recognized. Statutory rules are provided which limit the tax advantages obtainable through the acquisition of such "loss" corporations as follows:

1. Where the change in ownership of the "loss" corporation is due to the purchase of its stock or to a decrease in its outstanding stock, and there has been a change in its trade or business, the net operating loss carryover may be disallowed in full.

2. Where the change in ownership is due to a reorganization, the carryover may be disallowed in part.

Due to the Libson Shops Inc. v. Koehler decision in 1957 by the U.S. Supreme Court along with other court cases, confusion was added in the loss carryover area. The Libson Shops case was decided under the 1939 code, however, it presented problems under the 1954 code since the case has been cited as authority for the proposition that carryover privileges are not available unless there is a continuity of business enterprise (Libson Shops, Inc. v. Koehler, 353 U.S. 382).

The Tax Reform Act of 1976 was later drafted by the Senate Finance Committee, specifically stating that the Libson Shops case would no longer apply and substituting rules based on changes in stock ownership. The 1976 act amendments were to be effective in 1978, however since the act was a matter of continuing controversy and perplexity, the operative date of the 1976 Act amendments were continuously delayed and therefore those amendments have never been allowed to become operative.

Effective for taxable years beginning in 1984 and later years, California incorporated by reference the federal provisions allowing net operating loss carryovers (with certain very strict limitations) and also adopted the federal rules which eliminate or reduce the availability of deductions for net operating losses on the successor's return when the loss was incurred by a predecessor corporation. California specifically did not adopt the 1976 Tax Reform Act amendments since they were not operative for federal purposes.

<u>CURRENT CALIFORNIA LAW (Sec. 24416, 24417, 24431,24591 thru 24593)</u>

California has partially conformed to federal law which eliminates or reduces net operating loss carryovers in certain circumstances.

Special limitations may be imposed on the net operating losses after specific transactions involving a change in ownership of the corporation's outstanding stock, a taxable sale or exchange of stock in a loss corporation or certain tax-free reorganizations.

In the case of a purchase (or other taxable acquisitions) of a controlling stock interest in a loss corporation, net operating loss carryovers are disallowed if the loss corporation does not continue to conduct its historic trade or business.

In the case of a tax-free reorganization, the net operating loss carryovers are usually not allowed if the loss corporation's shareholders do not receive stock representing 20 percent or more of the value of the acquiring corporation.

Corporations that acquire property of another corporation primarily to evade or avoid taxes are disallowed all net operating losses under section 24431 of the Bank and Corporation law.

In addition to these limitations, California specifically limits the successor corporation's deduction for a predecessor corporation's net operating loss in the following manner:

In the case of an insolvency reorganization, where the assets of the corporation are transferred to another corporation pursuant to a court approved insolvency or bankruptcy reorganization plan, the net operating loss carryover deductions are generally available without limitations to the creditors who receive stock for securities. However, if unsecured creditors (e.g. trade creditors) exchange their debt claims for stock in a loss corporation, such exchange by the creditors are treated as a taxable purchase. When there is a taxable purchase, net operating losses and unused credit carryovers are generally limited.

The availability of a carryover for a net operating loss in California is limited to the following qualified taxpayers:

1. Taxpayer's engaged in a new small business,

2. Taxpayer's engaged in qualified business within a program area,

3. Taxpayer's engaged in a trade or business within an enterprise zone, or

4. Taxpayer's engaged in the business of farming in this state.

In the case of the qualified taxpayer engaged in a new small business or in the business of farming in California, the deduction for a net operating loss carryover is allowed only to the corporation incurring the net operating loss.

In the case of a qualified taxpayer within a economic development program area and a designated enterprise zone, the deduction for a net operating loss carryover is allowed only with respect to income attributed to the business activities of the taxpayer within the program area or enterprise zone.

<u>NEW FEDERAL LAW (Sec. 381 thru 383)</u>

The act retroactively repeals the 1976 Tax Reform Act amendments and instead provides that after an ownership change, the taxable income of a loss corporation for any taxable year ending after the change date available for offset by pre-acquisition NOL carryforwards is annually limited to the long-term tax-exempt federal bond rate times the value of the loss corporation's stock on the date of the ownership change.

In addition, NOL carryforwards are disallowed entirely unless the loss corporation satisfies continuity-of-business enterprise requirements for the two-year period following any ownership change. The act also expands the scope of the special limitations to include built-in losses and allows loss corporations to take into account built-in gains. Numerous technical changes and several anti-avoidance rules are also included along with similar rules applicable to carryforwards other than net operating losses, such as, net capital losses and excess foreign tax credits.

<u>Ownership changes</u>

In general, the act provides that there is an ownership change if immediately after any owner shift involving a 5-percent shareholder or any equity structure shift the percentage of the new loss corporation owned by any one or more 5 percent shareholders has increased by more than 50 percentage points relative to the lowest percentage of stock of the old loss corporation owned by those 5 percent shareholders at any time during the testing period (generally a three-year period).

The act also provides that changes in the holding of certain preferred stock are disregarded in determining whether an ownership change occurred.

Owner Shift Involving 5 Percent Shareholders

The act defines an owner shift involving 5 percent shareholder as any change in the respective ownership of stock of a corporation that affects the percentage of stock held by any person who holds five percent or more of the stock of the corporation (a "5 percent shareholder") before or after the change. For purposes of this rule, all less then 5 percent shareholders are aggregated and treated as one 5 percent shareholder.

Example 1:

On January 1, 1987, the stock of L corporation is publicly traded and no shareholder holds five percent or more in L stock. On September 1, 1987 unrelated individuals A, B and C each acquire one third of L stock. A, B, and C each have become 5 percent shareholders of L and in the aggregate, hold 100 percent of L stock. Accordingly, an ownership change has occurred, because the percentage of L stock owned by the three 5 percent shareholders after the owner shift (100 percent) has increased by more than 50 percentage points over the lowest percentage of L stock owned by A, B, and C and any time during the testing period (0 percent prior to September 1, 1987).

Equity Structure Shift

The act defines an equity structure shift as any tax-free reorganization within the meaning of section 368, other than a divisive reorganization or an "F" reorganization. In addition, to the extent provided in regulations, the term equity structure shift will include other transactions, such as public offerings not involving a 5 percent shareholder or taxable reorganization-type transactions (e.g., mergers or other reorganization-type transactions that do not qualify for tax-free treatment due to the nature of the consideration or the failure to satisfy any of the requirements for a tax-free transaction).

For purposes of determining whether an ownership change has occurred following an equity structure shift, the less than 5 percent shareholders of each corporation is segregated and treated as a single, separate 5-percent shareholder.

Example 2:

On January 1, 1988, L corporation (a loss corporation) is merged into P corporation (not a loss corporation), with P surviving.

Both L and P are publicly traded corporations with no shareholder owning five percent or more of either corporation or the surviving corporation. In the merger, L shareholders received 30 percent of the stock of P. There has been an ownership change of L, because the percentage of P stock owned by the former P shareholders (all of whom are less than 5 percent shareholders and are treated as a separate, single 5 percent shareholder) after the equity structure shift (70%) has increased by more than 50 percentage points over the lowest percentage of L stock owned by such shareholder at any time during the testing period (0 percent prior to the merger).

Multiple Transactions

The act provides that changes in ownership that occur by reason of series of transaction including both owner shifts involving a 5 percent shareholder and equity structure shift may constitute an ownership change. In addition, in determining whether an ownership change has occurred as a result of a transaction or transactions following an equity structure shift or an ownership change, unless a different proportion is established, the acquisition of stock after such a shift is treated as being made proportionately from all shareholders immediately before the acquisition.

Example 3:

The stock of L corporation and G corporation is widely held by the public; neither corporation has any shareholder owning as much as five percent of its stock. On January 1, 1988, B, an individual, purchases 10 percent of L stock on the stock exchange. On July 1, 1988, L and G merge (in a tax-free transaction), with L surviving, and G shareholders receiving 49 percent of L stock.

The merger of L and G is an ownership change because, immediately after the merger, the percentage of stock owned by G shareholders (49 percent) and B (5.1 percent = .51 x .10) has increased by more than 50 percentage points over the lowest percent of L stock owned by such shareholders at any time during the testing period (0 percent prior to the stock purchase of B).

Attribution and Aggregation of Stock Ownership

The act provides in determining an ownership change, the constructive ownership rules with several exceptions, are applied. The rules attributing ownership from corporations to their shareholders' are applied without regard to the extent of the shareholders ownership in the corporation. Thus, any stock owned by a corporation is treated as being owned proportionately by its shareholders. Moreover, except as provided in regulations, any such stock attributed to a corporation's shareholders is not treated as being held by such corporation. Stock attributed from a partnership, estate or trust similarly is not treated as being held by such entity.

In addition, the family attribution rules of section 318(a) and 318(a)(5)(B) do not apply, but an individual, his spouse, his parents, his children, and his grandparents are treated as a single shareholder.

Except to the extent provided in regulations, an option holder is treated as owning the underlying stock if such a presumption would result in an ownership change. (The subsequent exercise of such an option is, of course, disregarded if the owner of the option has been treated as owning the underlying stock).

Exceptions are also provided for (1) stock acquired by gift, separation, divorce, and death, (2) certain acquisitions of employer securities, (3) formations of a holding company unaccompanied by a change in the beneficial ownership of the loss corporation, and (4) certain changes in percentages which are attributable to fluctuations in value.

Three Year Test Period

The act provides that the relevant testing period is the 3-year period ending on the day of any owner shift involving a 5 percent shareholder or any equity structure shift.

The testing period for determining whether a second ownership change has occurred does not begin before the day following the first ownership change. In addition, the testing period does not begin before the first day of the first taxable year from which there is a loss carryforward excess credit. However, except as provided in regulations, this rule does not apply to any loss corporation with a net unrealized built in loss.

Value of Loss Corporation

The act provides that the value of the loss corporation is the fair market value of the corporation's stock (including preferred stock described in section 1504(a)(4)) immediately before the ownership change. For redemptions which occur in connection with an ownership change either before or after the change, the value of the loss corporation is determined after taking the redemption into account.

Long-Term Tax-Exempt Rate

The act defines the long-term tax-exempt rate as the highest of the Federal long-term rates determined under section 1274(d), as adjusted to reflect differences between rates on long-term taxable and tax-exempt obligations, in effect for the month in which the change date occurs or the two prior months.

Continuity of Business Enterprise Requirement

The act provides that the continuity of business enterprise requirement will be the same requirement that must be satisfied to qualify a transaction as a tax-free reorganization under section 368. Under this requirement, a loss corporation (or a successor corporation) must either continue the old loss corporation's business or use a significant portion of the old loss corporation's assets in the business.

Certain Capital Contribution Not Taken Into Account

The act provides that any capital contribution that is made to a loss corporation as part of a plan a principle purpose of which is to avoid any of the special NOL limitations will not be taken into account. For purposes of this rule, except as provided in regulations, a capital contribution made during the two-year period ending on the charge date is irrebuttably presumed to be part of a plan to avoid the limitation.

Reduction in Value for Corporations Having Substantial Nonbusiness Assets

The act provides that if at least one-third of the fair market value of a corporation's assets consists of nonbusiness assets, the value of the loss corporation, for purposes of determining the section 382 limitation, is reduced by the excess of the value of the nonbusiness assets over the portion of the corporation's indebtedness attributable to such assets.

The term "nonbusiness assets" includes any asset held for investment, including cash and marketable stock or securities. Assets held as an integral part of the conduct of a trade or business (e.g., assets funding reserves of an insurance company or similar assets of a bank) would not be considered nonbusiness assets. In addition, stock or securities in a corporation that is at least 50 percent owned (voting power and value) by a loss corporation are not treated as nonbusiness assets. The portion of a corporation's indebtedness attributable to nonbusiness assets is determined on the basis of the ratio of the value of nonbusiness assets to the value of all the loss corporation's assets.

The act also provides that regulated investment companies, real estate investment trusts or a real estate mortgage pool are not treated as having substantial nonbusiness assets.

Special Rules for Built-in Gains and Losses

In general, the act provides that if a loss corporation has a net unrealized built-in gain, the net operating loss limitation for any taxable year ending within the five-year recognition period is increased by the recognized built-in gain for the taxable year.

However, the increased limitation for any recognition period taxable year is not to exceed the net unrealized built-in gain reduced by the recognized built-in gains for prior years in the recognition period.

In the case where the loss corporation has a net unrealized built-in loss, the recognized built-in loss for any tax year ending within the five-year period ending at the end of the fifth post change year is subject to limitations in the same manner as if the loss was a pre-change loss (e.g., where taxable income is treated as having been first offset by the pre-change loss).

However, the recognized built-in loss for a taxable year cannot exceed the net unrealized built-in loss reduced by recognized built-in losses for prior taxable years ending in the recognition period.

<u>Bankruptcy Proceedings</u>

The act provides that in general, the special limitations do not apply after any ownership change of a loss corporation if (1) such corporation was under jurisdiction of a bankruptcy court in a Title 11 or similar case immediately before the ownership change, and (2) the corporation's shareholders and creditors (determined immediately before the ownership change) own 50 percent of the value and voting power of the loss corporation's stock immediately after the ownership change. For purposes of this rule, stock of a creditor that was converted from indebtedness is taken into account only if the indebtedness was held by the creditor for at least 18 months before the date the bankruptcy case was filed or arose in the ordinary course of the loss corporations trade or business and is held by the person who has at all times held the beneficial interest in the claim.

If the exception for bankruptcy proceedings apply, the following special rules apply:

(1) The pre-change losses and excess credits that may be carried to any taxable year ending after the change date are reduced by one-half of the amount of any cancellation of indebtedness income that would have been included in the loss corporation's income as a result of any stock-for-debt exchanges,

(2) The loss corporation's pre-change NOL carryforwards are reduced by the interest on the indebtedness that was converted to stock in the bankruptcy proceeding and paid or accrued during the period beginning on the first day of the third taxable year preceding the taxable year in which ownership change occurs and ending on the change date, and

(3) After an ownership change that qualifies for the bankruptcy exception, a second ownership change during the following two-year period will result in the elimination of NOL carryforwards that arose before the first ownership change.

Thrift Institutions

The act provides a special rule for certain financial institutions in the case of any ownership change involving a bankruptcy reorganization. The bankruptcy exception is applied in a modified version to qualified thrift reorganizations by requiring shareholders and creditors (including depositors) to retain 20 percent (rather than 50 percent) interest.

The general bankruptcy rules that eliminate from the NOL carryforwards both interest deductions on debt that are converted and income that would be recognized under the principles of section 108(e)(10) (an exchange of stock for indebtedness) are not applicable to thrifts. As under present law, the deposits of the troubled thrift that become deposits in the acquiring corporation are treated as stock. This rule also applies to ownership changes resulting from an issuance of stock or equity structure shift that is an integral part of a transaction involving such a reorganization, provided that transaction would not have resulted in limitations under present law.

Carryforwards Other Than NOLs

The act amends section 383, relating to special limitations on unused business credits and research credits, excess foreign tax credits, and capital loss carry forwards.

The act also expands the scope of section 383 to include passive actively losses and credits and minimum tax credits.

Anti-Abuse Rules

The act does not alter the continuing application of section 269, relating to acquisitions made to evade or avoid taxes as under present law. The act intents that the Libson Shops doctrine will have no application to transactions subject to the provisions of the act.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The act generally applies to ownership changes that occur on or after January 1, 1987.

In the case of equity structure shifts, the new rules apply to reorganizations pursuant to plans adopted on or after January 1, 1987.

The earliest testing period begins on May 6, 1986. If an ownership change occurs after May 5, 1986, but before January 1, 1987, and section 382 and 383 (as amended by the act) do not apply, then the earliest testing date will not begin before the first day immediately after such ownership change.

In the case of a reorganization that occurs as part of a Title 11 or other court-supervised proceeding, the amendments do not apply to any ownership change resulting from such a reorganization or proceeding if a petition in such case was filed with the court before August 14, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Joint Committee on Taxation (JCT) has estimated very modest net revenue gains to the nation from these corporate NOL-related provisions (less than $50 million annually). Since under California law NOL carryover deductions are allowed in only very limited cases, any revenue gains under the Bank and Corporation Tax Law from conformity would be minimal.

Title VIJ: Corporate Taxation

ACTION: AMEND THE RULES RELATING TO LIQUIDATING SALES AND DISTRIBUTIONS

Act Section 631, 632, & 633 — Conference Report Page 198

Form 540 Line No. N/A — Form 100 Line No. N/A

BACKGROUND

Based on a Supreme Court decision (General Utilities and Operating Co. V. Helvering, 296 U.S. 200 1935), the General Utilities rule was created to permit nonrecognition of gain by corporations on certain distributions of appreciated property to their shareholders and on certain liquidating sales of property.

Through the years the term "General Utilities Rule" has been used in a broader sense to refer to the nonrecognition treatment accorded in certain situations to liquidations as well as nonliquidation distributions to shareholders and to liquidating sales.

CURRENT CALIFORNIA LAW (Sec. 24481-24483.5, 24511, 24512-24517, & 24519)

California is generally conformed to federal law with respect to treatment of liquidating sales and distributions.

Under general principles of corporate taxation, gain from sales of appreciated property is taxed twice, first to the corporation when the sale occurs, and again to the shareholders when the net proceeds are distributed as dividends. However, if a transaction qualifies under the General Utilities rule gain is not recognized when a corporation sells or distributes its assets in a liquidation or certain "deemed" liquidation sale transactions following a purchase of a controlling interest in one corporation by another.

A corporation may also be entitled to nonrecognition on a nonliquidating distribution if it relates to stock held by a long-term noncorporate shareholder owning ten percent or more of the corporation's outstanding stock (qualified stock).

Application of the General Utilities rule is limited by other statutory provisions which require recognition of gain on corporate liquidations under the tax benefit doctrine, and collapsible corporation provisions. For federal purposes, the General Utilities rule is also limited by recapture rules which are designed to convert the nonrecognition of capital gains into ordinary income. The depreciation recapture rules have not been incorporated into the Bank and Corporation Tax Law since no distinction is made between ordinary gain and capital gain.

The Bank and Corporation Tax Law does not recognize Subchapter S Corporations. Accordingly, California taxes Subchapter S corporations at both the corporate and the shareholder level, whereas the federal government taxes at the shareholder level only.

NEW FEDERAL LAW (Sec. 311, 336, 337, 338, & 1362)

The act repeals the General Utilities doctrine.

The act provides in general that gain or loss is to be recognized to a corporation on a distribution of its property in complete liquidation, as if it had sold the property at fair market value.

Neither gain nor loss is recognized, however, with respect to any distribution of property by a corporation to the extent there is nonrecognition of gain or loss to the recipient under the tax-free reorganization provisions of the code.

Limitation on the Recognition of Losses

The act provides that no loss will be recognized by a liquidating corporation with respect to any distribution of property to a related person (within the meaning of 267), unless the property is distributed to all shareholders on a pro rata basis and the property was not acquired by the liquidating corporation in a transfer to a corporation controlled (commonly known as a section 351 transaction) by the transferor or as a contribution to capital during the five years preceding the distribution.

A special rule is provided for certain property acquired in certain carryover basis transaction where the principal purpose of the contribution of property to a corporation in advance of its liquidation is to recognize a loss upon the sale or distribution of the property and thus eliminate or otherwise limit corporate level gain. This rule provides that the basis (for purposes of determining loss) of any property acquired by such corporation in a section 351 transaction or as a contribution to capital will be reduced, but not below zero, by the excess of the basis of the property on the date of contribution over its fair market value on such date. For purposes of this rule, it is presumed, except to the extent provided in regulations, that any section 351 transaction or contribution to capital within the two-year period prior to the adoption of a plan to complete liquidation (or thereafter) has such a principal purpose.

The Secretary may also prescribe regulations under which, in lieu, of disallowing a loss for a prior taxable year, the liquidating corporation may recapture the disallowed loss by increasing gross income on the tax return for the taxable year in which, such plan of liquidation if adopted.

In the case of a complete liquidation of a subsidiary (section 332 liquidation) a special rule is provided where no loss will be recognized to the liquidating corporation on any distribution.

Complete Liquidation of a Subsidiary (Section 332 liquidation)

The act provides that no gain or loss will be recognized to the liquidating corporation for transfers of property within an affiliated group in a complete liquidation. This exception is also modified for complete liquidations in which an 80 percent corporation receives property with a carryover basis, to provide nonrecognition of gain or loss with respect to any property actually distributed to the controlling corporate shareholder (rather than a pro rata share of each gain or loss).

In the case of a minority shareholder receiving property in such a liquidation, the distribution is treated as a nonliquidating distribution where gain (but not loss) is recognized by the distributing corporation.

In the case that a shareholder is a tax-exempt organization, (other than a farmers' cooperative) the organization may recognize gain under the exception for 80 percent corporate shareholder unless the property received in the distribution is used by the organization in an unrelated trade or business immediately after the distribution. Once the property is used in a related trade or business of the organization acquiring the property, the organization will will be taxed at that time (in addition to any other tax imposed, for example, on depreciation recapture) on the lesser of (1) the built in gain in the property at the time of the distribution, or (2) the difference between the adjusted basis of the property and its fair market value at the time of the cessation.

In the case that the controlling corporate shareholder is a foreign corporation, except as provided in regulations, the nonrecognition of gain or loss exception pursuant to a 332 complete liquidation of subsidiary does not apply.

The Secretary will prescribe regulations to carry out the purposes of the amendments by the Tax Reform Act of 1986 including (1) regulations to ensure that the purpose of the new provisions is not circumvented through use of other provisions, including the consolidated return regulations or the tax-free reorganization provisions, and (2) regulations providing for appropriate coordination of the provisions of this section with the provisions of this title relating to taxation of foreign corporations and their shareholders.

Nonliquidating Distributions of Appreciated Property

The act generally conforms the treatment of nonliquidating distributions with liquidating distributions by providing that gain must generally be recognized to a distributing corporation if appreciated property (other than an obligation of the corporation) is distributed to the shareholder outside of complete liquidation.

The act also repeals the present law exception that a corporation may be entitled to nonrecognition of gain on a nonliquidating distributions to ten percent, long-term noncorporate shareholders, and for certain distributions of property in connection with the payment of estate taxes or in connection with certain redemptions of private foundation stock.

Conversion from C corporation to S corporation

The act modifies the treatment of an S corporation that was formerly C corporation by imposing a corporate-level tax on any gain that arose prior to the conversion and is recognized by the S corporation, through sale or distribution within ten years after the date on which the S election took effect. The gain will be taxed at the maximum corporate rate applicable to the lesser of (1) recognized built-in gains (to the extent the fair market value of assets exceed the aggregate adjusted basis of such assets) of the S corporation for the taxable year or (2) the amount which would be the taxable income of the corporation if such corporation were not an S corporation.

In addition, gains on sales or distributions of assets by the S corporation will be presumed to be built-in gains, except to the extent the taxpayer can establish that the appreciation accrued after the conversion, such as where the asset was acquired by the corporation in a taxable acquisition after the conversion.

Corporations will be allowed to continue to take into account all of its subchapter C tax attributes in computing the amount of the tax on recognized built-in gains permitting it, for example, to use unexpired net operating losses, capital loss carryovers, and minimum tax carryover credits to offset such tax.

Election to Treat Sales or Distributions of Certain Subsidiary Stock as Asset Transfers

A corporation which owns 80 percent of the value and voting power of the subsidiary and sells, exchanges, or distributes all of such stock, may elect to treat such transaction as a disposition of all of the assets of the other corporation and no gain or loss will be recognized.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The act will apply to any distribution in complete liquidation and any sale or exchange, made by a corporation after July 31,1986 unless (1) the corporation is completely liquidated before January 1, 1987, (2) a deemed liquidation pursuant to a section 338 election where the acquisition date (the first date on which there is a qualified stock purchase under section 338) occurs before January 1, 1987, and (3) any distribution (not in complete liquidation) made on or after January 1, 1987.

Built-in Gains of S Corporation

The act will generally be effective with respect to S elections made on or after January 1, 1987 and will not apply to S elections made before January 1, 1987.

Exceptions For Certain Plans of Liquidations and Binding Contracts

The act will not apply to (1) a liquidation made pursuant to a plan of liquidation adopted before August 1, 1986, that is completely liquidated before January 1, 1988, (2) a liquidation if 50 percent or more to the voting stock by value of such corporation is acquired on or after August 1, 1986, pursuant to a written binding contract in effect before such date and if such corporation is completely liquidated before January 1, 1988, (3) a liquidation of a corporation if substantially all of the assets of such corporation are sold on or after August 1, 1986, pursuant to 1 or more written binding contracts in effect before such date and if such corporation is completely liquidated before January 1, 1988, (4) a deemed liquidation under section 338, of a corporation for which a qualified stock purchase under section 338 first occurs on or after August 1, 1986, pursuant to a written binding contract in effect before August 1, 1986, provided the section 338 acquisition date occurs before January 1, 1988.

Transitional Rule for Certain Closely Held Corporations

The act provides for a transition rule for small closely held corporations which would be entitled to complete relief from recognition of gain on long-term capital gain property on liquidations before January 1, 1989.

Such corporations are those not exceeding $5 million in value and more than 50 percent of whose stock is owned directly or indirectly for a substantial period by no more than 10 individuals who have held their stock for five years or longer. Relief phases out for such closely held corporation with value between $5 and $10 million.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on a proration of the Joint Committee on Taxation's estimate for the nation, revenue gains under the Bank and Corporation Tax Law would be in the $8 million range for 1987-88 and in the $15 million range for 1988-89. A proration factor of 4 percent was used which represents the general relationship between California's corporate tax effort and the federal tax effort over the past few years.

Title VIK: Corporate Taxation

ACTION: AMEND BASIS ALLOCATION RULES FOR ASSETS PURCHASED

Act Section 641 — Conference Report Page 208

Form 540 Line No. 17 — Form 100 Line No. 6-9

CURRENT CALIFORNIA LAW (Sec. 18031, & 24541)

California has generally conformed to the federal law in determining the amount of a purchase price allocated to various assets.

Under current California law, a taxpayer is required to allocate the purchase price of a going business among the assets for tax purposes. Both the buyer and seller usually agree to a specific allocation. However, there is no provision in the law that requires that the contract agreement show how much of the purchase price was allocated to each asset. The contract agreement may simply indicate the total purchase price.

When a going business is sold for a lump-sum amount, the buyer and seller must each allocate the purchase price among the assets for tax purposes.

Two methods used to value goodwill and going concern value are the residual and formula methods.

Under the residual method, the goodwill (or going concern value) is the excess of the purchase price over the fair market value of the tangible and intangible assets.

Under the formula method, a taxpayer takes the position that he/she is entitled to allocate the amount in excess of the fair market value to the basis of each of the individual assets, rather than treating the excess as goodwill or going concern value.

Under the proposed and temporary Regulation 1.338(b)-2T, it is mandatory that the residual method of allocation be used in determining the basis of assets acquired in a qualified stock purchase.

Based on Revenue Ruling 68-609, the formula method is an appropriate method only when there is no better evidence of a value for goodwill and going concern value.

NEW FEDERAL LAW (Sec. 1060)

The act requires that both buyer and seller must use the residual method as described in Regulation 338(b)(5) in the case of any transfer of assets constituting a business in which the transferee's basis is determined wholly by reference to the purchase price paid for assets.

The bill also authorizes the Treasury Department to require information reporting by the parties to an applicable asset acquisition.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision is effective for transactions after May 6, 1986, unless pursuant to a binding contract in effect on that date and at all times thereafter.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on a proration of national estimates prepared by the Joint Committee on Taxation, the relative state tax impact under conformity would be revenue gains in the $100,000 range for 1987-88 and $400,000 range for 1988-89 under the Personal Income Tax Law. Estimated revenue gains under the Bank and Corporation Tax Law are in the $2 million range for both 1987-88 and 1988-89.

The PIT proration (4.2%) reflects the Policy Economics Group's state estimates relative to the nation for selected provisions analyzed. The Policy Economics Group did not specifically estimate this provision. Regarding the B&CTL proration of 4%, this factor represents the general relationship between California's corporate tax collections and federal tax collections over the past few years.

This provision would result in revenue gains due to the curtailment of deliberate asset-value allocations between buyers and sellers that result in the minimization of tax liabilities. Purchase price allocations are particularly controversial with regard to the assignment of goodwill and going concern value.

Title VII: Corporate Taxation

ACTION: REVISE THE RELATED PARTY DEFINITION

Act Section 642 | Conference Report Page 210

Form 540 Line No. 17 | Form 100 Line No. 6-9

CURRENT CALIFORNIA LAW (Sec. 17551 and 24667)

California law has conformed to federal law in denying the installment sales method for gain on the sale of depreciable property between related parties unless it is established that the principle purpose for the disposition was not tax avoidance.

Related parties for this purpose includes a person and all entities which are 80 percent owned directly or indirectly, with respect to that person. California has conformed to the specific attribution rules that apply under 1239(c)(2).

NEW FEDERAL LAW (Sec. 453 and 1239)

The act modifies the rules that limit installment sales treatment and capital gain treatment on certain sales between related parties.

The definition of related parties is expanded to include (1) two corporations which are members of the same controlled group, (2) a corporation and a partnership, (3) two "S" Corporations, and (4) an "S" Corporation and a "C" Corporation so that persons and entities with more than 50 percent relationships are covered (rather than 80 percent). California has adopted the special rules for pass-through entities and controlled groups which were enacted by the Tax Reform Act of 1984, except for federal rules that apply to S Corporations. This act also provides that the specific attribution and relationship rules under 1239(c)(2) will no longer apply. Instead constructive ownership will be determined in accordance with rules under section 267(c) that apply to limit losses on sales between related parties.

Instead of denying deferred income treatment to the seller where the fair market value of contingent payments cannot be reasonable determined, the act requires ratable basis recovery by the seller and denies an increase in the purchaser's basis until the seller recognizes the income.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The act applies to sales after October 22, 1986, except for binding contracts which were in effect on August 14, 1986, and at all times thereafter.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Joint Committee on Taxation estimates revenue gains of only $5 million annually from this corporate provision for the nation. Based on this low level of impact for the nation, conformity would result in minor revenue gains annually in the $200,000 range. No meaningful impact is expected under the Personal Income Tax Law.

Title VIM: Corporate Taxation

ACTION: TREAT SPECIFIED BOND PREMIUMS AS INTEREST

Act Section 643 Conference Report Page 211

Form 540 Line No. 47 Form 100 Line No. G-18

CURRENT CALIFORNIA LAW (Sec. 17201 and 24360-24363)

California law has conformed to federal law with respect to a deduction for amortization of premiums on taxable bonds owned by the taxpayer.

An amortizable bond premium exists where a taxpayer buys a taxable bond for more than the face value and elects to amortize the premium. The amount of the excess is allowed as a deduction over the remaining term of the bond, generally offsetting interest income on the bond. Such an election applies to all taxable bonds held by the taxpayer at the beginning of the first taxable or income year to which the election applies and to all bonds acquired by the taxpayer in subsequent years.

NEW FEDERAL LAW (Sec. 171)

The act requires amortizable bond premium deductions to be treated as interest, except as otherwise provided in regulations. Thus, bond premium will be treated as interest for purposes of applying the investment interest limitations.

In addition, the Secretary of Treasury will revoke all elections which were in effect on October 22, 1986 as they relate to bonds issued after that date.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The act is effective for obligations acquired after October 22, 1986. For taxpayers who have already elected to amortize bond premium, such election shall apply to obligations issued after October 22, 1986, only if the taxpayer chooses such application.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

It does not appear that this provision would significantly change tax liabilities of affected parties, if at all, in comparison with current law treatment of such bond premium payments.

Title VIN: Corporate Taxation

ACTION: MODIFIES INTEREST AND PROPERTY TAX DEDUCTIONS OF TENANT-STOCKHOLDERS IN A COOPERATIVE HOUSING CORPORATION

Act Section 644 | Conference Report Page 212

Form 540 Line No. 47 | Form 100 Line No. G-26

CURRENT CALIFORNIA LAW

Personal Income Tax (Sections 17201 and 17225)

Conforms to federal law generally, but provides a special rule for certain cases where there has been a separate appraisal of individual units.

Bank and Corporation Tax (Section 24382)

Conforms to federal law. A lending institution acquiring ownership of an interest in a cooperative housing corporation by foreclosure is allowed, for a period of up to three years from the date of acquisition, to deduct its proportionate share of the cooperative's real estate taxes and interest. Otherwise, the deduction is limited to individuals.

OLD FEDERAL LAW (Section 216)

The tenant-stockholder's proportionate share of the cooperative's interest and real estate taxes was based on the proportion of the cooperative's total outstanding stock held by the tenant-stockholder. Tenant-stockholders were generally limited to individuals.

NEW FEDERAL LAW (Sec. 216)

Under H.R. 3838, cooperative housing corporations that charge tenant-stockholders with a portion of the cooperative's interest or taxes in a manner that reasonably reflects the cost to the cooperative of the interest or taxes allocable to each tenant-stockholder's dwelling unit, may elect to have the tenant-stockholders deduct for income tax purposes the separately allocated amounts (rather than amounts based on proportionate ownership of shares of the cooperative).

In addition, the tax treatment accorded individuals who are tenant-stockholders is extended to corporations, trusts, and other entities that are stockholders.

In addition, maintenance and lease expenses are disallowed where payments by tenant-stockholders are allocable to amounts properly chargeable to the capital account of the cooperative.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applicable to taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Joint Committee on Taxation estimates revenue losses for the nation of less than $5 million annually. Based on this low level of impact for the nation, conformity would result in minor revenue losses annually of probably less than $200,000.

Title VIO: Corporate Taxation

ACTION: MODIFIES REQUIREMENTS FOR QUALIFICATION AND TAXATION OF REITs

Act Sections 661-669 Conference Report Page 214

Form 540 Line No. 14 Form 100 Line No. 6-6

CURRENT CALIFORNIA LAW (Sec. 24413)

California has been in conformity with federal law regarding the recognition and tax treatment of real estate investment trusts (REIT). A REIT is a corporation, trust, or association that specializes in investments in real estate and mortgages and is subject to specific requirements related to shareholder diversification, sources of income, nature of assets, and distribution of income.

Income earned by a REIT must be passive, i.e. from real estate investments rather than from income earned in the operation of an active business involving real estate. A REIT that distributes at least 95% of its taxable income to investors is allowed a deduction for distributions to its shareholders and thus is taxable at the regular corporation rate only on retained earnings.

Under federal law, a REIT may elect to pay capital gains dividends to its shareholders which are then treated as long-term capital gains. Under California law, such gains are taxed to the shareholder as ordinary income.

Federal law imposes a 100 percent tax on net income from prohibited transactions. In general, a prohibited transaction is the sale of property held primarily for sale in the ordinary course of business. A safe harbor is provided for property held by the REIT for at least four years if aggregate expenditures (includible in basis) during the last four years do not exceed 20 percent of the selling price of the property and the sale is one of not more than five sales during the taxable year.

NEW FEDERAL LAW (Sec. 856, 857, 4981, 6697)

Many of the provisions relating to the requirements for qualification as and the taxation of REIT's are modified. These modifications relate to the income and asset requirements for qualification, the definition of rents and interest, distribution requirements, the treatment of capital gains, prohibited transactions, and certain other provisions.

Generally, REITs are not permitted to be closely held and must have a minimum of 100 shareholders. Since this is a rather difficult standard for a newly formed REIT to meet, the new law makes the closely held requirement inapplicable during the first tax year for which a REIT election is made.

With regard to amounts received by a REIT in connection with the rental of property, services that may be provided by the REIT itself are those services which would not result in the receipt of "unrelated business income" by an exempt organization. Payments received for such services by the REIT would qualify as rents from real property and would not constitute a prohibited transaction.

Since a REIT must distribute its income currently in cash, the receipt of deemed income can put the REIT in a cash bind. Under the new law, the minimum amount a REIT is required to distribute to shareholders is reduced by the amount of three kinds of income that would not otherwise be recognized under the REIT's normal accounting method. These amounts are (1) Section 467 deferred rents; (2) original issue discount that the REIT is required to accrue with respect to a Section 1274 loan, and (3) certain income arising from the disposition of a real estate asset. The minimum distribution is reduced by the amount of the sum of these items exceeding 5% of the REIT's taxable income determined without regard to the dividends paid deduction and net capital gains.

To be deducted in the current taxable year, distributions by REITS now have to be declared by December 31 of the current calendar year and paid before February 1, rather than declared before the due date of the return and reported by shareholders in the following year.

A nondeductible excise tax is imposed which is equal to 4% of the excess, if any, of the "required distribution", over the amount distributed. This replaces the former 3% excise tax on undistributed income.

In determining the maximum amount of capital gains dividends that a REIT can pay for a taxable year, a REIT cannot offset its net capital gain with any net operating loss. To the extent the REIT elects to pay capital gains dividends in excess of its net income, the REIT can increase the amount of its NOL carryover by such amount.

An alternative safe harbor rule is provided whereby a REIT can make any number of sales during a taxable year as long as the adjusted basis of the property sold does not exceed 10% of the adjusted basis of all of the REIT's assets at the beginning of the REIT's taxable year. The value of improvements a REIT can make without resulting in a prohibited transaction is increased from 20% to 30% of the property's adjusted basis.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Provisions are effective with taxable years beginning on and after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on prorations of national estimates prepared by the Joint Committee on Taxation, the relative fiscal impact under state conformity would be revenue gains in the $1 million range for 1986-87, in the $200,000 range for 1987-88, and less than $100,000 for 1988-89. These revenue gains would occur under the PITL. The 1986-87 estimate reflects accelerated estimated tax payments by shareholders which will occur under the new calendar year declaration requirement for REIT's. The proration percentage to California (4.1%) represents the Policy Economics' Group California estimates relative to the nation for those provisions analyzed. The Policy Economics' Group did not specifically estimate this provision.

TAX POLICY ISSUES

Since California has elected previously to permit REIT status under former federal rules, it is consistent tax policy to remain in conformity to eliminate taxpayer confusion and administrative burdens associated with a different set of rules.

Title VIP: Corporate Taxation; Mortgaged-Backed Securities

ACTION: CREATES REMICS (REAL ESTATE MORTGAGE INVESTMENT CONDUITS)

Act Section 671-674 Conference Report Page 222

Form 540 Line No. 13 Form 100 Line No. 6-6

CURRENT CALIFORNIA LAW (No Provision)

No special tax rules are applied to entities that hold a fixed pool of mortgages and issue multiple classes of interests in itself to investors. Consequently, income from mortgaged-backed securities may be subject to more than one level of taxation depending upon whether the intermediary entity is treated as a nontaxable conduit (partnership), partially taxable entity (trust), or fully taxable entity (corporation).

NEW FEDERAL LAW (Sec. 856, 860A-860G, 1272, 6049, 7701).

The new law creates a special tax vehicle for entities which issue multiple classes of investor intersts backed by a pool of mortgages. The new vehicle is called the Real Estate Mortgage Investment Conduit (REMIC), which, as its name implies, is generally a conduit entity for tax purposes. There are complex rules covering qualification as a REMIC, and transfers to and liquidations of the entity. There are two tiers of ownership interests in REMICs and each is taxed differently.

The REMIC is intended to be the exclusive vehicle for issuing multiple-class mortgage-backed securities. Result: If the qualfiication requirements are met, any corporate, partnership, trust, or similar entity is granted pass-through REMIC status.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Provisions are generally effective with taxable years beginning on or after January 1, 1987. OID rules apply to debt instruments issued after December 31, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on a proration of the Joint Committee on Taxation's national estimates, the relative California impact under conformity would be revenue losses under the Bank and Corporation Tax Law in the $900,000 range for 1987-88 and in the $1.5 million range for 1988-89. This revenue loss occurs largely from the elimination of double taxation of the entity and shareholder. A proration factor of 4 percent was used which represents the general relationship between California's corporate tax collections and federal corporate tax collections over the past few years.

TAX POLICY ISSUES

Special tax rules are established under federal law pertaining to the issuance of multiple class, mortgage-backed securities. Since these specialized investment activities will have to comply with new federal rules, taxpayer confusion and administrative burdens will result if California does not conform.

Title VIQ: Corporate Provisions

ACTION: CHANGES QUALIFICATION RULES AND IMPOSES AN EXCISE TAX ON REGULATED INVESTMENT COMPANIES

Act Section 651-657 Conference Report Page 242

Form 540 Line No. 13 Form 100 Line No. G-6

CURRENT CALIFORNIA LAW (Sec. 17145, 23701(m))

California does not conform to federal law.

In California, corporations, business or other organizations which are classified as a management company (and a series within such company) under the Federal Investment Company Act of 1940, are tax-exempt for state tax purposes. California does not require any specified percentage of income to be distributed to shareholders. Under the same act federal law classifies a management company or a unit investment trust as a regulated investment company (RIC) which is subject to federal tax. However, the tax imposed on RIC is substantially reduced because the corporation is taxed only on undistributed income. California also does not conform to federal law which treats a RIC as a third party recordkeeper nor to excise tax provisions relating to a RIC.

CURRENT FEDERAL LAW (Sec. 852)

A corporation that qualifies under the Federal Investment Company Act of 1940 may elect to be taxed as a regulated investment company. The corporation is taxed only on undistributed income, as it may deduct most dividends paid. At least 90 percent of it's gross income must be dividends, interest, security loan payments and gains from the sale or disposition of stock or securities. Income from disposition of short-term securities must be less than 30 percent of gross income. A RIC must distribute dividends (not including capital gains dividends) at least equal to the sum of:

- o 90 % of investment taxable income, plus
- o 90 % of the excess of the RIC's tax-exempt interest over it's disallowed tax-exempt interest deductions

Regulated Investment Companies (RIC) are permitted to treat certain dividends paid after the close of a tax year as paid during the preceding taxable year. Shareholders who receive these "spillover dividends" include such dividends as income in the year received. Shareholders report such dividends as a long-term capital gain regardless of how long they held the stock. A RIC is not required to pay any capital gain tax on the amount distributed.

If a RIC, organized as a corporation, has several "series" of stock, with each series of stock representing an interest in the income and assets of particular fund, the RIC generally is treated as a single corporation. However, under current law it is unclear whether RIC property is treated as a single corporation or whether each fund is treated as a separate corporation when a RIC is organized as a business trust.

In the case of certain summonses served upon "third party recordkeepers" the IRS must notify the taxpayer that a summons has been issued regarding the taxpayer's books and records. A third party recordkeeper can include a bank, barter exchange, a broker, brokerage house, accountant, attorney, or other third party recordkeeper, but does not include RIC's.

NEW FEDERAL LAW (Sec. 851, 852, 4982)

The act provides that a business development company may qualify as a RIC.

This act also provides that, in the case of RICs that have so called series funds, each fund is treated as a separate corporation.

Additionally, a non-deductible excise tax is imposed, for any calendar year, on any RIC equal to four percent of the excess of the required distribution over the distributed amount for such calendar year. The required distribution amount has been increased to:

- 97% of the investment taxable income, plus
- 90% of the RIC's capital gain net income for the 1 year period ending on October 31 of such calendar year.

An additional amount is added to the excise tax if the RIC underpaid or overpaid their shareholders in the preceding year, as specified.

This excise tax is to be paid by March 15 of the succeeding calendar year.

Certain exceptions to the 30 percent passive income rule are provided relating to RIC's engaging in hedging transactions.

The act classifies a RIC as an entity upon which a summons may be issued.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This excise tax provision applies to calendar years beginning on and after January 1, 1987. The other provisions are effective for taxable years ending after October 22, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Direct State Budget Impact from Federal Changes

National estimates prepared by the Joint Committee on Taxation (JCT) reflect accelerated distributions to shareholders due to the calendar year requirement which explains the much larger impact for the first two fiscal years.

Based on a proration of national estimates prepared by the JCT, the relative fiscal impact would be Personal Income Tax Law revenue gains in the $20 million range for 1986-87, $35 million range for 1987-88 and in the $6 million range for 1988-89. The proration to California (4.1 percent) reflects the Policy Economics Group (PEG), California estimates relative to the nation for those provisions analyzed. The PEG has not specifically estimated this provision.

Based on a proration of national estimates, revenue gains under the Bank and Corporation Tax Law would be in the $2.5 million range for 1986-87, $2 million range for 1987-88, and in the $500,000 range for 1988-89. A proration factor of 4 percent was used which represents the general relationship between California's corporate tax collections and federal corporate tax collections over the past few years.

These estimates reflect direct state budget impacts since it is anticipated they will occur independently of the conformity issue.

The next page of this report is page 700.

TITLE VII

MINIMUM TAX PROVISIONS

TABLE OF CONTENTS

Title VIIA2: Minimum Tax Provisions-Individuals

ACTION: INCREASES THE ALTERNATIVE MINIMUM TAX RATE FOR INDIVIDUALS

Act Section 701 Conference Report Page 250

Form 540 Line No. 73 Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17062, 17062.1, and 17062.2)

Current law imposes a separate tax on specified items of tax preference in addition to the regular tax imposed on taxable income. The tax rate (after exemptions) ranges from 1/2 percent to 5 1/2 percent of preference income. The maximum rate is reached at preference income of $15,000 (single), $15,500 (head of household), and $30,000 (joint).

OLD FEDERAL LAW (Section 55)

Federal law required certain tax preference items to be subject to an alternative minimum tax. The rate of tax was 20 percent of the alternative minimum taxable income (after exemptions).

NEW FEDERAL LAW (Sec. 55)

H.R. 3838 increases the tax rate on the alternative minimum tax from 20 percent to 21 percent.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applicable to taxable years beginning or or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all individual minimum tax provisions. The JCT has indicated that, for provisions affecting individuals, the largest single item contributing to revenue gains is the passive loss provision which diminishes rapidly as the phase-in under the regular tax structure approaches 100 percent.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue losses under the PITL.

Projected state preference tax revenues are $442 million for 1987 and $473 million for 1988 under the PITL (assuming that capital gains will continue to be partially excluded from gross income). An approximation of AMT revenues that would be collected under the PITL is $140 million for 1987/88 and $80 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue losses under the PITL of $302 million for 1987/88 and $393 million for 1988/89. However, if the capital gains preference item under the PITL is repealed due to capital gain reform, the net impact from substituting the AMT for the preference tax structure would be a net revenue gain in the $56 million range for 1987-88 and a net revenue loss in the $10 million range for 1988-89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the PITL.

TAX POLICY ISSUES

The new federal law imposes a "flat tax" of 21% on alternative minimum taxable income. This rate is equal to 75% of the maximum regular tax rate (28-1).

Should California revise its tax on preference items to be a flat tax, rather than graduated?

Should California increase its tax on preference items to correspond more closely to 75% of the maximum regular tax rate?

Title VIIA3: Minimum Tax Provision - Individuals

ACTION: <u>PHASES OUT EXEMPTION AMOUNTS FOR ALTERNATIVE MINIMUM TAX</u>

Act Section 701 | Conference Report Page 250

Form 540 Line No. 73 | Form 100 Line No. N/A

<u>CURRENT CALIFORNIA LAW (Sections 17062, 17062.1 and 17062.2)</u>

California law is generally similar to federal law, but there are numerous differences including preference items, exemption amounts, and tax rates. California imposes a tax on "tax preference income" in addition to the tax imposed on taxable income. The intent is to impose an additional tax on taxpayers who benefit substantially from various forms of tax-free income or large deductions under the regular income tax rates. The tax is computed on tax preference income less the exemptions. The exemptions are $4,000 for a single person, married person filing a separate return, or joint custody head of household; and $8,000 for a married couple filing a joint return, surviving spouse, or head of household. Estates and trusts are allowed an exemption of $4,000 apportioned between the estate or trust and the beneficiaries in proportion to the income allocable to each.

<u>OLD FEDERAL LAW (Sec. 55(e)and (f))</u>

Federal law requires certain tax preference items to be subject to an alternative minimum tax. The tax due for the taxable year is the alternative minimum tax or the regular income tax, whichever is greater (adjusted by certain credits). The alternative minimum taxable income, upon which the alternative minimum tax is determined, is equal to the taxpayer's adjusted gross income increased by the tax preference items and reduced by certain itemized deductions and exemption amounts. The exemption amounts are $20,000 for a married person filing a separate return or an estate or trust, $30,000 for a single person or head of household, and $40,000 for a married couple filing a joint return or a surviving spouse.

<u>NEW FEDERAL LAW (Sec. 55(d))</u>

HR 3838 reduces (but not below zero) the exemption amounts by twenty five cents for each dollar of minimum taxable income that exceeds $75,000 for a married person filing a separate return or an estate or trust, $112,500 for a single person or head of household, and $150,000 for a married couple filing a joint return or a surviving spouse.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The phase out of the exemption amounts apply to taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all individual minimum tax provisions. The JCT has indicated that, for provisions affecting individuals, the largest single item contributing to revenue gains is the passive loss provision which diminishes rapidly as the phase-in under the regular tax structure approaches 100 percent.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue losses under the PITL.

Projected state preference tax revenues are $442 million for 1987 and $473 million for 1988 under the PITL (assuming that capital gains will continue to be partially excluded from gross income). An approximation of AMT revenues that would be collected under the PITL is $140 million for 1987/88 and $80 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue losses under the PITL of $302 million for 1987/88 and $393 million for 1988/89. However, if the capital gains preference item under the PITL is repealed due to capital gain reform, the net impact from substituting the AMT for the preference tax structure would be a net revenue gain in the $56 million range for 1987-88 and a net revenue loss in the $10 million range for 1988-89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the PITL.

TAX POLICY ISSUES

The federal exemption amounts ($20,000-40,000) are significantly higher than the state exemptions ($4,000-8,000). Consequently, the need for a phase-out of exemption amounts is not as great as under federal law.

Title VIIA4a: Minimum Tax Provisions - Individuals

ACTION: REPEALS, AS A TAX PREFERENCE ITEM, THE DIVIDEND INCOME EXCLUSION

Act Section 701 Conference Report Page 251

Form 540 Line No. 73 Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17063)

Because California has not conformed to the federal dividend income exclusion (under the regular income tax provisions for individuals), this exclusion is not a tax preference item for state purposes.

OLD FEDERAL LAW (Sec. 57)

Federal law required certain tax preference items to be included in the computation of the alternative minimum tax for individuals. One of these items was amount of dividends excluded from gross income (up to $100 per individual, $200 for joint returns).

NEW FEDERAL LAW (Sec. 57)

H.R. 3838 repeals the dividend income exclusion for regular tax purposes and, accordingly, this exclusion is no longer a tax preference item.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applicable to taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Since California does not have a dividend income exclusion for individuals, the issue of repeal is inapplicable.

ACTION: REDUCES THE AMOUNT OF ACCELERATED DEPRECIATION ON REAL PROPERTY TO BE INCLUDED AS A TAX PREFERENCE ITEM

Act Section 701 | Conference Report Page 251

Form 540 Line No. 73 | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17063)

California law conforms in principle to federal law in including as a tax preference income item depreciation in excess of the straight-line amount on real property. The amount of this excess, however, may be different from federal where there are differences in depreciation allowable for regular income tax purposes.

NEW FEDERAL LAW (Sec. 56)

H.R. 3838 changes the amount of accelerated depreciation to be included as a tax preference income item to the excess of regular tax depreciation over the new alternative depreciation provisions provided for in the Act. For real property other than (1) Section 1250 property and (2) property with respect to which the taxpayer elects or is required to use a straight-line method for regular tax purposes, the 150 percent declining balance method (switching to straight-line in the year necessary to maximize the allowance) over the alternative depreciation life of the asset is used. For Section 1250 property, it is the excess of regular tax depreciation over straight-line depreciation.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applicable to taxable years beginning on or after January 1, 1987 for real property placed in service on or after that date. Exceptions are provided for certain property constructed reconstructed, or acquired pursuant to a written contract that was binding as of March 1, 1986, and placed in service by a specified date.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all individual minimum tax provisions. The JCT has indicated that, for provisions affecting individuals, the largest single item contributing to revenue gains is the passive loss provision which diminishes rapidly as the phase-in under the regular tax structure approaches 100 percent.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue losses under the PITL.

Projected state preference tax revenues are $442 million for 1987 and $473 million for 1988 under the PITL (assuming that capital gains will continue to be partially excluded from gross income). An approximation of AMT revenues that would be collected under the PITL is $140 million for 1987/88 and $80 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue losses under the PITL of $302 million for 1987/88 and $393 million for 1988/89. However, if the capital gains preference item under the PITL is repealed due to capital gain reform, the net impact from substituting the AMT for the prefernce tax structure would be a net revenue gain in the $56 million range for 1987-88 and a net revenue loss in the $10 million range for 1988-89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the PITL.

ACTION: CHANGES THE AMOUNT OF ACCELERATED DEPRECIATION ON PERSONAL PROPERTY TO BE INCLUDED AS A TAX PREFERENCE INCOME ITEM

Act Section 701 | Conference Report Page 252

Form 540 Line No. 73 | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17063)

California law conforms in principle to federal law, including as a tax preference item depreciation in excess of the straight-line amount on leased personal property. The amount of this excess, however, may be different from federal where there are differences in depreciation allowable for regular income tax purposes.

NEW FEDERAL LAW (Secs. 56 and 57)

When computing alternative minimum taxable income, depreciation of personal property (other than transition property and property depreciated under the straight-line method for regular tax purposes) is computed using the 150 percent declining method (switching to straight-line in the year necessary to maximize the allowance) over an asset's ADR mid-point life.

When property acquired after 1986 (other than transition property) is disposed of, gain or loss for minimum tax purposes will be computed by reference to basis as adjusted for depreciation allowed under the minimum tax.

For property placed in service before 1987, or under the transition rules of the Act, accelerated depreciation is a preference item only to the extent provided under prior law.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applicable to personal property first placed in service on or after January 1, 1987. For property placed in service before 1987, or under the transition rules of the Act, accelerated depreciation is a preference item only to the extent provided under prior law.

Transition Property

Transition property generally is property which was (a) subject to a binding contract or under construction before 1986 in the case of property qualifying for the investment tax credit, and before March 1986 in the case of recovery property, and (b) which is placed in service before specified deadlines depending on the

ADR midpoint, and whether it is ITC property or recovery property.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all individual minimum tax provisions. The JCT has indicated that, for provisions affecting individuals, the largest single item contributing to revenue gains is the passive loss provision which diminishes rapidly as the phase-in under the regular tax structure approaches 100 percent.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue losses under the PITL.

Projected state preference tax revenues are $442 million for 1987 and $473 million for 1988 under the PITL (assuming that capital gains will continue to be partially excluded from gross income). An approximation of AMT revenues that would be collected under the PITL is $140 million for 1987/88 and $80 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue losses under the PITL of $302 million for 1987/88 and $393 million for 1988/89. However, if the capital gains preference item under the PITL is repealed due to capital gain reform, the net impact from substituting the AMT for the preference tax structure would be a net revenue gain in the $56 million range for 1987-88 and a net revenue loss in the $10 million range for 1988-89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the PITL.

Title VIIA4d: Minimum Tax Provisions - Individuals

ACTION: INCREASES THE AMOUNT OF INTANGIBLE DRILLING COSTS INCLUDED AS A TAX PREFERENCE ITEM

Act Section 701 | Conference Report Page 253

Form 540 Line No. 73 | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Section 17063)

Under California law, the excess of intangible drilling and development costs (other than costs incurred in drilling a nonproductive well) over the amount that would have been allowable if these costs had been amortized over 120 months beginning with the month production from the well begins, or cost depletion, is a tax preference item. This computation is applied separately with respect to oil and gas properties, and properties which are geothermal deposits.

OLD FEDERAL LAW (Section 57)

Under old federal law, the amount of the excess of intangible drilling and development costs (as described above) which exceeded 100 percent of net oil and gas income was a tax preference item.

NEW FEDERAL LAW (Section 57)

The Act increases the amount of intangible drilling and development costs included by including the costs in excess of 65 percent of the net oil and gas income as a tax preference item.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applicable to taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all individual minimum tax provisions. The JCT has indicated that, for provisions affecting individuals, the largest single item contributing to revenue gains is the passive loss provision which diminishes rapidly as the phase-in under the regular tax structure approaches 100 percent.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue losses under the PITL.

Projected state preference tax revenues are $442 million for 1987 and $473 million for 1988 under the PITL (assuming that capital gains will continue to be partially excluded from gross income). An approximation of AMT revenues that would be collected under the PITL is $140 million for 1987/88 and $80 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue losses under the PITL of $302 million for 1987/88 and $393 million for 1988/89. However, if the capital gains preference item under the PITL is repealed due to capital gain reform, the net impact from substituting the AMT for the preference tax structure would be a net revenue gain in the $56 million range for 1987-88 and a net revenue loss in the $10 million range for 1988-89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the PITL.

Title VIIA4j: Minimum Tax Provisions — Individuals

ACTION: REPEALS THE NET CAPITAL GAIN DEDUCTION AS A TAX PREFERENCE ITEM

Act Section 701 | Conference Report Page 255

Form 540 Line No. 73 | Form 100 Line No. N\A

CURRENT CALIFORNIA LAW (Sections 17063, 17063.1, 17063.4, and 17063.11)

Under California law, the tax preference item is the difference between (1) the taxpayer's total net capital gains and losses determined without regard to any capital loss carryover, (exclusive of gains from sale of principal residence, certain residential rental property, and small business stock), and (2) the taxpayer's net capital gains and losses included in taxable income.

NEW FEDERAL LAW (Sections 55 and 57)

The Act repeals the 60 percent net capital gain deduction (excess of net long-term capital gains over net short-term capital losses) as a tax preference item, to conform to the repeal of the net capital gain deduction for regular tax purposes. Capital gains will be taxed as ordinary income at a rate not to exceed 28 percent (33 percent during phase out of 15 percent tax rate and personal exemptions).

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applicable to taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all individual minimum tax provisions. The JCT has indicated that, for provisions affecting individuals, the largest single item contributing to revenue gains is the passive loss provision which diminishes rapidly as the phase-in under the regular tax structure approaches 100 percent.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue losses under the PITL.

Projected state preference tax revenues are $442 million for 1987 and $473 million for 1988 under the PITL (assuming that capital gains will continue to be partially excluded from gross income). An approximation of AMT revenues that would be collected under the PITL is $140 million for 1987/88 and $80 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue losses under the PITL of $302 million for 1987/88 and $393 million for 1988/89. However, if the capital gains preference item under the PITL is repealed due to capital gain reform, the net impact from substituting the AMT for the preference tax structure would be a net revenue gain in the $56 million range for 1987-88 and a net revenue loss in the $10 million range for 1988-89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the PITL.

Title VIIA41: Minimum Tax Provisions - Individuals

ACTION: INCLUDES INTEREST ON TAX-EXEMPT BONDS AS A TAX PREFERENCE ITEM

Act Section 701 | Conference Report Page 255

Form 540 Line No. 73 | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sections 17063, 17133 and 17143)

California imposes a tax on "tax preference income" in addition to the tax imposed on regular taxable income. The intent is to impose an additional tax on taxpayers who benefit substantially from various forms of tax-free income or large deductions under the regular income tax provisions. Interest income is not a tax preference item as it is includible in regular taxable income to the extent it is not barred under the Constitution or laws of the United States or by the California constitution.

California has not adopted the provisions of IRC Sections 103 and 103A that exempt interest on certain state and local government obligations. Interest on such bonds issued by other states is already subject to California tax, while interest on bonds issued in California is exempt from tax under other provisions of the law.

NEW FEDERAL LAW (New Section 57, Section 103 amended, Section 103A repealed, Sections 141-150 added)

The Act reorganized, as well as amended, the rules governing tax exemption for interest on government bonds. It amended Section 103, repealed Section 103A, and added new Sections 141-150.

Section 103 continues to recognize the principle that when bond proceeds are used exclusively for traditional governmental purposes the interest earned on the bonds is excludable from gross income. Bond interest, however, is taxable when it is derived from (a) state or local bonds that have not been issued in registered form, (b) arbitrage bonds, or (c) private activity bonds that are not exempt as qualified bonds.

The new Sections 141-150 organize various bond-related topics, and impose a number of new limitations.

As a general rule, the interest earned on "private activity bonds" is not tax-exempt unless 95 percent or more of the net bond proceeds are related to the governmental use financed by the issue and the issuance of the bonds falls under a codified exception. New Section 150(a)(3) defines "net proceeds" as the proceeds of an issue reduced by amounts in a reasonably required reserve or replacement fund. The term does not include the cost of issuance.

Alternative tests: An obligation is a private activity bond if:

(1) 10 percent or more of the bond proceeds are used for private business purposes and 10 percent or more of the debt service is derived from private use or is secured by payments or property used in a trade or business (Sec. 141(b)(1));

(2) more than five percent of the bond proceeds are both (a) used for private business purposes and (b) either derived from the private use or secured by the privately-used property or payments related to the use of that property (Sec. 141(b)(2));

(3) an amount exceeding the lesser of five percent or $5 million of the bond proceeds is used to finance loans to private persons (Sec. 141(c)).

"Private business use" means any direct or indirect use in a trade or business carried on by an individual or entity other than a governmental unit. Business use as a member of the general public is not taken into account for this purpose (Sec. 141(b)(6)).

In addition, a bond issue will not be tax exempt unless it meets three criteria:

(1) The amount of the issue must fall within the state volume cap (Sec. 146);

(2) The issue must satisfy each of the requirements in Section 147; and

(3) The issue must be either (a) an exempt facility bond, (b) a qualified mortgage bond, (c) a qualified veterans' mortgage bond, (d) a qualified small issue bond; (e) a qualified student loan bond, (f) a qualified redevelopment bond, or (g) a qualified Section 501(c)(3) bond. (Sec. 141(d)).

The Act also adds, as a new tax preference item, interest that is exempt for regular tax purposes on qualified private activity bonds issued after August 7, 1986. (Sec 157(a)(5)) Bonds issued before September 1, 1986 are treated as issued before August 8, 1986, if they meet the pre-1987 definition of governmental bond (as modified by an expanding security test), unless these bonds would be private activity bonds as defined in Section 141, modified as follows: 25 percent, rather than 10 percent, of the proceeds must be used for private business or as private security or payment; the five percent test in cases of unrelated private business use and the output facilities test is disregarded; and the private loan financing test is computed without regard to the

$5 million limitation in Section 141(c)(1)(B). (Sec. 57(a)(5)(c)(iv))

Where interest is included as a tax preference, but is excludable for regular tax purposes, Section 265 denying deductions for expenses and interest relating to tax-exempt income does not apply to the interest exclusion for minimum tax purposes. (Sec. 57(a)(5)(A))

Interest on current or advance refundings of bonds issued before August 8, 1986 (or September 1, 1986) is not a tax preference item. In the case of a series of current refunding, the original bond must have been issued before that date. Interest on qualified Section 501(c)(3) bonds is also excepted. (Sec. 57(a)(5)(c)(ii) and (iii))

A "qualified 501(c)(3) bond "is any private activity bond issued by a non-profit religious, charitable, scientific, or educational, organization (including certain hospital service organizations and certain amateur athletic organizations) that is an exempt organization under Internal Revenue Service Section 501(c)(3), if all property to be provided by the net proceeds of the issue is to be owned by the exempt organization or a governmental unit, and the bond would not be a private activity bond if (1) these exempt organizations were treated as governmental units with respect to their activities which are not unrelated trades or businesses, and (2) '5 percent' is substituted for '10 percent' in the tests for private activity bonds described above.

A $150 million limitation also applies on these bonds (other than a qualified hospital bond).

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applicable to taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all individual minimum tax provisions. The JCT has indicated that, for provisions affecting individuals, the largest single item contributing to revenue gains is the passive loss provision which diminishes rapidly as the phase-in under the regular tax structure approaches 100 percent.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue losses under the PITL.

Projected state preference tax revenues are $442 million for 1987 and $473 million for 1988 under the PITL (assuming that capital gains will continue to be partially excluded from gross income). An approximation of AMT revenues that would be collected under the PITL is $140 million for 1987/88 and $80 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue losses under the PITL of $302 million for 1987/88 and $393 million for 1988/89. However, if the capital gains preference item under the PITL is repealed due to capital gain reform, the net impact from substituting the AMT for the preference tax structure would be a net revenue gain in the $56 million range for 1987-88 and a net revenue loss in the $10 million range for 1988-89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the PITL.

Title VIIA4n: Minimum Tax Provisions - Individuals

ACTION: REQUIRES THE USE OF THE PERCENTAGE OF COMPLETION METHOD OF ACCOUNTING WITH RESPECT TO LONG-TERM CONTRACTS

Act Section 701 | Conference Report Page 256

Form 540 Line No. 73 | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Section 17063)

California law is generally similar to federal law, but there are numerous differences including preference items, exemption amounts, and tax rates. California imposes a tax on "tax preference income" in addition to the tax imposed on taxable income. The intent is to impose an additional tax on taxpayers who benefit substantially from various forms of tax-free income or large deductions under the regular income tax rates. The tax is computed on the total of tax preference items in excess of a base allowance exemption.

Current law does not include any part of income from long-term contracts as a tax preference item.

NEW FEDERAL LAW (Sections 55 and 56)

Federal law imposes an alternative minimum tax. The tax due for the taxable year is the alternative minimum tax or the regular income tax, whichever is greater (adjusted by certain credits).

Alternative minimum tax is the taxpayers taxable income, determined with specified adjustments, and increased by the amount of items of tax preference.

The Act requires, as one of the adjustments to regular taxable income, that the percentage of completion method of accounting must be used with respect to long-term contracts.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applicable to taxable years beginning on or after January 1, 1987, for long-term contracts entered into on or after March 1, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all individual minimum tax provisions. The JCT has indicated that, for provisions affecting individuals, the largest single item contributing to revenue gains is the passive loss provision which diminishes rapidly as the phase-in under the regular tax structure approaches 100 percent.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue losses under the PITL.

Projected state preference tax revenues are $442 million for 1987 and $473 million for 1988 under the PITL (assuming that capital gains will continue to be partially excluded from gross income). An approximation of AMT revenues that would be collected under the PITL is $140 million for 1987/88 and $80 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue losses under the PITL of $302 million for 1987/88 and $393 million for 1988/89. However, if the capital gains preference item under the PITL is repealed due to capital gain reform, the net impact from substituting the AMT for the preference tax structure would be a net revenue gain in the $56 million range for 1987-88 and a net revenue loss in the $10 million range for 1988-89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the PITL.

ACTION: INCLUDES AS A TAX PREFERENCE ITEM THE FULL GAIN REALIZED ON INSTALLMENT SALES OF DEALER PROPERTY IN THE YEAR OF DISPOSITION

Act Section 701 | Conference Report Page 257

Form 540 Line No. 73 | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17063)

California law is generally similar to federal law, but there are numerous differences including preference items, exemption amounts, and tax rates. California imposes a tax on "tax preference income" in addition to the tax imposed on taxable income. The intent is to impose an additional tax on taxpayers who benefit substantially from various forms of tax-free income or large deductions under the regular income tax rates. The tax is computed on the total of tax preference items in excess of a base allowance exemption.

Current law does not include any part of dealer installment sales as a tax preference item.

NEW FEDERAL LAW (Section 56)

Federal law imposes an alternative minimum tax. The tax due for the taxable year is the alternative minimum tax or the regular income tax, which ever is greater (adjusted by certain credits).

Alternative minimum tax is the taxpayer's taxable income, determined with specified adjustments, and increased by the amount of items of tax preference.

The Act requires, as one of the adjustments to regular taxable income, that the full gain realized in the year of disposition on dealer sales (stock in trade of the taxpayer or other property of a kind which would properly be included in inventory if on hand at the close of the taxable year, or property held primarily for sale to customers in the ordinary course of a trade or business), and sales of trade or business or rental property made after March 1, 1986, where the purchase price exceeds $150,000, be included in the alternative minimum taxable income.

Excepted from this provision are installment sales of manufacturers to dealers if (1) the dealer is obligated to pay on the obligation only when the dealer resells or rents the property, or (2) the manufacturer has the right to repurchase the property at a fixed or ascertainable price no later than the nine-month period beginning with the date of the sale. In addition, the aggregate face amount of the obligations that otherwise qualify for the exception must be equal to 50 percent of the total sales to dealers giving rise to the installment receivables in both the current tax year and the preceding year (e.g., the 50 percent test). A seller will be treated as failing to meet the 50 percent test only if it fails to meet the test for two consecutive tax years. This exception applies only if the taxpayer meets these requirements for its first tax year beginning after October 22, 1986. Also, exempted from this provision are installment sales of personal use property, farm property and timeshare and residential lots if the taxpayer elected to exclude the disposition from the installment sale proportionate disallowance rule.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applicable to taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all individual minimum tax provisions. The JCT has indicated that, for provisions affecting individuals, the largest single item contributing to revenue gains is the passive loss provision which diminishes rapidly as the phase-in under the regular tax structure approaches 100 percent.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue losses under the PITL.

Projected state preference tax revenues are $442 million for 1987 and $473 million for 1988 under the PITL (assuming that capital gains will continue to be partially excluded from gross income). An approximation of AMT revenues that would be collected under the PITL is $140 million for 1987/88 and $80 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue losses under the PITL of $302 million for 1987/88 and $393 million for 1988/89. However, if the capital gains preference item under the PITL is repealed due to capital gain reform, the net impact from substituting the AMT for the preference tax structure would be a net revenue gain in the $56 million range for 1987-88 and a net revenue loss in the $10 million range for 1988-89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the PITL.

Title VIIA4p: Minimum Tax Provisions

ACTION: ADDS NET LOSS FROM A PASSIVE ACTIVITY (OTHER THAN FARMING) AS A TAX PREFERENCE INCOME ITEM.

Act Section 701 | Conference Report Page 257

Form 540 Line No. 73 | Form 100 Line No. 54

CURRENT CALIFORNIA LAW (Sec. 17063 and 23401)

California law is generally similar to federal law, but there are numerous differences including preference items, exemption amounts, and tax rates. California imposes a tax on "tax preference income" in addition to the tax imposed on taxable income. The intent is to impose an additional tax on taxpayers who benefit substantially from various forms of tax-free income or large deductions under the regular income tax rates. The tax is computed on the total of tax preference items in excess of a base allowance exemption.

Current law does not include losses from passive activities (activities in which the taxpayer did not materially participate in management or provide substantial personal services) as a tax preference income item.

OLD FEDERAL LAW (Sec. 58(b) and (c))

Federal law requires certain tax preference items to be subject to an alternative minimum tax. The tax due for the taxable year is the alternative minimum tax or the regular income tax whichever is greater (adjusted by certain credits). Losses from passive activities are not a tax preference item.

NEW FEDERAL LAW (Sec. 58(b) and (c) and Sec. 469(i))

HR 3838 disallows, as a specified adjustment, (1) any net loss included in the taxpayer's taxable income attributable to trade or business activities in which the taxpayer did not materially participate in management or provide substantial personal services (passive activity), (2) and all losses from rental activities, except losses of up to $25,000 from real estate rentals in which the taxpayer is an active participant. The $25,000 exclusion is phased out between $100,000 and $150,000 of preference income.

The amount of the disallowed loss is reduced by the amount (if any) by which the taxpayer is insolvent (excess of liabilities over fair market valve of assets) as of the close of the taxable year.

This provision does not apply to certain working interests in oil and gas properties.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all individual minimum tax provisions and a single estimate only for all corporate minimum tax provisions. The JCT has indicated that, for provisions affecting individuals, the largest single item contributing to revenue gains is the passive loss provision which diminishes rapidly as the phase-in under the regular tax structure approaches 100 percent. For the corporate minimum tax estimate, the largest single item contributing to revenue gains is the inclusion of a portion of book income as taxable income.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue losses under the PITL and significant revenue gains under the B&CTL.

Projected state preference tax revenues are $442 million for 1987 and $473 million for 1988 under the PITL (assuming that capital gains will continue to be partially excluded from gross income). An approximation of AMT revenues that would be collected under the PITL is $140 million for 1987/88 and $80 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue losses under the PITL of $302 million for 1987/88 and $393 million for 1988/89.

Projected state preference tax revenues are $7 million under the B&CTL for 1987 and 1988. An approximation of AMT revenues that would be collected under the B&CTL are $240 million for 1987/88 and $230 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue gains under the B&CTL of $233 million for 1987/88 and $223 million for 1988/89. However, if the capital gains preference item under the PITL is repealed due to capital gain reform, the net impact from substituting the AMT for the preference tax structure would be a net revenue gain in the $56 million range for 1987-88 and a net revenue loss in the $10 million range for 1988-89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the PITL and B&CTL.

Title VIIA4q: Minimum Tax Provisions - Individuals

ACTION: ADDS NET LOSS FROM PASSIVE FARMING ACTIVITIES AS A TAX PREFERENCE INCOME ITEM

Act Section 701 — Conference Report Page 258

Form 540 Line No. 73 — Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17063)

California law is generally similar to federal law, but there are numerous differences including preference items, exemption amounts, and tax rates. California imposes a tax on "tax preference income" in addition to the tax imposed on taxable income. The intent is to impose an additional tax on taxpayers who benefit substantially from various forms of tax-free income or large deductions under the regular income tax rates. The tax is computed on the total of tax preference items in excess of a base allowance exemption.

Under California law (but not federal) net farm loss (other than from certain acquacultural activities) in excess of $50,000 ($25,000 in the case of a married taxpayer filing a separate return) which is deducted from non-farm income is treated as a tax preference item, unless two-thirds or more of the taxpayer's gross income from all sources for three taxable years out of the immediately preceding five years is from farming.

OLD FEDERAL LAW (Sec. 58(a) and (c))

Federal law requires certain tax preference items to be subject to an alternative minimum tax. The tax due for the taxable year is the alternative minimum tax or the regular income tax, whichever is greater (adjusted by certain credits).

NEW FEDERAL LAW (Sec. 58)

The Act disallows any loss from any tax shelter farm activity[1]. The disallowed loss may be carried forward, but may only be offset as a deduction against income allocable to the same activity in succeeding taxable years. This provision applies to

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[1] "Tax shelter farm activity" means any "farming syndicate" (as defined in Section 464 of the Internal Revenue Code) and any other activity consisting of farming in which the taxpayer does not materially participate (year-round involvement on a regular and substantial basis).

taxpayers other than corporations; however, personal service corporation will (within the meaning of § 469(g)(i)(c)) also be subject to this provision.

For purposes of computing the minimum tax, the amount of any tax shelter loss from farm activity is reduced by the amount (if any) by which the taxpayer is insolvent (excess of liabilities over fair market value of assets) as of the close of the taxable year.

If the taxpayer disposes of his/her entire interest in any tax shelter farm activity during any taxable year, the amount of loss attributable to that activity (determined after carryovers of the disallowed loss) is allowed for the taxable year in computing the alternative minimum taxable income and not treated as a loss from a tax shelter farm activity.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all individual minimum tax provisions. The JCT has indicated that, for provisions affecting individuals, the largest single item contributing to revenue gains is the passive loss provision which diminishes rapidly as the phase-in under the regular tax structure approaches 100 percent.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue losses under the PITL.

Projected state preference tax revenues are $442 million for 1987 and $473 million for 1988 under the PITL (assuming that capital gains will continue to be partially excluded from gross income). An approximation of AMT revenues that would be collected under the PITL is $140 million for 1987/88 and $80 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue losses under the PITL of $302 million for 1987/88 and $393 million for 1988/89. However, if the capital gains preference item under the PITL is repealed due to capital gain reform, the net impact from substituting the AMT for the preference tax structure would be a net revenue gain in the $56 million range for 1987-88 and a net revenue loss in the $10 million range for 1988-89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the PITL.

Title VIIA4r: Minimum Tax Provisions - Individuals

ACTION: <u>INCLUDES AS A TAX PREFERENCE ITEM THE UNTAXED APPRECIATION IN CHARITABLE CONTRIBUTIONS APPRECIATED PROPERTY</u>

Act Section 701 Conference Report Page 258

Form 540 Line No. 73 Form 100 Line No. N/A

<u>CURRENT CALIFORNIA LAW (Sections 17063 and 17063.2)</u>

California law is generally similar to federal law, but there are numerous differences including preference items, exemption amounts, and tax rates. California imposes a tax on "tax preference income" in addition to the tax imposed on taxable income. The intent is to impose an additional tax on taxpayers who benefit substantially from various forms of tax-free income or large deductions under the regular income tax rates. The tax is computed on the total of tax preference items in excess of a base allowance exemption.

Current law does not include the untaxed appreciation in charitable contributions of appreciated property as a tax preference item.

However the law does provide that specified itemized deductions, including contributions, which exceed 60 percent of the taxpayer's adjusted gross income, reduced by itemized deductions other than those specified, are a tax preference item.

<u>FEDERAL LAW (Section 57)</u>

Federal law imposes an alternative minimum tax. The tax due for the taxable year is the alternative minimum tax or the regular income tax, whichever is greater.

Alternative minimum taxable income is the taxpayer's taxable income, determined with specified adjustments, and increased by the amount of items of tax preference.

The Act adds as a tax preference item the untaxed appreciation on charitable contributions made after August 16, 1986 of property that has appreciated in value. A taxpayer who makes a charitable contribution of capital gain property must redetermine the deduction for purposes of the alternative minimum tax by adding back the amount by which the taxpayer's regular tax charitable contribution deduction would be reduced if all capital gain property were taken into account at its adjusted basis. This preference does not apply to carryovers of the deduction for contributions made before August 16, 1986.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applicable to taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all individual minimum tax provisions. The JCT has indicated that, for provisions affecting individuals, the largest single item contributing to revenue gains is the passive loss provision which diminishes rapidly as the phase-in under the regular tax structure approaches 100 percent.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue losses under the PITL.

Projected state preference tax revenues are $442 million for 1987 and $473 million for 1988 under the PITL (assuming that capital gains will continue to be partially excluded from gross income). An approximation of AMT revenues that would be collected under the PITL is $140 million for 1987/88 and $80 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue losses under the PITL of $302 million for 1987/88 and $393 million for 1988/89. However, if the capital gains preference item under the PITL is repealed due to capital gain reform, the net impact from substituting the AMT for the preference tax structure would be a net revenue gain in the $56 million range for 1987-88 and a net revenue loss in the $10 million range for 1988-89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the PITL.

Title VIIA5: Minimum Tax Provisions - Individuals

ACTION: <u>CONFORMS DEFINITION OF INVESTMENT INTEREST TO DEFINITION FOR REGULAR INCOME TAX PURPOSES</u>

Act Section 701 — Conference Report Page 259

Form 540 Line No. 73 — Form 100 Line No. N/A

<u>CURRENT CALIFORNIA LAW (Sec. 17063.2)</u>

Under current law, California imposes a tax on tax preference income in addition to the tax imposed on taxable income. The intent is to impose an additional tax on taxpayers who benefit substantially from various forms of tax-free income or large deductions under the regular income tax rates. The tax is computed on the total of tax preference items in excess of a base allowable exemption.

One of the tax preference items is "excess itemized deductions" which is the amount by which total itemized deductions other than (1) state and local taxes, (2) medical and dental expenses, and (3) casualty losses, exceeds 60 percent of the taxpayer's adjusted gross income reduced by items (1) through (3).

<u>NEW FEDERAL LAW (Sec. 56(b)(1)(C) & (e))</u>

Federal law requires certain tax preference items to be subject to an alternative minimum tax. The tax due for the taxable year is the alternative minimum tax or the regular income tax, whichever is greater (adjusted by certain credits).

For taxable years beginning before January 1, 1987, the alternative minimum taxable income, upon which the alternative minimum tax was determined, was equal to the taxpayer's adjusted gross income reduced by certain itemized deductions and increased by specified tax preference items. One of the itemized deductions allowable in determining the alternative minimum taxable income, was "qualified interest" which was housing interest plus other interest to the extent it did not exceed the taxpayer's qualified net investment income (qualified investment income less qualified investment expenses) for the taxable year. Qualified investment income means the sum of gross income from interest, dividends, rents and royalties, and any amount treated as ordinary income from the disposition of depreciable property to the extent such income, gain, and amounts are not from a trade or business. Qualified investment expenses are deductions directly connected with the production of qualified investment income to the extent those deductions are allowable in computing adjusted gross income and are not items of tax preference.

For taxable years beginning on or after January 1, 1987, the Act provides that the alternative minimum taxable income is equal to the taxpayer's regular taxable income modified by certain adjustments, and increased by specified tax preference items. The act conforms the definition of investment interest for the alternative minimum tax to the definition used for regular income tax purposes. For minimum tax purposes, qualified interest continues to include qualified housing interest and a clarification is made that upon the refinancing of a loan that gives rise to qualified housing interest, interest paid on the new loan is treated as qualified housing interest to the extent it does not increase the amount of the loan and it qualified under the prior loan as housing interest.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all individual minimum tax provisions. The JCT has indicated that, for provisions affecting individuals, the largest single item contributing to revenue gains is the passive loss provision which diminishes rapidly as the phase-in under the regular tax structure approaches 100 percent.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue losses under the PITL.

Projected state preference tax revenues are $442 million for 1987 and $473 million for 1988 under the PITL (assuming that capital gains will continue to be partially excluded from gross income). An approximation of AMT revenues that would be collected under the PITL is $140 million for 1987/88 and $80 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue losses under the PITL of $302 million for 1987/88 and $393 million for 1988/89. However, if the capital gains preference item under the PITL is repealed due to capital gain reform, the net impact from substituting the AMT for the preference tax structure would be a net revenue gain in the $56 million range for 1987-88 and a net revenue loss in the $10 million range for 1988-89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the PITL.

ACTION: ADDS A CARRY-FORWARD TAX CREDIT AGAINST THE REGULAR TAX FOR PRIOR YEARS' MINIMUM TAX LIABILITY ATTRIBUTABLE TO TIMING PREFERENCES

Act Section 701 Conference Report Page 260

Form 540 Line No. 73 Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (None)

California law is generally similar to federal law, but there are numerous differences including preference items, exemption amounts, and tax rates. California imposes a tax on "tax preference income" in addition to the tax imposed on taxable income. The intent is to impose an additional tax on taxpayers who benefit substantially from various forms of tax-free income or large deductions under the regular income tax rates. The tax is computed on the total of tax preference items in excess of a base allowance exemption.

Current law does not provide for any tax credit attributable to tax on preference income.

NEW FEDERAL LAW (Sec. 53)

Minimum tax paid in one year may be carried forward (but not back) indefinitely as a credit against regular tax liability. The credit may not, however, reduce the regular tax below the alternative minimum tax for that year.
The credit for any tax year is the amount of the taxpayer's adjusted net minimum tax for all tax years beginning after 1986, less amounts credited against the regular tax. The adjusted net minimum tax is the taxpayer's minimum tax reduced by the amount that would have been the taxpayer's minimum tax had only the following preferences (so-called exclusion preferences) been taken into account: itemized deductions, percentage depletion, tax-exempt interest, and the appreciated property charitable deduction.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applicable to taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all individual minimum tax provisions. The JCT has indicated that, for provisions affecting individuals, the largest single item contributing to revenue gains is the passive loss provision which diminishes rapidly as the phase-in under the regular tax structure approaches 100 percent.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue losses under the PITL.

Projected state preference tax revenues are $442 million for 1987 and $473 million for 1988 under the PITL (assuming that capital gains will continue to be partially excluded from gross income). An approximation of AMT revenues that would be collected under the PITL is $140 million for 1987/88 and $80 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue losses under the PITL of $302 million for 1987/88 and $393 million for 1988/89. However, if the capital gains preference item under the PITL is repealed due to capital gain reform, the net impact from substituting the AMT for the preference tax structure would be a net revenue gain in the $56 million range for 1987-88 and a net revenue loss in the $10 million range for 1988-89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the PITL.

Title VIIA10: Minimum Tax Provisions - Individuals

ACTION: LIMITS TO 90 PERCENT OF MINIMUM TAXABLE INCOME THE AMOUNT OF NET OPERATING LOSS THAT CAN BE USED TO REDUCE MINIMUM TAXABLE INCOME

Act Section 701	Conference Report Page 262
Form 540 Line No. 73	Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17064.8)

California law is generally similar to federal law, but there are numerous differences including preference items, exemption amounts, and tax rates. California imposes a tax on "tax preference income" in addition to the tax imposed on taxable income. The intent is to impose an additional tax on taxpayers who benefit substantially from various forms of tax-free income or large deductions under the regular income tax rates. The tax is computed on the total of tax preference items in excess of a base allowance exemption.

California allows tax preference income to be reduced by the amount (if any) of the taxpayer's net operating loss not eligible for carryover to future years. After that adjustment, California conforms to old federal law which provided for deferring a portion of the tax imposed on preference income to the extent of the net operating loss carryover to future years. In any succeeding income year in which the net operating loss carryover reduces net income for that year, the tax previously deferred is added to the preference tax (if any) for that year.

NEW FEDERAL LAW (Sec. 56)

Federal law imposes an alternative minimum tax. The tax due for the taxable year is the alternative minimum tax or the regular income tax, whichever is greater (adjusted by certain credits).

Alternative minimum taxable income is the taxpayer's taxable income, determined with specified adjustments, and increased by the amount of items of tax preference.

The Act requires, as one of the adjustments to regular taxable income, that net operating losses be reduced so that they do not offset more than 90 percent of the alternative minimum taxable income. Amounts not used because of this limitation may be carried forward to future years.

For minimum tax purposes, a separate net operating loss must be computed in a manner consistent with the adjustments and preferences defined by the minimum tax. Pre-1987 NOLs do not have to be recomputed. Consequently, the amount of the NOL carryover for minimum tax purposes will differ from the NOL carryover for regular tax purposes because of this separate NOL computation and the 90 percent rule limitation.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applicable to taxable year beginning on or after January 1, 1987. For purposes of determining an individual's NOL adjustment for taxable years beginning after 1982 and before 1987, the loss is adjusted with respect to the pre-1987 law rules of Section 55(d)(2) as effective on October 21, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all individual minimum tax provisions. The JCT has indicated that, for provisions affecting individuals, the largest single item contributing to revenue gains is the passive loss provision which diminishes rapidly as the phase-in under the regular tax structure approaches 100 percent.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue losses under the PITL.

Projected state preference tax revenues are $442 million for 1987 and $473 million for 1988 under the PITL (assuming that capital gains will continue to be partially excluded from gross income). An approximation of AMT revenues that would be collected under the PITL is $140 million for 1987/88 and $80 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue losses under the PITL of $302 million for 1987/88 and $393 million for 1988/89. However, if the capital gains preference item under the PITL is repealed due to capital gain reform, the net impact from substituting the AMT for the preference tax structure would be a net revenue gain in the $56 million range for 1987-88 and a net revenue loss in the $10 million range for 1988-89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the PITL.

Title VIIA11: Minimum Tax Provisions — Individuals

ACTION: <u>ADDS SPECIFIC PROVISIONS RELATING TO TAXPAYERS SUBJECT TO THE AT-RISK RULES, TAX BENEFIT RULE, AND ESTATES AND TRUSTS</u>

Act Section 701 | Conference Report Page 262

Form 540 Line No. 73 | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17064.5)

California law is generally similar to federal law, but there are numerous differences including preference items, exemption amounts, and tax rates. California imposes a tax on "tax preference income" in addition to the tax imposed on taxable income. The intent is to impose an additional tax on taxpayers who benefit substantially from various forms of tax-free income or large deductions under the regular income tax rates. The tax is computed on the total of tax preference items in excess of a base allowance exemption.

Under California law, the following special rules apply:

(1) The items of tax preference of an estate or trust are apportioned between the estate or trust and the beneficiaries on the basis of the net income of the estate or trust allocable to each. (Conforms to old IRC Section 58(c).)

(2) The $4,000 base allowance applicable to an estate or trust is reduced to an amount which bears the same ratio to $4,000 as the portion of the sum of the items of tax preference allocated to the estate or trust is to total items of tax preference. (No comparable provision in federal law.)

(3) In the case of a nonresident or part-year resident, minimum tax is computed on total items of tax preference from all sources, and this tax is then reduced to the ratio of California source items of tax preference to total items of tax preference. (Under IRC Section 897(a)(2), the alternative minimum tax of a nonresident alien is not less than 20 percent of the lesser of (i) the individual's alternative minimum taxable income, or (ii) the individual's net gain from dispositions of United States real property interests for the taxable year.)

(4) The items of tax preference of a common trust fund are apportioned among and treated as items of tax preference of the individual participants of the fund.

(Conforms to old IRC Section 58(e) and new IRC Section 59(d)(1)(B).)

(5) Where a return is made for a short period (less than 12 months), the base allowance is reduced to the ratio of the number of days in the short period to 365 days. (Under IRC Section 443(d), the alternative minimum taxable income for the short period is annualized, and the alternative minimum tax on that amount is then reduced to the ratio of the number of months in the short period to 12 months.)

(6) Tax on preference income is not included in the computation of estimated tax. (IRC Section 6654(d) provides for the inclusion of the alternative minimum tax in the payment of estimated tax.)

(7) The tax on preference income is not considered in the computation of the credit for taxes paid to another state. (Old IRC Section 55(c)(2) provided for allowance of the foreign tax credit in the computation of the alternative minimum tax, limited to the ratio of alternative minimum taxable income from sources without the United States to total alternative minimum taxable income.)

(8) The Franchise Tax Board shall prescribe regulations under which items of tax preference shall be properly adjusted where the tax treatment giving rise to those items will not result in the reduction of the taxpayer's tax. (Tax benefit rule.) (Conforms to old IRC Section 58(h), and new IRC Section 59(g).)

NEW FEDERAL LAW (Sections 59 and 897)

Federal law imposes an alternative minimum tax. The tax due for the taxable year is the alternative minimum tax or the regular income tax, whichever is greater (adjusted by certain credits).

Alternative minimum tax is the taxpayers taxable income, determined with specified adjustments, and increased by the amount of items of tax preference.

The Act provides new rules for items (1), (2), (3), and (7) above.

(1)
and
(2) In the case of an estate or trust, instead of allocating items of tax preference between the estate or trust and its beneficiaries (old IRC Sec. 58(c)), the minimum taxable income will be computed by determining taxable income under the general rules for the regular tax, taking into account any adjustments required under the minimum tax rules. The $20,000

exemption is deducted from minimum taxable income after the deduction for distributions to beneficiaries. Thus, the estate or trust receives the full benefit of the $20,000 exemption (no allocation).

(3) The rate specified in IRC Section 897(a)(2) is increased from 20 percent to 21 percent.

(7) The foreign tax credit cannot offset more than 90 percent of the minimum tax liability determined without regard to foreign tax credits and net operating losses. (IRC Sec. 59(a).)

In addition the Act clarifies that code sections suspending losses, and other sections specified in regulations, are recomputed for minimum tax purposes, to apply with respect to amounts otherwise deductible for purposes of the minimum tax. Thus, the amount of the deductions suspended or recaptured may differ for regular and minimum tax purposes, respectively. This clarification applies with respect to all taxpayers subject to the at-risk rules. (IRC Section 59(h).)

Also, since the regular and minimum taxes generally are computed separately, relief from the minimum tax under the tax benefit rule (IRC Sec. 59(g)) is not appropriate solely by reason of the fact that a taxpayer receives no benefit under the regular tax with respect to a particular item.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applicable to taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all individual minimum tax provisions. The JCT has indicated that, for provisions affecting individuals, the largest single item contributing to revenue gains is the passive loss provision which diminishes rapidly as the phase-in under the regular tax structure approaches 100 percent.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue losses under the PITL.

Projected state preference tax revenues are $442 million for 1987 and $473 million for 1988 under the PITL (assuming that capital gains will continue to be partially excluded from gross income). An approximation of AMT revenues that would be collected under the PITL is $140 million for 1987/88 and $80 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue losses under the PITL of $302 million for 1987/88 and $393 million for 1988/89. However, if the capital gains preference item under the PITL is repealed due to capital gain reform, the net impact from substituting the AMT for the preference tax structure would be a net revenue gain in the $56 million range for 1987-88 and a net revenue loss in the $10 million range for 1988-89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the PITL.

Title VIIB1: Minimum Tax Provisions - Corporations

ACTION: REPLACES THE ADD-ON CORPORATE TAX WITH AN ALTERNATIVE MINIMUM TAX

Act Section 701 | Conference Report Page 264

Form 540 Line No. N/A | Form 100 Line No. 20

CURRENT CALIFORNIA LAW (Sec. 23400 - 23405)

California law is generally similar to federal law, but there are numerous differences including preference items, exemption amounts, and tax rates. California imposes a tax on "tax preference income" in addition to the tax imposed on taxable income. The intent is to impose an additional tax on taxpayers who benefit substantially from various forms of tax-free income, large deductions, or tax credits under the regular income tax computation.

OLD FEDERAL LAW (Sec. 55-58)

For taxable years beginning before January 1, 1987, corporations (other than an S corporation) were subject to an "add-on" minimum tax on tax preference income, similar to the "add-on" minimum tax on preference income under California law.

NEW FEDERAL LAW (Sec. 55-58)

For taxable years beginning on or after January 1, 1987, HR 3838 replaces the corporation add-on minimum tax with an alternative minimum tax, similar to that imposed on individuals. The alternative minimum taxable income is equal to the taxpayer's regular taxable income modified by adjustments for items of tax preference.

Rules similar to those under the alternative minimum tax for individuals apply to incentive credits, the foreign tax credit, net operating losses, and the credit for minimum tax liability attributable to timing preferences.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all corporate minimum tax provisions. For the corporate minimum tax estimate, the largest single item contributing to revenue gains is the inclusion of a portion of book income as taxable income.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue gains under the B&CTL.

Projected state preference tax revenues are $7 million under the B&CTL for 1987 and 1988. An approximation of AMT revenues that would be collected under the B&CTL are $240 million for 1987/88 and $230 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue gains under the B&CTL of $233 million for 1987/88 and $223 million for 1988/89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the B&CT Law.

Title VIIB2: Minimum Tax Provisions – Corporations

ACTION: REPLACES THE CORPORATION 15 PERCENT ADD-ON TAX WITH A 20 PERCENT ALTERNATIVE MINIMUM TAX

Act Section 701 | Conference Report Page 264

Form 540 Line No. N/A | Form 100 Line No. 20

CURRENT CALIFORNIA LAW (Sec. 23400)

Under current law, California imposes a 2.5 percent tax on "tax preference income" in addition to the tax imposed on taxable income. The intent is to impose an additional tax on taxpayers who benefit substantially from various forms of tax-free income or large deductions under the regular income tax computation.

OLD FEDERAL LAW (Sec. 55)

For taxable years beginning before January 1, 1987, corporations (other then S corporations) were subject to a 15 percent "add-on" minimum tax on tax preference income, similar to the "add-on" minimum tax on preference income under California law.

NEW FEDERAL LAW (Sec. 55)

For taxable years beginning on or after January 1, 1987, HR 3838 replaces the corporation add-on minimum tax with an alternative minimum tax, similar to that imposed on individuals. The rate of tax is increased from 15 percent to 20 percent. Corporations will now be required to pay the higher of their regular tax liability or their minimum tax liability.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all corporate minimum tax provisions. For the corporate minimum tax estimate, the largest single item contributing to revenue gains is the inclusion of a portion of book income as taxable income.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue gains under the B&CTL.

Projected state preference tax revenues are $7 million under the B&CTL for 1987 and 1988. An approximation of AMT revenues that would be collected under the B&CTL are $240 million for 1987/88 and $230 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue gains under the B&CTL of $233 million for 1987/88 and $223 million for 1988/89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H. R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the B&CT Law.

TAX POLICY ISSUES

(1) Is voluntary assessment and payment of individual and/or corporate taxes influenced by public perceptions of "equity" and "fairness" and, more specifically, by the marginal tax rate imposed upon items of corporate preference income?

(2) Will an increase in the marginal rate of tax on items of corporate preference income ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and tax credits?

(3) What is the appropriate relationship between regular tax rates and the tax rates imposed upon items of preference income?

		Pref/Reg		Ratio
(A)	OLD FEDERAL LAW	15/46	=	.326
(B)	NEW FEDERAL LAW	20/34	=	.588
(C)	CALIFORNIA LAW	2.5/9.6	=	.260

Title VIIB3: Minimum Tax Provisions - Corporations

ACTION: INCREASES THE EXEMPTION AMOUNT TO $40,000

Act Section 701 Conference Report Page 264

Form 540 Line No. N/A Form 100 Line No. 20

CURRENT CALIFORNIA LAW (Sec. 23400)

Under current law, California imposes a tax on "tax preference income" in addition to the tax imposed on taxable income. The intent is to impose an additional tax on taxpayers who benefit substantially from various forms of tax-free income or large deductions under the regular income tax computation. The tax is computed on the total of tax preference items in excess of $30,000.

OLD FEDERAL LAW (Sec. 55)

For taxable years beginning before January 1, 1987, corporations (other then S corporations) were subject to an "add-on" minimum tax on tax preference income, similar to the "add-on" minimum tax on preference income under California law. The minimum tax base was the total of the corporation's tax preference income reduced by the greater of (1) $10,000 or (2) the full amount of its regular income tax.

NEW FEDERAL LAW (Sec. 55)

For taxable years beginning on or after January 1, 1987, HR 3838 replaces the corporation add-on minimum tax with an alternative minimum tax, similar to that imposed on individuals. The new exemption amount is $40,000, but is phased out at the rate of 25 cents on the dollar when alternative minimum taxable income exceeds $150,000.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all corporate minimum tax provisions. For the corporate minimum tax estimate, the largest single item contributing to

revenue gains is the inclusion of a portion of book income as taxable income.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue gains under the B&CTL.

Projected state preference tax revenues are $7 million under the B&CTL for 1987 and 1988. An approximation of AMT revenues that would be collected under the B&CTL are $240 million for 1987/88 and $230 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue gains under the B&CTL of $233 million for 1987/88 and $223 million for 1988/89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the B&CT Law.

TAX POLICY ISSUES

The difference between the state exemption ($30,000) and the new federal exemption ($40,000 with phase-out) is probably not significant and the administrative burden placed in the taxpayer might be reduced through conformity.

Title VIIB4a: Minimum Tax Provisions — Corporations

ACTION: <u>REVISES THE AMOUNT OF ACCELERATED DEPRECIATION ON REAL PROPERTY TO BE INCLUDED AS A TAX PREFERENCE ITEM</u>

Act Section 701 — Conference Report Page 265

Form 540 Line No. N/A — Form 100 Line No. 20

CURRENT CALIFORNIA LAW (Sec. 23401)

California law conforms in principle to federal law in including as a tax preference income item depreciation in excess of the straight-line amount on real property. The amount of this excess, however, may be different from federal where there are differences in depreciation allowable for regular income tax purposes.

NEW FEDERAL LAW (Sec. 56)

H.R. 3838 changes the amount of accelerated depreciation on real property to be included as a tax preference item to the excess of regular tax depreciation (straight-line over 27.5 or 31.5 years) over the new alternative depreciation provisions (straight-line over 40 years) provided for in the Act.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applicable to taxable years beginning on or after January 1, 1987 for real property placed in service on or after that date. Exceptions are provided for certain property constructed reconstructed, or acquired pursuant to a written contract that was binding as of March 1, 1986, and placed in service by a specified date.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate for all corporate minimum tax provisions. For the corporate minimum tax estimate, the largest single item contributing to revenue gains is the inclusion of a portion of book income as taxable income.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue gains under the B&CTL.

Projected state preference tax revenues are $7 million under the B&CTL for 1987 and 1988. An approximation of AMT revenues that would be collected under the B&CTL are $240 million for 1987/88 and $230 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue gains under the B&CTL of $233 million for 1987/88 and $223 million for 1988/89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the B&CT Law.

Title VIIB4b: Minimum Tax Provisions - Corporations

ACTION: ADJUSTS ACCELERATED DEPRECIATION ON PERSONAL PROPERTY FOR ALTERNATIVE MINIMUM TAX

Act Section 701 | Conference Report Page 265

Form 540 Line No. N/A | Form 100 Line No. 20

CURRENT CALIFORNIA LAW (Section 23401)

California imposes a tax on "tax preference income" in addition to the tax imposed on taxable income. The intent is to impose an additional tax on taxpayers who benefit substantially from various forms of tax-free income or large deductions under the regular income tax rates. The tax is computed on the total of tax preference items in excess of $30,000.

Current law does not include any portion of depreciation on personal property as a tax preference item.

NEW FEDERAL LAW (Sections 55 and 56)

Federal law imposes an alternative minimum tax. The tax due for the taxable year is the alternative minimum tax or the regular income tax, whichever is greater (adjusted by certain credits).

Alternative minimum tax is the taxpayer's taxable income, determined with specified adjustments, and increased by the amount of items of tax preference.

For minimum tax purposes, depreciation on leased personal property or leased recovery property is no longer treated as an item of tax preference solely for personal holding companies. Instead, the Act requires that all corporations computing alternative minimum taxable income determine the allowable depreciation by using the 150 percent declining method (switching to straight-line in the year necessary to maximize the allowance) over an asset's ADR mid-point life for assets, other than tangible personal property for which the "alternative ACRS (straight-line) method" is elected, and transition property, placed in service after 1986.

Transition property generally is property which (a) was subject to a binding contract or under construction before 1986 in the case of property qualifying for the investment tax credit, and before March 1986 in the case of recovery property; and (b) which is placed in service before specified deadlines depending on the ADR midpoint and whether it is ITC property or recovery property.

For property placed in service before 1987, or under the transition rules of the Act, the amount of accelerated depreciation treated as a preference item is determined under prior law.

When property acquired after 1986 (other than transition property) is disposed of, gain or loss for minimum tax purposes will be computed by reference to basis as adjusted for depreciation allowed under the minimum tax.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applicable to personal property first placed in service on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all corporate minimum tax provisions. For the corporate minimum tax estimate, the largest single item contributing to revenue gains is the inclusion of a portion of book income as taxable income.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue gains under the B&CTL.

Projected state preference tax revenues are $7 million under the B&CTL for 1987 and 1988. An approximation of AMT revenues that would be collected under the B&CTL are $240 million for 1987/88 and $230 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue gains under the B&CTL of $233 million for 1987/88 and $223 million for 1988/89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the B&CT Law.

Title VIIB4c: Minimum Tax Provisions - Corporations

ACTION: ADDS INTANGIBLE DRILLING COSTS AS A TAX PREFERENCE ITEM FOR ALL CORPORATIONS

Act Section 701 Conference Report Page 266

Form 540 Line No. N/A Form 100 Line No. 20

CURRENT CALIFORNIA LAW (Section 23401)

Under California law, no part of any corporation's intangible drilling and development costs is a tax preference item.

OLD FEDERAL LAW (Section 57)

Under old federal law the amount of the excess of intangible drilling and development costs which exceeded 100 percent of net oil and gas income was a tax preference item, but only for personal holding companies. Excess costs were defined as the ITC costs (other than costs incurred in drilling a nonproductive well) over that which would have been allowable if these costs had been amortized over 120 months (beginning with the month production from the well begins) or cost depletion. This computation was applied separately with respect to oil and gas properties, and properties which are geothermal deposits.

NEW FEDERAL LAW (Section 57)

The Act increases the amount of intangible drilling and development costs by including the costs in excess of 65 percent of the net oil and gas income as a tax preference item for all corporations.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applicable to taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all corporate minimum tax provisions. For the corporate minimum tax estimate, the largest single item contributing to revenue gains is the inclusion of a portion of book income as taxable income.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue gains under the B&CTL.

Projected state preference tax revenues are $7 million under the B&CTL for 1987 and 1988. An approximation of AMT revenues that would be collected under the B&CTL are $240 million for 1987/88 and $230 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue gains under the B&CTL of $233 million for 1987/88 and $223 million for 1988/89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the B&CT Law.

Title VIIB4e: Minimum Tax Provisions - Corporations

ACTION: INCREASES EXCESS MINING EXPLORATION AND DEVELOPMENT COSTS AS A TAX PREFERENCE INCOME ITEM

Act Section 701 | Conference Report Page 267

Form 540 Line No. N/A | Form 100 Line No. 20

CURRENT CALIFORNIA LAW (Section 23401)

California imposes a tax on "tax preference income" in addition to the tax imposed on taxable income. The intent is to impose an additional tax on taxpayers who benefit substantially from various forms of tax-free income or large deductions under the regular income tax rates. The tax is computed on the total of tax preference items in excess of $30,000.

Current law does not include any portion of mining exploration and development costs as a tax preference item.

NEW FEDERAL LAW (Sections 55, 56, 57 and 59)

Federal law imposes an alternative minimum tax. The tax due for the taxable year is the alternative minimum tax or the regular income tax, whichever is greater (adjusted by certain credits).

Alternative minimum tax is the taxpayer's taxable income, determined with specified adjustments, and increased by the amount of items of tax preference.

The Act increases the amount of expensed mining exploration and development costs with respect to each mine or other natural deposit (other than an oil, gas, or geothermal well) to be included as a tax preference item, and applies this provision to all corporations (formerly it was applied only to personal holding companies).

It does this by requiring that all mining exploration and development costs paid or incurred after 1986, and which are expensed under Sections 616 and 617, or amortized under Section 291, be capitalized and recovered ratably over a 10-year period beginning with the taxable year in which the expenditures were made. (Formerly this was a tax preference item only for personal holding companies.)

If a loss is sustained with respect to a mining property (e.g., the mine is abandoned as worthless, giving rise to a loss under Section 165), the taxpayer is permitted to deduct, for minimum tax purposes, all mining exploration and development costs relating to that property that have been capitalized and not yet written off under the minimum tax.

The amount of these costs which will be treated as a preference is increased, since Section 291 has been amended to require that 30 percent of exploration and development costs of corporations paid or incurred after 1986, be capitalized and recovered over a five-year (60 months) straight-line period beginning with the month that the expenditures were made. (Formerly 20 percent of these costs were required to be capitalized and recovered at varying percentages over a five-year period.) In addition, Sections 616 and 617 were amended to require that all foreign exploration and development costs paid or incurred after 1986 be recovered either (1) over a 10-year straight-line amortization schedule, or (2) at the election of the taxpayer, as part of the adjusted basis for computing cost depletion.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applicable to taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all corporate minimum tax provisions. For the corporate minimum tax estimate, the largest single item contributing to revenue gains is the inclusion of a portion of book income as taxable income.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue gains under the B&CTL.

Projected state preference tax revenues are $7 million under the B&CTL for 1987 and 1988. An approximation of AMT revenues that would be collected under the B&CTL are $240 million for 1987/88 and $230 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue gains under the B&CTL of $233 million for 1987/88 and $223 million for 1988/89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the B&CT Law.

Title VIIB4g: Minimum Tax Provisions - Corporations

ACTION: DELETES EXCESS RESEARCH AND EXPERIMENTAL EXPENDITURES AS A TAX PREFERENCE ITEM FOR PERSONAL HOLDING CORPORATIONS

Act Section 701 Conference Report Page 268

Form 540 Line No. N/A Form 100 Line No. 20

CURRENT CALIFORNIA LAW (Section 23401)

California imposes a tax on "tax preference income" in addition to the tax imposed on taxable income. The intent is to impose an additional tax on taxpayers who benefit substantially from various forms of tax-free income or large deductions under the regular income tax rates. The tax is computed on the total of tax preference items in excess of $30,000.

Current law does not include any portion of research and experimental expenditures as a tax preference item.

NEW FEDERAL LAW (Sections 56, 59, and 174)

Federal law imposes an alternative minimum tax. The tax due for the taxable year is the alternative minimum tax or the regular income tax, whichever is greater (adjusted by certain credits).

Alternative minimum tax is the taxpayers taxable income, determined with specified adjustments, and increased by the amount of items of tax preference.
Repeals the requirement for personal holding companies to include the excess of research and experimental expenditures paid or incurred over the amount that would have been allowable as a deduction if they had been capitalized and amortized ratably over a 10-year period. The former provisions of Section 174, providing for capitalizing these expenditures and amortizing them over a 10-year period for regular income tax purposes, have been retained. (Sec. 59(e) and 174(b))

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applicable to taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all corporate minimum tax provisions. For the corporate minimum tax estimate, the largest single item contributing to revenue gains is the inclusion of a portion of book income as taxable income.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue gains under the B&CTL.

Projected state preference tax revenues are $7 million under the B&CTL for 1987 and 1988. An approximation of AMT revenues that would be collected under the B&CTL are $240 million for 1987/88 and $230 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue gains under the B&CTL of $233 million for 1987/88 and $223 million for 1988/89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the B&CT Law.

Title VIIB4i: Minimum Tax Provisions – Corporations

ACTION: INCLUDES NET CAPITAL GAINS IN THE COMPUTATION OF MINIMUM TAXABLE INCOME

Act Section 701 | Conference Report Page 268

Form 540 Line No. N/A | Form 100 Line No. 20

CURRENT CALIFORNIA LAW (Sections 23400 and 23401)

California imposes an add-on tax of 2 1/2 percent on the amount of preference income which exceeds $30,000. Net capital gains is not included as a preference item, because net capital gains are included in full in the measure of income for regular tax purposes.

NEW FEDERAL LAW (Section 55)

This Act repeals the add-on minimum tax for corporations and replaces it with an alternative minimum tax, similar to that for individuals. Alternative minimum taxable income is the corporation's regular taxable income (or loss), as modified by certain adjustments, plus preference items, and reduced by a phased-out exemption of $40,000. Capital gains are fully included in the computation of the alternative minimum taxable income; however, capital gains will not generate any minimum tax revenues since, under the Act, capital gains are fully included in taxable income subject to the regular tax.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applicable to taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all corporate minimum tax provisions. For the corporate minimum tax estimate, the largest single item contributing to revenue gains is the inclusion of a portion of book income as taxable income.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue gains under the B&CTL.

Projected state preference tax revenues are $7 million under the B&CTL for 1987 and 1988. An approximation of AMT revenues that would be collected under the B&CTL are $240 million for 1987/88 and $230 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue gains under the B&CTL of $233 million for 1987/88 and $223 million for 1988/89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the B&CT Law.

Title VIIB4j: Minimum Tax Provisions - Corporations

ACTION: <u>INCLUDES INTEREST ON TAX-EXEMPT BONDS AS A TAX PREFERENCE ITEM</u>

Act Section 701 | Conference Report Page 269

Form 540 Line No. N/A | Form 100 Line No. 20

<u>CURRENT CALIFORNIA LAW (Section 23401)</u>

California imposes a tax on "tax preference income" in addition to the tax imposed on taxable income. The intent is to impose an additional tax on taxpayers who benefit substantially from various forms of tax-free income or large deductions under the regular tax provisions. Interest on tax-exempt bonds is not a preference item because all such interest is included in the measure of income for regular tax purposes of corporations subject to the franchise tax provisions of the law. For corporations subject only to the income tax provisions of the law (corporations which derive income from California sources, but not doing business in this state), interest income is not a tax preference item as it is includible in regular taxable income to the extent it is not barred under the Constitution or laws of the United States or by the California constitution.

California has not adopted the provisions of IRC Sections 103 and 103A that exempt interest on certain state and local government obligations. Interest on such bonds issued by other states is already subject to California tax, while interest on bonds issued in California is exempt from tax under other provisions of the law.

<u>NEW FEDERAL LAW (Section 57, Section 103 amended, Section 103A repealed, Sections 141-150 added)</u>

The Act reorganized, as well as amended, the rules governing tax exemption for interest on government bonds. It amended Section 103, repealed Section 103A, and added new Sections 141-150.

Section 103 continues to recognize the principle that when bond proceeds are used exclusively for traditional governmental purposes the interest earned on the bonds is excludable from gross income. Bond interest, however, is taxable when it is derived from (a) state or local bonds that have not been issued in registered form, (b) arbitrage bonds, or (c) private activity bonds that are not exempt as qualified bonds.

The new Sections 141-150 organize various bond-related topics and impose a number of new limitations.

As a general rule, the interest earned on "private activity bonds" is not tax-exempt unless 95 percent or more of the net bonds proceeds are related to the governmental use financed by the issue and the issuance of the bonds falls under a codified exception. New Section 150(a)(3) defines "net proceeds" as the proceeds of an issue reduced by amounts in a reasonably required reserve or replacement fund. The term does not include the cost of issuance.

Alternative tests: An obligation is a private activity bond if:

(1) 10 percent or more of the bond proceeds are used for private business purposes and 10 percent or more of the debt service is derived from private use or is secured by payments or property used in a trade or business (Sec. 141(b)(1));

(2) more than five percent of the bond proceeds are both (a) used for private business purposes and (b) either derived from the private use or secured by the privately-used property or payments related to the use of that property (Sec. 141(b)(2));

(3) an amount exceeding the lesser of five percent of $5 million of the bond proceeds is used to finance loans to private persons (Sec. 141(c)).

"Private business use" means any direct or indirect use in a trade or business carried on by an individual or entity other than a governmental unit. Business use as a member of the general public is not taken into account for this purpose (Sec. 141(b)(6)).

In addition, a bond issue will not be tax exempt unless it meets three criteria:

(1) The amount of the issue must fall within the state volume cap (Sec. 146);

(2) The issue must satisfy each of the requirements in Section 147; and

(3) The issue must be either (a) an exempt facility bond, (b) a qualified mortgage bond, (c) a qualified veterans' mortgage bond, (d) a qualified small issue bond; (e) a qualified student loan bond, (f) a qualified redevelopment bond, or (g) a qualified Section 501(c)(3) bond. (Sec. 141(d)).

The Act also adds, as a new tax preference item, interest that is exempt for regular tax purposes on qualified private activity bonds issued after August 7, 1986. (Sec 157(a)(5)). Bonds issued before September 1, 1986 are treated as issued before August 8, 1986, if they meet the pre-1987 definition of governmental bond (as modified by an expanding security test), unless these bonds would be private activity bonds as defined in Section 141, modified as follows: 25 percent, rather than 10 percent, of the proceeds must be used for private business or as private security or payment; the five percent test in cases of unrelated private business use and the output facilities test is disregarded; and the private loan financing test is computed without regard to the $5 million limitation in Section 141(c)(1)(B). Sec. 57(a)(5)(c)(iv))

Where interest is included as a tax preference, but is excludable for regular tax purposes, Section 265 denying deduction for expenses and interest relating to tax-exempt income does not apply to the interest exclusion for minimum tax purposes. (Sec. 57(a)(5)(A))

Interest on current or advance refundings of bonds issued before August 8, 1986 (or September 1, 1986) is not a tax preference item. In the case of a series of current refunding, the original bond must have been issued before that date. Interest on qualified Section 501(c)(3) bonds is also excepted. (Sec. 57(a)(5)(c)(ii) and (iii))

A "qualified 501(c)(3) bond "is any private activity bond issued by a non-profit religious, charitable, scientific, or educational, organization (including certain hospital service organizations and certain amateur athletic organizations) that is an exempt organization under Internal Revenue Service Section 501(c)(3), if all property to be provided by the net proceeds of the issue is to be owned by the exempt organization or a governmental unit, and the bond would not be a private activity bond if (1) these exempt organizations were treated as governmental units with respect to their activities which are not unrelated trades or businesses, and (2) '5 percent' is substituted for '10 percent' in the tests for private activity bonds described above.

A $150 million limitation also applies on these bonds (other than a qualified hospital bond).

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applicable to taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all corporate minimum tax provisions. For the corporate minimum tax estimate, the largest single item contributing to

revenue gains is the inclusion of a portion of book income as taxable income.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue gains under the B&CTL.

Projected state preference tax revenues are $7 million under the B&CTL for 1987 and 1988. An approximation of AMT revenues that would be collected under the B&CTL are $240 million for 1987/88 and $230 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue gains under the B&CTL of $233 million for 1987/88 and $223 million for 1988/89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the B&CT Law.

Title VIIB4k: Minimum Tax Provisions - Corporations

ACTION: <u>REQUIRES THE USE OF THE PERCENTAGE OF COMPLETION METHOD OF ACCOUNTING WITH RESPECT TO LONG-TERM CONTRACTS</u>

Act Section 701 Conference Report Page 269

Form 540 Line No. N/A Form 100 Line No. 20

<u>CURRENT CALIFORNIA LAW (Section 23401)</u>

California imposes a tax on "tax preference income" in addition to the tax imposed on taxable income. The intent is to impose an additional tax on taxpayers who benefit substantially from various forms of tax-free income or large deductions under the regular income tax rates. The tax is computed on the total of tax preference items in excess of $30,000.

Current law does not include any part of income from long-term contracts as a tax preference item.

<u>NEW FEDERAL LAW (Section 55 and 56)</u>

Federal law imposes an alternative minimum tax. The tax due for the taxable year is the alternative minimum tax or the regular income tax, whichever is greater (adjusted by certain credits).

Alternative minimum tax is the taxpayers taxable income, determined with specified adjustments, and increased by the amount of items of tax preference.
The Act requires, as one of the adjustments to regular taxable income, that the percentage of completion method of accounting must be used with respect to long-term contracts entered into by the taxpayer on or after March 1, 1986.

<u>EFFECTIVE DATE OF FEDERAL PROVISIONS</u>

Applicable to taxable years beginning on or after January 1, 1987.

<u>REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW</u>

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all corporate minimum tax provisions. For the corporate minimum tax estimate, the largest single item contributing to

revenue gains is the inclusion of a portion of book income as taxable income.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue gains under the B&CTL.

Projected state preference tax revenues are $7 million under the B&CTL for 1987 and 1988. An approximation of AMT revenues that would be collected under the B&CTL are $240 million for 1987/88 and $230 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue gains under the B&CTL of $233 million for 1987/88 and $223 million for 1988/89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the B&CT Law.

Title VIIB41: Minimum Tax Provisions - Corporations

ACTION: INCLUDES AS A TAX PREFERENCE ITEM THE FULL GAIN REALIZED ON INSTALLMENT SALES OF DEALER PROPERTY IN THE YEAR OF DISPOSITION

Act Section 701 | Conference Report Page 270

Form 540 Line No. N/A | Form 100 Line No. 20

CURRENT CALIFORNIA LAW (Sec. 23401)

California law is generally similar to federal law, but there are numerous differences including preference items, exemption amounts, and tax rates. California imposes a tax on "tax preference income" in addition to the tax imposed on taxable income. The intent is to impose an additional tax on taxpayers who benefit substantially from various forms of tax-free income or large deductions under the regular income tax rates. The tax is computed on the total of tax preferences items in excess of a base allowance exemption.

Current law does not include any part of dealer installment sales as a tax preference item.

NEW FEDERAL LAW (Sec. 56)

Federal law imposes an alternative minimum tax. The tax due for the taxable year is the alternative minimum tax or the regular income tax, whichever is greater (adjusted by certain credits). Alternative minimum tax is the taxpayer's taxable income, determined with specified adjustments, and increased by the amount of items of tax preference.

The Act requires, as one of the adjustments to regular taxable income, that in the year of disposition the full gain, less the amount recognized in that year for regular tax purposes, be included in the alternative minimum taxable income. This provision applies to:

- stock in trade of the taxpayer's inventory, and property held for sale to customers disposed of after March 1, 1986;

- Personal property disposed of after February 28, 1986, by a person who regularly sells personal property on the installment plan;

- Real property disposed of after February 28, 1986, that was held for sale to customers; and

- Real property disposed of after August 16, 1986, (with a sales price exceeding $150,000) that is used in the taxpayer's business or is held for the production of rental income.

Excepted from this provision are installment sales of:

- Personal use property
- Farm property
- Timeshares and residential lots, if the taxpayer elected to exclude the disposition from the installment sale proportionate disallowance rules.
- Manufacturers to dealers if (1) the dealer is obligated to pay on the obligation only when the dealer resells or rents the property, or (2) the manufacturer has the right to repurchase the property at a fixed or ascertainable price no later than the nine-month period beginning with the date of the sale. In addition, the aggregate face amount of the obligations that otherwise qualify for the exception must be equal to 50 percent of the total sales to dealers giving rise to the installment receivables in both the current tax year and the preceding year (e.g., the 50-percent test). A seller will be treated as failing to meet the 50-percent test only if it fails to meet the test for two consecutive tax years. This exception applies only if the taxpayer meets these requirements for its first tax year beginning after October 22, 1986, the Act's enactment date.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applicable to taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all corporate minimum tax provisions. For the corporate minimum tax estimate, the largest single item contributing to revenue gains is the inclusion of a portion of book income as taxable income.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue gains under the B&CTL.

Projected state preference tax revenues are $7 million under the B&CTL for 1987 and 1988. An approximation of AMT revenues that would be collected under the B&CTL are $240 million for 1987/88 and $230 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue gains under the B&CTL of $233 million for 1987/88 and $223 million for 1988/89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the B&CT Law.

Title VIIB4n: Minimum Tax Provisions - Corporations

ACTION: <u>INCLUDES AS A TAX PREFERENCE ITEM THE UNTAXED APPRECIATION IN CHARITABLE CONTRIBUTIONS OF APPRECIATED PROPERTY</u>

Act Section 701 | Conference Report Page 258

Form 540 Line No. N/A | Form 100 Line No. 20

CURRENT CALIFORNIA LAW (Section 23401)

California law is generally similar to federal law, but there are numerous differences including preference items, exemption amounts, and tax rates. California imposes a tax on "tax preference income" in addition to the tax imposed on taxable income. The intent is to impose an additional tax on taxpayers who benefit substantially from various forms of tax-free income or large deductions under the regular income tax rates. The tax is computed on the total of tax preference items in excess of a base allowance exemption.

Current law does not include the untaxed appreciation in charitable contributions of appreciated property as a tax preference item.

FEDERAL LAW (Sec. 57)

Federal law imposes an alternative minimum tax. The tax due for the taxable year is the alternative minimum tax or the regular income tax, whichever is greater.

Alternative minimum taxable income is the taxpayer's taxable income, determined with specified adjustments, and increased by the amount of items of tax preference.

The Act adds as a tax preference item the untaxed appreciation on charitable contributions made after August 16, 1986 of property that has appreciated in value. A taxpayer who makes a charitable contribution of capital gain property must redetermine the deduction for purposes of the alternative minimum tax by adding back the amount by which the taxpayer's regular tax charitable contribution deduction would be reduced if all capital gain property were taken into account at its adjusted basis. This preference does not apply to carryovers of the deduction for contributions made before August 16, 1986.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applicable to taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all corporate minimum tax provisions. For the corporate minimum tax estimate, the largest single item contributing to revenue gains is the inclusion of a portion of book income as taxable income.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue gains under the B&CTL.

Projected state preference tax revenues are $7 million under the B&CTL for 1987 and 1988. An approximation of AMT revenues that would be collected under the B&CTL are $240 million for 1987/88 and $230 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue gains under the B&CTL of $233 million for 1987/88 and $223 million for 1988/89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the B&CT Law.

Title VIIB4r: Minimum Tax Provisions - Corporations

ACTION: <u>INCLUDES IN TAX PREFERENCE INCOME AN ADJUSTMENT FOR BOOK INCOME AND CURRENT EARNINGS</u>

Act Sections 701 and 702	Conference Report Page 272
Form 540 Line No. N/A	Form 100 Line No. 20

<u>CURRENT CALIFORNIA LAW (Section 23401)</u>

California law is generally similar to federal law in that both impose an add-on tax on "tax preference income", but there are numerous differences including the items of tax preference, exemption amounts, and tax rates. California imposes an add-on tax on "tax preference income" which exceeds $30,000, in addition to the tax imposed on taxable income. The intent is to impose an additional tax on taxpayers who benefit substantially from various forms of tax-free income, large deductions, or tax credits under the regular income tax computation.

Current state and federal law do not include, as a tax preference item, any adjustment reflecting the difference between the corporations "book income" or "pre-tax earnings" and its income subject to regular tax.

<u>NEW FEDERAL LAW (Sections 55 - 59)</u>

The Act repeals the add-on minimum tax for corporations and replaces it with an alternative minimum tax, similar to that for individuals. Alternative minimum taxable income is the corporation's regular taxable income (or loss), as modified by certain adjustments, plus preference items, and reduced by a phased-out exemption of $40,000.

For taxable years beginning in 1987, 1988, and 1989, the Act requires that the alternative minimum taxable income (AMTI) of a corporation (other than an S corporation, regulated investment company, real estate investment trust or REMIC) must include one-half of the amount by which the corporation's adjusted net "book income" exceeds the corporation's AMTI (disregarding the business untaxed reported profits preference and the alternative minimum tax net operating loss deduction). Generally, the book income of a corporation is the net income or loss set forth on the applicable financial statement that it provides to satisfy regulatory or credit requirements, for purposes of reporting to its shareholders or other owners, or for other substantial non-tax purposes.

Book income is determined with reference to the corporation's applicable financial statement (see below), except that the adjustments described below must be made. In addition, appropriate adjustments must be made if the financial statement used to compute book income covers a period other than the tax year for which the book income preference is being computed.

Federal and foreign tax adjustment. Federal and foreign taxes reported on financial statements are generally disregarded. However, if no foreign tax credit was claimed under Section 931 for regular tax purposes, the foreign tax liability may be taken into account for purposes of computing book income. No item of federal or foreign income tax or benefit (other than foreign taxes deducted in lieu of claiming a credit), including any adjustment of deferred taxes resulting from the corporate tax rate changes, is to be included in the computation of pre-tax book income for minimum tax purposes.

Related corporations. A taxpayer filing a consolidated return is required to adjust book income by taking into account items on the financial statement that are allocated to group members on the consolidated return. In the case of any related corporation that is not included on a consolidated return, the earnings of the corporation are taken into account only to the extent of the dividends received by the taxpayer from that corporation plus any other amount required to be included in the taxpayer's gross income for alternative minimum tax purposes in respect of the other corporation's earnings.

Cooperatives. Patronage dividends and per-unit retain allocations paid by cooperatives are generally deductible for the purpose of computing book income.

Dividends from possessions corporations. If a dividend is received from a corporation eligible for the possessions tax credit under Section 936 and is included in the recipient's book income, the amount of withholding taxes paid with respect to such dividends is to be included in determining net book income. To the extent that AMTI is increased as a result of this adjustment, the related withholding taxes are treated as creditable foreign taxes paid by the recipient.

Financial statements. The following financial statements are to be used to compute the book income preference (if any). If a corporation uses more than one of the types of statements enumerated, the following priority system is followed:

(1) A financial statement used for complying with the filing requirements of the Securities and Exchange Commission;

(2) A certified audited income statement used for (a) credit purposes, (b) a report to shareholders, or (c) any substantial nontax purpose;

(3) An income statement that the corporation must submit to the federal government, the state, a political

subdivision of the state, any state or federal agency, or any agency of a political subdivision; or

(4) Any financial statement or report used for the purposes listed in (2), above.

Earnings and profits. Companies that do not have any of the statements described above are to use their earnings and profits to compute book income. In addition, a corporation that has only the financial statement described in (4), above, may make an irrevocable election to use its earnings and profits to compute net book income. The election is effective so long as the taxpayer qualifies under the elective provisions. Thus, if a corporation electing to use earnings and profits is required in a subsequent year to file an income statement with the state or federal government, the election to use earnings and profits would no longer be in effect.

In computing the preference for book income, a positive amount exceeds any negative amount (especially applicable in cases in which a corporation reports a negative AMTI before taking into account the book income preference).

Other adjustments may be required. The law grants the Treasury Department the authority to issue regulations requiring the adjustment of net book income to prevent the omission or duplication of any item. This grant of authority will be used, for example, to prevent the recording of items directly to the financial statement asset, liability or equity accounts that are properly included as items of financial statement income or expense.

For any tax year beginning after 1989, the alternative minimum taxable income of a corporation (other than an S corporation, regulated investment company, real estate investment trust or REMIC) is increased by 75 percent of the amount by which its "adjusted current earnings" exceed AMTI (determined without regard to the adjusted current earnings preference and the alternative minimum tax NOL deduction). The preference is to be taken into account regardless of whether the adjustments are positive or negative.

Negative adjustments. If a corporation's alternative minimum taxable income (prior to the adjustment) exceeds adjusted current earnings, a reduction in AMTI of 75 percent of the difference is permitted. However, the reduction cannot exceed the aggregate amount by which AMTI has been increased in prior tax years as a result of the adjusted current earnings preference less the reductions allowed as a result of the preference for prior years. A positive amount is always considered to be in excess of a negative amount.

Adjusted current earnings. In computing adjusted current earnings, a taxpayer must generally treat preference items in the same manner as required for computing alternative minimum taxable income. In the case of depreciable property placed in service after 1989, the deduction is the smaller of that computed under the alternative depreciation system or the method used for the corporation's financial statement.

For property placed in service after 1986 but before the first tax year beginning in 1990, and to which the modified ACRS system applies, the depreciation computation is made by taking into account the adjusted basis for AMT purposes as of the close of the last tax year beginning before 1990 and using the straight-line method over the remaining midpoint life of the property.

For depreciable property placed in service before 1987 to which the original ACRS system applies, the depreciation deduction is determined by taking into account the adjusted basis of the property as determined for regular tax purposes as of the close of the last tax year beginning before January 1, 1990 and using the straight-line method over the remainder of the recovery period that would have applied to the property under the Section 168(g) alternative depreciation system. Any other depreciable property placed in service before 1981 is depreciated in the same manner as used to compute the corporation's regular tax.

In the case of any depreciable property placed in service before 1990, if the depreciation method used for financial statement purposes yields a smaller depreciation deduction than that determined under the above methods, such method is to be used to determine adjusted current earnings. The determination as to which is the lower calculation is to be made by comparing the net present values of the deduction computed under each method.

For intangible drilling and development costs allowable under Section 263(d) the deduction is limited to the lower of: (1) the present value of the deouctions on the taxpayer's financial statement, or (2) the present value of the deduction computed using the 60-month amortization period under Section 312(n).

The depletion allowance is to be determined by using either cost depletion or the method used for financial statement purposes, whichever yields, on a present value basis, the smaller allowance.

<u>Items excluded from AMT or regular tax computations</u>. Certain items that are not taken into account for purposes of computing alternative minimum taxable income may be included in determining adjusted current earnings. Exclusion items are those items of income or expense that are included in earnings and profits computations for purposes of a corporation's regular tax but are not includible in income for purposes of either regular tax or alternative minimum tax computations (i.e., interest on tax-exempt bonds). In computing adjusted current earnings with respect to exclusion income items, deductions related to expenses incurred with respect to the income items are allowed, to the

extent that the deductions would have been allowable in computing AMTI if the income were includible in gross income.

With respect to an expense that is included in a corporation's earnings and profits computations but is not allowed for purposes of the regular or alternative minimum tax, no deduction is allowed for purposes of computing adjusted earnings. This means that the dividends received deduction is not taken into account in computing adjusted current earnings. However, in the case of dividends qualifying for a 100 percent dividends received deduction under Section 243 or 245, the deduction will be allowed to the extent that the payor corporation is subject to federal income tax and so long as the payor and recipient corporations would not qualify as members of the same affiliated group under the rules contained in Section 1504(b).

In the case of dividends received from Section 936 corporations (Puerto Rico and U. S. possessions other than the Virgin Islands), the full amount of the dividend is included in the computation of earnings and profits, along with 75 percent of the withholding tax paid with respect to the dividends.

Other earnings and profits computations required for regular tax purposes under Section 312 are to be taken into account, subject to rules regarding dates that apply for such purposes. For example, in the case of a post-1989 installment sale, use of the installment method to compute adjusted earnings and profits is not allowed, even if the use of the installment method applies for minimum tax purposes.

For purposes of the Section 312(n) adjustment concerning the capitalization of construction period carrying charges paid or incurred in tax years beginning after 1989, the "avoided cost method" of new Section 263A (relating to capitalization of specified costs and expenditures) applies to determine the amount of interest allocable to construction.

Debt pool exchange. No loss arising out of the exchange of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturities will be allowed.

Ownership changes. In the case of a corporation that experiences an ownership change after October 22, 1986, the date of enactment of the Tax Reform Act of 1986, the Act limits the corporation's basis in any property used in the computation of adjusted current earnings to the allocable portion of the purchase price paid (after adjustment for liabilities and other items) at acquisition.

Study of book income and earnings adjustments. New Section 59 directs the Treasury Secretary to study the operation and effect of the book income preference and the preference based on adjusted earnings. Also prior to 1990, regulations and rulings will be issued to provide guidance on the integration of a corporation's tax records used for regular and minimum tax purposes and the reporting of adjusted earnings and profits.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provisions relating to the increasing of the alternative minimum taxable income by one-half of any excess of pre-tax book income over AMTI are applicable for taxable years beginning on or after January 1, 1987 and before January 1, 1990.

The provisions relating to the increasing (or decreasing) of the alternative minimum taxable income by 75 percent of the amount by which adjusted current earnings are greater (or less) than AMTI are applicable to taxable years beginning on or after January 1, 1990.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all corporate minimum tax provisions. For the corporate minimum tax estimate, the largest single item contributing to revenue gains is the inclusion of a portion of book income as taxable income.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue gains under the B&CTL.

Projected state preference tax revenues are $7 million under the B&CTL for 1987 and 1988. An approximation of AMT revenues that would be collected under the B&CTL are $240 million for 1987/88 and $230 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue gains under the B&CTL of $233 million for 1987/88 and $223 million for 1988/89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the B&CT Law.

Title VIIB7: Minimum Tax Provisions

ACTION: <u>ALLOWS CORPORATIONS TO OFFSET 25 PERCENT OF MINIMUM TAX LIABILITY WITH CARRYOVER OF INVESTMENT TAX CREDIT</u>

Act Section 701 — Conference Report Page 280

Form 540 Line No. N/A — Form 100 Line No. 20

<u>CURRENT CALIFORNIA LAW (Sections 23400 - 23405)</u>

California has no provision for allowing credits against the tax on preference income.

<u>OLD FEDERAL LAW (Sec. 56)</u>

Incentive tax credits are not allowed against minimum tax. Credits that do not benefit the taxpayer due to minimum tax can be used as credit carryovers against regular tax. Incentive tax credits, for federal purposes, include the investment credit, targeted jobs credit, alcohol fuels credit, and ESOP credit.

<u>NEW FEDERAL LAW (Sec. 26, 38, 53, 55-59)</u>

Provides that the investment tax credit on transition property or carried over from prior years may reduce regular tax liability down to 75 percent of the alternative minimum tax liability, or if the alternative minimum tax exceeds the regular tax, it may offset up to 25 percent of the alternative minimum tax liability.

<u>EFFECTIVE DATE OF FEDERAL PROVISIONS</u>

Applicable to taxable years beginning on or after January 1, 1987.

<u>REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW</u>

Neither the federal minimum tax provision nor the investment tax credit have been adopted under California law.

Title VIIB9: Minimum Tax Provisions - Corporations

ACTION: LIMITS TO 90 PERCENT OF MINIMUM TAXABLE INCOME THE AMOUNT OF NET OPERATING LOSS THAT CAN BE USED TO REDUCE MINIMUM TAXABLE INCOME

Act Section 701 | Conference Report Page 282

Form 540 Line No. N/A | Form 100 Line No. 20

CURRENT CALIFORNIA LAW (Sections 23400-23405)

In California, tax preference income is reduced by that amount (if any) of the taxpayer's net operating loss which was used to reduce taxpayers gross income. Following this adjustment, the imposition of preference tax for that year is deferred to the extent of the ratio of the allowable net operating loss carryforward over the total amount of preference items. To the extent that this net operating loss carryforward reduces net income in a succeeding year, the tax previously deferred shall be added to the preference tax (if any) for that year.

NEW FEDERAL LAW (Sec. 56)

Net operating losses may be used to reduce up to 90 percent of alternative minimum taxable income. Amounts not used because of this limitation may be carried forward to future years.

For minimum tax purposes, a separate net operating loss must be computed in a manner consistent with the adjustments and preferences defined by the minimum tax. Pre-1987 NOLs do not have to be recomputed. Consequently, the amount of the NOL carryover for minimum tax purposes will differ from the NOL carryover for regular tax purposes because of this separate NOL computation and the 90 percent rule limitation.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applicable to taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all corporate minimum tax provisions. For the corporate minimum tax estimate, the largest single item contributing to

revenue gains is the inclusion of a portion of book income as taxable income.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue gains under the B&CTL.

Projected state preference tax revenues are $7 million under the B&CTL for 1987 and 1988. An approximation of AMT revenues that would be collected under the B&CTL are $240 million for 1987/88 and $230 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue gains under the B&CTL of $233 million for 1987/88 and $223 million for 1988/89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H.R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the B&CT Law.

Title VIIB10: Minimum Tax Provisions - Corporations

ACTION: REQUIRES THAT ESTIMATED TAX PAYMENTS BE MADE WITH RESPECT TO MINIMUM TAX LIABILITY

Act Section 701 Conference Report Page 283

Form 540 Line No. N/A Form 100 Line No. 22

CURRENT CALIFORNIA LAW (Secs. 25561 and 25562)

California imposes a tax on "tax preference income" in addition to the tax imposed on taxable income. The intent is to impose an additional tax on taxpayers who benefit substantially from various forms of tax-free income or large deductions under the regular income tax rates. The tax is computed on the total of tax preference items in excess of $30,000.

Current law requires the inclusion of tax preference income in the computation of estimated tax payments of corporations.

NEW FEDERAL LAW (Sec. 6154)

Federal law imposes an alternative minimum tax. The tax due for the taxable year is the alternative minimum tax or the regular income tax, whichever is greater (adjusted by certain credits).

Alternative minimum tax is the taxpayer's taxable income, determined with specified adjustments, and increased by the amount of items of tax preference.

The Act now requires that estimated tax payments of corporations be made with respect to minimum tax liability.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applicable to taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Federal alternative minimum tax (AMT) does not conceptually have a counterpart in state law. California's preference tax is a separate tax on certain tax allowances that is added to the regular tax liability and not used as a separate basis for calculation of the final income tax liability.

The Joint Committee on Taxation (JCT) has made a single estimate only for all corporate minimum tax provisions. For the corporate minimum tax estimate, the largest single item contributing to revenue gains is the inclusion of a portion of book income as taxable income.

The substitution of an AMT structure similar to federal law in place of the state's existing preference tax would produce significant revenue gains under the B&CTL.

Projected state preference tax revenues are $7 million under the B&CTL for 1987 and 1988. An approximation of AMT revenues that would be collected under the B&CTL are $240 million for 1987/88 and $230 million for 1988/89. If the preference tax estimates are subtracted from the AMT estimates, the results are net revenue gains under the B&CTL of $233 million for 1987/88 and $223 million for 1988/89.

These estimates are not precise but serve to indicate the possible order of magnitude of revenue effects. The AMT state estimates were developed by applying the same relative impact of federal AMT revenues, estimated by the JCT, compared to total federal budget receipts after H. R. 3838 to total state revenue projections for 1987/88 and 1988/89 under the B&CT Law.

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TITLE VIII

ACCOUNTING PROVISIONS

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Title VIIIA: Accounting Provisions

ACTION: RESTRICTION ON USE OF CASH METHOD OF ACCOUNTING

Act Section 801 Conference Report Page 285

Form 540 Line No. N/A Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17551, 24651, 24652, AND 24653)

The accounting method rules under California law are basically the same as those under federal law. In general, the methods are: cash receipts and disbursements, accrual, special methods for certain industries and situations, and with limitations, certain hybrid methods. The taxpayer adopts a method that is best suited to its needs and except for the following, there are no restrictions as to the method that can be used: 1) the method must clearly reflect income, 2) businesses with inventories must use the accrual accounting method with respect to purchases and sales, and 3) certain farming corporations are required to compute their income by the accrual method.

NEW FEDERAL LAW (Sec. 448)

Under the act the cash method of accounting may not be used by a tax shelter, a C corporation, a partnership with a C corporation as a partner, or certain trusts.

Exceptions to this treatment are provided for:

- corporations in the farming business,
- qualified personal service corporations,
- certain types of businesses with average annual gross receipts that do not exceed $5 million for the 3-taxable-year period ending with the prior taxable year.

The foregoing exceptions do not apply to tax shelters.

Any adjustments required due to the change from the cash method are to be taken into account over a period generally not to exceed four years.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This act shall apply to taxable years beginning on and after January 1, 1987, except that taxpayers who on or before September 25, 1985 have entered into loans or leases, certain real property contracts and transactions with certain related party, may elect not to apply the provisions of this act.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

It is not known how many entities will elect to change from the cash to accrual accounting method for California purposes, in order to simplify their recordkeeping, even if California does not conform to the federal restrictions.

However, it is noted that the types of businesses that are restricted for federal purposes may be more apt to maintain the separate records in order to continue the cash method for California. Under this reasoning and based on national estimates by the Joint Committee on Taxation:

- o The revenue gain under the Bank and Corporation Tax Law under conformity would be in the $24 million range for 1987/88 and $25 million range for 1988/89.
- o A proration factor of 4% was used which represents the general relationship between California's corporation tax collections and federal corporation tax collection over the past few years.
- o The impact under the Personal Income Tax Law from unincorporated tax shelters would be insignificant.

ACTION: CHANGE THE SPECIAL DOLLAR VALUE LIFO ACCOUNTING METHOD FOR CERTAIN SMALL BUSINESS

Act Section 802 | Conference Report Page 290

Form 540 Line No. 16 | Form 100 Line No. G-2

CURRENT CALIFORNIA LAW (Sec. 17551, and 24701 et seq)

With respect to noncorporate taxpayers, California conforms to the federal provision that allows certain small businesses to elect a special LIFO accounting method for inventories. An eligible small business is one with average annual gross receipts that do not exceed $2 million for the three tax years ending with the current year and that uses the dollar-value LIFO method of inventory accounting. These small businesses may elect to use a single inventory pool to value their inventory instead of the variety of pools that are otherwise required. Once the election is made, it can only be withdrawn with the consent of the Franchise Tax Board (or Secretary of the Treasury).

With respect to corporate taxpayers, California has generally conformed to the federal rules for LIFO inventory accounting, but has not adopted any provisions to allow a small business to elect to use one inventory pool.

NEW FEDERAL LAW (Sec. 474)

The act redefines eligible small business as businesses that have average annual gross receipts of $5 million for the 3 preceding taxable years, and the method of pricing the inventories is changed from the single inventory pool to a "simplified" method in which separate inventory pools are maintained by major categories as provided in indices published by the Bureau of Labor Statistics. The election to use the new method does not require consent of the Internal Revenue Service.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This act applies to taxable years beginning on and after January 1, 1987. Taxpayers who made an election under the old law may continue under the provisions of that law for as long as their election remains in effect.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on a proration of the national estimates that were prepared by the Joint Committee on Taxation (JCT), the relative fiscal impact, for individuals under state conformity, would be revenue losses in the $700,000 range for 1987-88 and $1.1 million range for 1988-89. The proration to California (4.1 percent) reflects the Policy Economic Group's (PEG) California estimates relative to the nation for those provisions analyzed. The PEG has not estimated this specific provision.

Based on the proration of the estimates for the nation by the JCT, the revenue loss under the Bank and Corporation Tax Law is estimated to be in the $8 million range for 1987-88 and in the $12 million range for 1988-89. A proration factor of 4 percent was used, which represents the relationship between California's corporate tax collections and federal tax collections over the past few years.

ACTION: <u>RESTRICT AND REVISE INSTALLMENT ACCOUNTING METHOD FOR CERTAIN INSTALLMENT SALES</u>

Act Section 811 and 812 | Conference Report Page 293

Form 540 Line No. N/A | Form 100 Line No. G-1

<u>CURRENT CALIFORNIA LAW (Sec. 17551, 17552.5, 24667, 24668 and 24670)</u>

Currently under California law an individual or corporation may elect to report installment sales using the installment accounting methods, which, generally, conform to the federal provisions. Under this method, the income that is reported for any year is that proportion of the payments received during the year that is equal to the ratio that the gross profit bears to the total contract price. California is also similar to federal with respect to the changing of accounting methods, in that: 1) a change in accounting method must be approved, and 2) adjustments to net income may be required to prevent amounts from being duplicated or omitted.

For individuals, California modifies the use of the installment method to the extent that enterprise zone properties and properties in program areas have previously been expensed.

Of special interest with respect to the installment method is the enactment of SB 85 (Ch. 660, Stats. 1986), as it generally conformed California's <u>corporation</u> provisions to the Federal Reform Act of 1986, operative for dispositions and/or income years beginning on or after January 1, 1988. At that time the use of the installment method will be restricted and method for determining the reportable income from installment sales is revised. In general, taxpayers making occasional installment sales could continue to use the existing installment method, whereas installment obligations that are held by corporate sellers and arise after December 31, 1987 from the disposition of: 1) personal or real property by taxpayers who regularly sell or otherwise dispose of personal or real property in the ordinary course of business, or 2) certain real property by taxpayers who used the property in the trade or business or production of rental income will be reporting a certain portion of the installment indebtedness as a payment. The corporation provisions that were not conformed to the federal act are discussed below:

<u>Effective date</u>

Basically, California's law is operative for income years beginning on or after January 1, 1988, whereas the federal act is effective for years beginning in 1987. However under California law, the effective date for the restricted use of the installment method specifically applies with respect to the dispositions, whereas under the federal act, it applies with respect to taxable years.

Restriction on the use of the installment method

Both California law and the federal act limit the use of the installment method to no longer allow the installment accounting method for installment sales of personal property under a revolving credit plan, sales of stock or securities traded on an established securities market, and certain other kinds of regularly traded property. California specifically allows the sales of crops or livestock held for slaughter to continue to be reported on the installment method. In addition, California specifically allows the full gain on the sale of irrigation equipment which is used to irrigate farmland to be reported under the installment method.

Under California law, those taxpayers who used the installment method to report sales from revolving credit plans on their last return beginning before January 1, 1988, can make the required adjustments over five years. Whereas under the federal act, the period for making the adjustments is limited to four years.

Determining the "allocable installment indebtedness"

The federal act provides casual sellers who have no outstanding applicable obligations with a special rule so that the computation to determine the allocable installment indebtedness can be made.

Defining "applicable installment obligation"

In determining what constitutes an applicable installment obligation, the California act contains a number of provisions that are different from the federal act, as follows:

- Both California law and the federal act provide that controlled groups, with specific reference to the the Internal Revenue Code's (IRC) definition of controlled groups, will be treated as one taxpayer. In addition to specifying this treatment for controlled groups, California specifically has a couple of provisions that deal with the treatment of affiliated groups, i.e., an affiliated group will be treated as one taxpayer, and certain shareholders will be treated as a member of an affiliated group. The federal act uses its reference to the IRC definition of controlled group to provide for the treatment of affiliated groups since the definition of a controlled group encompasses affiliated groups.

- o The interest that will be due on the portion of tax that is attributable to the payments that are received after the year of the sale will be computed using the federal short term rate on the date of the sale, adjusted at each anniversary date of the sale to the federal short term rate on that date. Under the federal act, the computation is made under Section 1274, which contains provisions for short-term, mid-term, and long-term rates depending upon the term of the obligation.

- o The Franchise Tax Board is not specifically required under the California act, as the Internal Revenue Service is under the federal act, to prescribe regulations for the proper treatment of reserves and to provide for the disallowance of the use of the casual sales special rules under certain situations. However, it is noted that existing California law already gives the Franchise Tax Board the authority to prescribe any rules and regulations necessary to administer the personal and corporation tax laws.

- o Does not provide special transitional rules for residential condominium projects, qualified buyouts of corporations, sales of real property by dealers, sales of personal property by dealers, and treatment of certain other installment obligations, as the federal act provides.

NEW FEDERAL LAW (Sec. 453, 453A, and 453C)

In addition to the above discussed changes to the corporation provisions, the new federal act also restricts an individual's use of the installment method and revises method for reporting such income. In general, it affects installment obligations that are held by the seller and arise from the disposition of: 1) personal or real property after February 28, 1986, by taxpayers who regularly sell or otherwise dispose of personal or real property in the ordinary course of business, or 2) certain real property after August 16, 1986, by taxpayers who used the property in their trade or business or for the production of rental income.

As the act pertains to individuals, the following federal provisions should be taken into consideration:

Restriction on the use of the installment method

Revolving credit plan obligations, installment sales of stocks traded on an established securities market, and other commodities traded on an established market can not be reported under the installment accounting method.

The change in the accounting method is treated as an approved election, and the required adjustments can be made over four years.

Determining the "allocable installment indebtedness"

In determining the indebtedness that must be reported as a payment, the act excludes personal use property from being taken into account in computing the installment percentage and the average quarterly indebtedness.

In addition, casual sellers who have no outstanding applicable obligations are provided with a special rule so that the computation to determine the allocable installment indebtedness can be made.

Defining an "applicable installment obligation"

Personal use property of an individual and any property used or produced in the trade or business of farming are specifically not considered to be applicable installment obligations.

In applying the special treatment with respect to timeshare sales, such property held by the spouse, children, grandchildren, or parents of an individual shall be treated as held by such individual.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The federal act generally applies to taxable years beginning on or after January 1, 1987. Transitional rules are provided for certain dispositions and obligations resulting from that disposition.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on a proration of national estimates prepared by the Joint Committee on Taxation (JCT) the relative fiscal impact under conformity would be revenue gains in the $105 million range for both 1987-88 and 1988-89. The proration to California (4.1 percent) reflects the Policy Economics' Group (PEG) state estimates relative to the nation for those provisions analyzed. PEG has not specifically estimated this provision.

Based on a proration of the JCT's estimate for the nation, revenue gains under the Bank and Corporation Tax Law would be in the $69 million range for 1987-88. A proration factor of 4 percent was used which represents the general relationship between California's corporate tax collections and federal tax collections over the past few years. To the extent corporations make the accounting change for California in 1987 rather than 1988, this revenue gain occurs independently of the conformity issue for 1987.

Title VIIID1: Accounting Provisions

ACTION: <u>AMEND THE CAPITALIZATION RULES RELATING TO INVENTORY</u>

Act Section 803 | Conference Report Page 302

Form 540 Line No. 16 | Form 100 Line No. G-2

<u>CURRENT CALIFORNIA LAW (Sec. 17551 & 24701)</u>

California has generally conformed to the federal accounting period and methods of accounting relating to inventories.

Taxpayers are required to maintain inventories under methods prescribed by the Internal Revenue Service as conforming to the best accounting practice in a particular trade or business and which clearly reflect income.

In the case of goods purchased for resale (e.g., wholesalers and retailers), a taxpayer must include in inventory the invoice price (less discounts) plus transportation or other necessary changes.

Taxpayers which manufacture property for sale are required to include in inventory all direct and indirect production cost in accordance with the full absorption method of accounting.

Direct production costs required to be included in inventory include the costs of materials forming an integral part of the product or consumed in the manufacturing process, and the labor that is directly involved in fabrication of the product.

Under the full absorption method, indirect production costs are divided into categories. The following eight indirect costs must be included in inventory:

1. repair expense,
2. maintenance,
3. utilities,
4. rent,
5. indirect labor and production supervisory wages,
6. indirect materials, and supplies,
7. tools and equipment not capitalized, and
8. costs of necessary inspection and quality control.

Certain indirect production costs are included in inventory only if they are included in inventory costs for purposes of the taxpayer's financial reports.

NEW FEDERAL LAW (Sec. 263A (a)(b)(2)(c)(d)(e)(h) and 460)

The act requires that certain uniform capitalization rules be applied in determining the cost that must be capitalized by all persons who produce real and tangible personal property or acquire real or personal property for resale.

Items affected. — Several items now being expensed will have to be capitalized and built into cost of goods sold. Among these are:

- o costs incident to purchasing inventory (e.g., wages or salaries of employees responsible for purchasing);
- o repackaging, assembly, and other costs incurred in processing goods while in the taxpayer's possession;
- o storage costs (e.g., rent or depreciation, insurance premiums, and taxes attributable to a warehouse and wages of warehouse personnel);
- o a portion of general and administrative costs allocable to these functions;
- o a portion of pension and profit-sharing costs; and
- o certain interest costs, including imputed interest.

The uniform capitalization rules only affect inventories valued at cost. The rules won't affect inventories valued at market by a taxpayer using the lower of cost or market method, or by a dealer in securities using the market method. But the rules will apply to inventories valued at cost by a taxpayer using the lower of cost or market method.

The capitalization rules will not apply to the following: (1) any portion of the cost constituting research and experimental expenditures, deductible mining development costs or intangible drilling costs, (2) property produced in a farming business where the preproductive period is less than two years or consist of livestock held for slaughter, (3) personal property acquired for resale if the taxpayer's average gross receipts are $10 million or less for the three prior tax years, (4) to the growing of timber and certain ornamental trees (i.e., those evergreen trees which are more than 6 years old when severed from roots and sold for ornamental purposes), (5) any property produced by the taxpayer for use by the taxpayer other than in a trade or business or activity engaged in for profit, and (6) property produced under a long-term contract.

In addition, aggregation rules similar to those for determining whether a business's annual gross receipts do not exceed $5 million for purposes of the small business exception to the accrual method requirement are applied to determine whether the

$10 million threshold (under the above exception number three) is exceeded.

Simplified Method

The act authorizes the Internal Revenue Service to provide a simplified method for applying uniform capitalization rules to property that is acquired for resale which can be separately used for each trade or business of the taxpayer. Taxpayers who do not elect to use the simplified method are required to use the same uniform capitalization rules that are applicable to manufactures and their election may not be changed without the IRS's permission.

Under the simplified method, the taxpayer determines the amounts of additional costs that must be capitalized and adds such amounts, along with amounts of additional costs contained in the beginning inventory balances where appropriate, to the preliminary inventory balances to determine their final balances.

Taxpayers using the first-in, first-out (FIFO) method who do not sell their beginning inventory during the year are to include in ending inventory a proportionate part of additional cost capitalized into the beginning inventory. Likewise, for a taxpayer using the last in, first out (LIFO) method, cost capitalized under these rules will be added to the LIFO layers applicable to the various years for which the costs were accumulated.

In general, four categories of indirect costs will be allocable to inventory under this simplified method:

(1) off-site storage and warehousing costs (including, but not limited to, rent or depreciation attributable to a warehouse, property taxes, insurance premiums, security costs, and other costs directly identifiable with the storage facility);

(2) purchasing costs such as buyer's wages or salaries;

(3) handling, processing, assembly, repackaging, and similar costs, including labor costs attributable to unloading goods (but not including labor costs attributable to loading of goods for final shipment to customers, or labor at a retail facility); and

(4) the portion of general and administrative costs allocable to these functions.

In applying (1), offsite storage and warehousing costs generally include the cost of a facility whose primary function is the storage or warehousing of goods.

For purposes of item (3), any reasonable method of apportioning labor costs between inventoriable and noninventoriable functions may be used. Detailed records establishing the time spent by an employee performing a particular function generally will not be required to substantiate an allocation by the taxpayer. However, if such records are available, they generally should be used in making allocations.

Storage Costs - Under the simplified method, a taxpayer includes storage costs in inventory based on the ratio of total storage costs for the year to the sum of (1) beginning inventory balance and (2) gross purchases during the year.

Example 1

Taxpayer uses the FIFO method.

Storage Cost Incurred = $1 million
Beginning Inventory Balance = $2 million
Gross Purchases = $8 million
Ending Inventory = $3 million

The ratio of storage costs equals 10 percent ($ 1,000,000 of storage cost divided by ($2 million of beginning inventory plus $8 million of gross purchases)). Thus, for each dollar of ending inventory, the taxpayer must capitalize ten cents of storage cost. Accordingly, the ending inventory is increased by $300,000 (.10 x $3 million) and the balance of the storage cost which is $700,000 ($1,000,000 - $300,000) would be included in the cost of goods sold.

In the case of LIFO taxpayers, to the extent that ending inventory exceeds beginning inventory, additional capitalization storage costs would be calculated by multiplying the increases in inventory for the year by the applicable ratio.

Purchasing Cost - Purchasing costs are to be allocated between inventory and cost of goods sold based on the ratio of purchasing costs to gross purchases during the year.

In the case of a taxpayer using the LIFO method for valuing inventory, ending inventory consists of a newly acquired items only to the extent that ending inventory exceeds beginning inventory.

Processing, repackaging, etc., - Processing, repackaging, and other similar costs are allocated based on the ratio of total processing, repackaging, etc., cost to the sum of (1) beginning inventory balance and (2) gross purchases during the year.

General and administrative expenses allocable to storage, purchasing and processing - General and administrative expenses that are allocable in part to storage, purchasing, and processing activities and in part to activities for which capitalization is required under the simplified method are allocated based on the ratio of direct labor costs incurred in a particular function to gross payroll costs.

Special Rules for Farmers and Ranchers

The act provides that the uniform capitalization rules, including those requiring capitalization of interest, will generally apply to all crops and livestock (other than animals held for slaughter) having a preproductive period of more than two years. For this purpose, the preproductive period of plants is deemed to begin when the plant or seed is first planted or acquired by the taxpayer, and to end when the plant becomes productive or is sold. The preproductive period of animals begins at the time of acquisition, breeding or embryo implantation, and ends when the animal is ready to perform its intended function.

The preproduction period of a plant grown in commercial quantities in the United States is to be based on the nationwide weighted average preproduction period for such plant.

The IRS is authorized to issue regulations that permit a taxpayer to use reasonable inventory valuation methods to compute the amounts that have to be capitalized in the case of plants and animals.

Exception - Farming corporations, farming partnerships with corporate partners and tax shelters who are required to use the accrual accounting method must capitalize preproduction costs without regard to whether the productive period is more than two years. Consistent with the general capitalization rules, such taxpayers are required to capitalize taxes and, to the extent the preproductive period exceeds two years, interest incurred prior to production.

Replacement of Damaged Crops - The act provides a special rule which allows a taxpayer to deduct the cost of replacing crops that are lost or damaged because of freezing, disease, drought, pests or other casualty and were intended for human consumption so long as the replacement plants bear the same type of crop as was destroyed or damaged. The land on which the replanting takes place does not have to be the same land on which the lost or destroyed plants were located, and the replanting can take place on any parcel of land of the same acreage located anywhere in the United States.

Two conditions must be met to qualify for the permitted deduction. First, the taxpayer who owns the property at the time of the loss or damage must have an equity interest of more than 50 percent in the property. Second, the additional persons incurring the costs must hold part of the remaining equity interest in the property and must materially participate in the planting, cultivating maintenance, or development. The determination of whether an individual materially participates in an activity is to be made in a manner similar to that under Section 2032A (relating to current use valuation of farm property).

Election to Deduct Preproductive Period Expense - The act provides an exception to the rules requiring capitalization of productive period expenses for certain farmers. Under this exception, a farmer (including producers of livestock, nursery stock, Christmas and other ornamental trees and agricultural crops), may elect to deduct currently all preproductive cost of plants and animals that may be deducted under prior law. If the election is made, any gain on disposition of the product is recaptured (generally treated as Section 1245 depreciation) and taxed as ordinary income to the extent of expensed deductions that otherwise would have been capitalized. Also, they are required to use the alternative cost recovery system (under Section 168(g)(2)) for all farm assets used predominately in farming and placed in service in any tax years covered by the election. The election can not be made by (1) tax shelters as defined in Section 6161(b)(2)(C)(ii), (2) taxpayers required to use the accrual method under Section 447, (3) farming syndicates (as defined in Section 464(c)), and (4) producers of pistachio nuts. The election also does not apply to the cost of planting, cultivating, maintaining, or developing any citrus or almond grove, incurred before the end of the fourth tax year after the trees are planted. If a grove is planted over more than one tax year, the part of the grove planted in each tax year is treated as a separate grove for determining the year of planting.

Partnerships and S corporations make the election at the partner or shareholder level. The election must be made in the first tax year that begins after 1986 during which the taxpayer is a farmer. Taxpayers making the election may (according to the House Committee Report) estimate the amount of preproductive period expenses that are subject to recapture using methods similar to one of the simplified inventory methods permitted to accrual method taxpayers under current law. The election can be revoked or changed only with IRS consent. It's binding on the taxpayer's spouse and minor children ("family members"), and on any corporations and their controlled groups and partnerships in which the taxpayer or his "family members" own at least a 50 percent direct or indirect interest by value. Minor children are defined as those who haven't attained age 18 before the close of the tax year.

Farming Business - For purposes of these rules, a farming business includes the trade or business of operating a nursery or sod farm or the raising or harvesting of trees bearing fruit, nuts or other crops; it does not include the raising, harvesting or growing of timber or ornamented evergreen trees that are more than six years old at the time they are severed from the roots.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The act relating to capitalization of inventory cost is generally effective for costs incurred on or after January 1, 1987.

The new rules for inventory take effect for tax years beginning on or after January 1, 1987. Adjustments resulting from the change in inventory accounting must be spread over a period of no more than four years under rules for changes initiated by taxpayer and approved by the Internal Revenue Service.

In the case of a corporation which was a member of an affiliated group of corporations on October 22, 1986, the parent which (1) was incorporated in California on April 15, 1925, (2) adopted the LIFO method of accounting on December 31, 1950, and (3) was, (on May 22, 1986) merged into a Delaware corporation incorporated on March 12, 1986, the amendments made by this section are to apply under a cutoff method whereby the uniform capitalization rules are applied only on costing layers of inventory acquired during taxable years beginning on or after January 1, 1986.

The special rule for casualty losses is to apply to expenses incurred on or after October 22, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on a proration of national estimates prepared by the Joint Committee on Taxation (JCT) the relative fiscal impact under state conformity for the 3 provisions D-1 thru D-3 (D-1 Amend the Capitalization Rules Relating to Inventory, D-2 Self-Construction Property and Noninventory Property Produced for Sale, and D-3 Expand the Types of Assets which have Interest Rules - Capitalization) would be revenue gains in the $20 million range for 1987-88 and $24 million range for 1988-89 under the Personal Income Tax Law. A proration factor of 4.1 percent to California was used which reflects the Policy Economic Group (PEG) estimates for California relative to the nation for those provisions analyzed. PEG has not specifically estimated this provision.

Based on a proration of the Joint Committee on Taxation estimate for the nation revenue gains under the Bank and Corporation Tax Law from conformity would be in the $280 million range the 1987-88 and in the $295 million range for 1988-89. A proration factor of 4 percent was used which represents the general relationship between California corporation tax collections and federal corporate tax collections over the past few years.

It is not know to what extent business taxpayers will use the same accounting methods for California reporting purposes even if California does not actually conform.

Title VIIID2: Accounting Provisions

ACTION: AMEND THE CAPITALIZATION RULES RELATING TO SELF-CONSTRUCTED PROPERTY AND NONINVENTORY PROPERTY PRODUCED FOR SALE

Act Section 803 | Conference Report Page 302

Form 540 Line No. 16 | Form 100 Line No. G-2

CURRENT CALIFORNIA LAW (Sec. 17201, 17551, 24373.5, 24673, & 24701)

California has generally conformed to federal law regarding the capitalization of the cost of acquiring, constructing, or improving buildings, machinery, equipment or other assets having a useful life beyond the taxable year. Construction period interest and taxes are required to be capitalized and amortized over a 10 year period, except for low-income housing, nonbusiness real property, or real property held by a cooperative housing corporation. California also exempts from this rule residential real property held by corporations.

In capitalizing these expenses, the cost may be recoverable through an offset against the amount realized if the property is sold or through depreciation or amortization deductions if the property is held for business or investment purposes. For individuals, production costs of films, books, records, and similar property must be deducted over the income period of the asset.

Although it is clear that direct expenses must be capitalized in these instances, the treatment of indirect costs associated with constructing an asset for the taxpayer's own use or a noninventory asset produced for sale have not been treated consistently by the courts.

NEW FEDERAL LAW (Sec. 189(Repealed) 263A(b)(1) & 280(Repealed))

The act provides that self-constructed (real or tangible personal property) and noninventory (real or tangible personal property) produced for sale are subject to uniform capitalization rules. In the case of property that is produced by the taxpayer, tangible personal property includes a film, sound recording, video tape, book or similar property.

These rules require the capitalization of the direct costs of producing or acquiring property and of an allocable portion of those indirect costs (including taxes) that benefit the assets. The cost allocation rules are to be patterned after the regulations which apply currently to extended period long-term contracts. The special rules relating to the capitalization of construction period interest and taxes and the production costs of films, books, records and similar property have been repealed.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The effective date applies to cost incurred on or after January 1, 1987 unless incurred with respect to property on which substantial construction occurred before March 1, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No relevant state tax data is available to estimate this provision.

The Joint Committee on Taxation has included this item in its impact estimate of VIII-D1 inventory. It is not possible, however, to isolate this item; therefore, the revenue effect for this particular provision is indeterminable.

Title VIIID3: Accounting Provisions

ACTION: EXPAND THE TYPES OF ASSETS TO WHICH THE CAPITALIZATION OF INTEREST RULES WILL APPLY

Act Section 803(a) and 804 Conference Report Page 302

Form 540 Line No. 16 Form 100 Line No. G-18

CURRENT CALIFORNIA LAW (Sec. 17201 & 24373.5)

California Personal Income Tax Law has conformed to federal law. Interest and taxes during the construction period of real property to be used or held for sale in trade or business or used in an activity for profit generally must be capitalized and amortized over 10 years. The amount of interest that must be capitalized is determined under the "avoided cost" method which requires a taxpayer to capitalize (in addition to interest directly traceable to construction indebtedness) any interest expense during the construction period that could have been avoided if funds had not been expended for construction.

The construction period commences with the date on which construction of the building or other improvement begins and ends on the date it is ready to be placed in service or held for sale.

The Bank and Corporation Tax Law generally is conformed to federal law except that it does not require the capitalization of interest and taxes with respect to any residential real propertyc acquired, constructed or carried by any bank or corporation and interest and taxes are deductible when paid or incurred with respect to those properties.

NEW FEDERAL LAW (Sec. 263A(f) and 460(c)(3))

The act repeals the capitalization rules for construction period interest and taxes along with the 10 year amortization rules. Under the new capitalization rules, interest on debt must be capitalized if the debt is incurred or continued to finance the construction, building, installation, manufacture, development or improvement of real or tangible personal property that is produced by the taxpayer and that has (1) a long-useful life (e.g., real estate or any other property that has a class life of 20 years or more under class life guidelines), (2) an estimated production period exceeding two years, or (3) an estimated production period exceeding one year and a cost exceeding $1 million. The production period for property begins on the date that production begins and ends on the date the property is ready to be placed in service or ready to be held for sale.

EXPANSION OF INTEREST CAPITALIZATION RULES

The act also provides that the interest capitalization rules are also applicable to (1) property that is produced for a taxpayer under a contract, and (2) property used to produce property including interest on loans that are used to finance the acquisition of building and equipment used in the production or construction of the property. Excluded from the capitalization rules is interest that constitutes qualified residence interest under Code Section 163(h). Except as provided in regulations, in the case of flow through entities (e.g., partnerships and their partners, S corporations and their shareholders, and estates and trust and their beneficiaries), the interest capitalization rules are to be applied first at the entity level and then at the beneficiary level.

Interest Allocation Rules

The act provides that interest on a debt that financed production or construction cost of a particular asset is first allocated and capitalized as part of the cost of the item. In addition, if the production or construction costs for an asset exceed the amount of this direct debt, interest on other loans is also subject to capitalization under the avoided cost method but only to the extend of this excess amount. For this purpose, the assumed interest rate would be computed as an average of the rates of the taxpayer's outstanding debts (excluding debt specifically traceable to production or construction).

Under the interest capitalization rules applicable to property that is produced for the taxpayer under a contract, the taxpayer capitalizes interest costs attributable to the payments to the contracts while the contractor must capitalize interest only with respect to indebtedness relating to the excess of its accumulated contract cost over the accumulated payments received by the contractor during the year.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The effective date of the provision applies to interest incurred after December 31, 1986 in taxable years ending after that date. Special transition rules are provided.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No relevant state tax data is available to estimate this provision.

The Joint Committee on Taxation has included this item in its impact estimate of VIIID1 Inventory. It is not possible, however, to isolate this item; therefore the revenue effect for this particular provision is indeterminable.

Title VIIIE: Accounting Provisions

ACTION: AMEND THE CAPITALIZATION RULES RELATING TO LONG-TERM CONTRACTS TO RESTRICT THE BENEFITS OF THE USE OF THE COMPLETED CONTRACT METHOD OF ACCOUNTING

Act Section 804 | Conference Report Page 310

Form 540 Line No. N/A | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17551, 24673, & 24701)

California generally has conformed to the federal special accounting rules applied to long term contracts.

A long-term contract for this purpose is a building, installation construction, or manufacturing contract that is not completed by the end of the taxable or income year in which it is entered into.

Manufacturing contracts qualify as long-term contracts only if it involves the manufacturing of either unique items of a type not normally carried in the finished goods inventory of the taxpayer, or items that normally require more than 12 months to manufacture, regardless of the length of the contract to make the product.

The rules common to both the California and the federal systems are as follows. A taxpayer with income from "long-term contracts" may report under the traditional cash or accrual methods or elect to report income and expense under the percentage of completion method or the completed contract method.

Under the completed contract method, all income and expenses are reported upon the completion of the contract. Under the percentage of completion method, the taxpayer deducts expenses currently, but reports the income in installments as the work on the contract progresses.

The rules relating to which costs are contract costs for purposes of the completed contract method vary depending on whether the contract is an extended period contract (generally one requiring longer than two years to complete) or a nonextended period contract. For example, indirect cost (e.g., research and development cost) need not be capitalized under nonextended period contracts but are to be capitalized under extended period contracts.

California has a special rule for corporations engaged in the performance of a contract in California that will take more than one year to complete. Under this rule the Franchise Tax Board may require a corporation doing business in more than one state to use the percentage of completion method, even if the taxpayer normally employs the completed contract method of accounting. This rule is intended to prevent tax avoidance.

NEW FEDERAL LAW (Sec. 460)

The act modifies the tax accounting methods for long-term contracts available to the taxpayer. Taxpayers may elect to use either a new percentage-of-completion method or the "percentage-of-completion capitalization method."

In general, the act also requires that all costs that directly benefit or are incurred because of a long-term contract are to be allocated to the contract in accordance with the regulations that currently apply to extended period long-term contracts. Moreover, additional general and administrative costs attributable to cost-plus contracts and to Federal government contracts requiring certification of costs are treated as contract costs. Some types of costs which include "independent research and development costs", expenses incurred in making unsuccessful bids and proposals, and marketing, selling, and advertising expenses are considered current deductions rather than capitalized expenditures.

In addition any incorrect total cost or income estimates using the above long-term contract methods will generally give rise to interest liabilities or income (look-back rule) upon completion of the contract. The completion percentage cannot be determined on the basis of the estimated percentage of work completed.

An exception from the long-term contract rules and the cost allocation rules (except for the production interest rules) provides that these rules are not to apply to contracts for the construction or improvement of real property if the contract (1) is expected to be completed within the two-year period beginning on the commencement date, and (2) is performed by a taxpayer with average annual gross receipts of $10 million or less for the three tax years preceding the tax year in which the contract is entered into. Gross receipts of all commonly controlled trades or businesses (including partnerships and proprietorships) and members of a controlled group of corporations during the three years are taken into account.

Percentage-of-Completion Capitalized-Cost Method

In the case of any long term contract not reported under the percentage-of-completion method, the taxpayer is to use the percentage-of-completion capitalization-cost method which is a combination of the percentage of completion method and the completed contract method. Accordingly, the taxpayer must take into account 40 percent of the items with respect to the contract using the percentage of completion method and the remaining 60 percent of the items are to be taken into account under the taxpayer's normal method of accounting.

Percentage-of-Completion Method

The act makes several modifications to this method.

First, the percentage of completion is determined by comparing the total contract cost incurred before the close of the taxable year with the estimated total contract costs rather than comparing work performed as was done prior to the 1986 act.

Second, costs that must be taken into account in computing the percentage of completion are those costs that have been allocated to the contract.

Third, upon completion of the contract, the look-back rule is applied where estimated cost and income were inaccurate as judged by the actual costs and income.

Look-back rule

The act provides that interest is to be payable by (or to) the taxpayer if the actual profit on a contract allocable to any year varies from the estimated profit profit used in reporting income. Thus the taxpayer is to recompute his tax liability for the years that the percentage of completion method was used on the basis of the actual contract price and costs and is to be compared with the previously reported tax liability. If the computations show an underpayment or overpayment of tax the taxpayer is to pay (or receive) interest computed at the same interest rate for overpayment of taxes (compounded daily).

Long-term Contracts

The act adopts the definition of long-term contract and manufacturing contracts under current law.

In addition, the Treasury Department is given authority to issue regulations treating two or more contracts as one and one contract as two or more separate contracts.

Controlled Group of Corporations

Under the act a controlled group includes (1) a parent-subsidary group, (2) a brother-sister corporate group, and (3) a combined group under common control. In determining whether corporations are controlled, only 50 percent or more of the voting power or value of the stock of a corporation need be commonly owned, but neither the rule attributing stock owned by estates and trusts to their beneficiaries nor the rule treating insurance companies as a separate controlled group are taken into account.

Independent Research and Development Cost

The term "independent research and development cost" means any expenses incurred in the performance of independent research and development other than (1) expenses directly attributable to a long-term contract in existence when the expenses are incurred, and (2) any expenses under an agreement to perform research and development.

Production Period Interest Allocation to Contract

Interest incurred in connection with a longer term contract generally must be allocated under the same rules as those that apply to property which is not produced under a long-term contract. However, only production period interest is allocated to a long-term contract.

In general, production period interest begins on the commencement dates (the date on which the taxpayer incurs any cost under the contract). In the case of a taxpayer who uses the accrual method, the production period begins on the later of the contract commencement date or the date on which at least 5 percent of the total estimated costs (including design and planning costs) under the contract have been incurred.

In addition, a de minimis rule is applied to projects taking less than one year and costing less than $1 million. The interest allocated on these long-term contracts under the uniform capitalization rules (Section 263(f)) are to be applied on a contract-by-contract basis; except that, in the case of a taxpayer using the accrual method the uniform capitalization rules are to be applied on a property-by-property basis.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The effective date of the provision is for contracts entered into on or after February 28, 1986. The treatment of independent research and development costs (as includible in the contract price but not includible in capitalizable contract costs) applies to all open taxable years of taxpayers.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on a proration of national estimates prepared by the Joint Committee on Taxation (JCT) the relative fiscal impact under state conformity would be Personal Income Tax revenue gains in the $4 million range for 1987-88 and 1988-89. A proration factor of 4.1 percent for California was used which reflects the Policy Economic Group (PEG) estimates for California compared to the nation for those provisions analyzed. PEG has not specifically estimated this provision.

Based on a proration of the JCT's estimate for the nation, revenue gains under the Bank and Corporation Tax Law from conformity would be in the $127 million range for 1987-88 and in the $87 million range for 1988-89. A proration factor of 4 percent was used which represents the general relationship between California corporate tax collections and federal corporate tax collections over the past few years.

It is not known to what extent business taxpayers will use the same accounting methods for California reporting purposes even if California does not actually conform.

Title VIIIF: Accounting Provisions

ACTION: DISALLOW THE RESERVE METHOD OF ACCOUNTING FOR BAD DEBTS FOR ALL TAXPAYERS OTHER THAN CERTAIN BANKS AND THRIFT INSTITUTIONS

Act Section 805 | Conference Report Page 314

Form 540 Line No. 16 | Form 100 Line No. G-15

CURRENT CALIFORNIA LAW (Sec. 17201 & 24348)

California is in general conformity with federal law regarding the accounting for bad debts.

The taxpayer may elect either the specific charge-off and reserve method.

Under the specific charge-off method, the taxpayer may take a deduction only for those debts that actually become worthless during the taxable or income year.

Under the reserve method, the taxpayer may be allowed a deduction for an reasonable addition to a reserve for bad debts. Whether an addition to the reserve account is reasonable depends primarily on the loan loss experience of the particular business.

An actual debt must be owed to the taxpayer in order to support the creation of a reserve for bad debts. For this reason, no deduction is generally allowed for potential losses of taxpayers who guarantee, endorse or provide indemnity agreements with respect to debts owed to others.

An exception to this rule is made for dealers in property who are allowed to establish a reserve for losses to the extent that these guaranteed obligations arise from the sale of real or tangible property.

Under SB 85 (Stats. 1986, Ch. 660), effective for income years beginning on or after January 1, 1988, the availability of the reserve method of deducting bad debts for all taxpayers, other than savings and loan associations, banks, or financial corporations is to be eliminated. Included in the act is also the disallowance of the reserve method for dealers in real and tangible personal property. Transitional rules provide that the existing reserve is to be taken into income ratably over a period of five years.

NEW FEDERAL LAW (Sec. 166)

The act repeals the availability of the reserve method in computing the expenses arising from bad debts for all taxpayers other certain financial institutions. In reference to dealers, the use of the reserve method in computing the deduction for losses on debts guaranteed is disallowed.

Taxpayers who are not allowed to continue to use the reserve method are allowed a deduction for bad debts when the debt becomes wholly or partially worthless. The balance of any existing reserve is taken into income ratably over a period of four years.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision is effective for taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on a proration of national estimates, the relative fiscal impact under state conformity would be a Personal Income Tax revenue gain in the $4 million range for both 1987-88 and 1988-89. A proration of 4.1 percent was used which reflects the Policy Economic Group (PEG) estimates, state vs. the nation, for those tax provisions analyzed. PEG has not specifically estimated this provision.

Regarding the effect of this provision under the Bank & Corporation Tax Law, California has recently repealed the reserve method for nonfinancial corporations in SB 85 (Chapter 660, Stats. of 1987) effective with income years beginning on or after January 1, 1988. Inasmuch as corporations will have to make this change for federal purposes in 1987 and for state purposes in 1988 it is anticipated that these corporations will initiate the state change in 1987 as well. Therefore, a corporate estimate for 1987-88 is provided below which will occur independently of whether or not California actually conforms to the 1987 effective date.

Based on a 4 percent proration factor of the Joint Committee on Taxation (JCT) estimate for the nation, it is estimated that the revenue gain under the Bank and Corporation Tax Law (B&CTL) revenue gain will be in the range of $70 million for 1987-88.

ACTION: REQUIRE THE USE OF THE CALENDAR YEAR AS THE TAXABLE YEAR OF PARTNERSHIPS, PERSONAL SERVICE CORPORATIONS, AND S CORPORATIONS

Act Section 806 Conference Report Page 317

Form 540 Line No. N/A Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17551, 17851, 24431, & 24631)

California has generally conformed to federal law in that taxable income is calculated on the basis of the taxpayer's annual accounting period which may be either the calendar year or a fiscal year.

A fiscal year means an accounting period of 12 months ending on the last day of any month other than December or a taxable year that ends on the same day of the week in each year (a 52-53 week year).

The taxable year for most individuals is the calendar year. Certain types of entities are required to select a taxable or income year that generally conforms to the taxable or income year of their owners.

A partnership entity is required to use the same taxable or income year as all its principal partners. If all principal partners do not have the same taxable or income year, the calendar year is used unless the partnership establishes to the satisfaction of the Franchise Tax Board a business purpose for selecting a different taxable or income year.

A principal partner means one who has an interest of five percent or more in the partnership profits or capital.

A special provision applies to certain "personal service corporations". This provision allows the Franchise Tax Board to allocate tax benefits between a personal service corporation and its employee-owners if substantially all of the services are performed for one other entity and its principal purpose is tax avoidance or evasion.

A "personal service corporation" is a corporation whose principal activity is the performance of personal services substantially by employee-owners (employees owning more than 10 percent of the corporations outstanding stock).

For California purposes, an S corporation is taxed as a corporation and dividends paid to shareholders are included in the shareholder's income based upon the shareholder's taxable year and method of accounting. California has no provision that requires (or permits) shareholders of an S corporation to take into account undistributed taxable income and net operating losses.

NEW FEDERAL LAW (Sec. 267, 269, 441, 706, & 1378)

The act requires that all partnerships, S corporations, and personal service corporations conform their taxable years to the taxable years of their owners.

The provision will require a partnership to adopt the same taxable year as that of the partners owning an aggregate interest in partnership profits and capital greater than 50 percent. In applying the majority interest rule, the partners must have owned a majority interest in the partnership for the three preceding taxable years of the partnership or the period of partnership existence. If such partners do not have the same taxable year, the partnership is required to adopt the taxable year of its principal partners. A principal partner is a partner who has at least a five percent interest in partnership profits or capital. A partnership not covered by either of the above rules is required to adopt the calendar year as its tax year.

For both S corporations and personal service corporations, the provision will generally require the adoption of the calendar year. For the accounting period rules the 10 percent ownership requirement that applies in defining a personal service corporation for purposes of giving the Internal Revenue Service reallocation powers does not apply. The constructive ownership rules do apply except that attribution is applied without regard to the 50 percent ownership requirement.

An exception will still be provided in each case where a partnership, S corporation or personal service corporation seeks a taxable year other than that required by this provision if it can establish, to the satisfaction of the Secretary of the Treasury, a business purpose for doing so. However, the present law rule that accepts as satisfying the business purpose requirement, the use of a taxable year which provides deferral of income of 3 months or less will no longer apply.

The act also extends the provision of section 267 (relating to matching deduction and payee income) in the case of expenses and interest to provide that a personal service corporation and its employee-owners are to be treated as related taxpayers regardless of the amount of the corporation's stock owned, directly or indirectly, by the employee owners, rather than having the provision only apply if the employee owns more than 10 percent of the corporations outstanding stock.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision is effective for taxable years beginning on or after January 1, 1987. Partners or shareholders of a partnership or S corporations that are required to include items from more than one taxable year of the partnership or S corporation in any taxable year may elect to take the net income of any short taxable year into account ratably over the first four years beginning on or after January 1, 1987. If an election is not made then such taxpayers are required to include all such income in the first taxable year (i.e., the short taxable year). The election is applicable to income from an S corporation only if such corporation was an S corporation for a taxable year beginning in 1986.

DIRECT STATE BUDGET FROM FEDERAL PROVISIONS

Since these connecting entities will be making taxable year changes for state tax purposes whether or not California actually conforms, the state estimates below reflect the change in budget receipts that will automatically occur under the Personal Income Tax (PITL) Law.

Based on a proration of national estimates prepared by the Joint Committee on Taxation (JCT), the relative fiscal impact would be a PIT revenue gain in the $24 million range for 1987-88 and $18 million range for 1988-89. A proration to California of 4.1 percent was used which reflects the Policy Economic Group (PEG) estimates for California relative to the nation for those provisions analyzed. This estimate allows for the fact that California doesn't provide for special 'S' corporation pass-thru treatment. According to the JCT, the 'S' corporation component of their estimates make up less than five percent of the total impact.

Title VIIIH1: Accounting Provisions

ACTION: <u>REPEAL THE PROVISION OF THE LAW RELATING TO QUALIFIED DISCOUNT COUPONS</u>

Act Section 823	Conference Report Page 321
Form 540 Line No. 16	Form 100 Line No. 6-26

<u>CURRENT CALIFORNIA LAW (Sec. 17551 & 24687)</u>

California law conforms to federal regarding to qualified discount coupons.

An issuer of qualified discount coupons using the accrual method of accounting may elect to deduct the cost of redeeming qualified discount coupons.

The deduction allowed is the sum of the cost of redemptions during the taxable or income year plus the cost of redeeming the coupons outstanding at the close of the taxable or income year which are received for redemption by the taxpayer within six months following the close of the taxable or income year.

A discount coupon is a sales promotion device used to encourage the purchase of a specific product by allowing a purchaser of that product to receive a discount on its purchase price.

A qualified discount coupon is a coupon which (1) is issued by the taxpayer, (2) is redeemable by the taxpayer, and (3) allows a discount on the purchase price of merchandise or other tangible personal property. A coupon is not considered a qualified discount coupon if (1) the face of the coupon is more than five dollars (2) the coupon may be used in conjunction with other coupons to bring about a price discount of more than five dollars or if (3) the coupon is redeemable directly by the issuer (i.e., a direct consumer rebate).

Under certain situations, a taxpayer is required to establish a suspense account in the year of election in order to limit the bunching of deductions in that year.

The election must be made with respect to each trade or business of the taxpayer and constitutes a method of accounting.

The taxpayer must secure a consent from the Franchise Tax Board to revoke an election.

<u>NEW FEDERAL LAW (Sec. 466)</u>

The Act repeals the provision which allows a current year deduction for the cost of redeeming qualified discount coupons received after the close of the taxable year. Only redemption costs actually incurred before the end of the taxable year can be deducted currently.

Any adjustment required to be made as a result of the change in method of accounting will be reduced by the amount of any suspense account and included in income over a period not longer than four years.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision is effective for taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on a proration of the Joint Committee on Taxation (JCT) estimate for the nation, revenue gains under the Bank and Corporation Tax Law from conformity would be in the $1.2 million range for 1987-88 and in the $1.4 million range for 1988-89. A proration factor of 4 percent was used which represents the general relationship between California's corporate tax collections and federal corporate tax collections over the past few years.

No meaningful impact under the Personal Income Tax Law is expected.

Title VIIIH2: Accounting Provisions

ACTION: RESTRICT ACCOUNTING METHOD FOR UTILITY SERVICES

Act Section 821 | Conference Report Page 322

Form 540 Line No. N/A | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17551, 24661)

California laws that pertain to accounting methods are generally similar to the federal provisions. In general, the permissible methods of accounting are: cash receipts and disbursements, accrual, special methods for certain industries and situations, and with limitations, certain hybrid methods. Entities providing utility services are currently allowed to use a hybrid accrual method which recognizes income based upon when a customer's utility meter is read or at the time the utility is billed, rather than when the utility service is actually provided.

California is also similar to the federal law with respect to changing of accounting methods, in that: 1) a change must be approved, and 2) adjustments to net income may be required to prevent amounts from being duplicated or omitted.

NEW FEDERAL LAW (Sec. 451)

Under the act, taxpayers using an accrual method of accounting that are providing utility services (whether regulated or unregulated) must include the sale or furnishing of the service in gross income no later than the taxable year in which the services were provided to the customers. The term utility services includes:

- o the providing of electrical energy, water, or sewage disposal,
- o the furnishing of gas or steam through a local distribution system,
- o telephone or other communication services, and
- o the transporting of gas or steam by pipeline.

A change in the accounting method required by this provision will be treated as an approved election and the required adjustments can be taken proportionally over a four year period beginning after December 31, 1986.

The act specifically provides that if a taxpayer used the cycle meter method for taxable years beginning before August 16, 1986, the method would be considered proper for those years.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective for taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on a proration of the Joint Committee on Taxation estimate for the nation by the revenue gains from this corporate provision under state conformity would be in the $21 million range for 1987-88 and in the $20 million range for 1988-89. A proration factor of 5.5 percent was used which represents the relationship between California's corporate tax collections from electric and gas utilities corporations and the federal tax collections from similar utility corporations for the 1983 income year.

Title VIIIH3: Accounting Provisions

ACTION: REPEAL THE SPECIAL RULE THAT TREATS CONTRIBUTIONS IN AID OF CONSTRUCTION TO REGULATED PUBLIC UTILITIES AS EXCLUDABLE FROM INCOME

Act Section 824 | Conference Report Page 324

Form 540 Line No. N/A | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. None)

California has conformed to federal law which provides that certain contributions made to regulated public utilities to the aid in construction are contributions to capital and therefore, excluded from gross income. Although there is no comparable provision in the Revenue and Taxation Code for California, the Franchise Tax Board has ruled under legal Ruling 362 dated December 14, 1973, that California will follow federal law in this area.

The corporate regulated public utilities which qualify for this treatment are those that provide electric energy, gas (through local distribution systems or transportation by pipeline), water, or sewage disposal services. Such contributions are treated as a contribution to capital (not included in gross income) and may not be included in the utility's rate base for rate making purposes. Property received or purchased with the proceeds of a contribution to capital has no depreciable basis for Federal or California income tax purposes. In addition, for federal purposes, the property will not be eligible for the investment tax credit.

NEW FEDERAL LAW (Sec. 118)

The act repeals the provision of present law which allows contributions in aid of construction received by a corporate regulated public utility to be excluded from gross income. Property, including money, that is received to encourage the provision of services to or for the benefit of the transferor must be included as an item of gross income.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The amendments made will generally apply to amounts received on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on a proration of national estimates prepared by the Joint Committee on Taxation (JCT), the relative fiscal impact under state conformity under the Bank and Corporation Tax Law would be revenue gains in the $5 million range for 1987-88 and $4 million range for 1988-89. The proration to California (4 percent) reflects the general relationship between California corporate tax collections and federal corporate tax collections over the past few years.

Title VIIIH4: Accounting Provisions

ACTION: REPEAL THE EXCLUSION FROM INCOME FOR THE DISCHARGE OF QUALIFIED BUSINESS INDEBTEDNESS

Act Section 822 Conference Report Page 324

Form 540 Line No. 27 Form 100 Line No. 6-10

CURRENT CALIFORNIA LAW (Sec. 17131 & 24307)

California is conformed to federal law which provides generally that if a debt of a solvent taxpayer is canceled or discharged by a payment of less than the principal amount of the debt, the taxpayer realizes income in the amount of the debt canceled.

Exceptions to the general rule are provided in cases where the discharge occurs in a case arising under title 11 of the United States Code (relating to bankruptcy), where the taxpayer is insolvent, or where the indebtedness discharged is qualified business indebtedness.

An indebtedness is treated as qualified business indebtedness if and only if (1) indebtedness was incurred or assumed (a) by a corporation; or (b) by an individual in connection with property used in a trade or business; and (2) the taxpayer makes an election to treat the indebtedness as qualified business indebtedness.

In the case of discharge of qualified business indebtedness, the amount of income excluded must be applied to reduce the basis of depreciable property of the taxpayer. If the discharge exceeds the basis of the taxpayer's depreciable property, the excess is included in gross income for the year in which the discharge occurs.

NEW FEDERAL LAW (Sec. 108)

The act repeals the provision that allows a solvent taxpayer an election to reduce the basis of depreciable property rather than currently recognize income from the discharge of qualified business indebtedness. Thus, the exclusion from income will only apply to discharges in bankruptcy or when the taxpayer is insolvent or is a farmer treated as being insolvent.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision is applicable to discharges of indebtedness occurring on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on a proration of national estimates prepared by the Joint Committee on Taxation (JCT), the relative fiscal impact under the Personal Income Tax Law under state conformity would be a revenue gain in the $200,000 range for 1987-88 and $100,000 range for 1988-89. A proration of 4.1 percent to California was used which reflects the Policy Economic Group (PEG) estimates for California relative to the nation for those provisions analyzed. PEG has not specially estimated this provision.

Based on a proration of the JCT's estimate for the nation, the revenue gains under the Bank and Corporation Tax Law would be in the $3 million range for 1987-88 and in the $2.5 million range for 1988-89. A proration factor of 4 percent was used which represents the general relationship between California's corporate tax collections and federal corporate tax collections over the past few years.

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TITLE IX

FINANCIAL INSTITUTIONS

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Title IXA1: Financial Institutions

ACTION: REPEALS THE USE OF THE BAD DEBT RESERVE METHOD FOR BAD DEBTS OF LARGE BANKS

Act Section 901 Conference Report Page 326

Form 540 Line No. N/A Form 100 Line No. G-15

CURRENT CALIFORNIA LAW (Sec. 24348)

California law has no specific provisions comparable to the detailed federal rules covering additions to reserves for bad debts for banks. California law conforms to federal law requiring recovery of bad debts to be included in income in the year of recovery to the extent the bad debt deduction in the prior year reduced the income subject to tax in that year.

Under California law, a reasonable addition to the reserve for bad debts of any bank or savings and loan association (including thrifts) for the income year may not exceed the amount necessary to increase the reserve at the close of the income year to the greater of:

(1) the amount which is determined by multiplying loans outstanding at the close of the income year by the ratio of (a) the total bad debts sustained during the income year and the five preceding years adjusted for recoveries of bad debts for that period to (b) the sum of loans outstanding at the close of those six income years. At the option of the taxpayer, in lieu of the ratio obtained by this formula, the ratio may be computed by using an average of annual averages for the six-year period,

(2) the amount which the taxpayer establishes as necessary to absorb current anticipated losses in light of prevailing conditions relating to the taxpayer's portfolio. This provision is intended to allow an addition to the reserve of an amount greater than that provided in paragraph (1) in those cases where the condition of the loan portfolio indicates that, as of the close of the income year, the amount expected to be realized from the portfolio in the normal course of business is less than its basis minus the reserve.

In computing the amount of loans outstanding at the end of the current year or any of the preceding five years, government insured loans, and unearned interest or discount on outstanding loans are excluded.

OLD FEDERAL LAW (Section 585)

Under prior law, commercial banks could compute their bad debt deduction for the year either by deducting only those debts that become worthless during the year (specific charge-off method) or by deducting a specific amount of a bad debt reserve (reserve method). Commercial banks using the reserve method used either the "bank experience method" or the "percentage of eligible loans method" to compute a reserve. Under the "experience method," the taxpayer's ending reserve balance was determined by reference to its own average experience for the current year and the five preceding years. Under the "percentage of eligible loans method," the reserve balance at the end of the year was the amount necessary to increase the reserve to 0.6 percent of outstanding loans.

NEW FEDERAL LAW (Sec. 585)

Effective for tax years beginning after December 31, 1986, large banks are not allowed to use the reserve method of computing deductions for bad debts. Instead, for accounts and loans that "go bad" in tax years beginning after 1986, the specific charge-off method must be used by large banks. The reserve method for computing bad debt deductions is still available for small banks.

Large bank defined. A bank is considered a "large bank" if, for the current taxable year or any taxable year beginning after December 31, 1986, the sum of the average adjusted bases of all assets of such bank exceeds $500 million or, if the bank is a member of a parent-subsidiary group, the sum of the adjusted bases of all assets of such group exceeds $500 million. The adjusted basis of an asset is generally considered to be the tax basis of the asset, adjusted by those amounts allowed as adjustments to basis by Section 1016. In determining the sum of the average adjusted bases of all assets of a controlled group, interests held by one member of such group in another member of such group are to be disregarded. The average adjusted basis of the assets of a bank or controlled group is determined by dividing the sum of the adjusted bases of the assets at each time during the taxable year when the bank is required to report for regulatory purposes by the number of required reports.

A controlled group as used in this provision is a parent-subsidiary controlled group of corporations described in Section 1563(a)(1). For the purpose of determining the sum of the adjusted bases of the assets of a controlled group, all corporations includible in the group under the ownership tests of Section 1563(a) are included, without regard to their status as an "excluded member" of a controlled group as a result of the application of Section 1563(b)(2), and whether or not the corporation meets the definition of a commercial bank.

In addition, unless a "cut-off method" (see below) is elected, the balance of a large bank's existing reserve must be recaptured and reported in income in each of the following four tax years and according to the following schedule: (1) a minimum of 10 percent in the first taxable year for which the provision is effective (although the taxpayer may elect to recapture up to 100 percent in the first year); (2) 2/9 of the balance remaining after the first year in the next succeeding year; (3) 1/3 of the balance remaining after the first year in the second succeeding year; and (4) 4/9 of the balance remaining after the first year in the third succeeding year. If the bank elects to include 10 percent of income during the first year, the above fractions translate into the following year-by-year percentages: second year, 20 percent (2/9 of 90 percent); third year, 30 percent (1/3 of 90 percent); and fourth year, 40 percent (4/9 of 90 percent). This recapture rule applies to banks that have "large bank" status for 1987 and to banks that attain this status in subsequent tax years.

However, there is no recapture of existing reserves for any year in which a bank was financially troubled. A bank is considered to be "troubled" if the amount of its non-performing loans exceeds 75 percent of its equity capital for the tax year. Nonperforming loans include (1) loans that are "past due 90 days or more and still accruing," (2) "nonaccrual" loans, and (3) "renegotiated 'troubled' debt" under the existing standards of the Federal Financial Institution Examination Council. Equity capital means assets less liabilities, as those amounts are reported for regulatory purposes. Equity capital does not include the balance in any reserve for bad debts. The average of nonperforming loans and equity capital for the year is to be determined as the average of those amounts at each time during the taxable year that the bank is required to report for regulatory purposes. In the case of a bank that is a member of a controlled group described in section 1563(a)(1), the determination of whether the bank is a financially troubled bank is made with respect to all members of that controlled group.

For purposes of the suspended recapture rule, the non-performing loan percentage of a troubled bank is the percentage determined by dividing (1) the sum of the outstanding balances of nonperforming loans of the bank at the close of each quarter of the taxable year by (2) the sum of the amounts of equity of the bank at the close of each such quarter. If a bank is a member of a parent-subsidiary controlled group for the taxable year, the percentage will be applied with respect to the group.

The four-year recapture formula is operative for large banks in every year when they are not financially troubled. For example, if a large bank is financially troubled in 1987 and 1989, its bad-debt reserve will be recaptured as follows: 1987 - 0 percent; 1988 - 10 percent (the minimum elective percentage); 1989 - 0 percent; 1990 - 20 percent; 1991 - 30 percent; and 1992 - 40 percent.

The provisions allowing a financially troubled bank to suspend the inclusion of its bad debt reserve in income does not affect the requirement that a large bank account for its bad debts using the specific-charge off method.

"Cut-off method. Banks can account for bad debt reserves by using another method after they attain large bank status. In lieu of recapturing the bad debt reserve over the four-year period, a large bank may elect to continue to maintain the reserve account and to charge bad loans and credit recoveries to the account balance under what is called the "cut-off method." However, the cut-off method is available only for those loans that were held by the bank on the first day of the tax year when it became a large bank. Such loans that become worthless reduce the balance in the reserve account and collections on accounts increase it. However, the charge off or recovery of loans can only be used to reduce the balance in the bank's reserve account to zero. Once an account has a zero balance, any collections will give rise to income and any further bad debts will create a deduction in the amount of the loan being charged. The use of the cut-off method means that no income will be realized through collections (or because of the recapture of the reserve) and that no deductions will be available for losses on such loans. This option is first available for tax years beginning in 1987 if the bank maintained a reserve for bad debts in 1986.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applicable to taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Bad Debt Reserves - Financial Corporation

If California were to conform to federal law by repealing the bad debt reserve method and recapturing prior year reserves of commercial banks, the revenue effects are estimated as follows (in millions):

Fiscal Year	Bad Debt Repeal	Recapture Provision	Preference Tax	Total
1987-88	$ + 6	$ +10	$ - 1	$+ 15
1988-89	+ 6	+15	- 1	+ 20

The net impact for 1987-88 would be a revenue gain in the $15 million range and for 1988-89 a revenue gain in the $20 million range. It is anticipated that additional revenues from the recapture provision will increase to $20 million for 1989-90, and to $25 million for 1990-91.

The bad debt deduction estimate was developed from audit data for 1978 through 1984 on the nine largest California banks which account for 98 percent of total net income for the industry.

This detail includes self-assessed information for those years on allowable additions to reserves, additions claimed, charges to the reserve and outstanding end-of-year balances. Since repeal of the reserve method would eliminate the preference tax on this item, this revenue loss is also provided.

These estimates are on the conservative side given the "financially troubled" exception to the recapture provision and the rather poor economic performance of a number of key commercial banks currently.

Title IXA2: Financial Institutions

ACTION: <u>REDUCES MAXIMUM PERCENTAGE OF INCOME THAT A THRIFT INSTITUTION MAY ADD TO A RESERVE FOR BAD DEBTS</u>

Act Section 901	Conference Report Page 330
Form 540 Line No. N/A	Form 100 Line No. 6-15

<u>CURRENT CALIFORNIA LAW (Section 24348)</u>

Deduction is allowed for bad debts under either the reserve method or the specific charge off method.

California law has no specific provisions comparable to the detailed federal rules covering additions to reserves for bad debts for thrift institutions (mutual savings banks, savings and loan associations and cooperative banks). California Regulation 24348(b) provides special rules governing additions to bad debt reserve accounts for banks and savings and loan associations. There are three alternative methods:

(1) The amount which is determined by multiplying loans outstanding at the close of the income year by the ratio of (a) the total bad debts sustained during the income year and the five preceding years, adjusted for recoveries of bad debts for that period, to (b) the sum of loans outstanding at the close of those six income years. At the option of the taxpayer, in lieu of the ratio obtained by this formula, the ratio may be computed by using an average of annual averages for the six-year period.

A newly organized bank or savings and loan association which does not have six years of loss experience may use the average of any combination of its own loss experience or the industry-wide experience for each year of the six-year period in determining the above ratio.

In the case of a merger, consolidation or the acquisition of all the assets of a predecessor bank or savings and loan association occurring within the six-year period, a new loss ratio, combining the ratio of the banks or savings and loan associations involved in the merger, consolidation or acquisition must be computed.

(2) The amount which is determined by multiplying loans outstanding at the close of the income year by the ratio of (a) the total bad debts sustained during the

income year and the two preceding years, adjusted for recoveries of bad debts for that period, to (b) the sum of loans outstanding at the close of those three income years. At the option of the taxpayer, in lieu of the ratio obtained by this formula, the ratio may be computed by using an average of annual averages for the three-year period.

(3) For income years beginning before January 1, 1989, the amount of the bad debt reserve determined as of December 31, 1976, provided that for income years beginning on or after January 1, 1985, the addition shall not exceed the amount necessary to increase the reserve to an amount of five times the amount of the maximum reserve determined under (1), above.

If the taxpayer is able to establish that the additions to the reserve provided by any of the above three methods are insufficient to absorb anticipated losses, it may claim an addition to its reserve in an amount necessary to absorb such losses provided that the amount of the reserve may not exceed the smaller of (a) the amount of the reserve required by or reported to bank and savings and loan association regulatory agencies and reflected in the taxpayer's published financial statements, or (b) one percent of the amount of the loans outstanding at the close of the income year.

In computing the amount of loans outstanding at the end of the current year or any of the preceding five years, bonds, government insured loans, and unearned interest or discount on outstanding loans are excluded.

OLD FEDERAL LAW (Sec. 593)

Under prior federal law, mutual savings banks, domestic building and loan associations and cooperative banks without capital stock which were organized and operated for mutual purposes and without profit (collectively called "thrift institutions"), were allowed to use either the specific charge-off method or the reserve method in computing their deduction for bad debts for federal income tax purposes. For thrift institutions using the reserve method, the reasonable addition to the reserve for bad debts was equal to the addition to the reserves for losses computed under the "bank experience" method, the "percentage of eligible loans" method, or, if a sufficient percentage of the thrift's assets constituted "qualified assets," the "percentage of taxable income" method.

The bank experience and percentage of eligible loans methods for thrift institutions generally were the same as for commercial banks.

Under the percentage of taxable income method, an annual deduction was allowed for a statutory percentage of taxable income[1]. The statutory percentage for tax years beginning after 1978 was 40 percent.

The full 40 percent of taxable income deduction was available only where 82 percent (72 percent in the case of mutual savings banks without capital stock) of the thrift institution's assets were qualified. Where the 82 percent test was not met, the statutory rate was reduced by three-fourths of one percentage point for each one percentage point of such shortfall. For mutual savings banks without capital stock, the statutory rate was reduced by 1 1/2 percentage points for each percentage point that qualified assets failed to reach the 72 percent requirement. At a minimum, 60 percent of a thrift institution's assets must have been qualifying (50 percent for mutual savings banks without stock) in order to be eligible for deductions under the percentage of income method.

A thrift institution could switch between methods of determining the addition to its loan loss reserves from one year to another.

NEW FEDERAL LAW (SEC. 593)

The act provides that thrift institutions (mutual savings banks, domestic building and loan associations and cooperative banks) will continue to be able to compute bad debt deductions using the bank experience method and the percentage of taxable income method. The percentage of eligible loans method has been repealed. In the case of the percentage of taxable income method, the portion of taxable income which may be deducted as an addition to a reserve for bad debts is reduced from 40 percent to 8 percent. The rules reducing the amount of the percentage of taxable income deduction available to a thrift institution which holds 60 percent of its assets in qualifying assets, but fails to hold a sufficient percentage of qualifying assets to use the maximum percentage of taxable income deduction, are eliminated. Any institution meeting the definition of a thrift institution and holding at least 60 percent of its assets as qualifying assets, will be eligible for the full 8 percent of taxable income deduction. The 60 percent test applies to mutual savings banks as well as other types of thrift institutions.

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[1]For purposes of determining the deduction under the percentage of income method, taxable income was computed without regard to any deduction allowable for any addition to the reserve for bad debts and exclusive of 18/46 of any net long-term capital gain, gains on assets the interest on which was tax-exempt, any dividends eligible for the corporate dividends received deduction and any additions to gross income from the thrift institution's own distributions from previously accumulated reserves.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The above provisions are effective for taxable years beginning on or after January 1, 1987.

REVENUE IMPACT UNDER CONFORMITY TO FEDERAL LAW

Even with the federal percentage reduction from 40 percent to 8 percent, the new federal rules for thrift institutions still provide more liberal bad debt deductions than current state law allowances. Based on national estimates of the relative change from a 40 percent to 8 percent deduction level, the corresponding state impact from adopting the 8 percent deduction would result in revenue losses in the $2 million range annually.

Title IXB: Financial Institutions

ACTION: DENIES DEDUCTIONS BY FINANCIAL INSTITUTIONS FOR INTEREST EXPENSE ALLOCABLE TO TAX-EXEMPT OBLIGATIONS

Act Section 902 | Conference Report Page 332

Form 540 Line No. N/A | Form 100 Line No. G-18

CURRENT CALIFORNIA LAW (Sec. 24271, 24344, 24370, and 24425)

California law generally conforms to federal law provisions denying a deduction for interest expense allocable to income not includible in the measure of tax. However, for purposes of the franchise tax, all interest income, including interest on tax-exempt obligations, is includible in the measure of tax. Accordingly, none of the interest expense allocable thereto is disallowed. Also, in the case of mutual savings banks, a deduction is allowed for all interest paid to depositors having no proprietary interest in the institution or its surplus, and for interest on deposits of members possessing a proprietary interest in the institution or its surplus at a rate determined by the State Superintendent of Banks to be the going rate of interest on savings deposits in the state.

OLD FEDERAL LAW (Sections 265 and 291)

No deduction was allowed for interest payments on debt incurred or continued to purchase or carry tax-exempt obligations. However, under a long-standing judicial and administrative interpretation, financial institutions generally were permitted to invest deposited funds in tax-exempt obligations, while continuing to deduct interest paid to depositors.

Also, the corporate tax preference rules reduced by 20 percent the amount which could be deducted by financial institutions for interest on funds allocable to tax-exempt obligations acquired after 1982. The portion of funds allocable to tax-exempt obligations was deemed to be equivalent to the ratio of (1) the average annual adjusted basis of tax-exempt obligations acquired after 1982 and held by the financial institution, to (2) the average annual adjusted basis of the financial institution's total assets.

NEW FEDERAL LAW (Sections 265 and 295)

Banks, thrift institutions and all other financial institutions are not allowed to deduct any portion of their interest expense that is allocable to tax-exempt interest (including amounts paid in respect of deposits, investment certificates, or withdrawable or repurchasable share) acquired after August 7, 1986, in taxable years ending after 1986. For purposes of the disallowance rule, the acquisition date of an obligation is the date on which the holding period begins with respect to the obligation in the hands of the acquiring financial institution. Thus, the acquisition of bonds as part of a tax-free reorganization is not treated as a new acquisition for purposes of this provision.

Also, the special rule of prior law regarding face-amount certificate companies (contained in Sec. 265(2)) is repealed. These companies are therefore subject to the 100 percent disallowance rule in the same manner as other financial institutions.

The prior 20 percent disallowance rule under Section 291 continues to apply with respect to tax-exempt obligations (including shares of stock of a regulated investment company that, during the taxable year of the holder, distributes exempt-interest dividends) acquired after 1982 and before August 8, 1986. Under the 20 percent rule, the portion of interest expense attributable to indebtedness on tax-exempt obligations that could otherwise be deductible for the year must be reduced by 20 percent.

Allocation. The portion of the taxpayer's interest expense that is allocable to tax-exempt interest is an amount that bears the same ratio to such interest expense as the taxpayer's average adjusted bases of tax-exempt obligations acquired after August 7, 1986, bear to such average adjusted bases for all assets of the taxpayer. For purposes of this provision, "interest expense" means the aggregate amount allowable to the taxpayer as a deduction for interest for the taxable year, determined without regard to Sections 265(b) and 291.

A permanent exception to the provision is provided for qualified tax-exempt obligations acquired by a financial institution. This exception applies whether the obligation is acquired at the original issuance or by a secondary purchaser. Qualified tax-exempt obligations include any obligation which (1) is not a private activity bond and (2) is issued by an issuer which reasonably anticipates to issue, together with subordinate entities, not more than $10 million of tax-exempt obligations (other than private activity bonds), during the calendar year. Qualified tax-exempt obligations must be designated as such by the issuer; not more than $10 million of obligations may be so designated by any issuer (including subordinate entities) for any calendar year. Refundings of outstanding bonds may qualify for this exception, and count toward the $10 million limitation, under the same terms as new issues.

For purposes of the exception for qualified tax-exempt obligations, subordinate governmental entities include entities deriving their issuing authority from another entity or subject to substantial control by another entity. For example, a sewer or solid waste authority created by a city or county in order to issue bonds for that city or county is considered a subordinate entity. An entity is not to be considered subordinate solely because of geographic inclusion in a larger entity (e.g., a city located within a larger county), if the smaller entity derives its powers independently of the larger entity and is not subject to significant control by the larger entity.

Qualified tax-exempt obligations are treated as acquired by the financial institution before August 8, 1986. Interest allocable to such obligations remains subject to the 20 percent disallowance contained in present law.

For purposes of this provision only, qualified section 501(c)(3) organization bonds are not treated as private activity bonds. In the case of bonds issued before August 15, 1986, for purposes of this provision only, bonds are not to be treated as private activity bonds if they are not IDBs, mortgage subsidy bonds, student loan bonds, or other private ("consumer") loan bonds for which tax exemption is permitted under present law.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective for taxable years beginning on or after January 1, 1987. Thus, bonds acquired after August 7, 1986, in taxable years ending in 1986 are subject to the 20 percent disallowance rule of prior law for the taxable year ending in 1986, but are subject to the 100 percent disallowance rule for subsequent taxable years.

A transitional exception is provided for tax-exempt obligations acquired after August 7, 1986 pursuant to a direct or indirect written commitment to purchase or repurchase such obligation, which commitment was entered into before September 25, 1985. Obligations qualifying for this exception are treated as if acquired before August 8, 1986; interest allocable to such obligations thus remains subject to the 20 percent disallowance contained in prior law. The Act also provides certain transitional rules for specified identified projects.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Since California law requires corporations to include interest received on "tax-exempt obligations" in the measure of the state franchise tax, it is proper for related interest expenses to be deducted. No estimate, therefore, is provided under the Bank and Corporation Tax Law.

Direct State Budget Impact from Federal Change

To the extent financial corporations reduce their investments in tax-exempt obligations due to the federal law change, other taxpayers (nonfinancial corporations and individuals) will increase their share of holding tax-exempt securities. Based on a proration of national estimates for individuals, the increase in individual holdings could result in revenue losses in the $15 million range for 1987-88 and in the $28 million range for 1988-89 under the Personal Income Tax Law.

Title IXD: Financial Institutions

ACTION: REPEALS SPECIAL REORGANIZATION RULES FOR FINANCIAL INSTITUTIONS

Act Section 904 | Conference Report Page 336

Form 540 Line No. N/A | Form 100 Line No. G-9

CURRENT CALIFORNIA LAW (Sec. 24562)

California did not the adopt the special provision (repealed by the Tax Reform Act of 1986) which relaxed certain requirements applicable to financially troubled thrift institutions for qualification as a tax-free bankruptcy reorganization, and for the exclusion from income of certain payments from the Federal Savings and Loan Insurance Corporation (FSLIC) to the troubled thrift institution.

OLD FEDERAL LAW (Sec. 368(a)(3)(D) and 597)

Former federal law provided special rules which exempted the acquisition of financially troubled thrift institutions from rules otherwise applicable to corporate reorganizations. These provisions relaxed certain requirements for qualification as a tax-free bankruptcy reorganization under the Internal Revenue Code (IRC). Thus, the requirements need not be met that (1) the acquired corporation undergo formal receivership or similar proceedings and (2) the shareholders and creditors of the acquiring corporation receive stock in the acquiring corporation. In addition, these provisions relaxed the rules regarding the survival of net operating loss carryovers following a merger, and excluded certain payments from the Federal Savings and Loan Insurance Corporation (FSLIC) to the troubled thrift institution from income, and from the requirement that basis in property be reduced by the amount of nonshareholder contributions to capital.

NEW FEDERAL LAW (Sec. 368(a)(3)(D) amended; Sec. 597 repealed)

The Act repealed the special provisions, above, applicable to financially troubled thrift institutions.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The special reorganization rules for troubled thrift institutions are repealed effective for acquisitions and mergers after December 31, 1988. The repeal of the special treatment for FSLIC payments is effective for payments after December 31, 1988, unless such payments are made pursuant to an acquisition or merger occurring on or before that date.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No impact, as California never adopted the special federal rules applicable to financially troubled thrift institutions for qualification as a tax free bankruptcy reorganization.

Title IXE: Financial Institutions

ACTION: ALLOWS INDIVIDUALS TO TREAT LOSSES ON DEPOSITS IN AN INSOLVENT OR BANKRUPT FINANCIAL INSTITUTION AS A CASUALTY LOSS RATHER THAN AS A SHORT-TERM CAPITAL LOSS

Act Section 905 Conference Report Page 337

Form 540 Line No. 47 Form 100 Line No. G-18

CURRENT CALIFORNIA LAW (Sections 17201, 17206, 24343, 24344, and 24370)

California conforms to federal law with respect to the loss of a deposit or account in a financial institution where it is determined that there is no prospect of recovery. Unless the deposit was created in connection with a trade or business of the taxpayer, the loss is treated as a short-term capital loss. Financial institutions are allowed to deduct interest accrued and credited on depositor's accounts.

NEW FEDERAL LAW (Sections 451 and 165)

The Act gives a "qualified individual" an election to deduct losses on deposits in a "qualified financial institution" as a personal casualty loss at the time the loss can be reasonably estimated if the loss arises as a result of bankruptcy or insolvency of the financial institution. A taxpayer may not take a deduction for a bad debt for any loss which the taxpayer elects to take as a casualty loss under this provision.

A casualty loss is subject to a $100 floor and total net casualty losses for the year are deductible only to the extent that they exceed 10 percent of the individual's adjusted gross income.

Under the bad debt rules, the loss is treated as a short-term capital loss and is subject to a maximum deduction limit of $3,000 per year, with the excess available as a carryover.

The Act also provides that accrued, but unpaid, interest on a "frozen deposit" in a financial institution for any taxable year is not includible in the "qualified individual's" taxable income for that taxable year if the interest is not available for withdrawal at the end of that taxable year. Such interest is includible in gross income in the taxable year in which it is withdrawable. Conversely, in the case of interest attributable to the period beginning January 1, 1983, and ending December 31, 1987, a "qualified financial institution" may deduct interest accrued on a "frozen account, even though such interest is not includible in the depositor's taxable income until it becomes available for withdrawal. Beginning January 1, 1988, no deduction is allowable to any "qualified financial institution" for interest accrued on a "frozen account" until such interest is includible in the depositor's taxable income.

A "qualified individual" means any individual except one:

(1) Who owns one percent or more in value of the outstanding stock of the financial institution,

(2) Who is an officer of the financial institution, or

(3) Who is related to an individual described in paragraphs (1) and (2).

A "qualified financial institution" means any commercial bank, thrift institution, insured credit union, or similar institution chartered or supervised under federal or state law.

"Frozen deposit" means any deposit, if at the close of the calendar year, any portion of the deposit may not be withdrawn because of (1) the bankruptcy or insolvency (or threat thereof) of the qualified institution, or (2) any requirement imposed by the state in which the institution is located by reason of the bankruptcy or insolvency (or threat thereof) of one or more financial institutions in the state.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The amendments to Sections 165 of the Internal Revenue Code (relating to the deduction for losses on deposits) apply to taxable years beginning on or after January 1, 1983. This is a retroactive application which allows for the filing of amended returns for taxable years not barred by the statute of limitations.

The amendments to Section 451 (relating to interest on frozen deposits) apply to taxable years beginning on or after January 1, 1983. However for taxable years beginning on or after January 1, 1983, and before January 1, 1987, these provisions apply only if the qualified individual elects to have the amendments apply for all such taxable years.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on the Joint Committee on Taxation's estimate for the nation, revenue losses under the PITL from conformity would be very minor, less than $100,000 annually.

The next page of this report is page 1000.

TITLE X

INSURANCE PRODUCTS AND COMPANIES

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Title XA1: Insurance Products and Companies

ACTION: REPEAL THE $1,000 EXCLUSION ON INSTALLMENT PAYMENTS OF LIFE INSURANCE PROCEEDS

Act Section 1001 | Conference Report Page 338

Form 540 Line No. 13 | Form 100 Line No. G-6

CURRENT CALIFORNIA LAW (Sec. 17131, 24302)

California conforms to federal law. Generally, amounts paid by an insurance company to the beneficiary of a life insurance contract upon the death of the insured person, are not includible in the beneficiary's gross income. The beneficiary may choose to receive payment through a series of installments, rather than as a lump sum. In determining the value of future payments, the insurance company is permitted to use mortality tables which distinguish among individuals based upon gender.

When life insurance proceeds are disbursed through installment payments, a pro-rated amount, deemed to represent the nontaxable death benefit continues to be excluded from income, while the remainder must be included. However, current law also provides an exclusion for the first $1,000 of the otherwise taxable portion of payments received. Amounts paid to the beneficiary in excess of the death benefit sum are generally considered to be payments made by the insurance company for the use of the beneficiary's money (the unpaid death benefit). This is likened to the interest paid by other financial institutions for the use of depositors' funds.

NEW FEDERAL LAW (Sec. 101)

All amounts payable to any beneficiary that are in excess of the amount deemed to be the death benefit, are includable in the beneficiary's gross income. The $1,000 exclusion is repealed.

For purposes of assigning value to the portion of any payment deferred beyond the death of the insured party that is treated as a nontaxable death benefit, mortality tables used may not distinguish among persons on the basis of sex. The mortality tables that can be used will be those prescribed in regulations promulgated by the Secretary of the Treasury.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective for amounts received with respect to deaths occurring after the date of enactment in taxable years ending after that date.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Joint Committee on Taxation estimates that revenue gains for the nation will be very minor, less than $5 million annually. Based on this low level of impact for the nation, conformity would result in very minor state revenue gains annually under the Personal Income Tax Law of less than $200,000.

Title XA2: Insurance Products and Companies

ACTION: LIMIT USE OF STRUCTURED SETTLEMENT AGREEMENTS TO CLAIMS INVOLVING PHYSICAL INJURY OR PHYSICAL SICKNESS

Act Section 1002 Conference Report Page 339

Form 540 Line No. 16 Form 100 Line No. G-1

CURRENT CALIFORNIA LAW (Sec. 17131, 24271)

California conforms to federal law which excludes from income the amount of any damages received on account of personal injuries or sickness, whether by suit or by agreement, and whether as a lump sum or as periodic payments.

The person liable to pay the damages may assign that obligation to a third party (a structured settlement company) to pay the damages in a series of periodic payments. The payment received by the structured settlement company for agreeing to the assignment is not included in income to the extent that it is used to purchase "qualified funding assets" to fund the liability. However the basis of the "qualified funding assets" must be reduced by the amount excluded from income. Upon disposition of the qualified funding asset(s), any gain is included as ordinary income.

The taxpayer liable for damages to an injured party is allowed to deduct the amount of damages as if they were paid in a lump sum.

NEW FEDERAL LAW (Sec. 130)

Favorable treatment of structured settlement agreements is limited to assignments requiring payment for damages on account of a claim for personal injuries involving the claimant's physical injury or sickness, including damages for wrongful death arising from physical injury or sickness.

EFFECTIVE DATE OF FEDERAL PROVISIONS

For assignments entered into on or after January 1, 1987 and for taxable years commencing on or after that date.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Joint Committee on Taxation estimates that revenue gains for the nation will be very minor, less than $5 million annually. Consequently, there would be no meaningful impact for California under the Personal Income Tax or the Bank and Corporation Tax Laws.

Title XA3: Insurance Products and Companies

ACTION: LIMIT INTEREST DEDUCTION ON POLICYHOLDER LOANS

Act Section 1003 | Conference Report Page 340

Form 540 Line No. 47 | Form 100 Line No. G-6

CURRENT CALIFORNIA LAW (Sec. 17201, 24424)

An insurance company may permit a policyholder to borrow against the policy, up to the cash surrender value of the insurance policy. The payments made to the policyholder reduce the value of the insurance policy in the event of surrender, or the amount paid to the beneficiary in the event of the policyholder's death.

California generally conforms to federal law, which treats policyholder loans as bona fide loans, and not as withdrawals from the policy. As such, the interest paid on the loan is deductible by the policyholder, provided that the indebtedness is not part of a systematic borrowing of increases in cash value and is not incurred or continued in order to purchase or carry a single premium life insurance contract.

NEW FEDERAL LAW (Sec. 264)

Deduction of interest on policyholder loans is denied to any person who is an officer, employee, or person with a financial interest in the trade or business to the extent that the aggregate loans exceed $50,000. In addition, current law is restated regarding the rule that no amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance contract is deductible.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applies to insurance policies (contracts) purchased after 6/20/86.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Joint Committee on Taxation estimates that revenue gains for the nation will be very minor: $27 million over the five year period analyzed. Based on this low level of impact for the nation, conformity would result in very minor state revenue gains under the Personal Income Tax Law of perhaps $200,000 annually.

The next page of this report is page 1100.

TITLE XI

PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; ESOP'S

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Title XIA1: Pensions and Deferred Compensation

ACTION: <u>PHASE OUT THE DEDUCTIONS MADE TO AN IRA BY ACTIVE PARTICIPANTS</u>

Act Section 1101-1103 & 1144 Conference Report Page 373

Form 540 Line No. 31 Form 100 Line No. N/A

BACKGROUND

The original federal provision relating to Individual Retirement Accounts (IRA) was enacted in 1975; California conformed in 1976. The federal law was extensively revised in 1981, effective generally in 1982, to extend the coverage to individuals who were active participants in employer retirement plans, increase the deduction limits, and make other changes. California conformed in 1982 to other 1981 Federal changes, but did not conform to the extended coverage or increased deduction limits. The difference between the amount deductible on the state and federal returns becomes basis for state purposes and such basis is to be recovered upon distribution from the plan. California conformed in 1985 to 1984 federal amendments, including the provision that alimony is treated as compensation for purposes of making IRA contributions.

CURRENT CALIFORNIA LAW (Sec. 17272, 17501, 17507)

California allows a deduction for an IRA up to the lesser of $1,500 or 15 % of the individual's compensation or earned income with an additional deduction for a nonworking spouse, up to an overall limit of $1,750 while federal allows a deduction up to the lesser of $2,000 or 100 percent of compensation with an additional deduction for a nonworking spouse, up to an overall limit of $2,250. For state purposes, no IRA deduction is allowed to individuals who are active participants in an employer pension plan including qualified voluntary employee contributions.

The additional spousal deduction is allowed only if (1) the spouse has no compensation for the year, (2) the spouse has not attained age 70 1/2, (3) the couple files a joint income tax return for the year, and (4) for state purposes, neither spouse is an active participant in an employer pension plan. If a spouse has a small amount of compensation, including amounts less than $250, the spousal IRA deduction is not available.

Under both federal and state laws, when an IRA acquires any collectibles, the collectibles are treated as a distribution from the IRA equal to the cost of the collectibles and is included in the IRA owner's income for the year deemed distributed. A collectible includes any stamp or coin regardless of the country of issuance.

NEW FEDERAL LAW (Sec. 219, 408, 6693)

The act provides that all taxpayers are able to contribute up to the lesser of $2,000 or 100% of compensation to an IRA. The deduction for the amount contributed by individuals who are active participants in employer-maintained retirement plans is phased down to zero on adjusted gross income between (1) $25,000 and $35,000 for single individuals, (2) $40,000 and $50,000 for married individuals filing a joint return, or (3) $0 and $10,000 for married individuals filing a separate return.

The phase out of the deductible portion of the contribution is made on the basis of adjusted gross income before reduction for an IRA contribution. For married taxpayers filing a joint return, the phase-out and loss of deduction would apply where either spouse is an active participant in an employer-provided retirement plan.

The act also provides for a minimum deduction of $200 for any taxpayer subject to the phase out rule whose adjusted gross income is not above the phase out range even if the phase out rules would provide for a lesser contribution.

A special rule applies to married individuals filing separate returns where either taxpayer is an active participant in an employer-provided retirement plan. The above mentioned phase out rules apply only to the spouse who is an active participant in a retirement plan. The spouse who is not an active participant may deduct the entire allowable deduction (the lesser of $2,000 or 100% of compensation).

Nondeductible IRA Contributions

To the extent the IRA deduction is reduced or eliminated by the active participant phase out rule, a taxpayer may elect to make nondeductible IRA contributions. In addition, the act permits a taxpayer to elect to treat deductible IRA contributions as nondeductible. Total combined contributions to both types of IRA's (deductible and nondeductible) may not exceed the $2,000 ($2,250 spousal) limitation on IRA contributions.

Contributions that exceed either the deductible limit or the nondeductible limit, whichever applies, are subject to an annual 6 percent excise tax on "excess contributions" under Sec. 4973. However, excess contributions made in one year may be applied against the contribution limits in a later year if the contributions in the later year are less than the limit.

The designation of a contribution as nondeductible must be made on the individual's tax return for the taxable year to which the designation relates. An individual who files an amended return for a taxable year may change the designation of IRA contributions from deductible to nondeductible or vice versa for the year being amended.

Distributions of Nondeductible Contributions

When nondeductible contributions are designated on the return or when distributions are received, the act requires the taxpayer to report the following information in that return:

(1) the amount of designated nondeductible contributions for the taxable year,

(2) the aggregate amount of designated nondeductible contributions for all preceding taxable years which have not previously been withdrawn,

(3) the aggregate balance of all IRA's of the individual as of the close of the calendar year,

(4) the amount of distributions from IRA's during the taxable year, and

(5) such other information as the Secretary may prescribe.

If this required information is not provided, then all IRA contributions are presumed to have been deductible and, therefore, are taxable upon withdrawal from the IRA.

If the required information is not provided on the individual's tax return for a taxable year, then all IRA contributions are presumed to have been deductible and, therefore, are taxable upon withdrawal from the IRA.

An individual who overstates the amount of designated nondeductible contributions made for any taxable year is subject to a $100 penalty for each overstatement unless the individual can demonstrate that overstatement was due to reasonable cause.

Amounts withdrawn from an IRA during a taxable year are includible in income for the taxable year under rules similar to the rules applicable to qualified plans under section 72. Under the rules applicable to IRAs, for purpose of Section 72, (1) all IRAs of an individual are treated as one contract, (2) all distributions during a taxable year are treated as one distribution, (3) the value of the contract (calculated after adding back distributions during the year), income on the contract, and investment in the contract is computed as of the close of the calendar year with or within which the taxable year ends, and (4) the aggregate amount of withdrawals excludable from income for all taxable years shall not exceed the taxpayer's investment in the contract for all taxable years. The act provides that, if an individual withdraws an amount from an IRA during a taxable year and the individual has previously made both deductible and nondeductible IRA contributions, then the amount includible in income for the taxable year is the portion of the amount withdrawn which bears the same ratio to the amount withdrawn for the taxable year as the individual's aggregate nondeductible IRA contributions bear to the aggregate balance of all IRAs of the individual (including rollover IRAs and SEPs).

Active Participant

The term "active participant" means an individual who is an active participant in any of the following plans: (1) a qualified pension plan, profit sharing or stock bonus plan, (2) a qualified annuity plan (sec. 403(a)), (3) a simplified employee pension (sec. 408(k)), (4) a plan established for its employees by the United States, by a state or political subdivision, (5) a plan described in section 501(c)(18), or (6) a tax-sheltered annuity (sec. 403(b)).

The determination whether an individual is an active participant depends on the type of plan in which the individual participates or is eligible to participate. Generally, an individual is an active participant in a defined contribution plan if any employer contribution or forfeiture is added to such individual's account during the tax year. In a defined benefit plan, an individual is an active participant if not excluded under the plan's eligibility requirements during any part of the plan year ending with or within the individual's tax year. Thus, individuals may be active participants in defined benefit plans for a year even though they accrue no benefits during the year. An individual is also treated as an active participant in a plan for any tax year during which that individual makes a voluntary or mandatory employee contribution, whether the employer contributes or not. The determination of whether an individual is an active participant is made without regard to whether the individual's rights under a plan are vested.

Certain members of reserve components of the Armed Forces and volunteer fire-fighters are not treated as active participants solely because of such service.

Spousal Deduction Allowed

The rules relating to spousal IRA contributions are amended to eliminate the requirement that the spouse have no earned income for the year in order to be eligible for the spousal IRA contribution, however, the spouse must elect to be treated as having no compensation. Thus, those spouses with small amounts of compensation have the option of establishing their own IRA or being included in a spousal IRA. If a spousal IRA deduction is claimed on a joint return for a tax year, the spouse is deemed to have elected to be treated as having no compensation.

The trustee of an IRA must report annually the amount of contribution to and distributions from the IRA and the account balances at the end of the year to the individual as well as to the Secretary of the Treasury. The information is required to be reported by the January 31 following the end of the calendar year. In the case of a failure to report the required information, as under present law, the penalty for the failure is

$25 for each day during which the failure occurs but the total amount imposed on any person for a failure to report is not to exceed $15,000.

Other Changes

The act also repeals the provision which allowed a deduction for a qualified voluntary employee contribution to an employer plan.

In addition, the act provides that the rules relating to IRA investments in collectibles do not apply to any gold or silver coins issued by the United States.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision relating to the election of a spouse to be treated as having no compensation is effective for taxable years beginning before, on, or after December 31, 1985.

All other IRA provisions are effective for taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Two possible conformity positions are identified. The first position would include new eligibles under current state dollar limits, i.e., those taxpayers with qualified pension plans that meet the new federal income test for the IRA deduction, with retention of the existing $1,500 state maximum deduction. The second position would include the new eligibles and existing state eligibles at the higher $2,000 federal maximum deduction.

It is estimated that (1) the first position would result in revenue losses in the $68 million range for 1987-88 and in the $59 million range for 1988-89; and (2) the second position would result in revenue losses in the $121 million range for 1987-88 and in the $107 million range for 1988-89.

These estimates are based on both state and federal data pertaining to IRA deductions. The number of new state eligibles meeting the federal income test was derived from prior Policy Economics' Group (PEG) runs on the number of returns with IRA deductions by state adjusted gross income class. This number for 1987 is projected to be 600,000 returns. The number of returns with IRA deductions under current state law is estimated to be 720,000 for 1987.

Revenue estimates were developed by (1) attributing an average deduction for the first group (new eligibles) 10 percent greater than the maximums ($1,650 under the existing state maximum and $2,200 under the federal maximum) to allow for two IRA's on some joint returns, times an assumed average marginal tax rate of 6 percent; and (2) attributing an average additional deduction to the second group (existing state eligibles) of $600 (this amount also reflects dual IRA's on joint returns', times an assumed average marginal tax rate of 6 percent.

These calculations resulted in the following revenue effects:

First Position - New Eligibles At $1,500

Taxable Years

1987	1988	1989
$59 million	$59 million	$59 million

Fiscal Years

1987-88	1988-89
$68 million	$59 million

Second Position - New and Existing Eligibles at $2,000

Taxable Years

1987	1988	1989
$105 million	$106 million	$108 million

Fiscal Years

1987-88	1988-89
$121 million	$107 million

Fiscal year estimates include a 15 percent allocation from the subsequent taxable year estimate to allow for adjustments to estimated tax payments and withholding.

Title XIA2: Pension and Deferral Compensation

ACTION: PROVIDE FOR A $7,000 MAXIMUM ANNUAL DEFERRAL UNDER ALL QUALIFIED CASH OR DEFERRAL ARRANGEMENTS

Act Section 1105 | Conference Report Page 380

Form 540 Line No. 12 | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17501 and 17510)

California has conformed to federal law which allows an employee under a qualified cash or deferred arrangement (commonly referred to as a 401(k) plan) to elect to have compensation deferred under a profit sharing or stock bonus plan (or certain pre-ERISA money purchase pension plans). The deferral is considered an employer contribution and is not included in the employee's gross income.

Under a qualified 401(k) plan, the elective deferrals are subject to the overall limits on contributions to a qualified plans which for defined contribution cannot exceed the lesser of $30,000 or 25 percent of the employees nondeferred compensation.

In addition, a special nondiscrimination test is applied to elective deferrals to assure that a plan does not discriminate in favor of highly compensated employees. The plan qualifies if: (1) the actual deferral percentage for the highly paid employee does not exceed the average deferral percentage for the other eligible employees by more than 150 percent or (2) the actual deferral percentage for the highly paid employees does not exceed the lesser of (a) the actual percentage for other eligible employees plus 3 percentage points, or (b) 250 percent of the actual deferral percentage for the other eligible employees.

An employee is considered highly compensated if the employee is one of the most highly compensated 1/3 of all employees eligible to defer under the arrangement.

A participant in a qualified 401(k) plan is not permitted to withdraw elective deferrals (and earnings thereon) prior to death, disability, separation from service, retirement, or (except in the case of a pre-ERISA money purchase pension plan) the attainment of age 59 1/2 or the occurrence of a hardship.

Under present law there is no statutory provision which states that tax-exempt and public employers may establish a cash or deferred arrangement. However, under General Counsel Memorandum (G.C.M.) 38283 and other memorandums, the Internal Revenue Service concluded that these organizations may provide their employees with employee incentive plans which include a profit sharing plan if the plan is adequately limited and safeguarded.

NEW FEDERAL LAW (Sec. 402, 4979 and 6051)

The act provides a maximum annual "elective deferral" of $7,000, adjusted for inflation, for an employee under all cash and deferred arrangements in the individual's tax year (rather than the plan's limitation year). This limit is determined without regard to any community property laws and is reduced by elective deferrals under Sec. 403(b) tax deferred annuities.

Elective Deferrals

The act provides that the term elective deferral is the sum of (a) any employer contribution under a qualified cash or deferred arrangement to the extent not includible in gross income (determined without regard to contributions made by the employer on behalf of the employee to a trust which is a part of a qualified cash or deferred arrangement), (b) any employer contribution to the extent not includible in gross income (determined without regard to contributions made by the employer on behalf of the employee to a simplified employee pension plan), and (c) any employer contribution to purchase an annuity contract under a salary reduction agreement.

Treatment of Excess Deferrals

The act provides that deferrals in excess of the $7,000 annual limit together with income earned on such contribution will be included in the employee's gross income for the year to which deferrals relate. The excess may be allocated among the cash or deferred arrangements the employee participates in by the following March 1. The plan or plans to which the excess deferrals are allocated may then distribute the excess allocations (plus earnings) to the employee by the following April 15.

This timely distribution of excess deferrals and related income to the employee will not be subject to the additional tax on early withdrawals and may be made despite plan provisions to the contrary. The amount of income earned by the plan will be allocated to the excess deferrals on a pro-rata basis. In addition, elective deferrals in excess of the annual limit are to be treated as elective deferrals for purposes of applying the special nondiscrimination requirements for qualified cash or deferred arrangements, if not distributed during the taxable year of deferral. Excess deferrals and related income not returned to the employee by April 15 of the year following contributions, will not be treated as after-tax employee contributions that is, they will not be treated as an investment in the contract. A 10 percent excise tax is assessed against an employer on excess contributions not returned to the employees within 2 1/2 months after the close of the plan year.

The act also prohibits tax-exempt organizations and State or local governments (or a political subdivision of a State or local government) from establishing qualified cash or deferred arrangements under Section 401(k) of the Code.

Information regarding these elective deferrals are required to be contained on the annual withholding statement supplied by employers to employees.

EFFECTIVE DATE OF FEDERAL PROVISIONS

In general the act is effective for taxable years beginning on or after January 1, 1987.

In the case of a plan maintained pursuant to 1 or more collective bargaining agreements between employee representatives and 1 or more employers ratified before March 1, 1986, the amendments are not effective, with respect to employees covered by the agreement, for plan years beginning before the earlier of (1) January 1, 1989, or (2) the date on which the last of the collective bargaining agreement terminates (determined without regard to any extensions in the collective bargaining agreement). However deferrals by employees under a collectively bargained plan will count against the $7,000 maximum with respect to any other employer plan which is not collectively bargained.

In the case of the taxable year of any partnership which begins before January 1,1987, and ends after January 1, 1987, elective deferrals made on behalf of a partner will be treated as having been made ratably during such taxable year.

The elective deferral reporting requirements are effective on October 22, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The following revenue estimates are composite estimates based on a proration of national estimates prepared by the Joint Committee on Taxation (JCT) combining XI-A2 Qualified Cash or Deferral Arrangements, XI-A3 Nondiscriminative Tests and XI-A4 Deferred Compensation Plans. The relative fiscal impact under state conformity is revenue gains in the $26 million range for 1987-88 and $28 million range for 1988-89. These revenue gains would occur under the Personal Income Tax Law. The proration to California used (4.1 percent) reflects the Policy Economic Group's (PEG) conformity estimates for California compared to national estimates for those provisions analyzed. The PEG has not specifically estimated this provision.

In their national estimates the JCT has allowed for the behavioral responses of some taxpayers who are denied IRA deducting switching to 401(k) arrangements to maintain tax benefits. This interaction, therefore, is included in the composite estimates above.

Title XIA3: Pensions and Deferred Compensation

ACTION: APPLY A NONDISCRIMINATIVE TEST TO EMPLOYERS MATCHING CONTRIBUTIONS AND EMPLOYEE CONTRIBUTIONS

Act Section 1117

Conference Report Page 392

Form 540 Line No. N/A

Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17501)

California law has conformed to federal law which permit employees to make either after-tax or pre-tax contributions to a qualified plan. These contributions may be voluntary or mandatory. Mandatory employee contributions include those made as a condition of obtaining employer-derived benefits (e.g., employee contributions made as a condition of obtaining employer matching contributions).

Under present law, a qualified plan must satisfy the nondiscrimination requirement which provides that a plan may not discriminate in favor of employees who are officers, shareholders, or highly compensated. Employer matching contributions are also required to satisfy the usual nondiscrimination rules applicable to qualified plans which prohibit a plan from discriminating in contributions and benefits.

In the past, voluntary employee contributions have been permitted if all participants are eligible to make such contributions and if no employee is permitted to contribute more than 10 percent of compensation, determined based on cumulative contributions and cumulative compensation during the period of participation.

NEW FEDERAL LAW (Sec. 401)

The act provides that a special nondiscrimination test be applied to (1) all types of employer matching contributions and employee contributions under qualified defined contribution plans, and (2) employer contributions under a defined benefit pension plan to the extent contributions are allocated to separate accounts on behalf of individual employees. These rules apply in lieu of the usual nondiscrimination tests.

Special Nondiscrimination Tests

The act provides that a defined contribution plan (and the employee contribution portion of a defined pension plan) will be treated as meeting the special nondiscrimination test if it meets one of two alternative tests.

Under the first test, the contribution percentage for highly compensated employees must be no greater than 125 percent of the contribution percentage for all other eligible employees. The plan will satisfy the second nondiscrimination test if the contribution percentage for highly compensated employees does not exceed the lesser of 200 percent of the contribution percentage for all other eligible employees, or such percentage plus two percentage points.

Contribution Percentages

The contribution percentage for a specified group of employees is the average of the ratios (calculated separately for each employee) of the sum of matching contributions and employee contributions to the employees' compensation for the plan year.

Under regulations to be issued, an employer will be permitted to elect to take into account in computing the contribution percentage any elective deferrals and qualified nonelective contributions under the plan or any other plan of the employer. The Secretary of the Treasury is to prescribe regulations to prevent the multiple use of the alternative nondiscrimination test for any highly compensated employee.

Highly compensated employees are defined the same as for purposes of the general nondiscrimination rules. In plans which require employee contributions as a condition of participation, otherwise eligible employees who do not make contributions are treated as participants on whose behalf no contributions are made for purposes of the special nondiscrimination tests.

Aggregation Rules

The act provides that if two or more plans of an employer to which matching contributions, or elective contributions are made are treated as one plan for purposes of minimum coverage requirements, these plans will be treated as one plan for purposes of applying the special nondiscrimination test. If a highly compensated employee participates in two or more plans of an employer to which such contributions are made, all such contributions are aggregated for purposes of applying the special nondiscrimination test under each plan in which the highly compensated employee participates.

Excess Contributions

The act provides that excess contributions which are contributions by on behalf of highly compensated employees which are in excess of the contributions which could be made for such individuals without violating the special nondiscrimination rules, will disqualify the plan. However, the plan will not be disqualified for not meeting the special nondiscrimination test, if the excess contributions (plus income allocable to such excess contributions) are distributed (or, if forfeitable, are forfeited) before the close of the following plan year. The rules for such distributions are generally the same as those applied to excess contributions to cash or deferred arrangements. Contributions which are forfeited may be used to reduce employer contributions or may be reallocated among other participants. However, no highly compensated employee who has been determined to have excess contributions may share in such reallocation.

The act also provides that excess contributions (other than those which are forfeited) may be distributed without regard to any other provision of law, and will not be subject to the additional tax on early withdrawals from qualified plans. Any distributions attributable to employee contributions will not be included in gross income except to the extent attributable to income on such contributions.

Excise Tax

The act provides that if the contribution percentage test is not met, the employer will be subject to an excise tax equal to 10 percent of the excess contributions (including excess contributions to a simplified employee plan or a 501(c)(18) plan). This tax will be waived if the excess contributions together with any earnings, are distributed within 2 1/2 months after the close of the plan year in which the excess contributions arose.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision is generally effective for plans on or after January 1, 1987, or in the case of tax-sheltered annuities, January 1, 1989. However, a special effective date applies to plans maintained pursuant to a collective bargaining agreement. Under this special rule, for a plan maintain pursuant to a collective bargaining agreement between employee representatives and one or more employers ratified before March 1, 1986, the amendments are not effective for plan years beginning before the earlier of (1) the later of (i) January 1, 1989, or (ii) the date on which the last of the collective bargaining agreements terminates; or (2) January 1, 1991. Extensions or renegotiations of the collective bargaining agreement, if ratified after February 28, 1986, are disregarded.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Joint Committee on Taxation has included this item in its impact estimate of XI-A2 Qualified Cash or Deferral Arrangements. It is not possible to isolate this item; therefore the revenue effect for this particular provision is indeterminable.

Title XIA4: Pensions and Deferred Compensation

ACTION: CHANGE RULES RELATING TO ELIGIBLE DEFERRED COMPENSATION PLANS AND UNFUNDED DEFERRED COMPENSATION PLANS

Act Section 1107 Conference Report Page 397

Form 540 Line No. N/A Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17501)

California has conformed to federal law which allows state and local government or tax-exempt rural electric cooperatives to establish a deferred compensation plan under which a part of an employee's compensation is not taxed until distributed or made available. The maximum that can be deferred each year is the lesser of $7,500 or one-third of employee's compensation. Amounts contributed to a tax-sheltered annuity (both elective and nonelective) are taken into account in calculating whether an employee's deferrals exceed the limits.

Under an eligible deferred compensation plan distributions are required to commence no later than 60 days after the close of the later of (1) the year in which the employee attains the normal retirement age under the plan, or (2) the year in which the employee separates from service. Payments made before the employee's death are required to satisfy a total benefit schedule under which the benefits projected to be paid to the participant must be more than 50 percent of the maximum amount that could have been paid to the participant if no provision were made for payments to the beneficiary. If the employee dies before the entire amount is paid out, any unpaid amount is to be paid to the employee's beneficiary over a period not greater than 15 years, unless the beneficiary was the employee's spouse, in which case payments may be paid over the life of the spouse or any shorter period.

NEW FEDERAL LAW (Sec. 457)

The act provides that the limitations and restrictions applicable to deferred compensation plans of State and local governments are extended to unfunded deferred compensation plans maintained by nongovernmental tax-exempt organizations. Accordingly, the maximum amount that can be deferred annually is the lesser of $7,500 or 33 1/3 percent of the employee's compensation (net of the deferred amount). However, the maximum deferral may increase to as much as $15,000 a year for the last three years before the tax year in which the participant reaches the normal retirement age under the plan.

In addition, the act provides that the amount a participant may defer under an eligible deferred compensation plan must be reduced, dollar for dollar, by elective deferrals under a qualified cash or deferred arrangement (except a qualified cash or deferred arrangement maintained by a rural electric cooperative). An elective deferral under a simplified pension plan, or deductible employee contribution to a 501(c)(18) plan, also reduce the amount the employee may defer under an eligible deferred compensation plan. As under prior law, amounts contributed to a tax-deferred annuity are taken into account in figuring whether the employee's deferrals under an eligible deferred compensation plan exceed the limits on such deferrals.

Minimum Distribution Requirements - In general, the act provides that an eligible deferred compensation plan maintained by a state or local government or a tax-exempt employer meets the distribution requirements if it (1) provides that amounts payable under the plan will be made available to participants or other beneficiaries not earlier than when the participant is separated from service with the employer or is faced with an unforeseeable emergency and (2) meets certain minimum distribution requirements outlined below.

Payments starting before the employees death must be under a payout schedule in which benefits projected to be paid over the lifetime of the participant are at least 66 2/3 percent of the total benefit payable with respect to the participant. If distributions (pre or post-death) are to be made over a period extending beyond one year, the distribution must be made in substantially nonincreasing periodic payments not less frequently than annually.

In addition, if the employee dies after beginning to receive payments, but before the total deferred amount has been distributed, the remaining amount must be distributed at least as rapidly as under the original payout schedule.

In the case of an employee that dies before beginning to receive benefits, the entire deferred amount must be distributed to the employee's beneficiary over a period not greater than 15 years, except that if the beneficiary is the employee's spouse, benefits may be paid over the life expectancy of the spouse.

In any event, payment must begin to commence no later than April 1st of the year following the year in which the employee either reaches 70 1/2 or retires.

Constructive Receipt - The act provides that benefits under such a plan won't be considered as made available merely because the employee is permitted to elect to receive a lump-sum payable within 60 days of the election. This rule applies, however, only if the total amount payable to the employee is not greater than $3,500, and no additional amounts may be deferred under the plan with respect to the employee. Thus, if the total benefits payable to an employee exceed $3,500, and the employee has the option to elect to receive a lump-sum benefit, the entire amount of the benefit would be immediately includable in the employee's taxable income even though the employee declined to exercise the option.

Transfers Between Plan - Under the act transfers between eligible plans are allowed. Accordingly, a participant in an eligible governmental deferred compensation plan may elect to have any portion of the amount payable to the participant transferred to another eligible deferred compensation plan of a state or local government or tax-exempt organization. The amount transferred will not be included in the participant's income solely as a result of the transfer.

State judicial plans - Qualified state judicial plans and certain other plans of tax-exempt organizations are exempted from the new requirements for eligible deferred compensation plans.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The act relating to application of the unfunded deferred compensation plan rules to tax-exempt organizations is effective for years beginning on or after January 1, 1987.

An exception is provided under the conference agreement for amounts deferred under a plan of a tax exempt organization which (1) were deferred from taxable years beginning before January 1, 1987, or (2) are deferred from taxable years beginning on or after January 1, 1987 pursuant to an agreement that (i) was in writing on August 16, 1986, and (ii) provided for annual deferrals of a fixed amount or an amount determined pursuant to a fixed formula on that date. This exception does not apply with respect to amounts deferred in a fixed amount or under a fixed formula for any taxable year ending after the date on which the amount or formula is modified after August 16, 1986. Providing the participant with any discretion regarding the amount of the deferral constitutes a modification for this purpose.

For purposes of the grandfather rule, amounts are considered deferred from a taxable year if, but for the deferral, they would have been paid in that year. Also, in applying the limits to a deferral not grandfathered, grandfathered amounts are taken into account.

The modifications to the distribution requirements applicable to eligible unfunded deferred compensation plans generally are effective for taxable years beginning on or after January 1, 1989. However, the provisions (1) permitting transfers between eligible unfunded deferred compensation plans and (2) permitting cashouts of certain benefits without constructive receipt are effective with respect to transfers or distributions in years beginning on or after January 1, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Joint Committee on Taxation has included this item in its impact estimate on XI-A2 Qualified Cash or Deferral Arrangements. It is not possible, however, to isolate this item; therefore, the revenue effect for this particular provision is indeterminable.

Title XIA5: Pension and Deferred Compensation

ACTION: APPLY RESTRICTIONS ON DEFERRED ANNUITY CONTRACTS

Act Section 1135 & 1123(b) Conference Report Page 400

Form 540 Line No. N/A Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17081, 17082, & 17085)

California has conformed to federal law where income is credited to the cash surrender value of a deferred annuity while escaping taxation until paid to the policyholder. Amounts received by the owner of the annuity before the annuity starting date (including loans under or secured by the Contract) that exceed the owner's investment in the contract are includible in owner's gross income. A portion of each distribution received after the annuity starting date is treated as ordinary income based on the ratio of the investment in the contract to the total distributions expected to be received.

Under both California and federal law a policyholder who receives any amount under an annuity contract before the age of 59 1/2, is required to pay an additional tax equal to 5 percent of the amount included in income.

This additional tax does not apply if the distribution is (1) one of a series of equal periodic payments made for the life of the taxpayer or over a period extending for at least 60 months after the annuity starting date or (2) is allocable to investment in the contract before August 14, 1982.

NEW FEDERAL LAW (Sec. 72(8))

Income on the Contract

The act provides that income from annuity contracts for any taxable year held by a person that is not a natural person (e.g. corporations, partnership or trusts) will not be treated as an annuity contract for income tax purpose and all income on the contract is to be treated as ordinary income received or accrued by the owner during the taxable year. If the nominal owner of an annuity contract is a non-natural person but the beneficial owner is a natural person, the contract will treated as if held by a natural person.

The act defines "income on the contract" as the excess of (1) the sum of the net surrender value of the contract at the end of the taxable year and any amounts distributed under the contract for all years, over (2) the investment in the contract (i.e., the aggregate amount of premiums paid under the contract minus policyholder dividends or the aggregate amounts received under the contract that have not been included in income).

Income from the following annuities held by persons that are not natural persons will be treated as if held by a natural person:

1. Annuity contracts acquired by the estate of a decedent by reason of the death of the decedent.

2. Annuity contracts under a qualified plan, a tax-shelter annuity or under an Individual Retirement Plan.

3. Qualified funding assets purchased by structured settlement companies and annuity contracts (which meet the definition of a qualified funding asset) purchased and held directly by a property or casualty insurance company to fund periodic payments for damages.

4. A deferred annuity that is purchased by an employer upon the termination of a qualified plan and held by the employer until the employee separates from service with employer.

5. An immediate annuity which is an annuity purchased with a single premium or annuity consideration with an annuity starting date commencing no later than 1 year from the date of purchase.

Early Withdrawal Tax

Under the act, the early withdrawal tax on deferred annuities is increased from 5 to 10 percent.

The early withdrawal tax is not imposed if the distribution is (1) a part of a series of substantially equal periodic payments made for the life (or joint lives) of the taxpayer and the taxpayer's beneficiary, (2) under an immediate annuity contract or (3) annuity constituting a qualified funding asset.

In addition, the act provides that the tax will be imposed if the individual changes to a distribution method prior to age 59 1/2 to a method that does not qualify for the exception. The additional tax will be imposed in the year of modification and will be equal to the tax that would have been imposed on the distributions had the exception never applied to those distributions. That recapture tax will also apply when the individual does not receive payments for at least 5 years even if the individual is more than 59 1/2 years old when the modification is made.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The act relating to the taxation on income or a deferred annuity contract is effective for amounts invested after February 28, 1986.

The act modifying the additional income tax on early withdrawals is effective for distributions in taxable years beginning on or after January 1, 1987 unless the individuals who, as of March 1, 1986 have commenced receiving benefits under the contract pursuant to a written election designating a specific schedule of benefit payments.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Joint Committee on Taxation estimates relatively minor gains of $12 million for 1987-88 and $27 million for 1988-89 for the nation. Based on this projected low level of impact, conformity would result in minor revenue gains of less than $500,000 annually under the Bank and Corporation Tax Law. The effects resulting from partnerships and other entities under the Personal Income Tax Law would be negligible.

ACTION: REDUCE THE LIMITS ON CONTRIBUTIONS TO TAX SHELTERED ANNUITIES

Act Section 1105(a) Conference Report Page 404

Form 540 Line No. N/A Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17501)

California has conformed to federal law where public schools and certain tax-exempt organizations (including churches and certain organizations associated with churches) may make payments on behalf of an employee to purchase a tax shelter annuity contract. Payments to a custodial account investing in stock of a regulated investment company (e.g., a mutual fund) are also permitted.

The amount paid by the employer is excluded from the employee's income for the taxable year to the extent the payment does not exceed the employee's exclusion allowance for the taxable year which is generally equal to 20 percent of the employee's includible compensation from the employer multiplied by the number of the employee's years of service with that employer, reduced by amounts already paid by the employer to purchase the annuity.

However, since employer payments to purchase a tax-sheltered annuity contract for an employee are subject to the overall limits on contributions and benefits under qualified plans, the limit on the annual additions on behalf of an employee generally is the lesser of 25 percent of compensation or $30,000.

Certain catch-up elections allow an employer to contribute in excess of the usual percentage limits in certain years. The catch-up election is available only to employers of an educational organization, a hospital, a home health service agency, or a church, convention or association of churches.

NEW FEDERAL LAW (Sec. 402(i))

The act provides that the amount that an employee of a public school or tax-exempt organization can elect to defer under all tax-sheltered annuities in which the employee participates would be limited to the greater of $9,500 or the cash or deferred arrangement cap, as indexed (i.e., $7,000 for 1987).

The act also provides that the elective deferrals under a cash or deferred arrangement, simplified employee pension plan and certain deductible contributions under a pre-1959 employee-only contribution plan reduce dollar for dollar the employee's $9,500 maximum elective deferrals under a tax sheltered annuity. Thus, the employee's elective deferrals will be combined to achieve coordination.

In addition the act provides an exception to the $9,500 limit for an employee who has completed 15 years of service with a qualified organization under a tax-sheltered annuity. Under the special catch-up rule, the $9,500 limitation is increased by the least of the following amounts:

1. $3,000,

2. $15,000 reduced by amounts not included in gross income in prior years under this special rule, and

3. $5,000 multiplied by the number of years of service of the employee with the qualified organization over the employer contributions made to the annuity for prior taxable years.

The term "qualified organization" means any educational organization, hospital, home health service agency, health and welfare service agency, church, or convention or association of churches. The also term includes an organization controlled or associated with a church or convention of churches.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provisions are effective for years on or after January 1, 1987.

With regard to a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986, the Act does not apply to contributions made before the earlier of (1) the date on which the last of collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986) or (2) January 1, 1989. However, for purposes of applying the $9,500 limit to employees who participate in collectively bargained plans and one or more other plans, elective deferrals under the collectively bargained plans are taken into account in limiting the amount that the employee is permitted to defer under any other plan.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No specific national estimate was developed by the Joint Committee on Taxation for this particular provision indicating a very minor or negligible impact for the nation. Any revenue impact that would occur under state conformity would be negligible.

Title XIA7: Pensions and Deferred Compensation

ACTION: PERMITS ELECTIVE SALARY REDUCTION ARRANGEMENTS FOR EMPLOYEES PARTICIPATING IN A SIMPLIFIED EMPLOYEE PENSION PLAN

Act Section 1108, 1116(c) Conference Report Page 406

Form 540 Line No. N/A Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17513, 17501, 17272, 17507 and 17510)

California has generally conformed to federal law which allows an employer to establish a simplified employee pension (SEP). These plans are usually established by the employers who are not willing or able to deal with the complexities of qualified retirement plans. SEPs are basically individual retirement accounts (IRA) or annuities. An employer may contribute up to $30,000 to the SEP on behalf of an employee. Amounts contributed to the SEP by an employer are includible in the employee's gross income and specific amounts are allowed as deductions under both state and federal law.

Deductions of Contributions

For federal purposes, an employee is entitled to deduct (in addition to his/her IRA deduction) up to (1) lesser of the amount contributed by the employer to the SEP and includible in the employee's gross income or (2) 15 percent of compensation determined without regard to the employer contribution to the SEP up to $30,000.

California allows a deduction for either an IRA or a SEP but not both. The SEP deduction in California is limited to the lesser of the amount contributed by the employer to the plan includible in the employee's gross income or 15 percent of compensation determined without regard for the employer contributions to the SEP up to $2,500. In addition, California provides that earnings on the nondeductible contributions are not currently taxed but will be taxed on distribution. The taxpayer is also granted basis in the account to the extent of the difference between the amount put into the account and the California deductible amount. Upon distribution, the basis will be fully recovered before any portion of the distribution is taxable. Any early withdrawals are subject to a 2 1/2 percent penalty.

Participation Requirements

An IRA will not qualify as an SEP unless the employer contributions are made on a nondiscriminatory basis on behalf of employee who (1) have attained age 25, and (2) have performed services for the employer during at least three of the immediately preceding five calendar years.

Employer contributions are considered to be nondiscriminatory if they are reasonably proportionate to the total compensation of each employee covered by the pension. The contributions may not be based on annual compensation in excess of $200,000.

In order to qualify on an SEP, the employer's contribution must be made according to a definite written allocation formula that specifies the requirements an employee must satisfy in order to participate and the manner in which allocated amounts are computed. The funds contributed on behalf of an employee must also vest immediately and are to be non-forfeitable.

Integration Rules

Generally, an employer's contributions to the SEP may be integrated with Social Security and other public benefits with special provisions for owner-employees. However, in applying nondiscrimination requirement, SEP contributions may be combined with employer OASDI contributions if the employer does not maintain any other integrated plan. Thus for those employers who maintain other integrated plans, SEP contributions may not be combined with Social Security.

NEW FEDERAL LAW (Sec. 219, 402, 404, 408)

In general, the act revises the qualification requirements relating to SEPs to permit employees to elect to have SEP contributions made on their behalf or to receive the compensation in cash. An election to have the employee make an SEP contribution would be treated as an elective deferral.

A qualified elective deferral would be subject to the $7,000 (indexed) cap similar to deferrals under a qualified cash or deferred arrangement (401(k) plans).

The above election is available only if (1) at least 50 percent of the employees have elected to have deferred amounts contributed to the SEP, (2) the deferral percentage for each highly compensated employee does not exceed the average deferral percentage for all other nonhighly compensated eligible employees by more than 125 percent, and (3) is only available in a taxable year in which the employer does not have more than 25 employees at any time during the prior taxable year.

The provision will not apply to a simplified employee pensions maintained by a state or local government or a tax-exempt organization. The act also makes miscellaneous changes to SEP requirements to decrease the administrative requirements applicable to an employer maintaining a SEP.

Distributions of Excess Contributions

Rules similar to the excess contribution requirements for qualified cash and deferred arrangements apply to excess contributions made to a SEP. In addition, a penalty tax will be imposed on excess contributions which are not distributed before two and a half months after the close of the plan year.

SEP Deduction Converted to Exclusion From Income

The act provides that amounts contributed to a SEP by an employer on behalf of an employee and the elective deferrals under SEP are to be excluded from gross income rather than deducted as under present law 402(h)(2). The amount excludable is the lesser of 15 percent of compensation or $30,000 reduced in the case of a highly compensated employee by the amounts taken into account contributions and benefits under Chapter 2 of the Internal Revenue Code (relating to tax on self-employment income, Chapter 21 (relating to Federal Insurance Contribution Act), Title II of the Social Security Act, or any other Federal or State law (Social Security Taxes). Any excess of the amount excludible is treated as distributed or made available to the employee. In addition, the act provides that the elective deferrals are to be included as wages for the purpose of employment tax.

Participation Requirements

The SEP participation requirements are modified by the act to require that an employer make contributions for a year on behalf of each employee (100 percent participation) who (1) has attained the age of 21, (2) has performed service for the employer during at least three of the immediately preceding five years, and (3) received at least $300 in compensation from the employer for the year.

In addition, the act provides that the 100 percent participation requirement apply separately to elective arrangements and, for purposes of such elective arrangements, an individual who is eligible is deemed to receive an employer contribution.

For purposes of the SEP participation requirements, employees covered by a collective bargaining agreement and nonresident aliens who receive no earned income are excluded from consideration.

In addition, employees who are eligible to have contributions made on their behalf under a salary reduction SEP are treated, for purposes of the SEP participation requirements, as receiving an employer contribution.

Cost-of-Living Adjustment

Under the act, the $200,000 limit on compensation and the $300 employee wage requirement are to be indexed at the same time and in the same manner as dollar limits under a defined benefit pension plan.

Computation Period

The act permits an employer to elect to use a computation period other than calendar year for purposes of determining contribution to a SEP.

In the case of a SEP maintained on a calendar year basis, contributions made in a calendar year are deductible for the taxable year with which or within which the calendar year ends.

In the case of a SEP maintained on a taxable year basis, contributions are deductible for the taxable year.

Integration Rules

The act eliminates the current rules under which nonelective SEP contributions may be combined with employer OASDI contributions, for purposes of the applicable nondiscrimination requirements.

The new rules will permit nonelective SEP contributions to be tested for nondiscrimination under the new rules for qualified defined contribution plans permitting a limited disparity between contribution percentages applicable to compensation below and compensation above the social security wage base.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provisions are effective for years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on data from the departments tax model, conforming to the higher federal deduction limits for SEP's would result in revenue losses in the $5 million range for 1987-88 and 1988-89.

The relative fiscal impact from conforming to the various other changes in this provision is revenue losses in the $1 million range for 1987-88 and in the $1.5 million range for 1988-89. The basis for these state estimates is the national estimates prepared by the Joint Committee on Taxation prorated to California by a 4.1 percent factor. This factor reflects the Policy Economic's Group (PEG) conformity estimates for California for those provisions analyzed relative to the nation. The PEG has not specifically estimated this provision.

The combined revenue loss under the Personal Income Tax Law is in the $6 million range for 1987-88 and $6.5 million for 1988-89.

Tax Policy Issue:

Two policy issues need to be considered. First, since the state restricts the tax benefits available for contribution to a SEP to a maximum deduction of $2,500 rather than the federal maximum of $30,000 should the state allow an exclusion from income under the new structure of $30,000 or some lesser amount?

Second, since the maximum benefit to a SEP in California is $2,500 should the new elective deferrals be allowed at the federal level of $7,000 or some lesser amount?

Title XIA8: Pensions and Deferred Compensation

ACTION: ALLOW CONTRIBUTION DEDUCTIONS FROM AN EMPLOYEE FUNDED TAX-EXEMPT TRUST WITHIN LIMITS

Act Section 1109 & 1107 | Conference Report Page 408

Form 540 Line No. N/A | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 23701s)

California generally conforms to federal law where a trust or trusts created before June 25, 1959 forming part of a pension plan funded solely by employee contributions are exempt from income tax if certain nondiscrimination requirements are met.

Under Rev. Rul. 54-190, contributions to a pension plan from a trust receiving tax-exempt status are deductible as union dues by an employee. These contributions were held to be deductible as union dues since members from a union were required to pay the assessment in order to remain in the union and keep their union jobs. However, after 1982, the Rev. Rul. 54-190 was declared obsolete by the Internal Revenue Service.

NEW FEDERAL LAW (Sec. 219, 501)

The act permits employees who participate in a tax-exempt trust pension plan to elect to make deductible contributions up to the lesser of $7,000 or 25 percent of compensation.

The amounts contributed to the plan reduce the $7,000 annual cap on elective deferrals under 401(k) plans and simplified employee pensions but do not reduce deferrals under tax sheltered annuities for employees of schools or tax-exempt charitable organizations.

In addition, the provision will provide that the election to make deductible contributions to tax-exempt trust pension plans is subject to a nondiscrimination test similar to the test applicable to qualified cash or deferral arrangements. If the test is not satisfied, rules similar to the rules applicable to excess contributions under a qualified cash or deferred arrangement are to apply.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision is effective for taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No national estimate was developed by the Joint Committee on Taxation for this particular provision indicating a very minor or negligible impact for the nation. Any revenue losses under state conformity would be negligible.

Title XIB1: Pensions and Deferred Compensation

ACTION: <u>REVISE THE COVERAGE TEST FOR QUALIFIED PLANS</u>

Act Section 1112(a)(c), 1115 Conference Report Page 410

Form 540 Line No. N/A Form 100 Line No. N/A

<u>CURRENT CALIFORNIA LAW (Sec. 17501)</u>

California has conformed to federal law under which a qualified plan is required to cover employees in general rather than merely employees who are officers, shareholders, or highly compensated.

A plan generally satisfies the coverage rule if (1) it benefits a significant percentage of the employer's workforce (percentage test), or (2) it benefits a classification of employees determined by the Secretary of the Treasury not to discriminate in favor of employees who are officers, shareholders, or highly compensated (classification test).

The Internal Revenue Service regulations provide that in determining whether the classification test is satisfied, all the surrounding facts and circumstances must be taken into account, allowing for a reasonable difference between the ratio of highly compensated employees who are benefited by the plan to all such employees and the corresponding ratio calculated for employees who are not highly compensated.

In accordance with published rulings (e.g., Rev. Rul. 83-58) other relevant facts and circumstances include (1) the percentage of total employees covered, and (2) the compensation of the covered employees and compensation of the excluded employees.

The regulations also do not consider the existence of separate lines of business or of benefits provided under other plans as a fact or circumstance in determining whether a justified disparity exists.

<u>Aggregation Rules</u>

In applying the qualification rules (including the coverage and nondiscrimination test) the following employees are aggregated and treated as employed by a single employer:

(1) All employees of corporations that are members of a controlled group of corporations,

(2) All employees of trades and businesses (whether or not incorporated) that are under common control,

(3) All employees of employers that are members of an affiliated service group.

Other persons who perform services and meet certain requirements are also treated as employees for purposes of certain rules applicable to qualified plans and simplified employee pensions.

Employers may designate two or more plans as a single plan for purposes of satisfying coverage requirements under present law as long as the combined plans considered as a unit provide comparable contributions or benefits that do not discriminate in favor of highly compensated employees.

Revenue Ruling 81-202 provides guidance that may be applied to determine whether the amount of employer-derived benefits or contributions provided under several plans discriminate in favor of highly compensated employees.

Excludable Employees

In determining what classifications are permissible, employees excluded by the plan's minimum age or service conditions must be taken into account even though they are disregarded in applying the percentage test. Employees covered by collective bargaining agreements and nonresident alien's however, are excluded from consideration.

NEW FEDERAL LAW (Sec. 401,410, and 414)

The act modifies the present-law coverage rules by requiring a plan to pass at least one of the following tests: (a) at least 70 percent of all nonhighly compensated employees must be covered by the plan (percentage test); (b) the percentage of covered nonhighly compensated employees must be at least 70 percent of the percentage of highly compensated employees covered by the plan (ratio test); or (c) the plan meets the average benefits test.

Average Benefit Test

Under the average benefit test, (1) the average benefits provided for non-highly compensated employees (as a percentage of compensation) must be at least 70 percent of the average benefit provided to highly compensated employees (as a percentage of compensation), and (2) the plan benefits such employees that qualify under a classification set up by employer and found by the Internal Revenue Service not to be discriminatory in favor of highly compensated employees (classification test).

For purposes of determining whether average benefit provided to nonhighly compensated employees is at least 70 percent of the average benefit provided to highly compensated employees, all employer-provided benefits and employer contributions, including elective deferrals are taken into account.

The term "average benefit percentage" means, with respect to any group of employees, the average of each employee's "benefit percentage".

The term "benefit percentage" means the employer-provided contributions (including forfeitures) or benefits of an employee under all qualified plans of the employer, expressed as a percentage of that employee's compensation.

Period of Computation Percentage

The act provides that each employee's benefit percentage is to be computed, at the election of the employer, on the basis of contributions or benefits for (a) the current plan year, or (b) a period of consecutive plan years (not in excess of 3 years) ending with the current plan year.

The period of consecutive plan years chosen by the employer is be uniformly applied and may not be changed without consent of the Secretary.

Exclusion of Certain Employees

For purposes of determining whether a plan benefits employees under the (a) percentage test, (b) ratio test or (c) satisfies the average benefit test, the act generally permits the employee to exclude from consideration certain classes of employees. As in present law, employees covered by collective bargaining agreements and nonresident aliens are excluded from consideration.

An employer is to disregard employees in applying the minimum coverage rules if all employees who do not satisfy the participation requirements prescribed by a plan are excluded.

An employer may elect to exclude employees who do not meet participation requirements from consideration in determining whether any plan of the employer meets the percentage or ratio test if they are covered under a separate plan of the employer which meets either of the new coverage tests. In addition, the employer may take into account all employees or, alternatively, can exclude only those employees who have not satisfied the minimum age and service requirements (with respect to a plan with the lowest age and service requirements for any plan), for purposes of determining the average benefit percentage in applying the average benefits test.

The act permits an employer to elect to test all excluded employees separately even if such employees are not covered by a separate plan. Alternatively, an employer may elect to test one group of excludable employees separately without testing all excludable employees separately if such group is defined in a nondiscriminatory manner solely by reference to the age or service requirement.

Line of Business Exception

The act generally requires the percentage test, ratio test, and the average benefit test be satisfied on an aggregate basis. However, exceptions are provided for an employer who establishes to the satisfaction of the Secretary of the Treasury that the employer operates separate lines of business or operating units for bona fide business reasons. A plan maintained for employees in one line of business or operating unit may satisfy the coverage requirements separately with respect to those employees provided certain requirement are met. The act also provides a safe - harbor rule which states that a line of business will be treated as a separate line of business if it is a separate, self sustaining unit and it has (1) at least 50 employee who do not perform service for any other line of business; (2) the employer notifies the Secretary of the Treasury that the line or business is to be treated as a separate line of business and (3) the employer receives the Secretary's approval.

However, if the highly compensated employee percentage is not less than one-half and not more than twice the percentage of all employees, the employer may be considered as having a bona fide business reason for operating separate lines of business without receiving the approval of the Secretary of the Treasury under (3). The term "highly compensated employee percentage" (as defined by IRC § 414(q)) means the percentage which highly compensated employees performing services for the line of business are of all employees performing services for the line of business. The highly compensated employee percentage of a line of business will be treated as not less than one-half of the percentage of all employees of the employer who are highly compensated if at least 10 percent of all highly-compensated employees of the employer are employed by the line of business or operating unit. An operating unit in a separate geographic area operated separately for a bona fide business reason will be considered to be a separate line of business.

The separate line of business exception will not apply in the case of an affiliated service group.

Special Rules For Certain Dispositions and Acquisitions

The act contains special transition rules for employers who become or ceases to be a member of a controlled group or affiliated service group. During the transition period, the coverage rules will be deemed satisfied provided that (1) the coverage rules were satisfied immediately before the acquisition or disposition, and (2) the coverage under the plan does not change significantly during the period beginning on the date of the acquisition or disposition and ending on the last day of the first plan year beginning after the acquisition or disposition.

Special Rules for Tax Credit ESOPs

A tax-credit employee stock owner plan (ESOP) that is the only plan of an employer will be treated as meeting the minimum coverage requirements if: (1) the plan benefits 50 percent or more of all employees who are eligible under a nondiscriminatory classification under the plan and (2) the sum of the amounts allocated to each participant's account for the year does not exceed two percent of the compensation of that participant for the year.

Eligible to Contribute

The act provides than an employee generally will be treated as benefiting under the plan only if the employee is a participant in the plan for purposes of the minimum coverage test. However, in the case of a cash or deferral arrangement (Code Section 401(K)) or the portion of a defined contribution plan to which employee contribution and employer matching contributions are made (Code Sec. 401(m)), an employee will be treated as benefiting under the plan (other than for purposes of the average benefit percentage component of the average benefit test) if he or she is eligible to make contributions to the plan.

Sanction

The act provides that a plan that does not satisfy the new coverage rules will be treated as exempt from tax only with respect to the employees that are not highly compensated. Highly compensated employees will be taxed on the present value of their employer-derived vested accrued benefits and income on any subsequent contributions to the extent such amounts have not previously been taxed.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provisions are generally effective for plan years on or after January 1 1989.

For plans maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers ratified before March 1, 1986, the act is not effective for plan years beginning before the earlier of (1) the date on which the last of the collective bargaining agreements terminates or (2) January 1, 1991.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Joint Committee on Taxation estimates revenue gains for the nation of less than $5 million annually. Based on this projected low level of impact for the nation, conformity would result in minor revenue gains, less than $200,000 annually under the Personal Income Tax Law.

ACTION: APPLY THE NONDISCRIMINATION RULES TO TAX-SHELTERED ANNUITIES

Act Section 1120 | Conference Report Page 417

Form 540 Line No. N/A | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17501 and 23701)

California has conformed to federal law where a qualified plan is required to meet nondiscrimination requirements which ensure that a plan does not favor employees who are officers, shareholders, or highly compensated as to coverage and as to contributions and benefits provided under the plan.

However, no coverage or nondiscrimination rules prohibit a tax-exempt charitable, educational or religious organization or state or local educational employer's tax sheltered annuity program from favoring highly compensated employees.

NEW FEDERAL LAW (Sec. 403)

The act generally applies the coverage and nondiscrimination rules that apply to qualified plans (as modified by the act) to nonelective and matching contributions or benefits of tax-sheltered annuity programs other than those maintained by a church.

The term church is defined to include a church under the Internal Revenue Code 501(c)(3) or a qualified church-controlled organization. These terms generally have the same meaning as they do for purposes of exclusion from SECA and FICA taxes (Sec. 1402 and 3121).

The applicable rules are those that relate to the minimum coverage requirements under 410(b), the exclusion of employees not meeting the age and service requirements under 401(a)(4), the line of business exceptions under 401(a)(5), and the additional participation requirements under 401(a)(26). These rules, however, will not apply to contributions made under salary reduction agreements.

Minimum Coverage Requirements

As under a qualified plan, the act provides that a tax-sheltered annuity program (other than those maintained by a church) must pass one of the following tests: (1) at least 70 percent of all non-highly compensated employees are covered by the plan (percentage test); (2) the percentage of non-highly compensated employees covered is at least 70 percent of the highly compensated employee covered (ratio test); or (3) the group of employees covered by the plan satisfies the non-discrimantory classification test.

A tax-sheltered program, standing alone, failing to satisfy any of the above tests may elect to treat the tax-sheltered annuity program, and a qualified plan or other tax-sheltered annuity program as a single plan solely for purposes of demonstrating that the tax-sheltered annuity program satisfies the minimim coverage requirement but only if the aggregated arrangement does not provide contributions that discriminate in favor of highly compensated employees.

However, a tax-sheltered annuity program may not be aggregated with a qualified plan for purposes of determining whether the qualified plan satisfies the applicable coverage and nondiscrimination rules, including the average benefit test.

Excludable Employees

The act excludes the same categories of employees in applying the coverage rules to tax-sheltered annuities as those applying to qualified plans, except that, an employee student who normally works less than 20 hours a week may also be excluded.

This rule only applies if the employer excludes all students working less than 20 hours.

Employers Subject to the Nondiscrimination Rule

The act provides that all employers eligible to sponsor a tax-sheltered annuity program (other than those maintained for church employees) are subject to the nondiscrimination rules added by the act. In addition, the other nondiscrimination rules regarding aggregation of employers and testing on a line of business or operating unit basis are to apply under rules prescribed by the Secretary.

Elective Deferral's

The act provides that special coverage and nondiscrimination rules apply to the elective deferrals permitted under a tax-sheltered program.

The elective deferrals permitted are those under a salary reduction agreement providing for contributions over $200, if the option to make elective deferrals is made available to all employees of the entity sponsoring the tax-sheltered program.

In applying the special test for deferrals the following employees may be excluded; (1) any employee who is a participant in an eligible deferred compensation plan, qualified cash or deferred arrangement of the organization or another tax-sheltered annuity; (2) any nonresident alien with the U.S. source earned income; and (3) student that normally work less than 20 hours a week.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provisions are generally effective for plan years on or after January 1, 1989.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No specific estimate was made by the Joint Committee on Taxation for this particular item indicating a very minor or negligible impact for the nation. Any revenue impact that would occur under state conformity would also be negligible

Title XIB3: Pensions and Deferred Compensation

ACTION: REVISE THE MINIMUM PARTICIPATION RULES FOR MULTIPLE PLANS

Act Section 1112(b) Conference Report Page 420

Form 540 Line No. N/A Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17501 and 17510)

California has conformed to federal law where an employer may designate two or more plans as a single plan for purposes of satisfying the minimum participation coverage requirements applicable to qualified plans.

If several plans are designated as a single plan, the plans (considered as unit) must be provided for the exclusive benefit of employees and also must provide contributions or benefits that do not discriminate in favor of highly compensated employees.

Rev. Rul. 81-202 provides guidance that may be applied to determine whether the amount of employer-derived benefits or contributions provided under several plans discriminate in favor of highly compensated employees by providing a means of comparing the benefits or contributions of different plans. This ruling allows either contributions or benefits to be compared regardless of the type of plan involved.

NEW FEDERAL LAW (Sec. 401)

The act provides that a plan is not a qualified plan unless it benefits the lesser of (a) 50 employees or (b) 40 percent of all of an employers nonexcludable employees. The requirement may not be satisfied by aggregating comparable plans nor can the test be applied on a line of business or operating unit basis.

Multiemployer plans are generally exempt from the minimum participation requirement, however plans covering professionals or unions for professionals (e.g., doctors, lawyers) are not exempt.

In the case of a cash or deferred arrangement (401 K plan) or the portion of a defined contribution plan in which employee contributions or employer matching contributions are made under Code Sec. 401(m), an employee will be treated as benefiting under the plan if the employee is eligible to make contributions to the plan.

Additional Participation Requirements

The act provides that the same categories of employers may be disregarded in applying the minimum participation rules as are excluded for purposes in applying the general coverage. In the case of a plan covering only employees included in a unit of employees covered by a collective bargaining agreement, all employees not included in such a unit for purposes of the minimum participation rule may be disregarded.

The act also explains how the minimum participation rules apply with respect to coverage of employees who could be excluded under the age or service rules from participation in a qualified plan. Generally, the excludable employees will not be considered in the application of the minimum participation rule. However, these excludable employee must be taken into account if:

1. the benefits for such excludable employees are provided under the same plan as benefits for other employees,

2. the benefits provided to such excludable employees are not greater than comparable benefits provided to other employees under the plan, and

3. any highly compensated employee (within the meaning of section 414(Q)) is included in the group of such excludable employees for more than one year.

Waiver of Excise Tax on Reversions

Under section 4980 an excise tax of 10 percent of the amount of any employer reversion from a qualified plan is to be imposed on reversions occurring on or after January 1, 1986.

The act provides that a plan may be terminated without having the 10 percent excise tax imposed on the reversion of assets to an employer for a plan that does not comply with the minimum participation rule if (1) the plan is in existence on August 16, 1986, (2) the plan would fail to meet the requirements of the minimum participation rule if such rule were in effect on August 16, 1986, and (3) there is no transfer of assets to, or liabilities from, the plan, or merger or spinoff involving the plan, after August 16, 1986.

In determining the amount of the employer reversion, the present value of the accrued benefit of any highly compensated employee, is to be determined by using an interest rate that is equal to the maximum interest rate that may be used for purposes of calculating a participant's accrued benefit under section 411(a)(11)(B).

In addition, the act provides a special rule for plans which may not terminate under title IV of the Employee Retirement Income Security of 1974 before the first year's to which the additional minimum participation rule would apply. The special rule, to the extent provided in regulations prescribed by the Internal Revenue Service, provides that the excise tax waiver will apply before the first year in which the plan is able to terminate.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provisions are effective for plan years beginning after on or after January 1, 1989.

For plans maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers ratified before March 1, 1986, the act is not effective for plan years beginning before the earlier of (1) the date on which the last of the collective bargaining agreements terminates or (2) January 1, 1991.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No specific national estimate was developed by the Joint Committee on Taxation for this particular provision indicating a very minor or negligible impact for the nation. Any revenue impact that would occur under conformity would be negligible.

ACTION: <u>PROVIDES MORE RAPID VESTING STANDARDS FOR PENSION PLANS</u>

Act Section 1113 | Conference Report Page 424

Form 540 Line No. N/A | Form 100 Line No. N/A

<u>CURRENT CALIFORNIA LAW (Sec. 17501)</u>

California has conformed to federal law which provides vesting standards to ensure that employees with substantial periods of service with the employer do not lose plan benefits upon separation from employment.

One of the requirements under the code is that an employer-provided benefits vest at least as rapidly under one of the following 3 alternative minimum vesting schedules: (1) full vesting is required upon completion of 10 years of service (no vesting is required before the end of the 10th year), (2) vesting begins at 25 percent after completion of 5 years of service and increases gradually to 100 percent after completion of 15 years of service, (3) requires 50 percent vesting after 5 years of service, when the sum of age and years of service is 45, an additional 10 percent vesting for each additional year of service, until 100 percent vesting is attained after 15 years of service (commonly known as the rule of 45). These vesting requirements also apply to multiemployer plans.

A more rapid vesting schedule may be required for an otherwise qualified plan if it is determined that there has been a pattern of abuse under the plan tending to discriminate in favor of employees who are officers, shareholders, or highly compensated, or if there has been or there is reason to believe there will be an accrual of benefits or forfeitures under the plan tending to discriminate in favor or officers, shareholders, or highly compensated employees.

For top-heavy plans, an employee's right to accrued benefits become nonforfeitable (vested) under the following 2 schedules: (1) full vesting after completion of at least 3 years of service, or (2) 20 percent vesting after 2 years of service , 40 percent at the end of 3 years of service, 60 percent at the end of 4 years of service, 80 percent at the end of 5 years of service, and 100 percent at the end of 6 years of service.

An alternative vesting method is also allowed for class plans which are profit-sharing, stock bonus, or money purchase plans that provide for the separate vesting of employee's rights to contributions on a year by year basis. The vesting requirements for class year plans are satisfied if each employee's right to benefits attributable to employer contributions become nonforfeitable before the fifth year following the year the contribution was made.

In addition, a qualified plan may be amended to change the vesting schedule provided that (1) the new schedule does not reduce any employee's vested interest under the old schedule, and (2) employees with at least five years of service can elect to have the non-forfeitable percentage of their benefit accruals calculated under the old schedule.

NEW FEDERAL LAW (Sec. 410,411)

The act provides that an employer-provided benefit under a qualified plan (other than multiemployer plan) would have to vest at least as rapidly as under one of the following two vesting schedules: (1) full vesting is required upon completion of five years of service (5 year vesting); or (2) vesting must begin at 20 percent after completion of three years and increase by 20 percent per year, until full vesting occurs after seven years of service (3 to 7 year vesting).

The act also requires the following additional vesting standards for the plans listed below:

1. Multiemployer Plan - An employee who (a) is covered by a collective-bargaining agreement and (b) has completed at least 10 years of service will have a nonforfeitable right to 100 percent of his or her accrued benefit derived from employer contributions.

2. Top-Heavy Plans - A plan that becomes top heavy is required to satisfy one of the two alternative vesting schedules applicable under present law to top-heavy plans (either 3 year vesting or 2 to 6 year vesting).

3. Class year plans - A plan will meet the qualification standards only if under the plan's vesting schedule, a participant's total accrued benefit becomes nonforfeitable under either the new 5 year or 3 to 7 year vesting as specified in the act.

Changes in Vesting Schedule

The act also modifies the rules relating to the changes in the vesting schedules. An employee with less than 3 years of service (instead of 5 years) must be able to elect within a reasonable period after the adoption of the amendment to have their benefit accruals calculated under the old schedules.

Vesting Eligibility Rule

The act provides that a plan may require, as a condition of participation, that an employee complete a period of service with the employer of not more than two years (instead of 3 years).

Also, a plan that requires an employee to complete more than one year of service as a condition of participation must also provide for full and immediate vesting of the accrued benefit at the time of accrual.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provisions are generally applicable for plan years on or after January 1, 1989 with respect to participants who perform at least one hour of service in a plan year to which the new provisions apply.

Special effective dates apply to plans maintained pursuant to a collective bargaining agreement. Under this special rule, in the case of a plan maintained pursuant to a collective bargaining agreement ratified before March 1, 1986, the amendments are not effective for plan years beginning before the earlier of (1) the date on which the last of the collective bargaining agreement terminates, or (2) January 1, 1991.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No identifiable revenue impact can be attributed to this change in the vesting of pension plans.

It is possible that some employers will drop plans or reduce contributions resulting in smaller expense deductions but the size of revenue gains from this reaction is indeterminable.

Title XIB5: Pensions and Deferred Compensation

ACTION: <u>MODIFY THE RULES GOVERNING THE INTEGRATION OF A QUALIFIED PLAN WITH SOCIAL SECURITY</u>

Act Section 1111 Conference Report Page 427

Form 540 Line No. N/A Form 100 Line No. N/A

<u>CURRENT CALIFORNIA LAW (Sec. 17501)</u>

California has conformed to federal law which provides that a plan is not considered qualified unless contributions or benefits do not discriminate in favor of employees who are officers, shareholders, or highly compensated.

Generally, in applying the nondiscrimination to benefits under a plan, the benefits that are provided by the plan for highly compensated participants (as a percentage of their compensation), is compared to the benefits that are provided for other participants. A similar test may be applied to employer contributions.

However, in determining whether defined benefit pension plan benefits (as a percentage of compensation) discriminate in favor of employees who are highly compensated, the portion of each employee's social security benefits that is considered to be paid by the employer may be taken into account. For this purpose social security means old age, survivors, and disability insurance (OASDI) benefits provided under the social security system.

The following are Internal Revenue Code Sections which provide guidelines on the methods of integrating plans:

1. Section 401(e) - Provides guidance in calculating the maximum amount of social security benefits that may be taken into account.

2. Section 401(a)(25) - Prevents increases in social security benefits after an employee's separation from service.

3. Section 411(b)(1)(G) - Provides that an employee's accrued benefit under a defined benefit plan may not be reduced on account of any increase in the employee's age or service.

4. Section 441(d)(b) - Provides that, with limited exceptions, the accrued benefit of a participant may not be decreased by plan amendments.

A plan is referred to as an integrated plan if it meets the nondiscrimination standards of the code and if social security benefits are taken into account.

The basic theory of social security integration in a pension or profit-sharing plan is that the employer may provide an increased benefit, based upon compensation, above the taxable wage base for those employers whose benefits under Social Security are limited by the taxable wage base. Either benefits or contribution under a plan may be integrated.

Integration of Defined Benefit Pension Plans

Two basic approaches to integration of defined benefit pension plans have been developed: (1) the "offset approach", and (2) the "excess approach". The basic concept is to convert the value of the benefits provided by the plan into the value of comparable benefits provided by the Social Security Act in order to show that a plan is not discriminatory.

Offset Plans

An offset plan is a defined benefit plan that integrates under the offset approach. An offset plan initially provides each employee with an annual pension benefit which (as a percentage of compensation) does not discriminate in favor of highly compensated employee. For each employee, this initial benefit is then reduced, or offset, by the employer-provided portion of that employee's social security benefit to arrive at the actual pension benefit under the plan.

In 1971, the Internal Revenue Service determined the value of employer-provided social security benefits is equal to 83 1/3 percent of the annualized primary insurance amount (PIA) to which an employee is entitled under Social Security Act.

In addition, the 83 1/3 percent factor is to be reduced if an offset plan provides employees with integrated ancillary benefits (e.g., normal retirement benefits not in the form of an annuity, pre-retirement death benefits, and early retirement benefits).

Excess Plans

Excess plans are pension plans that integrate under the excess approach. The basic theory underlying the excess approach is that the social security system provides benefits based on only a certain portion of employee earnings. An excess plan properly integrates if the benefits with respect to compensation in excess of the integrated level are not greater (as a percentage of pay) than the benefits provided by social security or compensation up to the integrated level.

The Internal Revenue Service determined the employer-provided portion of benefits under social security averages 37 1/2 percent of the average annual maximum wages on which social security benefits are based (covered compensation).

An excess plan may provide benefits at a higher rate than 37 1/2 on pay above the level of covered compensation if a plan provides benefits on compensation up to covered compensation. However, the rate above covered compensation cannot exceed the benefit rate (on covered compensation) by more than 37 1/2 percent.

Under an excess plan an adjustment to the 37.5 percent factor is required only if:

1. The plan has integrated ancillary benefits.

2. The plan uses an integrated wage level higher than covered compensation.

3. The participants final average compensation is determined on the basis of a period shorter than five consecutive years.

A defined benefit plan formula may be either a flat benefit formula or a unit benefit formula under which the benefit is based on the number of an employee's years of service with the employer.

Under present law, the integration rules allow an employer to implicitly take credit for the Old Age Security and Disability Insurance (OASDI) contributions of former employers of an employee since those benefits are earned over the entire working career of the employee.

Integration of Defined Contribution Plans

Defined contribution plans are integrated by taking into account the employer-paid portion of social security taxes. Since 1983, an employer has been able to integrate a defined contribution plan by reducing contributions on behalf of an employee by no more than an amount equal to the employee's taxable wage base multiplied by the actual OASDI tax rate.

Top Heavy Plans

A qualified plan that is top-heavy must provide a minimum nonintegrated benefit or contribution derived from employer contributions for each non-key employee who is a participant to the plan. A plan is considered to be top-heavy if more than 60 percent of the benefits it provides are for key employees.

A defined benefit pension plan satisfies this minimum benefit requirement if (on a cumulative basis) the accrued benefit of each participant who is not a key employee (when expressed as an annual retirement benefit) is not less than 2 percent of the employee's average annual compensation from the employer, multiplied by the number of the employee's years of service with the employer. However, an employee's minimum benefit is not required to exceed 20 percent of such average annual compensation and may not be eliminated or reduced on account of the employee's social security benefits.

For a plan year for which a defined contribution plan is a top-heavy plan the employer generally must contribute on behalf of each plan participant who is not a key employee an amount not less than 3 percent of the participant's compensation. However, if the employee's contribution rate for each participant who is a key employee for the plan is less than 3 percent, the required minimum contribution rate for each non-key employee generally is limited to the highest contribution rate for any key employee. The required minimum contribution must be a nonintegrated contribution.

NEW FEDERAL LAW (Sec. 401)

The act provides that a plan is not to be considered discriminatory merely because the contributions and benefits under the plan favor highly compensated employee's if the plan meets the new requirements (i.e., the disparity limits) of the act relating to the integration of contributions or benefits under qualified plans.

Permitted Disparity in Defined Contribution Plans

A defined contribution plan meets the disparity limits for integrated plans only if the excess contribution percentage does not exceed the lesser of 200 percent of the base contribution percentage or the sum of (1) base contribution percentage and (2) the greater of 5.7 percentage points or the percentage equal to the portion of tax imposed on employers under the Federal Insurance Contribution Act (in effect as of the beginning of the year) which is attributable to old-age insurance.

Defined Benefit Excess Plans

A defined benefit pension plan meets the disparity limits for integrated excess plans if (1) excess benefit percentage does not exceed a "maximum excess allowance" (2) any optional form of benefit, pre-retirement benefit, actuarial factor, or other benefit or feature under the plan provided with respect to compensation in excess of an amount specified in the plan for the year is provided with respect to compensation below the integration level, and (3) benefits are based on average annual compensation.

Maximum Excess Allowance

In the case of an excess plan, the "maximum excess allowance" with respect to benefits attributable to any year of service taken into account under the plan is the lesser of (1) the base benefit percentage, or (2) 3/4 of a percentage point. The maximum excess allowance for such a plan with respect to total benefits is the lesser of (1) the base benefit, or (2) 3/4 of a percentage point times the participant's years of service (not in excess of 35) taken into account under the plan.

These limits apply to excess plans that base benefits on final average compensation as well as excess plans that base benefits on career average compensation. In addition, the act provides that an integrated final pay plan may not base plan benefits on less than 3 years of service (or for a participant's full period of service, if less). The maximum excess allowance is to apply to both a flat benefit final pay plan and a unit benefit final pay plan.

Offset Plans

The act provides that a defined benefit pension plan will meet the integration requirements for offset plans if the plan provides that (1) a participant's accrued benefit attributable to employer contributions may not be reduced (by reason of the offset) by more than the maximum offset allowance and (2) benefits are to be based an average annual compensation for at least the lesser of a 3 year period or the total number of the participant's year of service. The term "offset plan" means any plan which the employer-provided benefit for each participant is reduced by an amount specified in the plan not in excess of the maximum offset allowance for such participant.

Maximum Offset Allowance

The maximum offset allowance with respect to a participant for any year of service taken into account under the plan is the lesser of (1) 50 percent of the benefit that would have accrued without regard to the offset reduction, or (2) 3/4 percent of the participant's final average compensation times the participant's years of service with the employer (not in excess of 35) taken into account under the plan.

Reduction of the 3/4 Percent Factor

The IRS is directed to prescribe regulations requiring the reduction of the 3/4 percent factor in the maximum excess allowance for plans (both final average and career average plans) using integration levels in excess of covered compensation. Any reductions are to be based on the percentages of compensation replaced by the employer-derived portions of primary insurance amounts under the Social Security Act for participants with compensation in excess of covered compensation.

Other Definitions and Special Rules

The term "average annual compensation" means the greater of (1) the participants' final average compensation (without regard to the limitation that prevents taking into account in any year compensation in excess of the Social Security taxable wage base for such year) or (2) the participant's highest average annual compensation for any other period of at least three consecutive years.

The term "covered compensation" has the same meaning as under current law, that is, with respect to an employee, the average of the taxable wage bases in effect for each year during the 35-year period ending with the year the employee attains age 65, assuming no increase in the taxable wage base for years after the current year and before the employee actually attains age 65.

The term "integration level" is the dollar or formula amount of compensation specified under the plan at or below which the rate at which contributions or benefits are provided (expressed as a percentage) is less than such rate above such amount. The integration level may not exceed the contribution and benefit base under the Social Security Act (that is, the taxable wage base) in effect at the beginning of the plan year ($42,000 for plan years beginning in 1986). The integration level must apply with respect to all participants.

The IRS is directed to provide rules under which an excess plan may use two or more integration levels.

For years beginning after 1986, compensation means compensation for service performed for an employer which is currently includible in gross income. The IRS may prescribe regulation for the determination of the compensation of an employee who is a self-employed individual based on the foregoing rule. The IRS also may provide for alternative methods of determining compensation which may be used by an employer except that these regulations must provide that an employer may not use the alternative method if its use discriminates in favor of highly compensated employees. An employer may elect to include as compensation any amount which is contributed by the employer under a salary reduction agreement and which is not includible in the employee's gross income.

The act also provides a special rule for plans maintained by railroads which provides that benefits of railroad employees are to be computed by taking into account their benefits under the plan, their Tier 2 Railroad Retirement Benefits and any supplemental annuity under the Railroad Retirement Act of 1974 in determining whether the plan meets the integration requirements.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provisions are effective for plan years beginning on or after January 1, 1989.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement. Under this special rule, in the case of a plan maintained under a collective bargaining agreement ratified before March 1, 1986, the minimum coverage rules are not effective for plan years beginning before the earlier of (1) the later of (a) January 1, 1989, or (b) the date on which the last of the collective bargaining agreements terminates, or (2) January 1, 1991. However, extensions or renegotiations of the collective bargaining agreement ratified after February 28, 1986, are disregarded.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No specific national estimates were developed by the Joint Committee on Taxation for this provision indicating a very minor or negligible impact for the nation. Any revenue impact that would occur under state conformity would be negligible.

Title XIB6: Pensions and Deferred Compensation

ACTION: APPLY A UNIFORM BENEFIT ACCRUAL RULE TO A QUALIFIED DEFINED BENEFIT PLAN

Act Section 1118 | Conference Report Page 440

Form 540 Line No. N/A | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17501)

California has conformed to federal law which provides additional qualification requirements for plans that primarily benefit an employer's key employees (top heavy plans). These additional requirements (1) limit the amount of a participant's compensation that may be taken into account; (2) require more rapid vesting; (3) provide minimum nonintegrated contributions or benefits for plan participants who are non-key employees; and (4) reduce the aggregated limit on contributions and benefits. Thus, the employer must first determine whether the plan is top-heavy, and if so, whether it meets the special qualification requirements for top-heavy plans.

Top-Heavy Plan Calculation

A defined benefit plan or a defined contribution plan is considered to be top heavy if for the determination date, the sum of the present values of the key employees' cumulative accrued benefits under the defined benefit plan within the aggregated group and key employees' account balances under defined contribution plans within the aggregation group exceed 60 percent of these amounts for all participants in each aggregated plan.

Accrued Benefits

In general, a defined benefit pension plan is considered qualified if the participants accrue benefits at a rate that meets one of three alternate schedules which provide the extent that an employer may defer (i.e., "backload") benefit accruals.

However, in determining whether a qualified plan is top heavy, cumulative accrued benefits are calculated using the benefit accrual method selected by the plan.

NEW FEDERAL LAW (Sec. 416(g)(4)(F))

The act provides that if an employer uses the same accrual method for all plans, then that method may be used to determine whether a plan is top heavy.

However, a uniform accrual rule is to be used in testing whether a qualified plan is top heavy (or super top heavy as defined under IRC 416(h))) when all of the employer's plans do not use the same method of accrual. This uniform accrual rule is termed the fractional benefit accrual rule which provides that each participant's accrued benefit at the end of any year must be at least equal to an amount determined by dividing the participant's years of participation by the total number of years of participation to normal retirement age.

A plan will be top-heavy if, as of the determination date, the present values of the cumulative accrued benefits for participants who are key employees exceeds 60 percent (90 percent for super top-heavy plans) of the present value of the cumulative accrued benefits for all employees under the plan.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision is effective for plan years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No specific national estimate was developed by the Joint Committee on Taxation for this particular provision indicating a very minor or negligible impact for the nation. Any revenue impact that would occur under state conformity would be negligible.

Title XIB7: Pensions and Deferred Compensation

ACTION: CREATES UNIFORM RULES FOR FORFEITURES UNDER A DEFINED CONTRIBUTION PLAN

Act Section 1119 | Conference Report Page 442

Form 540 Line No. N/A | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17501)

California has conformed to federal law in the treatment of forfeitures in a defined contribution plan.

In a defined contribution plan that is not a money purchase pension plan (such as a profit sharing or stock bonus plan), forfeitures may be reallocated to the remaining participants under a formula that does not discriminate in favor of employers who are officers, shareholders, or highly compensated. These reallocations result in an increase in the benefits of the remaining participants. Alternatively, the forfeitures may be used to reduce future employer contributions or to offset plan administrative expenses.

In a money purchase plan, forfeitures must be used to reduce future employer contributions or to offset plan administrative expenses and may not be reallocated to the remaining participants.

NEW FEDERAL LAW (Sec. 401)

The act provides that forfeitures arising in a defined contribution plan (including a money purchase pension) plan may be either reallocated to remaining participants in a nondiscriminatory manner or used to reduce future employer contributions or administrative costs.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The effective date of the provision is for plan years beginning on or after January 1, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No specific estimate was developed by the Joint Committee on Taxation for this particular provision indicating a very minor or negligible impact for the nation. Any revenue impact that would occur under state conformity would be negligible.

Title XIB8: Pensions and Deferred Compensation

ACTION: ADOPT A UNIFORM DEFINITION OF HIGHLY COMPENSATED EMPLOYEES

Act Section 1114 | Conference Report Page 442

Form 540 Line No. N/A | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17501)

California has conformed to federal law. An employee who is an officer, shareholder, or highly compensated is considered a highly compensated individual in whose favor plan benefits may not discriminate.

Based on judicial and administrative precedent, the level of compensation that makes an employee highly compensated depends on the facts and circumstances of each case.

NEW FEDERAL LAW (Sec. 414)

The act provides a new uniform definition of highly compensated employees that generally applies for purposes of the nondiscrimination rules for qualified plans and statutory employee benefit plans.

An employee is treated as highly compensated with respect to a year if, at any time during the year or preceding year, the employee (1) was a five-percent owner of the employer; (2) received more than $75,000 in annual compensation from the employer; (3) received more than $50,000 from the employer and was a member of the top-paid group of employees for the year, i.e., the top 20 percent of employees by pay during the same year; or (4) was an officer of the employer and received compensation greater than 150 percent of the dollar limit on annual additions to a defined contribution plan. For purposes of this fourth category, more than 50 employees (or if lesser, the greater of 3 employees or 10 percent of the employees) are treated as officers. If no officer of the employer received compensation in excess of 150 percent of the defined contribution plan dollar limit, then the highest paid officer of the employer is treated as a highly compensated employee.

In addition, the $50,000 and $75,000 amounts are indexed at the same time and in the same manner as the dollar limit on benefits under a defined benefit plan.

An exception to the rule is provided for certain employees. Specifically, an employee that is not a 5 percent owner or within the top 100 employees by pay for the current year and was not a highly compensated employee in the preceding year (without regard to this special rule) will not be treated as highly compensated for the year, but will be treated as highly compensated for the following year if the employee otherwise falls within the definition of highly compensated employee.

Top-Paid Group

The act provides that the following employees may be excluded for purposes of determining the size of the top-paid group:

1. employees who have not completed six months of service,

2. employees who normally work less than 17 1/2 hours per week,

3. employees who normally work fewer than six months during a year,

4. employees who have not attained age 21,

5. except to extent provided in regulations, employees who are included in a unit of employees covered by a bona fide collective bargaining agreement, and

6. employees who are nonresident aliens and receive no U.S. source earned income.

For purposes of the excludable employees rule, an employer may substitute a shorter period of service or lower age than that specified in (1), (2), (3) or (4) provided that the employer applies the test uniformly in determining its top-paid group with respect to all its qualified plans and employee benefit plans and for purposes of the line of business rules.

Treatment of Family Members

The act provides a special rule for treatment of family members of certain highly compensated employees. Under the special rule, an employee who is a family member of (i) either a 5 percent owner or one of the top 10 highly compensated employees by compensation is to aggregate any compensation paid to them including contributions or benefits under the plan made on their behalf) with the compensation paid and amounts contributed on behalf of the 5 percent owner or the highly compensated employee in the top 10 employees by pay. Therefore, such family member and employee is treated as a single highly compensated employee.

A family member is defined as an employee's spouse, parent and lineal descendant, or spouse of a parent or lineal descendant of the employee.

Former Employees

The act provides that a former employee is to be treated as highly compensated if the employee was highly compensated (a) upon separation from service or (b) at any time after the employee attained age 55.

Compensation

For purposes of the definition of "highly compensated" employees, compensation means the compensation received from the employer for the year determined without regard to elective contributions to a cafeteria plan, a qualified cash or deferred arrangement (401(k) plan), simplified employment pension (SEP) and employer contributions made under a salary reduction agreement for employees of tax exempt organizations or public schools. In the case of a self-employed individual compensation means that person's earned income for the year.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The new definition of "highly compensated employee" is generally effective for years beginning on or after January 1, 1987, except to the extent that the substantive rule to which it relates is effective at a later date. The minimum coverage rules, for qualified plans, to which the rules for highly compensated employees apply, are effective for plan years beginning after December 31, 1988.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No specific estimate was made by the Joint Committee on Taxation for this particular item indicating a very minor or negligible impact for the nation. Any revenue gains that would occur under state conformity would also be negligible.

Title XIC1: Pensions and Deferred Compensation

ACTION: PROVIDES UNIFORM MINIMUM DISTRIBUTION RULES WITH RESPECT TO COMMENCEMENT DATE AND THE AMOUNT DISTRIBUTED

Act Section 1121 | Conference Report Page 449

Form 540 Line No. N/A | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17501)

California has conformed to federal law which requires that a qualified trust distribute the participant's entire interest no later than the participant's required beginning date which generally is April 1 of the calendar year following the calendar year in which (1) the participant attains age 70 1/2 or (2) participant retires, whichever is later.

However, for 5-percent owners and all Individual Retirement Arrangement (IRA) owners, benefit distributions are required to commence at age 70 1/2 without regard to the date the participant retires.

In respect to the amount of distributions, minimum distributions are required under a qualified plan. Failure to satisfy the requirement may disqualify the plan.

NEW FEDERAL LAW (Sec. 401,402,408 and 4974)

The act establishes a uniform commencement date for benefits under all qualified plans, individual retirement arrangements, tax-sheltered annuities, custodial accounts, and unfunded deferred compensation plans of State and local government and tax-exempt employers.

Distributions under a qualified retirement plan must commence no later than April 1 of the calendar year following the calendar year in which the participant or owner attains age 70 1/2, without regard to the actual date of retirement or termination of employment.

In addition, the sanction for failure to make a minimum requirement distribution to a particular participant under a qualified retirement plan will be 50 percent nondeductible excise tax (in lieu of plan disqualification) on the excess in any taxable year of the amount that should have been distributed (the "minimum required distribution") over the amount that actually was distributed. This tax will be imposed on the individual required to take the distribution.

The act also authorizes the Secretary of the Treasury to waive the tax if the taxpayer is able to establish that any shortfall between the minimum required distribution for that year and the amount actually distributed during the year is due to reasonable error and reasonable steps are being taken to remedy the shortfall.

Minimum distribution requirements in any given taxable year are to be determined under regulations to be issued by the Secretary of the Treasury.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provisions generally apply to distributions made on or after January 1, 1989, with an exception for (1) distributions made pursuant to a designation made in accordance with section 242 (b)(2) of the Tax Equity and Fiscal Responsibility Act of 1982 and (2) individuals who are not 5-percent owners and who have attained age 70 1/2 by January 1, 1988 who may defer commencement of benefit payments. The second exception applies only if the individual is not a 5 percent owner in the plan year ending in the calendar year in which the individual attains age 66 1/2 or any succeeding plan year.

In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986, these provisions will not apply to distributions to individuals covered by such agreements in plan years beginning before the earlier of: (1) January 1, 1991 or (2) the later of (a) the date on which the last of the collective bargaining agreements terminates (determined without regard to any extension after February 28, 1986) or (b) January 1, 1989.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Since retirement plan distributions will be governed by the change in federal law, revenue effects at the state level will occur directly as a result of the federal change. The magnitude of the state budget impact will correspond to the estimates below.

The Joint Committee on Taxation estimates minor revenue gains for the nation of less than $5 million annually. Based on the projected low level of impact for the nation, this provision would result in minor revenue gains annually of less than $200,000 under the Personal Income Tax Law.

This estimate does not reflect the excise tax provisions.

ACTION: <u>PROVIDE UNIFORM WITHDRAWAL RESTRICTIONS AND EXTEND THE TAX ON PREMATURE DISTRIBUTIONS TO QUALIFIED CASH AND DEFERRAL ARRANGEMENTS</u>

Act Section 1116b, 1123, 1124 Conference Report Page 452

Form 540 Line No. N/A Form 100 Line No. N/A

<u>CURRENT CALIFORNIA LAW (Sec. 17082 and 17507)</u>

California has conformed to federal law where benefits may be distributed to a participant in a qualified pension plan only on account of plan termination or the employee's separation from service, disability or death.

<u>Withdrawal Restrictions</u>

Under present law plans are subject to different restrictions for early withdrawals. These plan restrictions (other than plan restrictions for a qualified pension plan) are listed below:

1. Qualified profit-sharing or stock bonus plans – Withdrawal of employer contributions are permitted after the expiration of a stated period of time (e.g., 2 years or longer) or after the occurrence of a stated event (e.g., hardship).

2. Qualified cash or deferred arrangement – A participant is permitted to withdraw elective deferrals (or earning on such deferrals) only if the participant dies, becomes disabled, separates from service, or (except in the case of a pre-ERISA money purchase pension plan) attains age 59 1/2 or encounters hardship.

3. A tax-sheltered annuity program invested in a custodial account of a regulated investment company (i.e., mutual fund) – An account owner is permitted to make withdrawals when the owner attains age 59 1/2, dies, becomes disabled, separates from service or encounters financial hardship.

4. Tax-sheltered annuities – Amounts <u>invested</u> in tax-sheltered annuities are not subject to any withdrawal restrictions.

Additional Income Tax on Early Withdrawals

Under California law, a 2 1/2 percent additional income tax is imposed on withdrawals from an individual retirement arrangement (IRA) or from a qualified plan (by or on behalf of 5 percent owners) before the owners attain the age of 59 1/2, dies, or become disabled. This differs from federal law which is a 10 percent additional income tax.

NEW FEDERAL LAW (Sec. 408F and 72)

In general the act revises the withdrawal restrictions on distributions and extends the 10 percent additional income tax to early withdrawals made by a participant from a qualified cash and deferral arrangement (including a tax-sheltered annuity).

Withdrawal Restrictions

The act provides that a qualified cash or deferred arrangement may make distributions on account of the plan's termination (provided no successor plan is established) as well as on account of the employee's death disability, separation from service, or (except in the case of a pre-ERISA money purchase pension plan) attainment of age 59 1/2. In addition, distributions may be made on account of the sale of substantially all of the assets used by a corporation in its business if the employee continues in employment with the purchaser.

Distributions on account of hardship are permitted only to the extent of an employee's elective deferrals. Hardship withdrawals are not permitted from income on any contributions or from employer matching or nonelective employer contributions taken into account for purposes of the special nondiscrimination test.

Tax-Sheltered Annuities - The withdrawal restrictions currently applicable to tax-sheltered custodial accounts generally are extended to other tax-sheltered annuities. Thus, early distributions from a tax-sheltered annuity are prohibited unless the withdrawal is made on account of death, disability, separation from service, or attainment of age 59 1/2. In addition, the act permits withdrawals on account of hardship from a tax-sheltered annuity or custodial account but only to the extent of the contributions made to a salary reduction agreement (does not include earning on contributions).

For both a qualified cash or deferred arrangement and tax-sheltered annuities, the present-law standard defining "hardship" for purposes of a qualified cash or defined arrangement will apply.

Additional Income Tax on Early Withdrawals

The 10 percent additional income tax currently imposed on early withdrawals from an IRA by the owner prior to the attainment of 59 1/2, death, or disability is extended to early withdrawals made by a participant from any "qualified retirement plan". Thus the tax applies to amounts distributed from plans qualified under section 401(a) of the Code (e.g., a qualified pension, profit sharing, or stock bonus plans), tax sheltered annuities and custodial accounts, and IRA's but does not apply to amounts distributed from unfunded deferred compensation plans of tax-exempt or state and local government employers.

The act includes the following exceptions to the tax:

1. a distribution that is part of a scheduled series of substantial equal periodic payments for the life of the participant (or the joint lives of the participant and the participant's beneficiary) or the life expectancy of the participant (or the joint life expectancies of the participant and the participant's beneficiary);

2. a distribution to an employee who has attained age 55, separated from service, and met the requirements for early retirement under the plan;

3. a distribution which is used to pay medical expenses to the extent that the expenses are deductible under section 213 (determined without regard to whether the taxpayer itemizes deductions);

4. a distribution made to a beneficiary (or to the estate of an employee) on or after the employee's death;

5. a distribution attributable to the employee's disability;

6. a distribution made to an employee from an employee stock ownership plan (ESOP) before January 1, 1990 to the extent that, on average, a majority of assets in the plan have been invested in employer securities for the 5 plan year period immediately preceding the plan year in which the distribution occurs. Where an ESOP has not been in existence for less than five years, the plan must have been so invested during the entire period prior to distribution;

7. distribution payments made to or on behalf of an alternate payee pursuant to a qualified domestic relations order;

8. certain distributions of excess contributions to and excess deferrals under a qualified cash and deferred arrangement;

9. lump-sum distributions made prior to March 15, 1987, if the distribution is made on account of separation from service in 1986 and the employee treats the distribution for federal tax purposes as paid in 1986;

10. dividend distributions under section 404(k) which relate to dividend paid deductions;

11. a distribution to an employee on or after he has attained the age of 59 1/2.

Limitations -

In the case of distributions from IRA's, the early retirement, medical expense, and ESOP exceptions do not apply. The exception for distributions pursuant to a qualified domestic relations order applies to an individual retirement arrangement only to the extent the arrangement is subject to qualified domestic relations order.

The exception for substantial equal payments applies only to distributions from a plan qualified under 401(a) and tax sheltered annuities and custodial accounts only if the distribution is made after separation from service.

Change in Substantially Equal Payments -

Individuals who change the distribution method prior to age 59 1/2 to a method which does not qualify for exception will be subject to the early withdrawal tax even if the substantial equal payment exception applies. The additional tax will be imposed in the first taxable year which the modification is made and will equal the tax (as determined under regulations) that would have been imposed had the exception not applied (plus interest).

In addition, the recapture tax will apply if an individual does not receive payments under a method that qualifies for the exception for at least 5 years, even if the method of distribution is modified after the individual attains 59 1/2. This 5-year minimum payout rule is waived upon the death or disability of the employees.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provisions relating to the withdrawal restrictions apply to years beginning on or after January 1, 1989.

The provisions permitting distributions upon plan termination, the sale of corporate assets, and the sale of a subsidiary are effective for distributions occurring in years beginning after 1984.

The provisions relating to the additional income tax on early withdrawals apply to taxable years beginning after December 31, 1986. However, there is an exception to the tax for individuals who, as of March 1, 1986, separated from service and began receiving benefits under a written election designating a specific schedule of benefit payments. In addition, if the participant failed to make a written election, the requirement that benefits be paid pursuant to a written election designating a specific schedule of benefit payments for the distribution of the entire accrued benefit of the participant will be deemed to be satisfied where the plan from which the benefits are paid provides for only one form of distribution, or where (1) the plan provides that, in the absence of an election to the contrary, a participant will be paid benefits according to the automatic form of payment specified in the plan and (2) the individual is, in fact, receiving benefits in that form.

Furthermore, an exception is provided for certain individuals who made grandfathered designations under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). TEFRA provided a special transitional rule under which a plan would not be disqualified under the before-and-after death distribution rules of Code Sec. 401(a)(9), as amended by TEFRA, because of distributions made pursuant to an employee's designation made before January 1, 1984 of a method distribution which did not meet the requirements of TEFRA-amended Code SEC. 401(a)(9), but which would not have disqualified the plan under former Code Sec. 401(a)(9).

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The relative fiscal impact under state conformity is revenue gains in the $9 million range for 1987-88 and $10 million range for 1988-89. These revenue gains would occur under the Personal Income Tax Law. The basis for the state estimates is the national estimates prepared by the Joint Committee on Taxation prorated to California by a 4.1 percent factor. This factor reflects the Policy Economic Group's (PEG) conformity estimates for California for those provisions analyzed relative to the nation. The PEG has not specifically estimated this provision.

Title XIC3: Pensions and Deferred Compensation

ACTION: REVISE RULES RELATING TO THE TAXATION OF PARTIAL AND LUMP-SUM DISTRIBUTIONS

Act Section 1122 — Conference Report Page 458

Form 540 Line No. N/A — Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17085, 17501, 17505, 17506, 17507, & 23701)

Although California has generally conformed to federal law where a distribution of benefits from a tax-favored retirement arrangement is included in gross income several differences exist and are discussed below.

Distributions In General

As under federal law, in the case of a tax-sheltered annuity, benefits are included in California income when paid or made available. Thus benefits are taxable when constructively received even though the payments have not been received.

A distribution from a qualified pension plan or an individual retirement arrangement (IRA), is included in gross income in the year in which it is paid or distributed, except that for California purposes, the following IRA distributions are recovered tax-free:

1. Contributions to IRA's that are not allowed as deductions under California law.

2. Interest on retirement bonds.

3. Interest earned in 1975 or 1976 on a 1975 contribution which was subject to California tax.

Special Averaging Method

When an employee receives a lump-sum distribution from a pension plan, a part or all of which is not entitled to capital gain treatment and does not elect to roll it over into another account, California law provides a special seven-year averaging formula for calculating the tax due on the ordinary income portion of the distribution.

For self-employed persons receiving distributions from H.R. 10 (Keogh) plans, the averaging formula is based on five years rather than seven years. This differs from federal law under which both employees and self-employed individuals may elect a special 10-year forward averaging method for the above types of distributions.

Capital Gain Treatment

For California purposes the portion of the lump-sum distribution attributable to the period before January 1, 1974 is entitled to capital gain treatment using a more than five year holding period.

This differs from federal law since the pre 1974 element of the lump-sum distribution is apportioned between long-term capital gains and ordinary income plus an option is provided to combine both the capital gain and the ordinary income portions together as ordinary income for purposes of the 10-year averaging computation.

Tax-Free Roll-Overs

For both California and federal law, qualifying distributions can be rolled over into another qualified plan, an annuity plan, or an individual retirement account, annuity, or bond, under certain conditions which provide a deferral of taxes.

Participants receiving a qualifying roll-over distribution of the balance of their entire account in a qualified plan are allowed 60 days in which to reinvest, in another qualifying plan, all or part of the amount received.

A partial distribution is eligible for a tax-free rollover if it is:

1. at least 50% of the balance to an employee's credit in a qualified trust;

2. not part of a series of periodic payments; and

3. covered by a special employee election to have the tax-free rollover treatment apply.

Basis Recovery Rules

Under both state and federal law, special rules are provided for treatment of basis (e.g.,employee contribution) when an individual receives a distribution before or after the annuity starting date from a tax-favored retirement arrangement.

Distributions prior to the annuity starting date are treated as being made first out of nontaxable employee contributions and then out of taxable amounts (employer contributions).

Distributions after the annuity starting date are treated under the following rules:

1. In general, each payment is treated in part as a payment of taxable income and part as a recovery of employee contributions which are nontaxable. The ratio of taxable and nontaxable portions of the distribution is calculated on the annuity starting date and is not subject to change. Thus, it is possible either to recover more than the employee's contribution when an annuitant lives longer than actuarial estimates or to recover less than the full amount of employee's contributions when the annuitant does not live as long as actuarially assumed.

2. Under a special rule, if an individual will receive an amount equal to all of the employee's contributions within the first three years after the annuity starting date, then all distributions are considered a return of employee contributions until the individual's basis has been recovered. Thereafter all distributions are fully taxable.

NEW FEDERAL LAW (Sec. 72, 401, 402, 403, 408, & 408)

Distributions In General

The act provides that benefits under a tax-sheltered annuity will not be taxed when constructively received but are includible in income only when benefits are actually received.

Special Averaging Method and Capital Gain Treatment

The act (1) phases out pre 1974 capital gains treatment over a six year period beginning on January 1, 1987, and (2) eliminates 10 year forward averaging for taxable years beginning on or after January 1, 1987, and instead permits a one-time election of five-year forward averaging for a lump-sum distribution received after attainment of age 59 1/2.

Under a transition rule, a participant who has attained age 50 before January 1, 1986 is permitted (1) to make one election of five year forward averaging (under the new tax rates) or 10 year forward averaging (under the new tax rates) without regard to the requirement of attainment of age 59 1/2, and (2) to retain the capital gains character of the pre-1974 portion of a lump sum distribution and that capital gain would be taxed at a rate of 20 percent. An election made under the transitional rule makes the taxpayer ineligible for an election under the general rule after age 59 1/2.

Tax-Free Roll-Overs

The act modifies the eligibility of partial distributions for rollover treatment. Partial distributions, including distributions which are part of a series of periodic payments may be rolled over only if the distribution is due to the death, separation from service (including the separation from service of a self-employed individual) or is made after the employee has become disabled.

The act also establishes a special rule in which a distribution in satisfaction of the diversification requirements under a employee stock ownership plan may be rolled over even if the distribution does not otherwise qualify for rollover treatment.

In addition, the act permits rollovers from frozen deposits in a bankrupt or insolvent saving and loan association to be made even after the 60-day rollover election period has expired. The individual has a minimum of 10 days after the release of the funds to complete the rollover.

Basis Recovery Rules

The act modifies the basis recovery rule for amounts distributed prior to a participant's annuity starting date to provide for pro-rata recovery of employee contributions. In determining the portion of employee benefits attributable to employer contribution only those employer contributions that have vested will be considered. For amounts received after the annuity starting date, the act eliminates the special three-year basis recovery rule.

In computing the portion of each payment that is excludable from income the employee's expected total return is to be determined as of the date of payment.

The act limits the total excludable amount to the total amount of the employee's contributions. In addition, if an employee's benefits cease prior to full recovery of employee contributions, the amount of unrecovered contributions is allowed as a deduction in the annuitant's last year.

The act also treats as a separate contract, the employee contributions to a defined contribution plan or a separate account of a defined benefit plan (and the income attributable thereto) for purposes of taxing amounts received from employee's annuities. Withdrawals of employee contributions from such plan or account will be considered to be in part a nontaxable return of employee contributions, and in part a taxable distribution of earnings on those contributions and will not be considered a distribution attributable to employer contributions. An employee may recognize a loss if a withdrawal of all amounts attributable to employee contributions is less than the employee's actual contributions.

In addition, the act provides basis recovery rules for distributions from an IRA to which nondeductible contributions have been made which are similar to the qualified plan annuity rules discussed above.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The basis recovery rules are generally effective with respect to distributions received on or after January 1, 1987.

The repeal of the 3-year basis recovery rule is effective with respect to individuals whose annuity starting date is on or after July 2, 1986.

The provision limiting the income exclusion to the amount of the employee's investment in the contract applies to individuals whose annuity starting date is on or after January 1, 1987.

The new rules with respect to partial distributions are effective with respect to amounts distributed on or after January 1, 1987.

The special rule for frozen deposits is generally effective with respect to distributions after October 22, 1986. With respect to amounts which were frozen but released prior to October 22, 1986, the rollover must be completed within 60 days following October 22, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Special Averaging Method

The relative fiscal impact under state conformity is revenue gains in the $1 million range annually for 1987-88 and 1988-89. These revenue gains would occur under the Personal Income Tax (PIT) Law. The basis for the state estimate is the national estimates prepared by the Joint Committee on Taxation (JCT) prorated to California by a 4.1 percent factor. This factor reflects the Policy Economic Group (PEG) conformity estimates for California relative to their national estimates for those provisions analyzed. The PEG has not specifically estimated this provision. The conformity estimate also reflects an adjustment of 57.1 percent to allow for the proportional difference between California's current seven year period and the 10 year period under former federal law.

Basis Recovery Rules

The relative fiscal impact under state conformity is revenue gains in the $72 million range for 1987-88 and $82 million range for 1988-89. These revenue gains would occur under the PIT Law. The basis for these estimates is the national estimates prepared by the JCT prorated to California by the same 4.1 percent factor as above.

Other changes that would have a revenue impact, such as the tax-free rollover change, are relatively minor and were not separately identified or estimated by the JCT.

ACTION: TIGHTEN RESTRICTIONS ON EXCEPTION TO THE INCOME EXCLUSION RULE PERTAINING TO AMOUNTS BORROWED FROM A QUALIFIED PLAN BY A PARTICIPANT

Act Section 1134	Conference Report Page 463
Form 540 Line No. 20	Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17081)

California conforms to federal law which allows, under narrowly defined conditions, an exclusion for amounts borrowed from a qualified plan in which the individual participates. Generally, a loan to a plan participant is treated as a taxable distribution of plan benefits. A loan to a participant is only permitted if the individual is a qualified participant in the plan, the loan bears a reasonable rate of interest, provides a reasonable repayment schedule, is adequately secured (his or her accrued benefit in the plan is used as security for the loan), and is not made available in a manner that discriminates in favor of employees who are officers, shareholders, or highly compensated. A loan is not permitted to be made to an owner-employee from a qualified plan.

The exception to the requirement that loans to a plan participant are taxable distributions applies when the loan (when added to the outstanding balance of all other loans to the participant from all plans maintained by the employer) does not exceed the lesser of: (1) $50,000, or (2) the greater of $10,000 or one half of the participant's accrued benefit under the plan.

This exception applies only if the loan, by its terms, must be repaid in five years. However, if the loan is for the purpose of purchasing or making improvements to the participant's principal place of residence (or to the principal place of residence of a member of the participant's family) the exception applies if the loan must be repaid within a reasonable amount of time.

NEW FEDERAL LAW (Sec. 72(P)(2))

The exception to the income exclusion rule is modified by reducing the $50,000 limit on a participant loan by the excess (if any) of the highest outstanding balance on any loans from the plan during the one year period ending on the day before the date the loan is made, over the outstanding balance of loans from the plan on the date the loan is made.

The extended repayment provision is applicable only to the purchase of a principal place of residence of the plan participant. Loans incurred for making improvements to the principal residence of the participant, to purchase a second home, or to finance the purchase of, or improvements to the home of a member of the participant's family, are subject to the five year repayment rule.

Plan loans must be amortized in level payments over the term of the loan, and made not less frequently than quarterly. This amortization rule does not apply when an employee is on an unpaid leave of absence for up to one year; nor is this provision intended to inhibit repayment or acceleration of the loan prior to the end of its commitment period.

The deduction of interest on a loan from a qualified plan or tax-sheltered annuity is subject to the general limits on deductibility of interest. For loans made, renegotiated, extended or renewed on or after January 1, 1987, no interest deduction is allowed as a result of (1) loans secured with elective deferrals under a qualified cash or deferred arrangement, or a tax-sheltered annuity, or (2) loans to a key employee.

EFFECTIVE DATE OF FEDERAL PROVISIONS

These provisions are generally effective for loans made, extended or revised on or after January 1, 1987. No basis is allowed for any interest paid on a loan from a qualified plan on tax-sheltered annuity effective on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Joint Committee on Taxation estimates revenue gains for the nation of less than $5 million annually. Based on this projected low level of impact for the nation, conformity would result in minor revenue gains annually not exceeding $200,000. These revenue gains would occur under the Personal Income Tax Law.

ACTION: <u>IMPOSE OVERALL LIMITATIONS ON PENSION PLAN CONTRIBUTIONS AND BENEFITS</u>

Act Section 1106 & 1133 Conference Report Page 466

Form 540 Line No. 20 Form 100 Line No. G-24

<u>CURRENT CALIFORNIA LAW (Sec. 17501 and 17510)</u>

California law generally conforms to federal provisions limiting benefits and contributions under qualified pension plans. Specific provisions to which California does not conform and special limitations on plans for self-employed or owner-employees will be discussed below.

Currently, contributions and benefits provided to participants in qualified plans, tax sheltered annuity programs, and Simplified Employee Pensions (SEP's) are subject to overall limits. The annual addition to all defined contribution plans maintained for an employee by the same employer; and the annual benefit that may be provided for an employee under all defined benefit plans, are also subject to limitations.

<u>Defined Contribution Plans</u>

A defined contribution plan is one which provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant's account, plus any income, expenses, gains and losses, and any forfeitures of accounts of other participants, that may be allocated to the participant's account. The annual addition to an employee defined contribution plan is limited to the lesser of $30,000, or 25 percent of compensation for the year. The annual addition consists of employer contributions, certain employee contributions and reallocated forfeitures (the amount of employer contributions that an employee forfeits when he or she does not satisfy the requirements of the plan). **Employee contributions that are used to determine the annual addition are limited to the lesser of 1/2 of the employee contribution, or all employee contributions in excess of 6 percent of the employees compensation. For California purposes, if the plan provides for contributions for individuals who are self-employed or owner-employees, deductible contributions can not exceed the lesser of $2,500 or 10 percent of earned income.**

Also, California does not conform to the federal special limitation on contributions to Employee Stock Ownership Plans (ESOP's) of the lesser of $30,000 or the amount of employer securities contributed, or purchased with cash contributed to the

ESOP per year. If a defined contribution plan does not meet the special limitation for an ESOP, under Federal law it shall not fail to be qualified under California law.

Unlike federal law, California law provides that the amount of income that is attributable to the nondeductible portion of a defined contribution plan shall not be included in the employee's gross income for the taxable year or succeeding taxable years. However, this nondeductible portion will be included in the employee's gross income upon distribution to the employee (as a result of a provision of the plan, or operation of law).

Defined Benefit Plans

A defined benefit plan is the same as a defined contribution plan except that the limitation is applied to the annual benefit the participant may receive, rather than the annual addition to the plan. The limit on the annual benefit derived from employer contributions is the lesser of $90,000, or 100 percent of average compensation for the employee's 3 high years (the period of not more than 3 consecutive calendar years during which the participant was both an active plan participant, and had the greatest aggregate compensation from the employer). If the plan provides benefits for individuals who are self-employed or owner-employees, the basic benefit of that plan for that individual can not exceed the sum of (1) annual compensation not over $25,000 plus, (2) a percentage determined by the age at which participation began.

Retirement benefits that commence before age 62 reduce the $90,000 limit (or the lower self-employed or owner-employee limit) so that the limitation, when reduced, equals an annual benefit equivalent to $90,000 (or the lower self-employed or owner-employee limit) at age 62. However, retirement benefits for employees other than self-employed or owner-employees that commence before age 62, and on or after age 55 will be reduced to a limit no lower than $75,000. For retirement benefits that begin before age 55, the $90,000 limit is actuarially reduced so that is the equivalent of $75,000 at age 55. Conversely, retirement benefits that commence after the participant reaches age 62 are actuarially increased.

The limit is also reduced by short duration of plan participation. For participants with 10 years of service or less, the limit on annual benefit is reduced by 10 percent for each year of plan participation less than 10.

Limit on a Combined Plan

Amounts contributed on behalf of an employee who participates in both a defined contribution plan and a defined benefit plan, when those plans are offered by the same employer, are also subject to limitation. The limitation is calculated by determining the sum of the defined benefit plan fraction and the defined contribution fraction, which may not exceed 1.0 (The defined benefit plan fraction is determined by dividing the projected annual benefit for the defined benefit plan by certain factors; and the defined contribution plan fraction is determined by dividing the annual additions to the participant's defined contribution account by the close of the year by certain factors. The sum of the resulting 2 fractions may not be greater than 1.0). Currently, there is no limit on employee's benefits from combined plans offered by more than one employer. If contributions are made to two or more plans for a self-employed individual or owner-employee, aggregate deductible amounts and limited to the lesser of $2,500 or 10 percent of earned income from all trades or businesses with respect to which plans are established.

Tax Sheltered Annuity Program

Certain tax-exempt organizations, including public schools, churches, and some organizations associated with churches, may make payments on behalf of an employee to purchase a tax-sheltered annuity contract. Also permitted are payments to a custodial account investing in stock of a regulated investment company (a mutual fund, for example).

Like contribution and benefit plans, employer contributions to tax sheltered annuity programs are subject to an overall limitation. Generally, tax sheltered annuity programs are defined contribution-type arrangements. As such, annual additions to tax sheltered annuity programs are limited to the lesser if $30,000, or 25 percent of the employee's annual compensation, paid by the employer.

A special "catch up" election is provided for certain lower paid employees, in order to increase the overall limit for the year of election. Catch up payments are included in the employee's income exclusion allowance, on account of prior years of service. However, they are not permitted with respect to the overall annual limit on additions to the plan ($30,000 or 25 percent of compensation for the year).

NEW FEDERAL LAW (Sec. 401, 402, 415, 416 & 4983)

Defined Benefit Plans

The normal retirement age under a defined benefit plan is raised from 62, to the social security retirement age (SSRA) which is currently age 65; however, it will be incrementally raised to age 67 over a twenty year period. Present law limits on annual benefits are retained: the lesser of $90,000, or 100 percent of compensation for the year. If, however, a participant retires before attaining the SSRA, the $90,000 limit must be actuarially reduced so that it is equivalent to $90,000 at SSRA.

The $90,000 limit is reduced by shortness of duration of service, rather than duration of plan participation. For participants with 10 years of service or less, the $90,000 limit on annual benefit is reduced by 10 percent for each year of service less than 10. It will never be less than $9,000 (10 percent of $90,000).

The reduction of the benefit limitation for retirement prior to reaching the SSRA, does not apply to airline pilots, police and firefighters, or participants in government and tax-exempt plans who retire early.

Phase in of maximum benefit limit

The maximum benefit limitation,phased in over 10 years, is also to be applied to any benefit increases of a qualified defined benefit plan as if such increase were a new plan. It is anticipated that regulations will be drafted to provide for the application of a concentration test under which this phase-in would not apply to a benefit increase, if the increase in benefits is not primarily for highly compensated employees, (i.e, update of compensation scales, cost of living increases for retirees, etc.)

Qualified Cost of Living Arrangements

The new law allows a defined benefit plan to maintain a qualified "cost of living arrangement" which permits a certain amount of employer and employee contributions to be applied toward providing cost-of-living increases to the primary benefit under the plan. Such an arrangement permits certain contributions to be designated as applying only toward the provision of increases in benefits, and not toward the provision of benefits themselves. Employee contributions under these arrangements are not treated as an annual addition in applying the separate limit on annual additions, but contributions to these arrangements are treated as an annual addition for purposes of applying the combined plan limitation of $112,500 (discussed in the section on combined plans). However, any benefit attributable to an employer contribution will be treated as a benefit derived from an employer contribution for purposes of the limitation on annual benefits.

Key employees may not participate in a qualified arrangement if the plan is a top heavy plan.

Defined Contribution Plans

Under prior federal law, the amount of nondeductible employee contributions taken into account as annual additions was limited to the lesser of 1/2 of the employee's total contributions, or total employee contributions in excess of 6 percent of compensation. Now, all employee contributions are included in the annual addition, as well as employer contributions and forfeitures.

Cost of Living Adjustments (COLA) to the defined contribution plan limit are temporarily suspended until the $30,000 limit is 25 percent of the defined benefit plan dollar limit ($120,000).

The COLA will be determined by reference to the Consumer Price Index, and will not be tied to the social security wage base.

Combined Plans

The overall limit on the amount of benefits received from any combination of tax favored plans by an individual is the greater of 125 percent of the defined benefit plan dollar limit or $112,500. If the participant receives a lump sum distribution subject to long term capital gains treatment, or subject to the 5 year averaging method, the overall $112,500 limit is raised. If the participant elects lump sum treatment, or long term capital gains treatment, the $112,500 limit is applied separately to the lump sum distribution and the limit is increased to 5 times the generally applicable limit ($562,500).

Any amount in excess of the overall limit is subject to a 15 percent excise tax.

Tax Sheltered Annuities

Employers that are health and welfare service agencies are included in the class of employers whose employees are entitled to the special catch-up election. The rules governing the catch-up election are clarified to emphasize that they apply before separation from service.

Includible Compensation

Under prior federal law, the limit on compensation that could be taken into account for SEP's and top heavy plans was limited to $200,000. This $200,000 limit is now extended to all qualified plans. The includible compensation limit will be adjusted for inflation in the same manner as the dollar limits on defined benefit plan benefits.

The $200,000 limit also applies for purposes of computing allowable deductions for employee's trust or annuity plans, and deferred compensation plans. The $200,000 limit applies as well for purposes of determining the qualified status of a plan.

For defined benefit plans, the $200,000 limit applies to each year's compensation (including years prior to 1987), not solely to the final average or career average compensation of an individual.

In the case of bona fide collective bargaining agreements, this provision applies to benefits accruing on or after the earlier of: (1) January 1, 1991, or (2) the later of: January 1, 1989, or the date the agreement ends. For benefits accruing from all other plans, the $200,000 limitation applies to benefits accruing in years beginning on or after January 1, 1989.

EFFECTIVE DATE OF FEDERAL PROVISIONS

These provisions are generally effective for plan years beginning on or after January 1, 1987. For distributions made on account of plan termination prior to January 1, 1987, the provisions will not apply to distributions made before January 1, 1988.

Effective Date Transition Rules

Plans subject to bona fide collective bargaining agreements that were ratified before March 1, 1986, do not have to apply the new limits on benefits and contributions until the last of those contracts terminates, or until January 1, 1989, whichever is earlier. This is without regard to contract extensions or amendments.

For participants in defined benefit pension plans that were in existence prior to May 6, 1986, the benefit that was accrued is not reduced merely because the dollar limits on benefits payable under the plan have been reduced, or because the period required to earn the maximum benefit has been increased. However, benefits that accrue in plan years beginning on or after January 1, 1987 are not protected by this transition rule.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The relative fiscal impact under state conformity is revenue gains in the $36 million range for 1987-88 and $39 million range for 1988-89. These revenue gains would occur under the personal Income Tax Law. The basis for the state estimates is the national estimates prepared by the Joint Committee on Taxation prorated to California by a 4.1 percent factor. This factor reflects the Policy Economic Groups (PEG) conformity estimates for California for those provisions analyzed relative to the nation. The PEG has not specifically estimated this provision.

ACTION: TIGHTEN REQUIREMENTS RELATING TO EMPLOYER DEDUCTIONS FOR CONTRIBUTIONS TO QUALIFIED PLANS

Act Section 1131 | Conference Report Page 479

Form 540 Line No. N/A | Form 100 Line No. 6-24

CURRENT CALIFORNIA LAW (Sec. 17501, 24601-24615)

California conforms to federal law as it applies to employer deductions to qualified plans. Such contributions are deductible in the year paid providing that they are either a necessary and ordinary business expense, or an expense for the production of income.

Certain overall limitations on the amounts contributed apply, depending upon whether or not the employee is also covered by another plan of the same employer, and upon the type of plan to which the contribution is made. While the contribution deduction for a given year may not exceed the overall limits on benefits or contributions, if a contribution exceeds the deduction limits, the excess may be carried forward and deducted in subsequent years.

Profit Sharing and Stock Bonus Plans

As it pertains to profit sharing and stock bonus plans, employer contributions are deductible for the year paid, to the extent that the contributions do not exceed 15 percent of the aggregate compensation of covered employees. In a given year, if employer contributions exceed the limitation, the excess amount may be carried over and deducted in subsequent years. Conversely, if a given year's contribution is less than the overall 15 percent limitation, the unused limitation percentage may be carried forward to subsequent years. However, the accumulated limitation percentage may not exceed 25 percent of the aggregate compensation of employees covered by the plan during that year.

Defined Benefit Pension Plans

Employer deductions for contributions to defined benefit pension plans are subject to a minimum funding requirement, and are limited to the largest of the following amounts: (1) the contribution amount that is necessary for meeting the minimum funding requirement for plan years ending with or within the taxable or income year; (2) the level amount or percentage of compensation that is required to cover the remaining unfunded present and past service credits for all employees under the plan for the duration of their future service (if however, the remaining unfunded cost attributable to any three persons is more than 50 percent of the total employee cost, then the cost attributable to each of the three employees must be spread over a period of five or more taxable years); or (3) an amount equal to the normal cost of the plan plus an additional amount necessary to amortize past service or certain other credits, if provided, in equal annual payments over a 10 year period. This rule permits contributions in excess of the amounts required by the minimum funding standard.

The minimum funding standard provides that an employer need not make additional contributions during a period when the plan is fully funded (the full funding limitation). This provision does not, however, prevent the employer from making contributions in excess of the full funding limitation. Such excess contributions are not deductible, but may be carried forward to subsequent years.

Other Pension Plans

Employer contributions to money purchase pension plans are generally deductible under the same provisions that apply to defined benefit plans. In this case, the amount required in order to meet the minimum funding standard is the contribution rate specified by the plan.

A combination of plans provided by an employer for an employee pension plan (such as defined benefit or money purchase plan), and a profit sharing or stock bonus plan for the same year is subject to a deduction limitation of the the greater of: (1) 25 percent of the aggregate compensation of employees covered by the plans for the year, or (2) the contribution amount necessary in order to meet the pension plan's minimum funding requirement. In the case of a combination of plans, deduction and limitation carryovers apply.

NEW FEDERAL LAW (Sec. 404(a)(3)(A), 404(a)(7))

The deduction limit carryforward is repealed, as it applies to profit sharing and stock bonus plans. The combined plan deduction limit is extended to a combination of defined benefit and defined contribution plans. A 10 percent nondeductible excise tax is imposed on employer contributions in excess of the deductible limits. The excise tax also applies to tax exempt employers making excess contributions to a qualified plan that would be nondeductible if the employer were not otherwise exempt. A limit of $200,000 is imposed on the amount of compensation that may be taken into account for the purpose of computing deductions for plan contributions. Fully insured plans are deemed equivalent to defined benefit plans for the purpose of the combined plan deduction limit. The annual premium payments in this case are considered to be the amounts required to meet the minimum funding requirement of a fully insured plan.

EFFECTIVE DATE OF FEDERAL PROVISIONS

These provisions are effective for taxable or income years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No specified national estimate was developed by the Joint Committee on Taxation for this particular provision indicating an insignificant impact for the nation. Any revenue gains that would occur under state conformity would be minor. The excise tax would probably not apply under state law.

Title XID3: Pensions and Deferred Compensation

ACTION: IMPOSE A NONDEDUCTIBLE EXCISE TAX UPON THE RECIPIENT OF ASSET REVERSIONS UNDER A QUALIFIED PLAN

Act Section 1132 | Conference Report Page 482

Form 540 Line No. 27 | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17501)

California conforms to federal law which requires that a qualified plan must be for the exclusive benefit of employees. Employers are prohibited from using the assets held under a qualified plan for any purposes other than for the exclusive benefit of the employees and their beneficiaries. However, assets remaining in a defined benefit plan after the termination of the plan (due to actuarial error) may revert to the employer after plan benefits accrued to the date of plan termination have been distributed. Assets received by the employer must be included in the employer's gross income.

NEW FEDERAL LAW (Sec. 4980)

A 10 percent nondeductible excise tax is imposed on the employer upon asset reversions from a qualified plan. Exempted from the excise tax are employers who have been continuously tax-exempt. Also, the excise tax does not apply to a return of mistaken contributions, nor does it apply to the portion of a reversion that is transferred, under certain circumstances, to an Employee Stock Ownership Plan (ESOP), or to amounts returned when covered by the Employee Retirement Income Security Act of 1974 (ERISA).

EFFECTIVE DATE OF FEDERAL PROVISIONS

Generally, the provision applies to reversion amounts received on or after January 1, 1986. However, if a reversion is received on or after January 1, 1986, but the termination date of the plan is before January 1, 1986, the reversion is excepted from the excise tax. Regarding transfers to an ESOP, the provision applies for (2) reversions occurring on or after January 1, 1986 and before January 1, 1989; and (2) reversions received wherein the termination of the plan occurred on or after January 1, 1986 and before January 1, 1989.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Since California does not normally impose an excise tax of this sort, a conformity estimate is not provided.

Title XIE1: Pensions and Deferred Compensation

ACTION: REMOVE EMPLOYER CONTRIBUTION LIMITATION APPLYING TO PROFIT SHARING OR STOCK BONUS PLANS

Act Section 1136 | Conference Report Page 485

Form 540 Line No. N/A | Form 100 Line No. G-24

CURRENT CALIFORNIA LAW (Sec. 17501)

California generally conforms to federal law regarding the level of employer contributions to a profit-sharing or stock bonus plan. Currently, the amount that an employer contributes may vary from year to year, at his or her discretion. However, this discretionary contribution is limited by the requirement that it may not exceed the employer's current accumulated profits.

NEW FEDERAL LAW (Sec. 401)

Employer contributions to profit-sharing or stock bonus plans are not limited to the employer's current or accumulated profits.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Effective for years beginning on or after January 1, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No specific national estimate was developed by the Joint Committee on Taxation for this particular provision indicating a very minor or negligible impact for the nation. Any revenue impact that would occur under the Personal Income Tax Law from conformity would be negligible.

Title XIE2: Pensions and Deferred Compensation

ACTION: REQUIRE THAT COLLECTIVE BARGAINING AGREEMENTS BE BONA FIDE

Act Section 1137 Conference Report Page 485

Form 540 Line No. N/A Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17020.7)

California conforms to federal law with respect to effective dates and nondiscrimination standards as they apply to plans or programs instituted under the auspices of a collective bargaining agreement. Currently, many of these dates and standards apply separately (or do not apply at all) to plans that are held to be the result of a collective bargaining agreement, where retirement benefits were the subject of good faith bargaining between employee representatives and the employer. Plans determined to be the result of collective bargaining agreements are often subject to delays in instituting effective dates, while certain employee benefits are excluded from some of the nondiscrimination standards that apply to other qualified plans. Current law provides no comprehensive definition of a collective bargaining agreement.

NEW FEDERAL LAW (Sec. 7701)

Federal law is clarified by providing that no agreement will be treated as a collective bargaining agreement unless it is undertaken as a bona fide agreement, entered into by bona fide employee representatives and one or more employers.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective on October 22, 1986. However, because this provision is a clarification of present law, it is the intent of the committee that this provision be given retroactive affect where applicable.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

There is no apparent revenue effect under Personal Income Tax Law from this collective bargaining clarification.

Title XIE3: Pensions and Deferred Compensation

ACTION: TREAT CERTAIN FISHERMEN AS SELF-EMPLOYED

Act Section 1143 | Conference Report 486

Form 540 Line No. 20 | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 621 - Unemployment Insurance Code)

California conforms to federal law, which provides special rules for treating commercial fishermen as self employed for purposes of employment taxes. However, commercial fishermen are treated as employees for the purpose of determining whether a pension, profit-sharing, or stock bonus plan is a qualified plan.

NEW FEDERAL LAW (Sec. 401)

Members of fishing boat crews are treated as self employed for the purpose of determining whether a pension, profit-sharing, or stock bonus plan is qualified.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective for taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No specific national estimate was developed by the Joint Committee on Taxation for this particular provision, indicating a very minor or negligible impact for the nation. Any state revenue effect that would occur under conformity would be negligible.

ACTION: <u>MODIFY INTEREST RATE REQUIRED TO BE USED TO DETERMINE PRESENT VALUE OF CERTAIN ACCRUED BENEFITS</u>

Act Section 1139	Conference Report Page 487
Form 540 Line No. 20	Form 100 Line No. N/A

<u>CURRENT CALIFORNIA LAW (Sec. 17501)</u>

California generally conforms to federal law regarding requirements for determining the present value of an employee's accrued benefits, qualified pre-retirement survivor annuity, or qualified joint and survivor annuity. When the present value of a participant's accrued benefit exceeds $3,500, the pension, profit-sharing, or stock bonus plan is prohibited from immediately disbursing any portion of the amount upon the employee's separation from service, without his or her consent. Amounts of $3,500 or less may be cashed out without obtaining the participant's consent.

Plans that are subject to the automatic survivor benefit requirements must obtain the approval of the participant and the participant's spouse in order to make immediate distribution of any portion of accrued benefits where present value is in excess of $3,500. In the case where the participant is deceased, the consent of the surviving spouse is required.

The interest rate that is used to calculate the present value of a lump sum distribution may not exceed the interest rate that would be used by the Pension Benefit Guaranty Corporation (PBGC) as of the date of distribution. The PBGC rate that is in effect at the beginning of a plan year may be used throughout the remainder of the year if the plan so provides.

<u>NEW FEDERAL LAW (Sec. 411, 417)</u>

For purposes of determining whether: (1) a participant's accrued benefit can be cashed out without the participant's consent because the present value of the vested benefit is less than $3,500, and (2) the present value of a participant's vested accrued benefit is less than $25,000; a plan is required to use an interest rate that would be used by the PBGC (as of the date of distribution) upon the plan's termination.

When the present value of the vested accrued benefit is $25,000 or less the amount to be distributed to the participant is to be calculated by using the PBGC rate. The interest rate used by the

PBGC at the beginning of the plan year may be used throughout the plan year. When present value of accrued benefits exceeds $25,000 the amount to be distributed to the participant is to be calculated by using an interest rate no greater than 120 percent of the deferred or immediate interest rate (whichever is appropriate) that would be used by the PBGC (as of the distribution date) upon termination of the plan. However, in no case is the amount to be distributed to be less than $25,000 when the 120 percent rule is used.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is generally effective for distributions for plan years beginning on or after January 1, 1985. However, this provision does not apply to distributions beginning after December 31, 1984 and before January 1, 1986, which were made in accordance with temporary regulations issued under the Retirement Act of 1984.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No specific national estimate was developed by the Joint Committee on Taxation for this particular provision, indicating a very minor or negligible impact for the nation. Any revenue impact that would occur under the Personal Income Tax Law from conformity would be negligible.

ACTION: <u>ESTABLISH TIMEFRAMES REQUIRED FOR PLAN AMENDMENTS, ISSUANCE OF REGULATIONS, AND DEVELOPMENT OF CASH OR DEFERRED ARRANGEMENT (SECTION 401K) MODEL PLANS</u>

Act Section 1140-1142 Conference Report Page 489

Form 540 Line No. N/A Form 100 Line No. N/A

<u>CURRENT CALIFORNIA LAW (Sec. 17501)</u>

California conforms to federal law regarding changes made to plan qualification provisions. Under present law, if a pension, profit-sharing, or stock bonus plan is qualified, it must satisfy certain specific requirements, and the plan must comply with these requirements in operation as well as form. If changes in the qualification requirements are made in the tax laws, the conforming plan amendments must be adopted no later than the last day of the first plan year to which the change applies; and the amendment must be effective, for all purposes, no later than the first day of that plan year.

<u>NEW FEDERAL LAW (Sec. 401)</u>

Changes in the qualification requirements of pension, profit-sharing, and stock bonus plans resulting from enactment of the Tax Reform Act of 1986 will not affect the qualified status of a plan, or require the plan amendment to be made prior to the first plan year beginning on or after January 1, 1989, providing: (1) the plan complies in operation with the required changes as of the effective date (generally, years beginning on or after January 1, 1987), (2) the plan is amended to comply with the required changes no later than the last day of the first plan year that commences on or after January 1, 1989, and (3) the amendment is effective retroactively to the applicable effective date.

This provision allows for delay of effective dates for certain collectively bargained plans. Such collectively bargained plans to which the delayed effective dates apply will not fail to be qualified for any year beginning before the later of: (1) January 1, 1989, or (2) the earlier of (a) January 1, 1991, or (b) the first plan year beginning after the termination of the collective bargaining agreement.

The Secretary of the Treasury is required to issue final regulations covering certain qualified plan provisions by February 1, 1988. These provisions are: (1) rules covering the integration of benefits (plan benefits considered in conjunction with social security benefits), (2) the coverage requirements for qualified plans, (3) nondiscrimination requirements applicable to tax sheltered annuity programs, (4) the definitions of highly compensated employees, and the 10 percent excise tax on excess distributions; (5) separate lines of business and definition of compensation, (6) the minimum vesting standards, (7) amendments applicable to qualified cash or deferred arrangements, and (8) the non-discrimination rules for employer matching and employee contributions.

The Internal Revenue Service is required to begin issuing opinion letters by May 1, 1987 regarding master and prototype plans for cash or deferred arrangements, and is required to begin accepting opinion letter requests by May 1, 1987 relating to model plans for cash or deferred arrangements.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provisions affecting opinion letters and regulations are effective as of October 22, 1986. The effective dates for required plan amendments are discussed above.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No specific national estimate was developed by the Joint Committee on Taxation for this particular provision, indicating a very minor or negligible impact for the nation. Any state revenue impact that would occur from conformity would be negligible.

Title XIE6: Pensions and Deferred Compensation

ACTION: PROVIDE A PENALTY FOR OVERSTATEMENT OF PENSION LIABILITIES

Act Section 1138 Conference Report Page 491

Form 540 Line No. N/A Form 100 Line No. G-24

CURRENT CALIFORNIA LAW (Sec. 17501)

California law generally conforms to federal law which provides for a limited employer deduction for contributions to a trust that is part of a qualified plan, or to plans funded with annuity contracts.

Under present law, there is no provision for imposition of a penalty when it is determined that the actuarial assumptions used to determine the employer deduction are unreasonable. In this event, the limit on employer deductions is recalculated using reasonable assumptions and the excess deduction is denied.

NEW FEDERAL LAW (Sec. 6659A)

The act provides for assessment of a penalty an addition to tax, for overstatement of the deduction for pension liabilities. As an addition to tax, the penalty is to be assessed, collected, and paid in the same manner as the tax.

The following percentages are to be used to determine the penalty when there is an overstatement of deductions for pension liabilities:

If the valuation claimed is the following percentage of the correct valuation:	The applicable percentage is:
Less than 150 percent	0
150 percent or more, but not more than 200 percent	10
More than 200 percent, but not more than 250 percent	20
More than 250 percent	30

If the underpayment attributable to pension liability overstatement is less than $1,000 for a taxable year, the penalty shall not apply. Additionally, at the Treasury Secretary's discretion, all or part of the penalty may be waived if the taxpayer demonstrates that the deduction was claimed in good faith, and that there was a reasonable basis for the claim. Reliance by the employer upon an enrolled actuary or other professional in the determination of the proper deduction amount will not constitute grounds for a good faith claim by the employer.

EFFECTIVE DATE OF FEDERAL PROVISIONS

For valuation overstatements occurring on or after October 22, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No specific national estimate was developed by the Joint Committee on Taxation for this provision, indicating a very minor or negligible impact for the nation. Any additional penalty collections that would occur under conformity would be minor.

Title XIE7: Pensions and Deferred Compensation

ACTION: CHANGE EFFECTIVE DATE OF A PROVISION OF THE RETIREMENT EQUITY ACT OF 1984

Act Section 1145 — Conference Report Page 493

Form 540 Line No. 20 — Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec.17501)

California generally conforms to federal law, which provides that a pension plan is to extend automatic survivor benefits (1) in the form of a qualified joint and survivor annuity, where the participant retires under the plan, and (2) in the form of a qualified preretirement survivor annuity benefitting the surviving spouse of a vested participant who dies prior to the annuity starting date. These provisions, as part of the Retirement Equity Act of 1984 (REA) apply to any participant who performs at least one hour of service under the plan, on or after the REA's enactment date.

For participants who separate from service prior to the date of enactment, and whose benefits were not in pay status, REA provides a special transition rule. This rule covers participants who: (1) completed a minimum of one hour's service under the plan after September 1, 1974, (2) separated from service prior to the first day of the plan year beginning on or after January 1, 1976, and (3) are covered by plans required to provide a qualified joint and survivor annuity. This special rule permits the participant to elect to receive benefits in the form of a qualified joint and survivor annuity.

NEW FEDERAL LAW (Sec. 401, 404)

A plan is exempt from the REA survivor benefit requirements if (1) under the plan, participation is substantially limited to participants who ceased employment covered by the plan prior to January 1, 1976, and (2) the plan was established before January 1, 1954 as a result of an agreement between employee representatives and the federal government during a period of government operation, under seizure powers, of a major part of the industry's productive facilities.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective as of October 22, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No specific national estimate was developed by the Joint Committee on Taxation for the provision, indicating a very minor or negligible impact for the nation. Any state revenue impact that would occur under conformity would be minor.

Title XIE8: Pensions and Deferred Compensation

ACTION: MODIFY EMPLOYEE LEASING RULES

Act Section 1146 Conference Report Page 494

Form 540 Line No. N/A Form 100 Line No. G-24

CURRENT CALIFORNIA LAW (Sec. 17501)

California conforms to federal law regarding the provision of pension benefits to leased employees. A leased employee is any person who is not an employee of the recipient and who provides services to the recipient while meeting three requirements. (1) The services must be provided to the recipient through an agreement between the recipient and the leasing organization (the organization providing the services of the leased employee). (2) The leased employee must have provided the services to the recipient on a substantially fulltime basis for a period of at least one year. (3) The services provided by the leased employee must be of a type historically performed in the recipient's field of business, by employees. The pension requirements relating to leased employees treated as employees of the recipient are, in general, the rules covering nondiscrimination, vesting, benefit and contribution limitations, top heavy plans, and simplified employee pensions (SEP's).

When a leased employee is covered by a safe harbor plan through the leasing organization he or she is not treated as an employee of the recipient. A safe harbor plan is a money purchase pension plan that provides for immediate participation, and full and immediate vesting. A safe harbor plan must have a nonintegrated contribution rate of at least 7 1/2 percent.

NEW FEDERAL LAW (Sec. 444)

The coverage provided under a safe harbor plan is modified by raising the required contribution rate from 7 1/2 percent to 10 percent. To qualify as a safe harbor the plan must also cover all employees of the leasing organization other than (1) employees who substantially performed all of their services for the leasing organization rather than the recipient, and (2) employees whose total compensation from the leasing organization is less than $1,000 during the plan year, and during each of the three prior plan years.

With respect to the 10 percent contribution rate, and the $1,000 rule, compensation is defined as having the same meaning used for purposes of the limitation on benefits and contributions (IRC Sec. 415), and additionally, elective deferrals under a qualified cash or deferred arrangement (CODA's), simplified employee pension plan SEP, tax sheltered annuity program, or elective contributions under a cafeteria plan are to be added to compensation amounts.

Retained by the act is the provision from prior law, which requires that an employee covered under a safe harbor plan is to receive the mandatory allocation regardless of: (1) the number of hours of service credited to the employee for the year, (2) whether he or she is employed by the leasing organization on any specified date during the year, and (3) the participant's age.

Under the act, each leased employee is to be treated as an employee of the recipient, regardless of the existence of a safe harbor plan, when more than 20 percent of an employee's nonhighly compensated workforce are leased employees. A "nonhighly compensated workforce" consists of the number of persons (other than highly compensated employees) who are: (1) employees of the recipient, other than leased employee, who have performed services for the recipient on a substantially full time basis for a period of at least one year, and (2) leased employees with respect to the recipient. "Leased employee" includes any person who performs services for the recipient as both an employee and a nonemployee, and who would be a leased employee if all such services were performed as a nonemployee.

The employee leasing rules are also applied to certain employee benefit requirements. Leasing organizations that maintain safe harbor plans are normally exempted from treating leased employees as employees of the recipient, however this exemption does not apply to employee benefits. Regarding core health benefits, the normal period during which an employee must perform services on a substantially full-time basis is lowered from one year to six months.

EFFECTIVE DATE OF FEDERAL PROVISIONS

These provisions are generally effective for services performed on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Joint Committee on Taxation estimates revenue gains for the nation of less than $5 million annually. Based on this projected low level of impact for the nation, conformity would result in minor revenue gains annually not exceeding $200,000.

Title XIE9: Pensions and Deferred Compensation

ACTION: CLARIFY THE TAX TREATMENT OF EMPLOYEE'S CONTRIBUTIONS TO THE FEDERALLY MAINTAINED THRIFT SAVINGS PLAN

Act Section 1147	Conference Report Page 497
Form 540 Line No. 27	Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17501, 17631)

California generally conforms to federal law, which provides that income is not subject to tax until it is received. Thus, compensation that is deferred is not taxed until it is distributed to the employee.

PRIOR FEDERAL LAW (Sec. 401, 501)

Under federal law both preceding and subsequent to the passage of the 1986 Act, an employee is allowed to contribute up to 10 percent of his or her rate of basic pay to the federally maintained Thrift Savings Plan, beginning in 1987. These employee contributions are to be included in employees income when they are distributed from the plan, not in the year in which the deferral occurs. However, this intended tax treatment was not specifically referred to in the Internal Revenue Code prior to the passage of the 1986 Act.

NEW FEDERAL LAW (Sec. 7701(j))

The act clarifies the tax treatment of compensation deferred to the Thrift Savings Plan maintained by the Federal government. An employee's contribution is not treated as made available (and thus to be included in income) merely because the employee had an election to receive the amounts in cash. This provision emphasizes that amounts deferred are not includible in an employee's income until they are distributed.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective October 22, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

There is no apparent impact on revenues from this codification of current tax treatment.

Title XIF1: Pensions and Deferred Compensation

ACTION: <u>ESTABLISHES COMPREHENSIVE NONDISCRIMINATION RULES FOR CERTAIN EMPLOYEE BENEFIT PLANS</u>

Act Section 1151 & 1114 Conference Report Page 498

Form 540 Line No. 12 Form 100 Line No. 6-25

<u>CURRENT CALIFORNIA LAW (Sec. 17081, 17131, 17151, 17631, 17641, 23701, 23701q, & 23705)</u>

California has conformed to federal law regarding specific income exclusions for specific benefits provided by an employer to employees. These benefits are (1) prepaid legal services, (2) employer provided transportation, (3) employee education assistance and (4) dependent care assistance. The exclusion from income of employees is allowed only if the employer-provided benefit is provided on a nondiscriminatory basis. Each employee benefit is not available unless nondiscrimination rules are met. This prevents the benefits from favoring certain categories of employees who are officers, owners, or highly compensated.

Currently separate nondiscrimination rules apply with respect to each of the following:

Health benefit plans

Group-term life insurance plans,

Group legal service plans,

Educational assistance plans,

Dependent care assistance programs,

Welfare benefit plans,

Cafeteria plans.

<u>NEW FEDERAL LAW (Sec. 79, 89, 117, 120, 125, 129, 414, 6039, & 6652)</u>

The act provides strict nondiscrimination rules to ensure consistent and uniform treatment of all employee benefits. Comprehensive nondiscrimination rules have been established for the following statutory fringe benefit plans:

Group term life insurance plans; and

Accident or health plans.

Group legal service plans, educational assistance programs and dependent care assistance programs will be considered as statutory employee benefit plans, subject to the nondiscrimination rules, only if an employer elects to treat them as such. The statutory employee benefit plan will be considered nondiscriminatory if both the nondiscrimination eligibility test and nondiscriminatory benefit test are met.

Eligibility Test

The three part nondiscrimination eligibility test for statutory fringe benefit plans is to be applied in the following order:

(1) The 50 percent eligibility test;

(2) The 90 percent/50 percent eligibility test; and

(3) The benefits test.

To meet the 50 percent eligibility test, at least 50 percent of the employees eligible to participate in the plan must be nonhighly compensated employees.

To meet the 90 percent/50 percent eligibility test, 90 percent of the employer's nonhighly compensated employees must be eligible for a benefit that is at least 50 percent as valuable as the benefit available to the highly compensated employees to whom the most valuable benefits are made available.

To meet the nondiscrimination benefits test, the average employer- provided benefit received by nonhighly compensated employees under all plans of the employer of the same type must be at least 75 percent of the average such benefit received by highly compensated employees.

Alternate Test

For health plans and group term life insurance plans there is a special rule which specifies that if at least 80 percent of nonhighly compensated employees are covered during the plan year the plan meets the nondiscriminatory eligibility test and benefit test.

Aggregation of Comparable Health Plans:

An employer may treat a group of comparable health plans as one plan for purposes of applying the eligibility test and the alternative nondiscrimination test. A group of comparable plans is any group of plans of the same type selected by the employer if the smallest employer provided benefit available to any participant is at least 95 percent of the largest employer provided benefit available to any participant in any such plan.

Special Rules for Family Coverage:

For purposes of the benefits test an employer may elect to disregard any employee from accident or health plan coverage if the employee, the employee's spouse and dependent are covered by a health plan that provides core benefits and is maintained by another employer. Any employer who uses the above election must obtain sworn statements, in accordance with rules prescribed by the Internal Revenue Service, attesting that the employee has a spouse or dependents and the core health benefits under a plan of another employer.

A highly compensated employee may not be disregarded under this exception if the coverage provided to her/him is valued at more than 33 1/3 percent higher than the average benefit provided to nonhighly compensated employees. If family coverage is tested separately, the family of a highly compensated employee may not be disregarded if the coverage provided to the family is valued at over 33 1/3 percent higher than the coverage provided to families of nonhighly compensated employees.

Highly Compensated Employees

An employee is considered highly compensated if at any time during the year or the preceding year, the employee:

(1) Was a five percent owner of the business;

(2) Earned more than $75,000 in annual compensation from the employer;

(3) Earned more than $50,000 in annual compensation from the employer and was a member of the top paid group of the employer during the same year; or

(4) Certain company officers.

Excludable Employees

Employees which may be excluded from consideration when applying the nondiscrimination rules are:

1. Employees who have not completed one year of service (six months for core benefits under a health plan) or a shorter period as may be specified in the plan. An employee will be excluded from consideration until the first day of the first month following completion of the required service.

2. Employees who normally work less than 17 1/2 hours per week (or fewer hours as may be specified in the plan).

3. Employees who normally work no more than six months during any year (or a shorter period may be specified in the plan).

4. Employees who are included in a unit of employees covered by a collective bargaining agreement between employee representatives and one or more employers and the type of benefits provided under the plan was the subject of good faith bargaining as determined by the Internal Revenue Service.

5. Employees who have ;not reached age 21 (or an earlier age as may be specified in the plan).

6. Employees who are nonresident alien and who received no earned income from the employer that constitutes income from sources within the United States.

Cafeteria Plan:

The definition of cafeteria plan has been modified to include a plan under which an employee may only choose among qualified benefits and may not choose cash or a taxable benefit, as well as a plan under which an employee may choose between cash and one or more employee benefits. A plan that provides for deferred compensation is not included in the definition of a cafeteria plan, except a profit sharing or stock bonus plan that includes a qualified cash or deferred plan or a retirement plan of an educational institution. Cafeteria plans must satisfy the eligibility or concentration test and the benefits test.

Line of Business Exception:

If an employer establishes to the satisfaction of the Internal Revenue Service that separate lines of business or operating units are operated for bona fide business reasons, the employer may apply the nondiscrimination tests separately to employees in each line of business or operating unit. The line of business exception will not apply unless the plan is available to a group of employees who qualify under a classification set up by the employer and found not to be discriminatory in favor of highly compensated employees. The Internal Revenue Service has the final determination whether a business will be treated as a separate line of business.

Employer Notification Requirement

An employer is required to provide employees with notification of any amounts which are to be included in the employees' gross income.

If any employer does not report the discriminatory excess to the affected employees and the Internal Revenue Service on Forms W-2 on or before the due date, the employer is subject to penalty whether or not the employees report some or all of the benefits as income. The penalty the employer is liable for is an excise tax equal to the highest individual tax rate for the year in question multiplied by the amount of the total value of employer provided benefit for the affected employees for the same type of benefit. This tax is not deductible and may not be offset by credits or deductions in any manner. However, if the employer can demonstrate the failure to report was due to reasonable cause the penalty will not be assessed.

Inclusion in Income of Employee Benefits

Employer provided benefits must be included in an employee's gross income unless the plan meets five conditions:

(1) The plan must be in writing.

(2) The plan must provide employees with reasonable notification of benefits available under the plan. For dependent care assistance plans, the notification must include a description of the dependent care credit and circumstances under which the credit is more advantageous than the exclusion.

(3) The plan must be maintained for the exclusive benefit of employees or spouses and dependents of employees where permissible.

(4) The employee's rights under the plan must be legally enforceable. If a plan is discretionary with an employer it will usually be considered to be not legally enforceable.

(5) The employer must have intended to maintain the plan indefinitely when it was established.

Plans, in addition to the statutory employee benefit plans, which are required to meet the these five condition are: qualified tuition reduction programs: cafeteria plans; fringe benefit programs providing no additional cost services, qualified employee discounts or employer-operated eating facilities which are excludable from gross income; plans of voluntary employees' associations for payment of accident or other benefits, trusts for unemployment compensation benefits; and trusts formed for qualified group legal service plans.

If a plan does not meet these conditions, the value of the employer provided benefit (which is to be included in income) will be the value of the benefits provided rather than the value of the coverage under the plan.

Employee benefits that favor key or highly compensated employees must have the discriminatory excess included in the key or highly compensated employees' gross income in the employees' taxable year or the year within which the plan year ends. The discriminatory excess is determined by reducing the tax-favored dollars of highly compensated employees (beginning with employees with the greatest nontaxable benefits) until the plan (or plans) being taxed would not be discriminatory.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The effective date for nondiscrimination rules is the later of:

(1) Plan years beginning after 1987, or

(2) Plan years beginning at least three months following the issuance of Internal Revenue Service regulations, or after 1988, whichever is earlier.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement. For employees covered under a plan maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers ratified before March 1, 1986, the new law does apply to employees covered by the agreement in years beginning before the earlier of January 1, 1991, or the date on which the last of the collective bargaining agreements terminates.

The effective date for a church plan that maintains an insured accident or health plan is January 1, 1989.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The relative fiscal impact under state conformity is revenue gains in the $3 million range for 19877-88 and in the $5 million range for 1988-89. These revenue gains from various strict nondiscrimination rules would occur ;under the Personal Income Tax law. The basis for the state estimate is the national estimates prepared by the Joint Committee on Taxation prorated to California by a 4.1 percent factor. This factor reflects the Policy Economic Group (PEG) conformity estimates for California on those provisions analyzed relative to the nation. The PEG has not specifically estimated this provision.

Title XIF2: Pensions and Deferred Compensation

ACTION: ALLOWS A NEW DEDUCTION FOR HEALTH INSURANCE COSTS OF SELF-EMPLOYED INDIVIDUALS IN COMPUTING ADJUSTED GROSS INCOME

Act Section 1161 — Conference Report Page 538

Form 540 Line No. 16 — Form 100 Line No. G-24

CURRENT CALIFORNIA LAW (Sec. 17201 & 17210)

California is conformed to federal law which allows a corporate employer's contribution to a plan providing accident or health benefits for employees to be excluded from the employee's gross income. However, a self employed individual is not allowed a similar exclusion for amounts paid for accident or health insurance for themselves and their dependents and must treat those payments as medical care expenses . Medical expenses are deductible only to the extent that they exceed 5 percent of the taxpayer's federal adjusted gross income.

NEW FEDERAL LAW (Sec. 162)

This act provides for a deduction from gross income for 25 percent of the amounts paid for health insurance for a taxable year on behalf of a self employed individual, the individual's spouse and dependents. A self employed individual means an individual who has earned income which meets the requirements of the definitions and rules relating to self employed individuals and owner employees. Under the act, no deduction is allowable to the extent the deduction exceeds the self employed individual's earned income from self employment. Additionally, no deduction is allowable to any taxpayer who is eligible to participate in any subsidized health plan maintained by an employer of the taxpayer or of the spouse of the taxpayer. The deduction is allowed only if the coverage is provided under one or more plans meeting the applicable nondiscrimination requirements, as if the coverage were employer provided. Any amount paid by a taxpayer for self employed health insurance cannot be taken as a deduction for medical or dental expenses.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision of the act applies to taxable years beginning on or after January 1, 1987 and sunsets December 31, 1989.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The relative fiscal impact, under the Personal Income Tax Law if California conformed to this provision allowing a deduction for health insurance costs by self-employed individuals, is revenue losses in the $8 million range for fiscal year 1987-88 and $9 million in fiscal year 1988-89. This estimate is based on the national estimates prepared by the Joint Committee on Taxation prorated to California by a 4.1 percent factor. This factor reflects the Policy Economic Group's (PEG) conformity estimate for California on those provisions analyzed relative to the nation. The PEG has not specifically estimated this provision.

Title XIF3: Pensions and Deferred Compensation

ACTION: EXTENDS THE EXCLUSION FOR EDUCATIONAL ASSISTANCE PROGRAMS, QUALIFIED GROUP LEGAL PLANS AND LIMITS DEPENDENT CARE ASSISTANCE PROGRAMS

Act Section 1162 & 1163	Conference Report Page 539
Form 540 Line No. 12	Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17131, 17151, and 23701q)

California law has conformed to federal law regarding the exclusion from income for educational assistance, group legal services and dependent care assistance programs.

Educational Assistance

An employee is required to include in income the value of educational assistance provided to the employee by an employer, unless the cost of the assistance qualified as a deductible job related expense of the employee. Under prior law, which sunsetted December 31,1985, the maximum amount of educational assistance an employee could receive tax-free in any taxable year was $5000.

Group Legal Services

Under prior law which sunsetted December 31, 1985 amounts contributed by an employer to a qualified legal services plan for employees or their families were excluded from gross income. This exclusion also applied to any services received by an employee or any amounts paid to an employee under a plan as reimbursement for employees or their families for the cost of legal services.

Additionally, an organization whose exclusive function was to provide legal services or indemnification against costs of legal services as part of a qualified group legal services plan was entitled to tax exempt status.

Dependent Care Assistance Programs

Under current law amounts paid or incurred by an employer for dependent care assistance provided to an employee through a dependent care assistance program are excludable from income. The amount excludable is limited to the employee's earned income for the year or, for married couples, the lesser of the employee's earned income or the earned income of the employee's spouse. A dependent care assistance program must be a written plan for the exclusive benefit of employees, must not discriminate in favor of employees who are officers, shareholders or highly compensated and meet other requirements.

NEW FEDERAL LAW (Sec. 120, 127 &129)

The new federal law extends for two years (1986 and 1987) the educational assistance and group legal assistance exclusions and the tax exempt status of group legal services organizations. Additionally the new federal law increases the cap on annual excludable educational assistance benefits from $5,000 to $5,250. A transition rule for group legal services benefits provided under a cafeteria plan provides that an employee is permitted to revoke an election to take cash or a qualified benefit other than group legal services and make a new election to take group legal services. The revocation and new election must be make no later than 60 days after the date of this law's enactment, October 22, 1986, and may relate to any period after December 31, 1985. This transition rule is limited to cafeteria plans that prior to August 16, 1986, did not allow employees to elect group legal service benefits with respect to a period after December 31, 1985.

The new federal law limits the employee's exclusion for dependent care assistance programs to $5,000 a year ($2,500 for married filing separately). Also, for on-site facilities the amount excluded with respect to any dependent must be based on actual utilization and the value of the services provided.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The educational assistance and group legal assistance provisions had sunsetted December 31, 1985, and the new federal law extends the sunset date to December 31, 1987.

The effective date of imposing the limits on dependent care assistance programs is for taxable years beginning after December 31, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Educational Assistance and Group Legal Services

The 1987-88 relative fiscal impact under state conformity for educational assistance is revenue losses in the $3 million range and also losses in the $3 million range for group legal services. These revenue losses would occur under the Personal Income Tax Law (PITL). The basis for the state estimates is the national estimates prepared by the Joint Committee on Taxation (JCT) prorated to California by a 4.1 percent factor. This factor reflects the Policy Economic Group (PEG) conformity estimate for California on this provision relative to the nation for those provisions analyzed. The PEG has not specifically estimated this provision.

Dependent Care Assistance Program

The JCT estimates revenue gains for the nation of less than $5 million annually. Based on this projected low level of impact for the nation, conformity would result in minor revenue gains of probably less than $200,000 under the PITL.

This effect results from smaller employee exclusions for dependent care assistance paid by employers.

ACTION: TREATS FULL-TIME INSURANCE SALESPERSONS AS EMPLOYEES FOR CAFETERIA PLANS

Act Section 1166	Conference Report Page 542
Form 540 Line No. 12	Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17027)

California law conforms in substance to federal law, the exception being the effective date for California law. The law provides that for purposes of providing certain employee benefits a full time insurance salesperson qualifies as as an employee if the person is considered an employee for the Federal Insurance Contributions Act, or in the case of services performed before January 1, 1953, for California (January 1, 1951 for federal purposes), who would have been considered an employee if his or her services were performed during 1953 (1951).

The substance of the law is that a full time insurance salesperson is treated as an employee for the following employee benefit exclusions, (1) compensation for injuries or sickness, (2) amounts received under accident or health plans and (3) contributions by an employer to accident and health plans. However, even if the salesperson is eligible to receive benefits provided under a cafeteria plan, he or she is not treated as an employee for purposes of cafeteria plan provisions.

NEW FEDERAL LAW (Sec. 7701 (a)(20))

Adds a provision to the law so that a full time insurance salesperson is treated as an employee for purposes of eligibility for cafeteria plan provisions.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The new federal law applies for years beginning after December 31, 1985.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No specific national estimate was made by the Joint Committee on Taxation (JCT) for this particular item indicating a very minor (less than $5 million) impact for the nation. Revenue losses that would occur under state conformity would be very minor, less than $200,000 annually on a comparable basis.

Title XIF6: Pensions and Deferred Compensation

ACTION: ALLOWS FOR POST-RETIREMENT GROUP TERM LIFE INSURANCE UNDER A CAFETERIA PLAN FOR EMPLOYEES OF QUALIFIED EDUCATIONAL INSTITUTIONS

Act Section 1151(d) | Conference Report Page 543

Form 540 Line No. 12 | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17131)

Current California law conforms to federal law.

Under current law the cost of permanent benefits under a life insurance policy provided by an employer to an employee is includible in income. A permanent benefit is a benefit with an economic value extending beyond a policy year, such as a paid-up policy for future years.

No amount is includible in the gross income of a participant in a cafeteria plan meeting certain requirements solely because, under the plan, the participant may choose among the benefits. Except with respect to elective contributions under a qualified cash or deferred arrangement, the term "cafeteria plan" does not include any plan which provides for deferred compensation.

NEW FEDERAL LAW (Sec. 125(c)(2)(C))

Under the new federal law with respect to employees of educational institutions a cafeteria plan may allow participants to choose among cash, qualified benefits or post-retirement group life insurance coverage. All contributions for the insurance would have to be made before retirement and have no cash surrender value at any time prior to retirement from the service of the employer. Additionally, the coverage must be treated as term insurance for purposes of the exclusion for group-term life insurance.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The new federal law is effective beginning after the later of December 31, 1987 or the earlier of the date on which is three months after the date the Internal Revenue Service issues regulations necessary to carry out the new nondiscrimination provisions, or December 31, 1988.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Joint Committee on Taxation did not make a specific estimate for this particular item, indicating a very minor or negligible impact for the nation. The impact of California conformity, therefore, is that any revenue losses that would occur would be negligible.

Title XIF7: Pensions and Deferred Compensation

ACTION: CODIFIES THE TAX TREATMENT OF QUALIFIED CAMPUS HOUSING BY ESTABLISHING A STATUTORY MAXIMUM RENTAL VALUE

Act Section 1164 | Conference Report Page 544

Form 540 Line No. 12 | Form 100 Line No. N/A

BACKGROUND

Several federal court decisions have held that on-campus housing furnished to faculty or other employees by an educational institution at below fair-market value does not qualify for exclusion from income under Section 119 of the IRC, relating to meals and lodging for the convenience of the employer. However, the Deficit Reduction Act of 1984 (P.L. 98-369) prohibited the Treasury Department from issuing, prior to January 1, 1986, any income tax regulations that would provide for inclusion in gross income of qualified campus housing. This moratorium applies only to lodging furnished after December 31, 1983 and before January 1, 1986.

The purpose of the moratorium was to allow further time for consideration of arguments by schools and universities that special tax rules governing treatment of housing furnished their employees should be provided by statute.

Qualified campus lodging is lodging located on or near the campus of an educational institution that is provided to an employee of the institution or spouse or dependent of the employee.

CURRENT CALIFORNIA LAW (Sec. 17131)

California is conformed to federal law and regulations relating to meals or lodging furnished for the convenience of the employer. However, since the moratorium prevented changes to the federal regulations and California has not adopted separate regulations dealing with the excludability of qualified campus lodging, federal case law would be applied for California purposes. This means that the difference between the amount paid for the lodging and the fair-market value of the rental would be included in the gross income of the faculty member or other employee for California purposes.

NEW FEDERAL LAW (Sec. 119)

Generally, gross income will not include the value of qualified campus lodging. However, the value of the housing will be included in income to the extent the actual rent paid is the lesser of: (1) five percent (annualized) of the appraised value of the lodging; or (2) the average rents paid by other persons (not employees or students) to the institution for comparable housing. Therefore, if the rent paid is equal to or exceeds the lesser of (1) or (2), the value of the lodging is excludible from income.

Qualified campus lodging means lodging which is located on, or in the proximity of the campus and is furnished to the employee, the employee's spouse and any dependents by or on behalf of the institution for use as a residence.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The effective date of this provision of the act is for taxable years beginning after December 31, 1985.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The revenue impact of conformity, under Personal income Tax Law, would result in minor revenue losses in the $200,000 range annually. The Joint Committee on Taxation estimates revenue losses for the nation of less than $5 million. California revenue losses are based on this projected low level of impact for the nation.

Title XIF9: Pensions and Deferred Compensation

ACTION: LIMIT THE TIME PERIOD FOR COMPUTING THE DEDUCTION FOR ADDITIONS TO RESERVE ACCOUNT FOR VACATION PAY

Act Section 1165 Conference Report Page 546

Form 540 Line No. 16 Form 100 Line No. G-25

CURRENT CALIFORNIA LAW (Sec. 17081, 17551, 24274 and 24685)

California has conformed to the federal law as to the time period for computing the deduction for additions to the reserve account for vacation pay. Currently an employer is entitled to a deduction for vacation pay in the taxable year of the of the employee for which the vacation pay (1) vests (if the vacation pay plan is funded by the employer) or (2) is paid. In addition, an employer may elect to deduct reasonable additions to the vacation pay account for vacation pay earned before the close of the current year and expected to be paid by the close of that year or within 12 months following the close of the taxable or income year.

NEW FEDERAL LAW (Sec. 463)

The new federal law provides that a deduction for additions to a reserve account for vacation pay is limited to the vacation pay that is paid during the taxable year or within eight and one-half months after the close of the taxable year of the employer.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The new federal provision is applicable for taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The revenue impact, under the Personal Income Tax Law, if California conformed to the new federal law, regarding the deduction for additions to a reserve account for vacation pay, would be revenue gains in the $300,000 range for the 1987-88 fiscal year and in the $100,000 range for the 1988-89 fiscal year. These estimates are based on the national estimates prepared by the Joint Committee on Taxation (JCT) and prorated to California by a 4.1 percent factor. This factor reflects the Policy Economic Group (PEG) conformity estimate for California for those provisions analyzed relative to the nation. The PEG has not specifically estimated this provision.

The revenue impact, under the Bank and Corporation Tax law, would be revenue gains in the $3 million range for 1987-88 fiscal year and in the $700,000 range for the 1988-89 fiscal year. These estimates are also based on the JCT estimate for the nation using a proration factor of 4 percent which represents the general relationship between California's corporate tax collections and the federal corporate tax collections over the last few years.

Title XIF10: Pensions and Deferred Compensation

ACTION: ENUMERATES MILITARY FRINGE BENEFITS

Act Section 1168 | Conference Report Page 548

Form 540 Line No. 12 | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17131)

California has conformed to federal law as to the items included in gross income for military personnel. Currently, a variety of benefits are provided to military personnel and their dependents and are excludable from gross income. These exclusions are by federal statute, regulation, or long standing administrative practice.

NEW FEDERAL LAW (Sec. 134)

The new federal law defines a qualified military benefit excludable from income as any allowance or in-kind benefit which is received by any member or former member of the United States uniformed services, or any dependent of the member and was excludable from gross income on September 9, 1986 under any provision of law or regulation which was in effect on that date (other than a provision of the Tax Reform Act of 1986).

Benefits are excludable only to the extent of the amount authorized and excludable on September 9, 1986, except that adjustments may be made pursuant to a provision of law or regulation in effect on September 9, 1986, if the adjustments are determined by reference to fluctuations in cost, price, currency or other similar index.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The new federal law applies to taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

There would be no revenue impact if California conformed to this provision. This act consolidates existing rules for the tax treatment of military benefits into a statutory provision.

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TITLE XII

FOREIGN TAX PROVISIONS

TABLE OF CONTENTS

Title XIIA: Foreign Tax Provisions

ACTION: MODIFIES CALCULATION OF FOREIGN TAX CREDIT

Act Section 1201 | Conference Report 561

Form 540 Line No. N/A | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (None)

The federal government taxes all the income of U.S. incorporated entities (residency based) and allows a credit for taxes paid to foreign countries to the extent income is "sourced" in that country. This credit is allowed to relieve international double taxation. California, in general, taxes only income "sourced" in California and therefore has no need for a tax credit mechanism since it does not tax income "sourced" in foreign countries.

NEW FEDERAL LAW (Sec. 864, 904, 954)

Foreign tax credits have been calculated by comparing foreign income to overall income and allowing a credit for all foreign taxes to the extent the total does not exceed the federal effective rate on such income. The new law divides foreign income in to a number of separate baskets based upon the type of income received in an effort to reduce the unintended shielding of certain income from U.S. taxation.

The adoption of new, tighter, federal rules will lead to an increase in federal audit activity in the area and a more thorough examination of transactions between U. S. and foreign incorporated entities. The classification of income as Sub-part F income will also be affected.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision are effective for taxable years beginning on or after January 1, 1987.

INDIRECT REVENUE IMPACT FROM FEDERAL CHANGE

Tightening up of federal rules in the Sub-part F area will result in increased revenue to the state of an unknown amount for entities electing to file on a water's edge basis.

DIRECT REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Not applicable to California.

Title XIIB1: Foreign Tax Provisions

ACTION: MODIFIES RULES FOR SOURCING INCOME FROM SALES OF PERSONAL PROPERTY

Act Section 1211 | Conference Report 595

Form 540 Line No. N/A | Form 100 Line No. G-1

CURRENT CALIFORNIA LAW (None)

California has no rules for sourcing of individual items of income. These rules will have application under the recently enacted Section 25110 for those taxpayers electing a water's edge group (effective 1/1/88).

NEW FEDERAL LAW (Sec. 861-865, 871, 881, 904)

The law sources income to the seller's place of residence rather than the place title passes.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Generally effective for taxable years on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Minor net revenue gain or loss.

ACTION: MODIFIES RULES FOR DETERMINING THE SOURCE OF DIVIDENDS AND INTEREST

Act Section 1214	Conference Report 600
Form 540 Line No. N/A	Form 100 Line No. G-4

CURRENT CALIFORNIA LAW (None)

California in general does not source income by statutory rules. For those taxpayers electing a water's edge group (Section 25110, effective January 1, 1988), the federal sourcing rules will have some significance for a limited number of entities.

NEW FEDERAL LAW (Sec. 861, 871, 881, 1441, 6049)

Interest and dividends received from U. S. incorporated entities are treated as U. S. source income subject to a "flow-through" exception. Previously an 80/20 test allowed all interest and dividend income to be treated as foreign source.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Effective generally for taxable years beginning on or after January 1, 1987 with outstanding debt obligations grandfathered in.

INDIRECT REVENUE IMPACT FROM FEDERAL CHANGE

Tightening of federal rules and increased federal audits will give rise to a slight increase in state revenues of an unknown amount.

DIRECT REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Not applicable to California.

Title XIIB5: Foreign Tax Provisions

ACTION: MODIFIES RULES FOR ALLOCATING VARIOUS EXPENSES TO FOREIGN SOURCES

Act Section 1215 | Conference Report 604

Form 54 Line No. N/A | Form 100 Line No. G-18

CURRENT CALIFORNIA LAW (None)

California has no rules for the sourcing of individual expenses. California does have statutes limiting the deductibility of interest expense specifically and expenses generally as they relate to income not included in California tax base. These rules will have application under recently enacted Section 25110 for those taxpayer's electing a water's-edge group (effective 1/1/88).

NEW FEDERAL LAW (Sec. 864)

Expense allocations are made on an overall basis rather than entity by entity.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Generally effective for taxable years beginning on or after January 1, 1987 with phase-in rules for previously outstanding debt.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

It is estimated that conformity (through regulations) will yield a $1.7 million revenue gain in 1987/88, $9.6 million gain in 1988/89 and $12.0 million gain in 1989/90.

Title XIIB6: Foreign Tax Provisions

ACTION: <u>MODIFIES RULES FOR ALLOCATING RESEARCH EXPENSES BETWEEN U. S. AND FOREIGN SOURCE INCOME</u>

Act Section 1216 Conference Report 608

Form 540 Line No. N/A Form 100 Line No. G-26

<u>CURRENT CALIFORNIA LAW (None)</u>

California has no rules for the sourcing of individual expenses. California does have statutes limiting the deductibility of interest expense specifically and expenses generally as they relate to income not included in California tax base. These rules will have application under recently enacted Section 25110 for those taxpayer's electing a water's-edge group (effective 1/1/88).

<u>NEW FEDERAL LAW (Sec. 861, 862, 863)</u>

Fifty percent of research expenses are allocated directly to U.S. income and the remaining fifty percent is apportioned on the basis of either gross sales or gross income. This is another deferral of application of current regulations (deferred since 1981) which allocate 30 percent of such expenses to U.S. income.

<u>EFFECTIVE DATE OF FEDERAL PROVISIONS</u>

Effective for taxable years beginning after August 1, 1986 and on or before August 1, 1987.

<u>REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW</u>

Not applicable to the 1987 income year, since the water's-edge election is not effective until 1/1/88.

For income years beginning on or after 1/1/88, there are two possible effects (revenue estimates in constant 1987 dollars):

1. If Congress <u>does not extend</u> the provision enacted in the 1986 Tax Reform Act, and California conforms to existing federal regulations, there would be an ongoing revenue loss of $8.4 million per year. This result is based upon the 30 percent allocation required by current regulations.

2. If Congress <u>extends</u> the provision enacted in the 1986 Tax Reform Act, and California conforms to federal law, there would be an ongoing revenue loss of $14 million per year. This result is based upon a 50 percent allocation.

Title XIIC1: Foreign Tax Provisions

ACTION: EXPANSION OF RULES PROVIDING FOR CURRENT TAXATION OF TAX HAVEN INCOME

Act Section 1221 | Conference Report 609

Form 540 Line No. N/A | Form 100 Line No. G-1

CURRENT CALIFORNIA LAW (None)

Under current law California has no provision for special treatment of tax haven income. For those taxpayers electing a water's edge group, newly enacted Section 25110 (effective 1/1/88) will pick-up Subpart F Tax Haven income.

NEW FEDERAL LAW (Sec. 864, 952-955)

The new law expands categories of Subpart F income, tightens exceptions and modifies thresholds which together result in an increase in Subpart F income.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Generally effective for taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The revenue impact is estimated to be a $0.5 million gain for 1987/88, $2.0 million gain for 1988/89 and $2.2 million gain for 1989/90.

ACTION: <u>REQUIRES VALUE OF INTANGIBLES TRANSFERRED TO RELATED PARTIES TO BE DETERMINED BY REFERENCE TO INCOME GENERATED</u>

Act Section 1231 Conference Report 637

Form 540 Line No. N/A Form 100 Line No. G-8

<u>CURRENT CALIFORNIA LAW (None)</u>

Under current law transfers between related parties are disregarded. For those taxpayers electing a water's-edge group (Section 25110 effective 1/1/88), the treatment of such transfers will be significant.

<u>NEW FEDERAL LAW (Sec. 367, 482, 936)</u>

Actual or deemed royalty payments are adjustable periodically to reflect substantial increases in the actual income generated by the intangible.

<u>EFFECTIVE DATE OF FEDERAL PROVISIONS</u>

Generally effective for taxable years beginning on or after January 1, 1987 for transfer made after 1) November 16, 1985 to foreign persons, 2) August 16, 1986 to U.S. persons and 3) all transfers to Section 936 entities.

<u>REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW</u>

The revenue effect is estimated to be a \$0.2 million gain for 1987/88, \$1.1 million gain for 1988/89 and \$1.5 million gain for 1989/90.

Title XIIF1: Foreign Tax Provisions

ACTION: ADOPTS STATUTORY RULES FOR DETERMINING THE AMOUNT AND TIMING OF GAIN OR LOSS ON CURRENCY FLUCTUATIONS

Act Section 1261 | Conference Report 659

Form 540 Line No. N/A | Form 100 Line No. G-1

CURRENT CALIFORNIA LAW (Reg. 25137-6)

California, by regulation, has adopted a functional currency approach.

NEW FEDERAL LAW (Sec. 985-989)

A "functional currency" approach is adopted to provide for uniform treatment of gains and losses from foreign currency position.

EFFECTIVE DATE OF FEDERAL LAW

Effective for taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Minor net revenue gain or loss.

ACTION: ADOPTS RULES FOR PRESCRIBING WHEN AND HOW EXCHANGE RATE GAINS AND LOSSES ARE TO BE REPORTED

Act Section 1261 | Conference Report 662

Form 540 Line No. N/A | Form 100 Line No. G-1

CURRENT CALIFORNIA LAW (Reg. 25137-6)

California regulations provide for nonrecognition of gain or loss until a transaction is closed.

NEW FEDERAL LAW (Sec. 988, 1092, 1256)

Gain or loss is recognized on certain transactions, even though not closed.

EFFECTIVE DATE OF FEDERAL LAW

Effective for taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Minor net revenue gain or loss.

Title XIIF3: Foreign Tax Provisions

ACTION: SPECIFIC RULES ARE ESTABLISHED FOR THE METHOD OF TRANSLATION (PROFIT/LOSS), COMPUTATION OF EARNINGS AND PROFITS OF A SUBSIDIARY AND TRANSLATION OF BRANCH INCOME

Act Section 1261 | Conference Report 670

Form 540 Line No. N/A | Form 100 Line No. G-1

CURRENT CALIFORNIA LAW (Reg. 25137-6)

California requires the use of the profit and loss method in a corporation functional currency with some modification. No rules are needed for determining a subsidiary's earnings and profits or the results of branch activity.

NEW FEDERAL LAW (Sec. 985-989)

The new federal law, in general, restricts a corporation to use of the profit/loss method calculated in its functional currency.

EFFECTIVE DATE OF FEDERAL LAW

Effect for taxable years beginning in or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Minor net revenue gain or loss.

The next page of this report is page 1300.

TITLE XIII

TAX-EXEMPT BONDS

ACTION: <u>RESTRICTIONS APPLIED TO TAX-EXEMPT BONDS</u>

Act Section 1301-1318 Conference Report Page 683

Form 540 Line No. N/A Form 100 Line No. N/A

<u>CURRENT CALIFORNIA LAW (Sec. 17143 and 24272)</u>

California has not conformed to federal law which provides that interest on bonds of the United States, its agencies or its instrumentalities is fully taxable and interest on state and local bonds of any state and certain industrial development bonds is tax exempt. Instead, the California Constitution excludes from income interest on bonds issued by California or a local government in California while statutory law excludes from gross income interest the state is prohibited from taxing under the U.S. Constitution and federal law or under the Constitution of California.

Based on the above, the new federal law would not be applicable for California purposes. Accordingly, an analysis is not required.

<u>REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW</u>

Since this provision represents a non-conformity issue, no revenue effects apply.

The next page of this report is page 1400.

TITLE XIV

TRUSTS AND ESTATES;
MINOR CHILDREN;
GIFT AND ESTATE TAXES;
GENERATION-SKIPPING TRANSFER TAX

TABLE OF CONTENTS

Title XIVA1: Trusts and Estates; Minor Children; Gift and Estate Taxes; Generation-Skipping Transfer Tax

ACTION: <u>NARROWS TAX BRACKETS APPLICABLE TO TRUSTS AND ESTATES</u>

Act Section 1401 | Conference Report Page 763

Form 540 Line No. N/A | Form 100 Line No. N/A

<u>CURRENT CALIFORNIA LAW (Sec. 17041(e))</u>

California law is similar to current federal law as it has various tax rate brackets for trusts and estates. However, California tax rate brackets are different from the federal tax rate brackets. The federal rates range from 11 percent to 50 percent; the California rates range from 1 percent to 11 percent.

<u>NEW FEDERAL LAW (Sec. 101)</u>

This provision of the act provides that the rate schedule applicable to trusts and estates is modified to have a top individual rate of 28 percent. This means, taxable income of trusts and estates from $0 to not over $5,000 is taxable at 15 percent and the taxable income over $5,000 is taxed at 28 percent. The benefit of the 15 percent bracket phases out between $13,000 and $26,000. A transitional rate schedule is provided for taxable years beginning in 1987.

Adjustments for inflation for 1989 and subsequent years to the tax rate schedules are to be made no later than December 15, 1988 and each subsequent calendar year thereafter.

<u>EFFECTIVE DATE OF FEDERAL PROVISIONS</u>

This provision is effective for taxable years beginning on or after January 1, 1987.

<u>REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW</u>

Tax revenue effects in this area depend on tax policy decisions reached regarding the extent to which , if any, California elects to modify its tax rate structure pertaining to fiduciaries in light of federal tax law changes.

No revenue estimates, therefore, can be provided at this time.

Title XIVA2: Trusts and Estates; Minor Children; Gift and Estate Taxes; Generation-Skipping Transfer Tax

ACTION: CHANGES TAXABLE YEAR OF TRUSTS TO THE CALENDAR YEAR

Act Section 1403 — Conference Report Page 763

Form 540 Line No. N/A — Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17731)

California has conformed to federal law as to taxable year of a trust. Currently a trust may establish its taxable year in any month. When a trust has a taxable year different from the taxable year of its beneficiaries, the amounts includible in the gross income of the beneficiaries are determined by reference to income of the trust for its taxable year ending with or within the taxable year of the beneficiary. Thus, in the case of a taxable year of trust ending on January 31 and the taxable year of the beneficiary ending on December 31 (the calendar year) the taxation of trust income which is distributed to the beneficiary is deferred eleven months.

NEW FEDERAL LAW (Sec. 645)

The act provides that both newl/ created and existing trusts (but not estates) are required to adopt a calendar year as their taxable year. However, tax-exempt trusts and wholly charitable trusts are not required to adopt a calendar year.

Additionally, a transitional rule is provided that any trust beneficiary who is required to include in gross income any distribution from a trust in the first taxable year of the beneficiary beginning after December 31, 1986, because the trust was required to file a short taxable year return, the income shall be ratably included in the income of the trust beneficiary over the four taxable year period beginning with the first taxable year.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The effective date of this provision is for taxable years beginning on or after January 1, 1987.

DIRECT STATE IMPACT FROM FEDERAL PROVISIONS

Since trusts will be making taxable year changes for state tax purposes whether or not California actually conforms, the state estimates below reflect the change in budget receipts that will automatically occur under the Personal Income Tax Law (PITL).

Based on a proration of national estimates prepared by the Joint Committee on Taxation, the relative fiscal impact would be a PIT revenue gain in the $4 million range for 1987-88 and 1988-89. A proration to California of 4.1 percent was used which reflects the Policy Economic Group's (PEG) estimates for California relative to the nation for those provisions analyzed. The PEG has not specifically estimated this provision.

Title XIVA6: Trusts and Estates; Minor Children; Gift and Estate Taxes; Generation - Skipping Transfer Tax

ACTION: <u>REPEALS TEN YEAR EXCEPTION AND TREATS TRUST AS GRANTOR TRUST</u>

Act Section 1401 & 1402 Conference Report Page 763

Form 540 Line No. N/A Form 100 Line No. N/A

<u>CURRENT CALIFORNIA LAW (Sec. 17731)</u>

California law has conformed to federal law regarding the treatment of grantor trusts. Under certain circumstance the grantor (or other person having the power to revoke the trust) is taxed directly on trust income. The grantor is not treated as having a revisionary interest if the trust property reverts to the grantor's spouse (a spousal remainder trust). The grantor generally is treated as the owner of all or a portion of the trust if the assets will return to the grantor within 10 years or the grantor retains significant control of the trust assets.

<u>NEW FEDERAL LAW (Sec. 672, 673, 674, 676 & 677)</u>

The act treats the grantor as holding the same power or interest in trust property that is held by the grantor's spouse if the spouse was living with the grantor on the date of transfer.

The act further provides that the 10 year exception is repealed. The grantor is considered to be the owner of any portion of a trust in which he or she has a revisionary interest of more than five percent in either the corpus or the income of the trust. A grantor will not be considered the owner if he or she has a revisionary interest in a trust that takes effect only upon the death of a minor who dies before age 21 and who is a lineal descendant of the grantor.

Conforming amendments are made to the IRC sections which relate to (1) the power to control beneficial enjoyment of a trust; (2) the power to revoke a trust; and (3) income for the benefit of a grantor.

The above provisions do not apply for any transfer in trust made after March 1, 1986 where a binding property settlement agreement was entered into on or before March 1, 1986 which required the taxpayer to establish a grantor trust. The settlement agreement must provide for the transfer of a specified sum of money to the trust by the grantor. The exemption applies only to the amount required to be transferred by the agreement.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective for transfers in trust made after March 1, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No specific national estimate was developed by the Joint Committee on Taxation for this particular provision indicating a very minor or negligible impact for the nation. Any revenue gain that would occur under state conformity would be minor.

Title XIVA8: Trusts and Estates; Minor Children; Gift and Estate Taxes; Generation-Skipping Transfer Tax

ACTION: REPEALS ELECTION FOR ESTATE TO PAY TAX IN FOUR EQUAL INSTALLMENTS AND REQUIRES TRUSTS AND ESTATES TO MAKE PAYMENTS OF ESTIMATED INCOME TAX

Act Section 1404 | Conference Report Page 763

Form 540 Line No. N/A | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 18682, 18551)

California has conformed to federal law and does not require trusts and estates to make payments of estimated tax. California has not conformed to a federal law provision which allows an estate to elect to pay its income tax in four equal installments beginning with the due date of the return and for each three month period thereafter.

NEW FEDERAL LAW (Sec. 643, 6152 (repealed) and 6654)

This provision of the act requires trusts and estates to make payments of estimated tax, however, estates are not required to pay estimated tax for their first two taxable years. Additionally, a trust making estimated payments may have the trustee elect to assign any amount of its quarterly payments to a beneficiary or beneficiaries. The election must be made on the income tax return of the trust which is filed within 65 days after the end of the trust's taxable year. If the trustee makes this election, the amount of credits assigned to a beneficiary is considered a distribution under the 65 day rule, which means the amount shall be considered paid or credited to the beneficiary(ies) on the last day of the trust's taxable year.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective for taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Estimated Tax Payments by Trusts

Based on a proration of national estimates prepared by the Joint Committee on Taxation, the relative fiscal impact would be a Personal Income Tax (PIT) revenue gain in the $27 million range for 1987-88 and $1 million range for 1988-89. A proration to California of 4.1 percent was used which reflects the Policy Economic Group's (PEG) estimates for

California relative to the nation for those provisions analyzed. The PEG has not specifically estimated this provision.

Estimated Tax Payments by Estates

No relevant state data is available to estimate this item. However, the Joint Committee on Taxation indicate a very minor impact for the nation. Therefore, any revenue gains that would occur under state conformity would be minor under the PIT Law.

Title XIVB: Trusts and Estates; Minor Children; Gift and Estate Taxes; Generation-Skipping Transfer Tax

ACTION: <u>ESTABLISHES SPECIAL RULES FOR UNEARNED INCOME OF MINOR CHILDREN</u>

Act Section 1411	Conference Report Page 767
Form 540 Line No. 13, 14	Form 100 Line No. N/A

<u>CURRENT CALIFORNIA LAW (Sec. 17041)</u>

California has conformed to federal law as to the tax liability of a minor child. Generally the gross income of a minor child is computed in the same manner as an adult. A minor child is allowed a personal exemption deduction for federal purposes and a personal exemption credit for state purposes.

California does not conform to federal law which provides that if the child is claimed or may be claimed by another taxpayer the zero bracket amount is limited to the child's earned income and cannot be used to offset unearned income.

Currently parents may transfer income producing property to a child and that income is then taxed at the child's lower marginal rates.

<u>NEW FEDERAL LAW (Sec. 1, 63 & 6103)</u>

The act provides that the net unearned income over $500 of a child under 14 years of age regardless of the source of the assets generating the income will be taxed to the child at a rate equal to the marginal rate the parent would be required to pay if the unearned income were included in the parent's taxable income.

Net unearned income means unearned income less the sum of $500 and the greater of: (1) $500 of the standard deduction or $500 of itemized deduction, or (2) the deductions allowed the child that are directly connected with the production of the child's unearned income. For example, if the child has $900 of unearned income and no earned income, the child's standard deduction for 1988 is $500 which is subtracted from the $900 leaving a net unearned income of $400. This $400 would be taxed at the child's (lower) rate because the net unearned income is less than $500. If however, the child has $1,500 of unearned income and no earned income, the child's standard deduction of $500 is allocated against his unearned income so that his unearned income equals $1,000. The first $500 of that amount is taxed at his rate and the remaining $500 of unearned income is taxed at the top rate of the parents.

Additionally, the taxpayer identification number of the parent is required to be provided to the child or the child's legal representative for inclusion on the child's tax return.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective for taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The relative fiscal impact under state conformity is revenue gains in the $5 million range for 1987-88 and for 1988-89. These revenue gains would occur under the Personal Income Tax Law. The basis for the state estimates is the national estimates prepared by the Joint Committee on Taxation prorated to California by a 4.1 percent factor. This factor reflects the Policy Economic Group (PEG) conformity estimates for California relative to the nation for those provisions analyzed. The PEG has not specifically estimated this provision. The estimate above allows for the fact that California does not currently provide a zero bracket amount deduction for minors.

The next page of this report is page 1500.

TITLE XV

COMPLIANCE AND TAX ADMINISTRATION

TABLE OF CONTENTS

Title XVAi: Compliance and Tax Administration

ACTION: SIMPLIFY AND CONSOLIDATE PENALTIES FOR FAILURE TO FILE INFORMATION RETURNS OR STATEMENTS

Act Section 1501 Conference Report Page 777

Form 540 Line No. N/A Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17932, 18681.1-18681.9, 18685.07, 18802, 18802.1-18802.9, 18803)

California has generally conformed to federal law which requires a taxpayer to file information returns and to furnish a copy to the taxpayer. The information required relates to salaries, other compensation, dividends, rents, and other specified payments.

The penalties imposed under state and federal law are somewhat different. For California purposes, the penalty imposed for failure to provide the information to either the Franchise Tax Board or the taxpayer is $50 for each failure not to exceed $10,000 during any calendar year. This differs from federal law which provides that the penalty is $50 for each failure, not to exceed $50,000. If the penalty is imposed for intentional disregard of the filing requirement, the $10,000 limitation (or $50,000 for federal purposes) does not apply.

California law also imposes a $100 penalty for each failure to provide a copy of federal information returns with respect to mortgage interest, cash received, and foreclosures. Only the $50 penalty is applicable for federal purposes.
In addition, California law provides that a penalty be imposed of either $5 or $10 (depending on the nature of the failure) for failure to supply identifying numbers (social security number or FEIN) not to exceed $10,000 during any calendar year imposed on each person. Federal law provides a penalty of either $5 or $50 not to exceed $50,000.

For both federal and state law, no penalty is imposed for including incorrect information on an information return.

NEW FEDERAL LAW (Sec. 4997, 6031, 6034, 6034A, 6037-6045, 6049, 6050A-6050K, 6052, 6652, 6676, 6678, & 6721-6724)

The Act simplifies and consolidates the code provisions relating to failure to file an information return with the Internal Revenue Service and failure to supply a copy of the information return to the taxpayer.

The maximum penalties for these failures are raised from $50,000 to $100,000, while retaining the exception that there is no limit on the amount of these penalties in the case of intentional disregard.

The penalty for failure to report cash transactions that exceed $10,000 is increased to 10 percent of the amount that should have been reported. Also, the penalty for failure to report exchanges of certain partnership interests or failure to report certain dispositions of donated property is 5 percent of the amount that should have been reported.

A new penalty of $5 is also imposed for each information return (or copy to the taxpayer) that contains incorrect information, up to a $20,000 maximum, except in cases of intentional disregard (no maximum). The new penalty will not be assessed for failure to supply a correct taxpayers identification number, if for the same tax year, the person filing the return is already subject to the penalty for failure to supply a correct identification number.

These provisions also have been redrafted to clarify when a person is required to furnish a written statement to the taxpayer.

In addition, stricter rules apply to interest and dividend returns or statements. While the information reporting penalties don't apply to failures that are due to reasonable cause and not willful neglect, interest and dividend reporting failures will be excused only if the taxpayer exercised due diligence. And the maximum amount limitations applicable to the other penalties don't apply.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision is effective for information returns due (without regard to extensions) on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

According to the Joint Committee on Taxation (JCT) the impact for the nation will be additional penalty collections less than $5 million annually. Based on this low level of impact, conformity would result in minor increases in penalty collections of less than $200,000 annually.

Title XVA2: Compliance and Tax Administration

ACTION: INCREASE THE PENALTY FOR FAILURE TO PAY TAX

Act Section 1502 — Conference Report Page 778

Form 540 Line No. N/A — Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 18681, 18684.2, 25931, 25931.3, & 25934.2)

Under current California law, a penalty may be imposed on taxpayers for failure to pay taxes by the due dates.

The penalties imposed under the California Personal Income Tax Law, Bank and Corporation Tax Law, and Federal Internal Revenue Code are somewhat different.

Under the California Personal Income Tax Law, the penalty is 5 percent of the total unpaid tax plus an amount computed at a rate of .5 percent per month for the period the tax is unpaid (maximum of 36 months). This is the same as the federal law, except that federal law does not include the initial 5 percent of unpaid tax and the maximum is 25 percent (50 months).

Under the Bank and Corporation Tax Law, the penalty is 5 percent of the total unpaid tax with a minimum penalty of $5 and a maximum of $1,000. This differs from the federal penalty which is .5 percent per month for a maximum of 50 months. Also, there is no minimum or maximum dollar amount under federal law.

Under federal law, but not state law, the penalty for failure to pay the tax also applies to assessments not paid within ten days after notice and demand.

Under both California Personal Income Tax Law and the Bank and Corporation Law, the penalty for failure to pay the tax is not assessed if the penalties for failure to file, or failure to file after demand are equal to or greater than the penalty for failure to pay the tax. This differs from federal law which does not take the greater of the penalties but rather reduces the failure to file penalty by amounts assessed for failure to pay tax shown on the return and for failure to pay tax not shown on the return after notice and demand for payment of such tax.

Under the federal and state laws, each of the above penalties may be waived if the taxpayer can show that failure was due to a reasonable cause and not willful neglect.

NEW FEDERAL LAW (Sec. 6651)

The act increases the penalty to pay taxes when due from .5 percent per month to one percent per month (up to a maximum of 25 percent) when the collection of tax is in jeopardy or after the taxpayer has been notified that the Internal Revenue Service will levy upon the taxpayer's assets to collect the past-due taxes.

The act also repeals a special offset rule (unique to federal law) which can result in the imposition of a smaller penalty to a taxpayer that never files a return than to a taxpayer who files a return, but does not pay on assessment within 10 days after the notice and demand has been made.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision is effective for the amount assessed on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

In comparing the current state penalty assessment with the new federal computation formula, it appears that conformity would result in reduced penalty collections under the PITL and increased amounts under the B&CTL.

Based on a proration of national estimates adjusted to allow for differences between current state law and former federal law, the amount of reduced PITL penalty collections under conformity could amount to $7 million annually.

Based on a departmental recap report on corporate penalties for failure to pay, additional penalty collections under conformity could amount to $1.2 million annually under the B&CTL.

TAX POLICY ISSUES

The California penalty for failure to pay the tax applies to the amount of tax shown on the return, whereas federal law also includes a separate penalty for the amount of tax not shown on the return. That California law does not apply to the total unpaid tax seems to be an omission rather than an intentional difference.

Title XVA3: Compliance and Tax Administration

ACTION: MODIFIES THE NEGLIGENCE & FRAUD PENALTIES

Act Section 1503 | Conference Report Page 779

Form 540 Line No. N/A | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 18684, 18685, 18698.5 25934, & 25935)

Under current California law, a taxpayer may be subject to a negligence or fraud penalty. The amount of the penalty and computation rules are in conformity to federal law.

Negligence Penalty

If a taxpayer has underpaid any part of a deficiency due to negligence or intentional disregard of the rules and regulations without the intent to defraud, the Franchise Tax Board may impose a negligence penalty.

The negligence penalty is 5 percent of the total amount of the deficiency. There is an additional penalty of 50 percent of the interest due on the portion of the underpayment that is attributable to negligence or intentional disregard of rules and regulations.

In order to avoid the negligence penalty, the taxpayer must present clear and convincing evidence that no negligence was involved.

Fraud Penalty

If a taxpayer has underpaid any part of their deficiency due to fraud with intent to evade taxes, the Franchise Tax Board may impose the fraud penalty.

The fraud penalty is 50 percent of the total amount of deficiency along with an additional penalty of 50 percent of the interest due on the portion of the underpayment that is attributable to fraud. The additional penalty due to fraud is in lieu of the additional penalty due to negligence or disregard of rules and regulations.

Before the fraud penalty can be imposed on the taxpayer, the Franchise Tax Board has the burden of proving fraudulent intent.

NEW FEDERAL LAW (Sec. 6653)

The Tax Reform Act of 1986 expands and modifies the negligence and fraud penalties.

Negligence Penalty

The provision will expand the scope of the negligence penalty by making it applicable to all taxes under the code.

The scope of the definition of negligence will include any failure to make a reasonable attempt to comply with the provisions of the code as well as any careless, reckless, or intentional disregard of rules or regulations.

The bill will also expand the negligence provision so that it will be applicable to failures to show properly on the taxpayer's tax return any item reported to him on an information return (as defined by newly enacted code section 6724(d)(1) of the Internal Revenue Code) or on any of certain specified income tax returns (returns of partnership income, return of S corporation, return by estate or trusts, return relating to unemployment compensation, and return relating to state and local income tax refunds).

Fraud Penalty

The provision will modify the fraud penalty by increasing the amount from 50 to 75 percent. Application of the penalty will be limited to the amount of the underpayment attributable to fraud (same as the interest component).

The act also provides that if any fraud is found, the taxpayer has the burden of showing what part of an underpayment isn't attributable to fraud.

In the case where a joint return is filed and there has been a fraudulent failure to pay tax, the fraud penalty will not apply to a spouse signing the return unless at least some or part of the underpayment is the result of fraud committed by that spouse.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision is effective for returns required to be filed on or after January 1, 1987 (determined without regard to extensions).

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Joint Committee on Taxation (JCT) feels this provision will have a minor impact on penalty collections of less than $5 million annually. Based on this low level of impact for the nation, conformity would result in very minor additional penalty collections of less than $200,000 annually.

Title XVA4: Compliance and Tax Administration

ACTION: INCREASE THE PENALTY FOR SUBSTANTIAL UNDERSTATEMENT OF TAX LIABILITY

Act Section 1504 — Conference Report Page 782

Form 540 Line No. N/A — Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 18684.4 & 25934.4)

Under current California law for both individuals and corporations, there is a penalty for substantial understatement of tax liability, computed in accordance with section 6661 of the Internal Revenue Code.

The penalty is 10 percent of the tax attributable to the understatement and is imposed only when the tax return contains an understatement that exceeds the greater of 10 percent of the tax liability or $5,000 ($10,000 for corporations).

The penalty generally does not apply to amounts in respect to which (1) there was substantial authority for the tax treatment of the item at issue or (2) the relevant facts affecting the item's tax treatment are adequately disclosed in the tax return.

Under the Bank and Corporation law, the penalty applies only when the understatement is attributable to a tax shelter, the promotion of which would be subject to penalties under the Internal Revenue Code 6700.

NEW FEDERAL LAW (Sec. 6661)

The Tax Reform Act of 1986 increases the penalty for substantial understatement of tax liability from ten percent to 20 percent of the amount of the underpayment attributable to the understatement.

The Omnibus Budget Reconciliation Act of 1986 increased the penalty from 10 percent to 25 percent and repeals the provision in the Tax Reform Act of 1986.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The increase in this addition to tax under the Omnibus Budget Reconciliation Act of 1986 is effective for penalties assessed on or after October 22, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on departmental reports on penalties due to under statement of tax, the amount of additional penalty collections under the

Personal Income Tax Law from conformity could amount to the $12 million range annually.

Based on the same reports, the amount of additional penalty collections under the Bank and Corporation Tax Law could amount to the $5 million range annually.

Title XVB1: Compliance and Tax Administration

ACTION: CHANGE METHOD OF DETERMINING INTEREST RATES

Act Section 1511 Conference Report Page 784

Form 540 Line No. 97 Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 18686, 19051, 19062, 19269, 26071, 26080)

California is generally conformed to federal law in that the interest rate taxpayers pay to the state and the rate the state pays to taxpayers are the same.

The rate of interest is determined semiannually for six month periods ending on September 30 and March 31 and is adjusted January 1 and July 1, respectively. The rate utilized is the prime rate quoted by large commercial banks as determined by the Board of Governors of the Federal Reserve System.

NEW FEDERAL LAW (Sec. 6611, 6621)

This act provides that the interest rate that Treasury pays to taxpayers on overpayments is the federal short-term rate plus two percentage points, rounded to the nearest full percent. The act also provides that the interest rate that taxpayers pay to the Treasury on underpayments is the federal short-term rate plus three percentage points, rounded to the nearest full percent.

'he federal short term rate is determined by the Secretary based on the average market yield on outstanding marketable obligations of the United States with remaining periods to maturity of three years or less.

The interest rates are to be adjusted quarterly. The rates are determined during the first month of a calendar quarter, and become effective for the following calendar quarter.

The act provides that the Secretary of the Treasury may prescribe regulations providing transitional rules to coordinate the differential interest rates for netting of tax underpayments and overpayments (IRC § 6601(f); PIT § 18691; B&C § 25102). These regulations would apply through the period ending three years after the date of enactment of the bill. It is anticipated that by that time the Internal Revenue Service will have developed data processing capabilities to net underpayments and overpayments automatically.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective for purposes of determining interest for periods after December 31, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Estimating the net revenue effect of conforming to the new federal procedure for tax interest rate determinations (i.e., quarterly periods based on federal short-term rates with a 1 percent differential on underpayments) is extremely difficult due to unknowns related to taxpayer response, future interest rate levels, and other interactive effects. The Joint committee on Taxation has estimated average net revenue gains to the Treasury in the $170 million range from individuals and in the $250 million range from corporations over the five year period ending in 1991. Approximate state revenue gains under conformity based on these national estimates would be in the $5 million range from individuals, and in the $10 million range from corporations.

Title XVCi: Compliance and Tax Administration

ACTION: REQUIRE INFORMATION REPORTING ON REAL ESTATE TRANSACTIONS

Act Section 1521 | Conference Report Page 786

Form 540 Line No. N/A | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 18802.3, 18802.4)

California and federal law both require brokers and barterers to file information returns; however, these reports do not include the reporting of real estate transactions. California law does contain a provision that real estate transactions be reported upon written request by the Franchise Tax Board.

NEW FEDERAL LAW (Sec. 6045)

The reporting requirement for brokers and barterers is expanded to include real estate transactions. The person who has primary responsibility for reporting the real estate transaction is the one responsible for closing the transaction. Generally this is the person conducting the settlement, including any title company or attorney who closes the transaction.

If there is no person responsible for closing the transaction, the reporting must be done by the mortgage lender, the seller's broker, or the buyer's broker, in that order of responsibility. When there are no persons fulfilling any of the above obligations the reporting is to be done in accordance with regulations to be prescribed by the Secretary of the Treasury.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision affects real estate transactions for which the closing date occurs on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on a proration of national estimates prepared by the Joint Committee on Taxation, the relative state impact under conformity would be revenue gains in the $14 million range for 1987-88 and in the $21 million range for 1988-89. These estimates apply under the Personal Income Tax Law. The proration used (4.1%) reflects the Policy Economics' Group estimates for California relative to the nation for those provisions analyzed. The PEG did not specifically estimate this provision.

ADMINISTRATIVE CONCERNS

This reporting requirement, as it is provided for in the Act, will place an administrative burden on state governmental entities in their conformity effort. Specifically, information that is provided to the federal government by brokers and barterers reporting on real estate transactions, will be of limited use to California if it lacks identification of the state in which the property transfer occurs, the transferrer's state of residency, and the transferrer's identification number).

Including information on the state in which the property transfer occurs, where the transferrer maintains residency, and the transferrer's identification number, as well as the date of transaction, the full sales amount, and the transferrer's name and address, would enable California to effectively use a copy of the federal information return.

These concerns were forwarded to assistant commissioner Percy Woodard, Internal Revenue Service, on November 17, 1986.

Title XVC2: Compliance and Tax Administration

ACTION: REQUIRE INFORMATION REPORTING FOR PERSONS RECEIVING CONTRACTS FROM CERTAIN FEDERAL AGENCIES

Act Section 1522 | Conference Report Page 787

Form 540 Line No. N/A | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (None)

Neither state nor federal law has a provision requiring information reporting on persons receiving contracts from federal or state agencies. However, current California law does generally require that copies of federal information returns be filed with the Franchise Tax Board.

NEW FEDERAL LAW (Sec. 6050M)

The head of each Federal executive agency is required to file an information return furnishing the Taxpayer Identification Number, name and address of each person with whom the Federal agency enters into a contract, subcontract or license. Minimum amounts for the reporting requirement shall be established by the Secretary of the Treasury.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective for all contracts in effect on Janaury 1, 1987 or thereafter.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No identifiable revenue effect exists for a similar requirement at the state or local governmental level.

TAX POLICY ISSUES

It would be inappropriate for the state to require information reports from federal agencies, however, similar reports could be required of state and/or local government agencies.

ACTION: TIGHTEN INFORMATION REPORTING REQUIREMENTS FOR ROYALTY INCOME

Act Section 1523 Conference Report Page 788

Form 540 Line No. N/A Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 18802)

California generally conforms to federal law, which requires that an information return be filed when income received from interest, dividends, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income exceeds a specified amount during any year. For California law the amount is generally $600. Under federal law reports must be filed on interest, dividends and certain other transactions if amounts received during the year exceed $10. Other items are subject to a $600 reporting floor under federal law.

California makes no specific mention of information reporting on royalties.

NEW FEDERAL LAW (Sec. 6050N, 6041)

Income received from royalties is specifically included in the information reporting requirement. Royalties paid to any person in the aggregate amount of $10 or more in a calendar year, must be reported to the Internal Revenue Service by the payor of the royalty(ies). If a person makes payments to a nominee, the nominee must report the information to the taxpayer and to the Internal Revenue Service.

Examples of royalty payments required to be reported include royalties paid for the right to exploit natural resources such as oil, timber, gas, coal, sand, gravel, and other mineral interests. Also included are royalties paid for the right to exploit intangible property such as copyrights, trademarks, trade names, franchises, books, and other literary and musical compositions; artistic works, secret processes or formulas, and patents.

The rules that generally apply to the filing of information returns for payments of interest and dividends also apply to this provision, including requirements and penalties relating to the furnishing of identification numbers and provisions relating to backup withholding.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective for royalty payments made on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Joint Committee on Taxation has issued a single estimate for all information reporting provisions. Their evaluation of the various components of the estimate ranks the royalty income reporting requirement change as a very minor revenue gain (i.e., less than $3 million annually).

Conforming to this information reporting change at the state level would not result in any meaningful revenue gain. Indeed, in many cases the state will automatically receive this information on federal 1099 forms submitted by payors.

Title XVC4: Compliance and Tax Administration

ACTION: REQUIRE REPORTING OF TAXPAYER IDENTIFICATION NUMBERS FOR DEPENDENTS

Act Section 1524   Conference Report Page 789

Form 540 Line No. 9   Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 18934, 18685.07)

California is generally conformed to federal law with respect to the allowance of an additional exemption for qualified dependents supported by the taxpayer. Under both laws, these additional exemptions are claimed on the first page of the tax return by listing the names and relationships of the dependents in the space provided.

NEW FEDERAL LAW (Sec. 6109, 6676)

Taxpayers are required to report on the tax return, the taxpayer identification numbers of dependents claimed, who are five years of age or older. The penalty for failure to include the number will be $5 for each such failure.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective for returns due on or after January 1, 1988 (without regard to extensions).

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

National estimates of revenue gains from reduced dependent exemption deductions and the $5 penalty for failure to provide information are $350 million for 1988-89 and $363 million for 1989-90. A straight proration of national estimates for a conformity estimate is not appropriate since the benefit of California's dependent credit is only one-twentieth the benefit of the new federal dependent exemption on the average. If the 4.1 percent California proration (based on Policy Economics Group California estimates on those provisions analyzed vs. the nation were adjusted by a factor of one-twentieth, the Conformity estimate would be $750,000 for 1989-90.

As an alternative methodology, if it is assumed that 5 percent of the current number of dependent exemptions claimed in California (6 million on taxable returns) were subject to the $5 nonreporting penalty, state revenue gains would be in the $1.5 million range annually. Additional unknown revenue gains would result from any denied dependent exemptions that were not subsequently substantiated.

Based on these methodologies, state conformity would result in annual revenue gains in the $1-2 million dollar range.

Title XVC5: Compliance and Tax Administration

ACTION: REQUIRE REPORTING OF ALL TAX-EXEMPT INTEREST RECEIVED OR ACCRUED DURING THE TAXABLE YEAR

Act Section 1525 | Conference Report Page 790

Form 540 Line No. 13 | Form 100 Line No. 6-6

CURRENT CALIFORNIA LAW (Sec. 18401)

Under current California law interest on tax-exempt bonds and other exempt obligations is not required to be reported on the tax return. This is different from current federal law which requires that taxpayers with taxable social security benefits report the tax exempt interest they receive.

NEW FEDERAL LAW (Sec. 6012)

Any person required to file a tax return must report on that return the amount of tax exempt interest received or accrued during the taxable year.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Taxable or income years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No directly identifiable revenue impact exists under the Personal Income Tax Law from this provision.

Title XVC6: Compliance and Tax Administration

ACTION: MODIFY SEPARATE MAILING REQUIREMENTS FOR CERTAIN INFORMATION RETURNS

Act Section 1501 | Conference Report Page 791

Form 540 Line No. N/A | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 18802, 18802.1)

California conforms to federal law which requires that payors of dividends, interest, and patronage dividends report the amounts paid. In addition, payors are required to provide a copy of this information report to all payees.

Under federal law, the information report may be provided to the taxpayer either in person, or in a separate, first class mailing. If the latter method is used, nothing other than the information report may be enclosed in the envelope. This provision applies only to patronage dividends under current California law. For all other dividends and interest, it is only required that a written report be provided to the taxpayer. The method of provision is not specified.

NEW FEDERAL LAW (Sec. 6042)

When payors of interest, dividends, and patronage dividends must provide copies of information returns to the taxpayer, they are required to either furnish them in person, or in a statement mailing sent by first class mail. Statement mailings may include a check, a letter explaining why no check is enclosed, or a statement of the taxpayer's account. The mailing must include adequate notice that the statement is enclosed by stating on the outside of the envelope "Important Tax Return Document Enclosed".

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision is effective for information returns filed after the date of enactment, for those returns reporting interest, dividends, and patronage dividends.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No identifiable revenue effect would result under conformity.

Title XVD2: Compliance and Tax Administration

ACTION: MODIFICATION OF TAX SHELTER RATIO TEST FOR PURPOSES OF THE TAX REGISTRATION REQUIREMENT

Act Section 1531 Conference Report Page 793

Form 540 Line No. N/A Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 18803.1)

Currently, any person required to register a California tax shelter with the Secretary of the Treasury as required by the Internal Revenue Code must send a duplicate of the registration information to the Franchise Tax Board.

The registration information must be sent to the Franchise Tax Board no later than the day on which the first offering for sale of interest in that tax shelter occurs.

A California tax shelter is defined as any investment organized in California, for which the ratio of the deductions plus 200 percent of the credits to the cash actually invested is projected to be greater than 2 to 1. This definition is in conformance with Federal law. The investment also must be subject to Federal or State security requirements or be privately placed with 5 or more investors.

NEW FEDERAL LAW (Sec. 6111)

Tax shelter organizers are required to register with the Internal Revenue Service all "tax shelters" they organize, develop, or sell.

The act redefines a "tax shelter" (to conform to the individual tax rate changes) to mean an investment for which the ratio of the deductions plus 350 percent, (instead of 200 percent) of the credits to the cash actually invested is projected to be greater than 2 to 1.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The amendment made by this section which take effect on January 1, 1987, will apply to any tax shelter (within the meaning of section 6111 of the Internal Revenue Code of 1986) interests in which are first offered for sale after December 31, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Joint Committee on Taxation has not specifically estimated the impact of this change in tax-shelter reporting signifying that any revenue gains that might be derived from it are considered to be very minor. Revenue gains under state conformity would most likely be negligible.

Title XVD3A: Compliance and Tax Administration

ACTION: <u>INCREASE THE PENALTY FOR FAILURE TO REGISTER A TAX SHELTER</u>

Act Section 1532 | Conference Report Page 794

Form 540 Line No. N/A | Form 100 Line No. N/A

<u>CURRENT CALIFORNIA LAW (Sec. 18681.8)</u>

California imposes a penalty on those persons who fail to furnish information in connection with the registration of a California tax shelter.

Under both California and federal law, the penalty is the <u>lesser</u> of $10,000 or 1 percent of the aggregate amount invested in the shelter but in no event will the penalty be less than $500.

<u>NEW FEDERAL LAW (Sec. 6707)</u>

The act repeals the $10,000 maximum and increases the level of this penalty to the <u>greater</u> of one percent of the aggregate amount invested in the tax shelter or $500.

<u>EFFECTIVE DATE OF FEDERAL PROVISIONS</u>

The revised penalty applies to failures to register tax shelters in which interests are first offered for sale after October 22, 1986.

<u>REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW</u>

The Joint Committee on Taxation feels that the level of compliance will be high and that any increase in penalty collections that might occur will be negligible for the nation. Conformity will also produce negligible results for California.

Title XVD3b: Compliance and Tax Administration

ACTION: INCREASES THE PENALTY FOR FAILURE TO REPORT THE TAX SHELTER IDENTIFICATION NUMBER ON THE RETURN

Act Section 1533 Conference Report Page 794

Form 540 Line No. N/A Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 18681.8)

California has conformed to federal law. A taxpayer is required to pay a penalty if he or she does not report the tax shelter identification number on the return in which a deduction, credit or other benefit is claimed with respect to that tax shelter.

For both federal and state law, the penalty for each failure to include the tax shelter registration number is $50 unless the failure is due to reasonable cause.

NEW FEDERAL LAW (Sec. 6707(b))

The act increases the penalty for failure to report a tax shelter identification number on a tax return from $50 to $250. The present-law exception from penalty where the failure to report the number is due to reasonable cause remains unchanged.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision is effective for tax returns filed after October 22, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Joint committee on Taxation indicates a negligible impact for the nation. Any change in penalty collections, plus or minus, at the state level under conformity would also be negligible.

Title XVD3c: Compliance and Tax Administration

ACTION: INCREASES THE PENALTY FOR FAILURE TO MAINTAIN LISTS OF INVESTORS

Act Section 1534 Conference Report Page 795

Form 540 Line No. N/A Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 16681.4)

California generally conforms to federal law which imposes a penalty for failure to maintain list of investors however, the California penalty is substantially greater than the federal penalty. A tax shelter promoter who is subject to information return filing requirements who fails to keep required records is subject to a penalty unless it is shown that such a failure is due to reasonable cause.

The penalty for each promoter who fails to comply is $1,000 multiplied by the number of investors per calendar year.

If the number of investors cannot be determined by the Franchise Tax Board, the penalty is $100,000 per calendar year.

OLD FEDERAL LAW (Sec. 6708)

Federal law provides that organizers and sellers of specific tax shelters are required to maintain list of investors. The penalty for failure to do so is $50 for each name missing from the list, unless the failure is due to reasonable cause, up to a maximum of $50,000 per year.

NEW FEDERAL LAW (Sec. 6708)

The act increases the maximum penalty to $100,000 per calendar year.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The increase in the maximum amount this penalty is applicable to failures occurring or continuing after October 22, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Reductions in penalty collections from conforming to the new federal assessment are unknown but would be very minor.

Title XVD4: Compliance and Tax Administration

ACTION: EXPAND THE TAX SHELTER TRANSACTIONS ON WHICH 120 PERCENT OF THE NORMAL INTEREST RATE WILL BE CHARGED

Act Section 1535 Conference Report Page 795

Form 540 Line No. N/A Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 19269)

California did not conform to the 1984 federal provision which imposed a higher interest rate on deficiencies with respect to substantial underpayment of tax as determined by the tax court to be attributable to tax motivated transactions. However, interest (compounded daily) is charged upon deficiencies or other delinquent payments of tax at a rate adjusted on January 1 and July 1 to reflect the average predominant bank rate for the six month periods ending September 30 and March 31, respectively.

Old FEDERAL LAW (Sec. 6621)

Since 1984, the federal law has provided that a higher interest rate equal to 120 percent of the normal interest rate must be paid by the taxpayer due to substantial underpayment of tax (more than $1,000) as determined by the tax court to be attributable to a tax-motivated transaction.

Tax-motivated transactions are defined as those involving:

1. Any valuation overstatement of 150 percent or more.

2. Any loss disallowed by 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 for any period.

5. Any deduction disallowed relating to an activity or transaction not entered into for a profit.

Based on Tax Court decisions (DeMartino v. Comm'r., T.C. Memo 1986-263 (June 30, 1986); Forseth v. Comm'r., T.C. Memo 1985-279 (June 11, 1985)) sham transactions are not subject to the special interest rate since the transactions are not considered genuine transactions.

NEW FEDERAL LAW (Sec.6621)

The act, consistent with the original legislative intent, enacted in 1984, explicitly adds that underpayments resulting from sham or fraudulent transactions would be made subject to interest at 120 percent of the applicable rates as are underpayments attributable to tax-motivated transactions.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision is effective for interest accruing on or after January 1, 1985; except in the case of any underpayment where there was a final court decision before October 22, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on Joint Committee on Taxation estimates of an earlier proposal that would have raised the additional interest from 120 percent to 200 percent, comparable revenue gains to the state from adopting a 120 percent interest rate differential would be in the $1 million range annually.

TAX POLICY ISSUES

California did not conform to the Tax Reform Act of 1984 section 144 which applied a higher interest rate due to substantial under payments attributable to tax-motivated transactions. According to the Congressional Committee reports the purpose in enacting the provision was to give the Tax Court an additional tool in managing its large backlog of pending tax shelter case and California did not have this large backlog at the Board of Equalization (the state appeal body). (Item 91a and 91b of the Assembly Committee on Revenue and Taxation Report dated February 14, 1985).

As of September 15, 1986, there are 29 tax shelter cases under appeal at the Board of Equalization for a revenue amount of $1,048,386.25. There are an additional 1100 cases in the process of being affirmed by the Franchise Tax Board which have a high probability of being appealed to the Board of Equalization.

ADMINISTRATIVE CONCERNS

Conforming to this federal provision would not significantly impact the operation of the department.

Title XVEi: Compliance and Tax Administration

ACTION: INCREASE REQUIRED PAYMENTS OF ESTIMATED TAX PAYMENTS

Act Section 1541 Conference Report Page 797

Form 540 Line No. 78 Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 18682)

California generally conforms to the federal exceptions that pertain to the imposition of the penalty for the underpayment of estimated tax by individuals. In order to avoid the imposition of the penalty, at least 80% of the current year's tax must be paid in four equal installments. In addition, under California law, no penalty will be imposed if:

- 80% of the preceding or current year's tax was paid by withholding of tax on wages.
- 80% of the current year's adjusted gross income consists of wages subject to withholding.

California law also differs from federal law in that California does not:

- impose a penalty if the total unpaid tax is less than $100, whereas the federal threshold is $500; and
- require the payments of estimated tax to include the California preference tax, whereas, federal law requires estimated payments of the alternative minimum tax, when applicable.

NEW FEDERAL LAW (Sec. 6654)

Under this act at least 90% of the current year's tax (regular or alternative minimum) must be paid in four equal installments in order to avoid the underpayment penalty.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This act is effective for taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Assuming this provision is effective for estimated tax payments that are due for taxable years beginning on or after January 1, 1988, the 12.5% increase in payments (80% to 90%) would result in a personal income tax revenue gain of $62 million for 1987-88, the first fiscal year affected, and $6 million for 1988-89.

The gain in the first fiscal year is significantly larger, because the April and June payments that are due for taxable year 1988 are paid during the 1987-88 fiscal year, however, the return is not filed until the subsequent fiscal year. After the first year, the revenue gain will level off, accordingly.

These estimates are based on the following assumptions:

1) Projected total estimated tax payments for taxable year 1988 (1984 payments of $2.656 billion increased 10% per year).. $3.889 billion

2) 40% of the estimate tax payments are paid based upon the current year's tax, and therefore, would be affected........ $1.556 billion

3) The increase in the estimated tax payments would average 8% rather than the full 12.5%, because there are those whose payments currently exceed 80%....... $124 million

TAX POLICY ISSUES

In reviewing this provision, consideration could also be given as to whether:

o the estimated tax requirements should apply to California's tax on preference income;

o the withholding amount should be increased from 80% to 90% of the tax to avoid the penalty for underpayment of estimated tax.

ADMINISTRATIVE CONCERNS

It should be noted that if conformity is applicable, the federal act should also be followed with respect to the effective date in The California provision should be operative with respect to payments for the taxable year following enactment. Otherwise:

1) the department may incur increased administrative costs to resolve underpayment penalties that would result. The penalty would result because prior payments for the same tax year would be based on the 80% requirement and, therefore, the amount of the installments would not be equal. The installments must, also, be equal in amount to avoid the underpayment penalty; and,

2) implementation problems may occur if the Office of State Printing could not accommodate the printing of the revised estimated tax payment instruction form at the particular time of the year which would be required

to facilitate the increase in the estimate payments that would be payable during the remainder of the taxable year of enactment.

In addition, there is concern that since the payments are due and payable within relatively short periods of time during the year (basically quarterly), there would be insufficient time after enactment to notify the taxpayers before the next installment would be due.

ACTION: REQUIRE ESTIMATED TAX PAYMENTS ON UNRELATED BUSINESS INCOME OF EXEMPT ORGANIZATIONS

Act Section 1542 Conference Report Page 797

Form 540 Line No. N/A Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 25561)

California currently does not conform to federal law with respect to the payment of estimated taxes on unrelated business income of exempt organizations or net investment income that is subject to excise taxes. Unlike federal law, California requires exempt corporations that have unrelated business income to make estimate tax payments. California does not impose an excise tax.

NEW FEDERAL LAW (Sec. 6154)

The act requires certain private foundations that are subject to excise tax on net investment income and exempt organizations that have unrelated business income to make estimated payments on the tax that is due on that income.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective for taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

This provision has no impact on California's revenue since California already requires estimated tax payments on unrelated business income of exempt corporations.

Title XVE3: Compliance and Tax Administration

ACTION: WAIVER OF ESTIMATED TAX PENALTIES

Act Section 1543 Conference Report Page 798

Form 540 Line No. N/A Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (No provision)

No provision.

NEW FEDERAL LAW (Act Sec. 1543)

The act provides that no penalty for underpayment of the estimated tax will be imposed for periods prior to April 16, 1987, with respect to individuals, and March 16, 1987 for corporations, to the extent that the underpayment was created by or the result of changes in law made by the Tax Reform Act of 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No specific national estimate was developed by the Joint Committee on Taxation for this waiver of the underpayment penalty. Any reduction in penalties collected under state conformity is unknown but would probably not be significant.

TAX POLICY ISSUES

If California desires to conform to the principle of this issue, the exception should apply to periods prior to April 16, 1988 (March 16, 1988 for corporate taxpayers) with respect to the extent that any underpayment was created or increased by the provisions of the bill conforming to the federal changes.

Title XVFi: Compliance and Tax Administration

ACTION: REVISE AWARDS OF ATTORNEYS' FEES

Act Section 1551 Conference Report Page 799

Form 540 Line No. N/A Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 19420 and 26491)

California is conformed to federal law with respect to civil proceedings commenced on or after July 28, 1983 and on or before December 31, 1985, in that a taxpayer can be awarded reasonable litigation costs, by court order or an agreement of the parties, if the taxpayer can prove that the State's position in the proceeding was unreasonable and the taxpayer prevailed with respect to the amount in controversy or with respect to the most significant issues or sets of issues.

In conforming, California did not extend this provision to the proceedings before the State Board of Equalization, which has a role comparable to the U. S. Tax Court, in that it hears the appeals of tax issues.

NEW FEDERAL LAW (Sec. 7430)

Under this act:

- an award by the Tax Court is specifically payable in the same manner as an award by the district court.
- the $25,000 maximum amount that can be awarded for reasonable litigation costs is lifted, and instead, the reasonable expenses of an expert witness can not exceed the highest rate of compensation paid for expert witnesses paid by the United States, and the reasonable fees paid for an attorney can not exceed $75 per hour unless the court determines that an increase in the cost of living or special factor justifies a higher rate.
- the award will be denied if the taxpayer unreasonably extends the proceedings.
- to be subject to an award, the taxpayer has to establish that the government's position was not "substantially justified" rather than "unreasonable". In addition, in general, the individual, at the time the proceeding is initiated, cannot have a net worth that exceeds $2 million, and the owners of businesses (other than sole proprietorships) cannot have a net

worth that exceeds $7 million nor more than 500 employees.

- the December 31, 1985 sunset date is removed.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This act applies to amounts paid after September 30, 1986 in proceedings commenced on or after January 1, 1986. However, the change that makes the tax court awards payable in the same manner as those of the district court, is retroactive.

In cases where the proceeding was commenced on or after January 1, 1986 but is disposed of prior to October 22, 1986, a request for attorney's fees can be made within the 30-days immediately following October 22, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Joint Committee on Taxation has not provided a separate estimate on this change, which signifies a rather minor impact for the nation and no state data is available to estimate the state impact of this provision. Therefore, state conformity to these changes, would result in an unknown impact.

ACTION: PROVIDE PENALTY FOR FAILURE TO EXHAUST ADMINISTRATIVE REMEDIES

Act Section 1552 | Conference Report Page 802

Form 540 Line No. N/A | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 19414)

California does not conform to the federal's appeal process. Under California law, the review levels for the protest and the appeal of a proposed assessment are administrative only, i. e., a taxpayer's protest of a proposed assessment is filed with the Franchise Tax Board, which is an administrative review, and then, the taxpayer is able to appeal the department's findings to the Board of Equalization (California's counterpart to the U.S. Tax Court), which is also an administrative review.

California conforms, however, to the federal penalty for unmeritorious proceedings, in that the Board of Equalization (or any court) shall impose a $5,000 penalty when it determines the taxpayer's protest serves no purpose except to delay or that it is frivolous or groundless.

NEW FEDERAL LAW (Sec. 6673)

Federal law allows the taxpayer to choose whether to request an administrative review of the protested proposed assessment prior to an appeal to the Tax Court or whether to appeal directly to the Tax Court. This act authorizes the Tax Court to consider imposing the penalty for unmeritorious proceedings if the court finds that the taxpayer was unreasonable in failing to pursue the available administrative remedies prior to initiating the Tax Court proceeding.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This act is effective for proceedings commenced on or after October 22, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Since California's appeal process is not comparable, to federal law, with respect to the discretionary administrative review procedure, no identifiable revenue effect can be assigned to this provision.

Title XVF3: Compliance and Tax Administration

ACTION: REPORT TO CONGRESS ON TAX COURT INVENTORY

Act Section 1552 | Conference Report Page 803

Form 540 Line No. N/A | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (No provision)

California uses the State Board of Equalization (SBE) as the appellant body for tax issues, instead of a tax court as the federal does.

NEW FEDERAL LAW (Sec. None)

The act requires the Internal Revenue Service and the Tax Court to prepare a report to the congressional finance committees for 1987 and for each 2-calendar year period thereafter on the inventory of cases in the Tax Court and the measures to close cases more efficiently.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

This provisions is not applicable to tax revenue.

Title XVF4a: Compliance and Tax Administration

ACTION: ESTABLISH A TAX COURT PRACTICE FEE

Act Section 1553 Conference Report Page 803

Form 540 Line No. N/A Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (None)

California law does not have a tax court. Instead the taxpayer appeals the department's findings to the State Board of Equalization.

There is no requirement to apply for admission to practice before the Board of Equalization, therefore, anyone can represent an appellant.

NEW FEDERAL LAW (Sec. 7475)

This act authorizes the Tax Court to impose a periodic registration fee, not to exceed $30 per year, on practitioners that are allowed to practice before it. This fee is in addition to the $25 application fee that is currently required prior to admission to practice. The Tax Court is to use the fee to employ independent counsel to pursue disciplinary matters.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This act is effective January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No identifiable revenue effect can be assigned to this provision under the Personal Income Tax Law or Bank and Corporation Tax Law.

Title XVF4b: Compliance and Tax Administration

ACTION: CLARIFICATION OF TAX COURT'S JURISDICTION OVER LATE PAYMENT PENALTIES

Act Section 1554 — Conference Report Page 804

Form 540 Line No. N/A — Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 18583.5 and 25662.5)

Under California and federal law, a deficiency assessment is issued if it is determined that the tax disclosed on the original return is less than the tax that is required to be shown. Any interest, penalty or addition to tax, may also be assessed as a deficiency.

Under California law, the amount of any deficiency assessment may be protested and is subject to an appeal. In addition, denied claims for refund are subject to appeal. Taxpayers appeal to the State Board of Equalization however, the manner in which the penalty (or tax) is imposed determines the method of appeal:

1) Late payment penalties are imposed as deficiency assessments if a deficiency in tax is also at issue. Under this method of assessment the Board of Equalization has jurisdiction over the imposition of the late payment penalty (and tax) if a timely protest and appeal is filed.

2) If a tax deficiency is not at issue (or the additional tax is due as a result of a math error), the late payment penalty is imposed through a notice and demand. Under this method, the Board of Equalization has jurisdiction over the late payment penalty (and tax) only after the amount is paid and a claim for refund has been denied.

NEW FEDERAL LAW (Sec. 6214)

This change is clarification of the Tax Court's authority to determine whether any additions to tax should be assessed. The use of the word "any", makes the jurisdiction inclusive of penalties. This amendment is in response to a Tax Court decision, Estate of Young v Commissioner, 81 T.C. 879 (1983), which held that although a tax court had jurisdiction to redetermine a deficiency it did not have jurisdiction to impose penalties for failure to pay the tax owed.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This change would apply to any decisions of the Tax Court that are not final before October 22, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

There would be no apparent revenue impact.

Title XVF4c: Compliance and Tax Administration

ACTION: SPECIFICALLY AUTHORIZE TAX COURT TO USE U.S. MARSHALS

Act Section 1555 Conference Report Page 804

Form 540 Line No. N/A Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (None)

California does not have a tax court. Instead of a tax court, the taxpayer appeals the department's findings to the State Board of Equalization.

NEW FEDERAL LAW (Sec. 7456)

This act specifically requires the U. S. Marshal to attend any session of the Tax Court when requested to do so by the Chief Judge.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective October 22, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No identifiable tax revenue effect can be attributed to this provision under state law.

Title XVF4d: Compliance and Tax Administration

ACTION: <u>INCREASE REIMBURSEMENT FOR EXPENSES OF SPECIAL TRIAL JUDGES AND PROVIDE FOR SALARY</u>

Act Section 1556 Conference Report Page 805

Form 540 Line No. N/A Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (None)

California does not have a tax court. Instead of a tax court, the taxpayer appeals the department's findings to the State Board of Equalization. The members of the Board are elected officials whose salaries are statutorily established.

NEW FEDERAL LAW (Sec. 7443A)

This change adds a provision that authorizes the Chief Judge of the Tax Court to appoint Special Trial Judges to hear declaratory judgement proceedings, certain disputes involving $10,000 or less, and any other proceeding which the Chief Judge may designate. The salary of the special trial judges is set at 90 percent of the salary of a judge of the tax court and the special trial judges will be entitled to the same travel and subsistence allowances as a judge of the tax court.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provisions relative to the salary of the Special Trial Judges would be effective on the first day of the first month beginning after October 22, 1986. The other provisions would be effective October 22, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Since California has a different judicial system at the trail court level, this federal provision cannot be directly applied to California.

Title XVF4e: Compliance and Tax Administration

ACTION: ALLOW RETIRED TAX COURT JUDGES TO PRACTICE AND RECEIVE RETIREMENT PAY

Act Section 1557 — Conference Report Page 805

Form 540 Line No. N/A — Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (None)

California does not have a tax court. Instead of a tax court, the taxpayer appeals the department's findings to the State Board of Equalization. Members of the Board are elected officials and are not judges of a court. As an elected official, a Board member may become a member of the Legislators' Retirement System. A Board member's retirement pay is not contingent upon or restricted by subsequent practice of tax law or acceptance of another government position.

NEW FEDERAL LAW (Sec. 7447)

This act revises the retirement requirements for tax court judges so that judges with less than 15 years of service can retire, if they are older than 65 years of age.

If a tax court judge elects to freeze his/her retirement pay so that it is no longer tied to the salary of active tax court judges then the judge can receive compensation for services in any civil office or for the federal government, and the retirement pay is no longer forfeited but instead is suspended for the duration of the period for which compensation is received. In addition, the retired judge may practice tax law privately and continue to receive their retirement pay.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This act is effective October 22, 1986. It is expressly provided that this act does not apply to any individual, who prior to October 22, 1986 elected not to receive his or her retirement pay.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Because California law is not compatible with this federal provision no identifiable revenue effect can be assigned.

Title XVF4f: Compliance and Tax Administration

ACTION: SPECIFICALLY PROVIDE FOR THE APPEAL FROM A TAX COURT'S INTERLOCUTORY ORDER

Act Section 1558 | Conference Report Page 806

Form 540 Line No. N/A | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (No Provision)

There are no provisions in California law that authorize California courts or the State Board of Equalization (California's counterpart to the U. S. Tax Court) to grant interlocutory orders allowing the appellant court to decide a controlling question of law that is necessary to the decision that is before the court that granted the order. In addition, there is no authority that allows California courts jurisdiction over appeals from such orders.

NEW FEDERAL LAW (Sec. 7482)

Current federal law specifically authorizes the judge of a district court to grant an interlocutory order and provides the Court of Appeal with jurisdiction over such an order. Case law has held that the Court of Appeals does not have the authority to hear an appeal from an interlocutory order of the Tax Court. This act specifically provides the Tax Court with the authority to issue such interlocutory orders and to allow the U.S. Court of Appeals jurisdiction over the order if a judge of the tax court includes in the interlocutory order a statement that a controlling question of law is involved, that there is substantial ground for difference of opinion regarding the question of law, and that an immediate appeal might materially advance the alternate termination of the litigation.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This act is effective for orders of the Tax Court entered after October 22, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Because California law is not compatible with this federal provision no identifiable revenue effect can be assigned.

Title XVHi: Compliance and Tax Administration

ACTION: EXPAND SUSPENSION OF RUNNING OF STATUTE OF LIMITATIONS

Act Section 1561 | Conference Report Page 809

Form 540 Line No. N/A | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 18586.7, 19254, 25663d, 26423)

California conforms to federal law with respect to suspending the running of the statute of limitations for a deficiency assessment, false or fraudulent return, or criminal prosecution, if a taxpayer initiates a motion to quash a subpoena or subpoena duces tecum. The running of the statute of limitations is suspended for the period during which the enforcement of the subpoena is pending.

California law is also similar to federal law in that the Franchise Tax Board has the authority to demand a taxpayer's records from parties other than the taxpayer (third-parties) who have control of such records. In addition, the Franchise Tax Board has the authority to issue an administrative subpoena or subpoena duces tecum to obtain the records (whereas the IRS uses an administrative summons).

Under California law, a delay by a third-party to produce the records or otherwise resolve the matter, will not stop the running of the statute of limitations.

NEW FEDERAL LAW (Sec. 7609)

Under the new federal law, if a third-party is summoned to produce the taxpayer's records, the third-party has 6 months from the date the summons was served to comply or otherwise resolve the matter at issue, otherwise the running of the statute of limitation for a deficiency assessment, false or fraudulent return, or criminal prosecution is suspended beginning on the day after the expiration of the 6-month period until the final resolution of the matter at issue.

In addition, if the running of the statute of limitations is suspended because of a third-party delay and the summons is one in which the taxpayer is not identified, the third-party must notify the person described in the summons of the suspension.

EFFECTIVE DATE OF FEDERAL PROVISIONS

These changes are effective October 22, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No state data exists to estimate the impact under state conformity. However, based on the negligible revenue gain to the nation anticipated by the Joint Committee on Taxation, any resulting state revenue gains are unknown, but most likely would be very minor in any given year.

Title XVH2: Compliance and Tax Administration

ACTION: PROVIDE AUTHORITY TO RESCIND STATUTORY NOTICE OF DEFICIENCY

Act Section 1562 | Conference Report Page 810

Form 540 Line No. N/A | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 18592, 25666)

California law differs from the federal law with respect to the protest of a deficiency assessment. Under California law, the department is the first level of review (rather than a tax court) and, therefore, the department has the authority to rescind the notice of deficiency assessment.

NEW FEDERAL LAW (Sec. 6212)

The act provides the Internal Revenue Service with the authority to rescind a notice of deficiency with the taxpayer's consent. Currently only the Tax Court can cause a deficiency assessment to be rescinded.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective with respect to notices of deficiencies issued on or after January 1, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

This provision would not impact tax revenue since under state law the department can rescind deficiency assessments on its own accord.

Title XVH3: Compliance and Tax Administration

ACTION: <u>PROVIDE AUTHORITY TO ABATE INTEREST DUE TO THE INTERNAL REVENUE SERVICE'S ERROR OR DELAY</u>

Act Section 1563 | Conference Report Page 810

Form 540 Line No. N/A | Form 100 Line No. N/A

<u>CURRENT CALIFORNIA LAW (Sec. 18688, 19111, 25901b, 26281)</u>

The following are California's provisions that relate to interest that may accrue as a result of errors made by the Franchise Tax Board:

- o Effective on or after January 1, 1987, the department has the authority to abate interest, in certain cases where a taxpayer is delinquent in paying the required tax because of reliance upon the Franchise Tax Board's written advice. (AB 2615, Ch. 535 Stats. 1986)

- o California law does not specifically authorize the department to complete a taxpayer's tax return, but administratively, under limited circumstances, the department will do so. California law is comparable to the federal, in that it contains no specific authority to waive interest that accrues as a result of the error by the department in completing a taxpayer's return.

- o Under current practice, interest accrues on an erroneous refund made to an individual, from the date the department issues a demand for payment until the date paid; for erroneous refunds to corporations, interest accrues from the date the erroneous refund was issued until the date paid.

Effective January 1, 1987 by law, interest will accrue on erroneous refunds made to individuals and corporations beginning 30 days after the date that the demand for payment is mailed until the amount is paid (irrespective of whether the taxpayer caused the refund, or the amount of the refund). (AB 2891, Ch. 550 Stats. 1986)

With respect to claims for refund or credit, California allows such claims to be filed four years from the due date of the return, or one year from the date of payment, which ever is later, whereas under federal law it is, generally, three years from the return or two years from the date paid. Under both laws, claims filed outside the statute of limitations are barred.

NEW FEDERAL LAW (Sec. 6404, 6602)

The federal act provides the Internal Revenue Service (IRS) with the authority to abate all or any part of the interest that results from its error or delay in the performance of ministerial acts, which includes the completion of tax returns for taxpayers.

In addition, the act requires the IRS to abate any interest on erroneous refunds that accrues prior to the date the demand for payment is made, unless the taxpayer has in any way caused the erroneous refund or the refund exceeds $50,000. This provision is retroactively applied, whereas California's similar provision (AB 2891, Ch. 550 Stats. 1986) is prospective in application.

The statute of limitations for refunds or credits resulting from these retroactive abatement provisions is modified, so that any resulting refund or credit is not barred if the claim is filed by October 22, 1987.

EFFECTIVE DATE OF FEDERAL PROVISIONS

These provisions are effective with respect to deficiencies or payments for taxable years beginning on or after January 1, 1979.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The net impact on interest collections as a result of these various interest provisions is unknown. However, since the Joint Committee on Taxation did not specifically estimate this item, which signifies a very minor impact, these provisions, under conformity, would also be minimal.

POLICY CONSIDERATIONS

To conform to the federal act's retroactive effective date would be in violation of the California Constitution as providing for a gift of public funds.

Title XVH4: Compliance and Tax Administration

ACTION: SUSPEND THE COMPOUNDING OF INTEREST FOR LATE NOTICES OF A DEFICIENCY

Act Section 1564 Conference Report Page 812

Form 540 Line No. N/A Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 18688.5)

California has a provision that is similar to that of the federal law with respect to the suspension of the accrual of interest when the department delays in issuing an individual's deficiency assessment. However under California law,

- o suspension begins 46 days after the department's final review of the auditor's findings, whereas for federal purposes, the suspension begins 31 days after the taxpayer agrees with the auditor's findings by waiving his or her rights to protest the deficiency assessment; and

- o during this period of suspension, the accrual of all interest that relates to the deficiency assessment is suspended, whereas under the federal law, the suspension of interest was specifically applicable to only that accruing on the deficiency rather than any interest that is related to the deficiency.

OLD FEDERAL LAW (Section 6213, 6601)

Federal law allows a taxpayer to waive his/her right to appeal a deficiency to the Tax Court. Following such waiver, the Internal Revenue Service issues a notice and demand for payment. If the notice and demand is not issued within 30 days of the waiver, the accrual of interest is suspended from the 30th day until the notice and demand is issued. However, the compounding of interest upon the previously occured interest is not suspended.

NEW FEDERAL LAW (Sec. 6601)

The act provides that during the period when the accrual of interest is suspended because of the Internal Revenue Service's delay in issuing an individual's or corporation's deficiency assessment, interest will also not be imposed during the suspension period on any interest that is accruing relative to the deficiency.

The statute of limitations for refunds or credits resulting from this provision is modified if certain circumstances prevent the timely issuance of the refund or credit, for the claims filed by October 22, 1987.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective with respect to interest accruing after December 31, 1982.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Since complete conformity would require other changes in California law and practice, no revenue estimate has been made. With respect to suspending the compounding of interest during the period for which California currently suspends the accrual of interest, there would be no revenue effect.

ADMINISTRATIVE CONCERNS

Current California law does not allow a taxpayer to waive his/her rights to protest and appeal. Thus complete conformity to this provision would require other changes in California law and practice.

ACTION: EXEMPT SERVICE-CONNECTED DISABILITY PAYMENTS FROM LEVY

Act Section 1565 | Conference Report Page 812

Form 540 Line No. N/A | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 18817)

California law has a levy provision similar to that of federal law in that the department has the authority to levy (Order to Withhold) on payments due to a tax-debtor from various income sources, unless the payments are exempt from levy through other laws. The levy under California law, however, is not as far reaching as that of federal law, because the California levy can only attach to payments where the payor is subject to California law. For example, payments that are due from the federal government are not subject to the department's levy because the federal government is not subject to California law. Another example of the difference in the reaching affect of the levies is with respect to veteran's benefits (which includes service-connected benefits) under the United States Code (USC). Under the USC, creditors (which includes the Franchise Tax Board) are prohibited from levying on the payments of veteran's benefits, but, a levy under the IRC is expressly allowed.

NEW FEDERAL LAW (Sec. 6334)

The act specifically exempts an individual's service-connected veteran disability benefits from levy under the Internal Revenue Code.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective for amounts payable on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

This provision is not applicable under California law. No state revenue impact exists from the federal change.

Title XVH7: Compliance and Tax Administration

ACTION: EXEMPT INTERNAL REVENUE SERVICE AGENTS FROM CERTAIN RECORDKEEPING REQUIREMENTS

Act Section 1567 Conference Report Page 814

Form 540 Line No. N/A Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17131, 17201, 17270.5)

California conforms to the federal law that provides that under certain conditions the usage of an unmarked law enforcement vehicle is excluded from gross income and that the law enforcement officer is exempt from the substantiation rules. For this purpose, a law enforcement officer means an individual who is employed on a full-time basis by a governmental unit that is responsible for the prevention or investigation of crime involving injury to persons or property, and who is authorized by law to carry firearms (and regularly carries firearms, unless working undercover), execute search warrants and make arrests.

The term law enforcement officer does not include an Internal Revenue Service special agent. The Franchise Tax Board uses investigation specialists and tax compliance representatives to investigate criminal tax law violations, however, the department's investigators are not authorized to carry firearms, execute search warrants, or make arrests and are not considered to be law enforcement officers.

NEW FEDERAL LAW (Sec. 132 and 274)

The act specifically excludes from gross income and the usual substantiation requirements for an employer provided automobile used in the employees activities of an automobile by a special agent of the Internal Revenue Service.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provisions is effective beginning on or after January 1, 1985.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Any personal use of vehicles that are assigned to either state or federal tax enforcement employees would result in taxable income under current state law.

- Conforming to the federal exclusion would produce unknown but minimal revenue loss under the Personal Income Tax Law.

- o If California were to conform <u>and</u> extend the provision to include the department's investigation staff, the revenue impact would, again, be unknown but minimal.

The elimination of the record keeping requirements does not have a directly identifiable revenue impact.

Title XVH8: Compliance and Tax Administration

ACTION: <u>EXPAND TAX RETURN DISCLOSURE TO INCLUDE CERTAIN CITIES</u>

Act Section 1568 | Conference Report Page 814

Form 540 Line No. N/A | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 19282, 26451)

The California disclosure laws are similar to the federal provisions in that the department is prohibited from disclosing, unless otherwise specifically provided, any information contained on any returns, reports, or documents required to be filed.

The department is authorized to disclose tax return information to certain state agencies for purposes so specified and to state and federal tax officials for tax purposes.

With respect to the need to disclose information to city officials, the department is not authorized to make such disclosure at this time, and the Revenue and Tax Code prohibits cities from imposing a tax on income.

NEW FEDERAL LAW (Sec. 6103)

The act authorizes the Internal Revenue Service to disclose tax return information to certain city officials if the city has a population in excess of 2 million and imposes a tax on income.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective October 22, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

This provision is not applicable California, given the existing statutory prohibition on local income taxes.

TAX POLICY ISSUES

The Franchise Tax Board in its Resolution of March 4, 1986 stated its opposition to any legislation that breaches the confidentiality of income tax return information for nontax purposes.

Title XVH10: Compliance and Tax Administration

ACTION: GIVE CERTAIN LOCAL LAW ENFORCEMENT FORFEITURES SPECIFIC PRIORITY OVER INTERNAL REVENUE SERVICE'S TAX LIENS

Act Section 1569 | Conference Report Page 815

Form 540 Line No. N/A | Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 18881 and 26161)

The Personal Income and Bank and Corporation Tax Law, with respect to tax liens, generally conforms to the federal law in that it creates a lien upon any property interests of a taxpayer at the time an unpaid tax liability becomes due and payable. Once the lien is recorded or filed it takes priority over the unrecorded liens of general creditors and certain other interests.

Under certain California laws (e.g., controlled substances/Health and Safety Code; criminal profiteering activity/Penal Code), when property is used in, acquired or accumulated through the commission of certain criminal offenses, a law enforcement agency has the authority to petition the court to have the seized property forfeited upon conviction.

Under the Personal Income and Bank and Corporation Tax Law a state tax lien that is recorded or filed after the property is seized for forfeiture by the law enforcement, is not given priority over the law enforcement agency's interest in the seized property.

NEW FEDERAL LAW (Sec. 6323)

The act provides that an Internal Revenue Service tax lien, that is recorded or filed after the seizure of the property by a local law enforcement agency, does not take priority over the agency's interest in that property, unless the local law provides that someone with an intervening claim has priority in the property.

The act also provides that the local law enforcement interest in the property is acquired at the time the property is seized.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision was effective October 22, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

There is no identifiable revenue impact from this provision.

TAX POLICY ISSUES

It should be noted that from the department's standpoint, the most significant aspect of this provision is the establishment of when a law enforcement agency's interest in the property for forfeiture is acquired. Currently there is no such law and local law enforcement agencies (as well as federal agencies) argue that the interest is acquired at the time of the criminal offense, which may be years prior to seizure.

The department is not currently pursuing the enforcement of its tax liens against this type of seized property, as the property ultimately benefits the law enforcement programs and does not benefit the taxpayer. Even though this provision would not impact the priority of a tax lien with respect to its priority at the time of seizure, this provision could be viewed by the department as indirectly beneficial because it codifies the establishment of a time that the law enforcement agency's interest is acquired. This could be beneficial to the department if it was found necessary to enforce a lien that was recorded or filed prior to the law enforcement agency's seizure, because codifying the time of the seizure as the time of acquiring interest in the property implies that the law enforcement agency does not have an interest prior to the seizure, and, therefore, a tax lien recorded or filed prior to that time would be senior to the forfeiture.

On the other hand, conformity would undoubtedly be opposed by the local law enforcement agencies (including the State Department of Justice) if they realize the implication that exists.

ACTION: AUTHORIZE INTERNAL REVENUE SERVICE TO RELEASE SEIZED PROPERTY TO THE TAX DEBTOR UNDER CERTAIN CIRCUMSTANCES

Act Section 1570 Conference Report Page 816

Form 540 Line No. N/A Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 18907, 26191, and 26221)

The Personal Income Tax Law (PITL) does not conform to the federal law with respect to the authorization to seize and sell property of a tax debtor, in that the department can not make such seizures and sales itself. It is only authorized to instruct a law enforcement officer to do so, whereas the federal law authorizes the Internal Revenue Service (IRS) to make the seizure and sale. Under California law, the law enforcement officer is required to sell the property through the auction procedure that is outlined in the Code of Civil Procedure, which is basically the procedure that is outlined in the Internal Revenue Code. In following this procedure, if a bid which equals or exceeds the established minimum acceptable price is not received, the property can be released to the tax debtor, unless the department takes additional actions (e.g., issues another warrant to have the officer retain possession of the property; bids, with an authorized pre-approval, the established minimum price and purchases the property for the State.).

The law for corporations with respect to the seizure and sale of property of a tax debtor basically conforms to that of the federal law, in that the department is authorized to make the seizure and auction sale itself. However, there is no provision which prohibits the release of the property to the tax debtor. In addition under corporation tax law, the department is provided with the same authority as provided under PITL, which is to instruct a law enforcement officer to seize and sell property. Under current practice, the department uses the law enforcement officer to seize and sell the property of corporate tax debtors, rather than initiate the action itself.

NEW FEDERAL LAW (Sec. 6335(e))

A provision is added to federal law to allow the IRS to release seized property to the tax debtor, if the minimum price is not bid at the auction sale and the Secretary determines that purchase at the minimum price is not in the best interest of the United States. However, the property would still be subject to a government lien and any expense incurred in the levy process would be added to the existing lien amount.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This change applies to property seized after October 22, 1986 and property seized prior to but not sold by October 22, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

There is no apparent revenue impact in as much as the authority to release seized property to the tax debtor already exists under state law.

Title XVH12: Compliance and Tax Administration

ACTION: <u>RESTRICTS THE USE OF THE OPTIONAL METHOD OF EMPLOYEE TIP ALLOCATION</u>

Act Section 1571 Conference Report Page 817

Form 540 Line No. 00 Form 100 Line No. 00

<u>CURRENT CALIFORNIA LAW (Sec. 18802)</u>

California law differs from the federal law with respect to the reporting of income information in that under California law the Franchise Tax Board administers the receipt of some of the information but the majority of the information as it relates to employers/employees is administered by the Employment Development Department (EDD). The Personal Income Tax Law requires certain payors of income to report information pertaining to the payment to the Franchise Tax Board, however, the reporting of tips is specifically excluded from this provision. The law relating to the reporting of tips is administered by EDD.

<u>NEW FEDERAL LAW (Act Sec. 1571)</u>

The act restricts, to establishments employing less than 25 full-time employees, permission to use the optional method of substituting the number of hours worked by a tipped employee for the portion gross receipts attributable to that employee.

<u>EFFECTIVE DATE OF FEDERAL PROVISIONS</u>

This change is effective for any payroll period beginning on or after January 1, 1987.

<u>REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW</u>

No estimates of possible revenue effects from this provision are provided by the Joint Committee on Taxation which signifies an insignificant impact for the nation. Therefore, conforming to this provision would have a negligible state revenue impact.

Title XVH13: Compliance and Tax Administration

ACTION: <u>PROVIDE THAT FORFEITURES UNDER LAND SALES CONTRACTS ARE TREATED AS SALES FOR PURPOSES OF INTERNAL REVENUE SERVICE TAX LIENS</u>

Act Section 1572 Conference Report Page 818

Form 540 Line No. N/A Form 100 Line No. N/A

<u>CURRENT CALIFORNIA LAW (Sec. 18881 and 26161)</u>

The Personal Income and Bank and Corporation Tax Laws (PITL/BCTL) do not conform to the federal provision that specifically requires notification of sales of property in order to have the lien extinguished or discharged and to prevent the property from remaining subject to the lien. However, there is a requirement that mortgagees or trustees notify the state taxing agency of pending foreclosure sales when tax liens are recorded. Also, under California's current business practices, the department is notified of most pending real property sales which have recorded tax liens so that the lien can be satisfied and the property sold free and clear of all liens.

With respect to sales of real property under land sales contracts, California law differs from the Washington state law which resulted in this provision in the federal act. Under California law a default in such a land sale contract is enforced by allowing the contract to expire or by clearing title through a judicial proceeding. Under Washington state law, a default results in a forfeiture back to the seller without a judicial proceeding.

Under California law, the PITL/BCTL lien is enforced through the provisions of the Civil Code and Code of Civil Procedure and is usually satisfied through judicial proceedings brought by other parties which includes quiet title actions or actions to determine lien priority.

In addition, a state taxing agency has the authority to bring a judicial proceeding to foreclose on its tax lien through a sale, or issue a warrant to have a law enforcement officer sell the tax debtor's interest in the property at an auction sale. Generally, a forced sale would be considered only if the tax debtor's interest is clearly defined and sufficient to warrant the action, all other collection remedies have been exhausted. At an auction sale, the department has the authority, upon pre-approved request, to purchase the tax debtor's interest in the property at issue.

In all actions in which a state taxing agency (e.g., FTB) is a party, the State's interest in the property is protected in that upon a pre-approved request the taxing agency can bid upon and purchase the tax debtor's interest in the property at issue.

NEW FEDERAL LAW (Sec. 7425(c))

This provision requires sellers of land sales contracts to notify IRS of defaults prior to forfeiture when IRS tax liens are recorded at least 30 days prior to the declaration of forfeiture. This notification enables the IRS to review the case at that time to determine whether the tax debtor's interest in the property is sufficient to warrant the IRS's purchase of the interest.

This amendment is in response to the effect of the application of Washington state law upon the IRS. Application of this local law resulted in the IRS's failure to be notified of the pending forfeiture because it was deemed a sale and, thereby, restricted its opportunity to purchase the tax debtor's interest in the contract or otherwise assert its tax lien.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision applies to forfeitures after November 21, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Not applicable to California.

Title XVI: Compliance and Tax Administration

ACTION: MODIFY EMPLOYEE WITHHOLDING

Act Section 1573 Conference Report 819

Form 540 Line No. 77 Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 18806, 18806.5; U.I. Code Sec. 13024, 13040, 13041)

California has laws governing the withholding of taxes which are similar to the federal laws. However, the authority and responsibility for administering the state's withholding provisions is split between the Franchise Tax Board (FTB) and the Employment Development Department (EDD).

The FTB must annually prepare and make available to the EDD, a wage withholding table for determining the appropriate amount of tax to be deducted and withheld from the employee. The withholding table is to specifically reflect a tax, so far as practicable, that will be representative of the taxpayer's actual tax liability. Unless other specifically provided, the provisions of any law effecting changes in withholding begin with withholding in the calendar year succeeding the year that the provision was chaptered, or operative, whichever is later.

Under certain circumstances, as prescribed under EDD's regulations, the employee can request additional withholding.

An employer, generally, uses the withholding exemption certificate filed by the employee and the withholding table prepared by FTB to compute the amount of withholding. Generally, the certificate remains in effect until a new one is filed. If a certificate is not on file or is improper, no withholding exemptions are allowed.

NEW FEDERAL LAW (Sec. 3402(i))

The act requires the Internal Revenue Service (IRS) to revise the withholding schedules and withholding exemption certificate (W-4) to approximate the actual tax liability that will be due as a result of this act. In addition, the act removes the IRS' discretionary authority to issue regulations to allow a taxpayer to decrease the withholding otherwise required.

If a taxpayer does not file a revised withholding allowance certificate as provided, the employer must withhold income taxes based on the maritial status reflected on the taxpayer's previous certificate.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective October 22, 1986. However, the revised withholding certificate is to be filed with the employer before October 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The new federal withholding guidelines have been developed within the framework of the new federal law. These federal modifications to employee withholding are not applicable to current state law. To the extent California conforms to the new federal law, appropriate modifications for state withhoding purposes will be initiated as prescribed by current state law.

Since withholding changes are designed to reflect tax law liabilities, their is no identifiable revenue effect.

Title XVJ: Compliance and Tax Administration

ACTION: DEVELOP A RETURN-FREE SYSTEM FOR INDIVIDUALS

Act Section 1572 Conference Report Page 821

Form 540 Line No. N/A Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (NONE)

Under current California law, taxpayers are required to file an individual tax return for each taxable year. The principal forms used are Form 540 (the resident long form), Form 540A (the individual short form), and Form 540NR (for nonresidents and part-year residents).

NEW FEDERAL LAW (Act. Sec. 563)

The act requires a report from the Internal Revenue Service to the taxwriting committees on implementation of a return-free system which would state (a) who can participate and who cannot, (b) how the proposal would be phased in, (c) what resources are needed, and (d) the types of changes to the Code that would inhibit or enhance the use of the return-free system.

The Internal Revenue Service would also be directed to consider whether an in-house test, using previously filed information returns and individual income tax returns to test the practicality of the proposed system.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The report would be due six months after October 22, 1986 (April 22, 1987) to the Senate Committee on Finance and the House Committee on Ways and Means.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

No identifiable revenue impact exists from a study of this sort.

The next page of this report is page 1600.

TITLE XVI

EXEMPT AND NONPROFIT ORGANIZATIONS

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ACTION: EXCLUDES FROM THE UNRELATED BUSINESS INCOME TAX OF CERTAIN TAX-EXEMPT ORGANIZATIONS INCOME FROM EXCHANGING OR RENTING OF MEMBERSHIP OR DONOR MAILING LISTS TO OTHER TAX-EXEMPT ORGANIZATIONS

Act Section 1601	Conference Report Page 822
Form 540 Line No. N/A	Form 109 Line No. A-12

BACKGROUND

Charitable and other tax-exempt organizations are subject to a tax on income from an unrelated trade or business (the UBIT), i.e., a business, the conduct of which is not substantially related to the exempt functions of the organization (IRC Secs. 511-514; Rev. & Tax. Code Secs. 23731-23741).

The U. S. Court of Claims has held that income received by the Disabled American Veterans from other exempt organizations and from commercial businesses for the use of its mailing lists constitutes unrelated business taxable income, and does not constitute royalties exempted from the UBIT under IRC Section 512(b)(2)(Rev. & Tax. Code Sec. 23732(b)(2)). The court found that the DAV operated in a competitive, commercial manner with respect to taxable firms in the direct mail industry; that the organization regularly carried on the mailing list activities; and that these activities were not substantially related to accomplishment of exempt purposes.

CURRENT CALIFORNIA LAW (Sec. 23734)

California law conforms to federal law (Sec. 513(a)) in the definition of "unrelated trade or business", for purposes of the tax on unrelated business income of a tax-exempt organization.

NEW FEDERAL LAW (Sec. 513)

The Act amended Section 513 by adding subsection (h) providing that the exchanging or renting of membership or donor lists between tax-exempt organizations eligible to receive tax-deductible charitable contributions is not an unrelated trade or business", i.e., a business the conduct of which is not substantially related to the exempt functions of the organization.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision applies to exchanges and rentals of membership and donor lists occuring after October 22, 1986, the date of enactment of the Tax Reform Act of 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on a proration of the Joint Committee on Taxation's estimate for the nation, the revenue loss under the Bank and Corporation Tax Law from conformity would be in the $300,000 range for 1987-88 and for 1988-89. A proration of 4 percent was used which represents the general relationship between California's corporate tax collections and federal corporate tax collections over the past few years.

ACTION: <u>CODIFIES FEDERAL REGULATIONS RELATING TO THE DISTRIBUTION OF LOW COST ARTICLES BY CERTAIN TAX-EXEMPT ORGANIZATIONS</u>

Act Section 1601	Conference Report Page 822
Form 540 Line No. N/A	Form 109 Line No. N/A

BACKGROUND

Charitable and other tax-exempt organizations are subject to a tax on income from an unrelated trade or business (the UBIT), i.e., a business the conduct of which is not substantially related to the exempt functions of the organization (IRC Secs. 511-514; Rev. & Tax. Code Secs. 23731-23741). Under federal regulations, the UBIT does not apply where an organization "sends out low cost items incidental to the solicitation of charitable contributions" (Reg. sec. 1.513-1(b)). The regulations do not provide a definition of low cost articles.

CURRENT CALIFORNIA LAW (Sec. 23734)

California law conforms to federal law (Sec. 513(a)) in the definition of "unrelated trade or business", for purposes of the tax on unrelated business income of a tax-exempt organization. The California Administration Code (Title 18, Subchapter 3.5) does not include a regulation for Section 23734 of the Revenue and Taxation Code. In the absence of a state regulation and where California law conforms to federal law, the federal regulation applies (Sec. 23051.5).

NEW FEDERAL LAW (Sec. 513)

The Act amended Section 513 by adding subsection (h) providing that in the case of a tax-exempt organization eligible to receive tax-deductible charitable contributions, the term unrelated business income does not include activities of that organization relating to the distribution of low cost articles incidental to the solicitation of charitable contributions.

For this purpose, an article is low cost if its cost to the organization distributing the item (or on whose behalf the item is distributed) is not more than $5 (adjusted for inflation beginning in 1988). If more than one item is distributed by or on behalf of an organization to a single distributee in any calendar year, the total cost of the items distributed is treated as one article for purposes of the dollar limitation.

A distribution of low cost articles qualifies only if:

1. the distribution is not made at the request of the distributee;

2. the distribution is made without the express consent of the distributee; and

3. the articles distributed are accompanied by a request for a charitable contribution to the organization, and also by a statement that the distributee may keep the low cost article regardless of whether the distributee makes a charitable contribution to the organization.

This provision codifies current federal regulation 1.513-1(b), and defines "low cost article".

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision applies to distributions of low cost articles occurring after October 22, 1986, the date of enactment of the Tax Reform Act of 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

There is no revenue effect under the Bank and Corporation Tax Law from this provision that codifies current practice.

ACTION: EXCLUDES FROM THE UNRELATED BUSINESS INCOME TAX OF CERTAIN TAX-EXEMPT ORGANIZATIONS INCOME FROM QUALIFIED TRADE SHOWS AND CONVENTIONS

Act Section 1602 | Conference Report Page 823

Form 540 Line No. N/A | Form 109 Line No. A-1

BACKGROUND

Charitable and other tax-exempt organizations are subject to a tax on income from an unrelated trade or business (the UBIT), i.e., a business the conduct of which is not substantially related to the exempt functions of the organization (IRC Secs. 511-514; Rev. & Tax. Code Secs. 23731-23741).

An exception from the UBIT is provided for income derived by trade associations (IRC Sec. 501(c)(6)), or by labor, agricultural, or horticultural organizations (IRC Sec. 501(c)(5)), from qualified trade show and convention activities of which members of the sponsoring organization sell products or services (IRC Sec. 513(d)).

CURRENT CALIFORNIA LAW (Sec. 23734b)

California conforms to federal law exempting from the UBIT income derived by trade associations (Sec. 23701f), or by labor, agricultural, or horticultural organizations (Sec. 23701a), from qualified trade show and convention activities at which members of the sponsoring organization sell products or services (Section 23734b).

NEW FEDERAL LAW (Section 513)

The Act amends Section 513 by expanding the exception from the UBIT to include (1) qualified trade shows or conventions at which suppliers to the sponsoring organization's members sell products or services related to the exempt activities of the organization, and (2) qualified trade show and convention activities of charitable organizations including churches and schools (IRC Sec. 501(c)(3), Rev. & Tax. Code Sec. 23701d) and social welfare organizations (IRC Sec. 501(c)(4), Rev. & Tax. Code Sec. 23701f). This provision simplifies and equalizes the tax treatment of trade show income received by these organizations with that received by trade associations and by labor, agricultural and horticultural organizations.

EFFECTIVE DATE OF FEDERAL PROVISIONS

These provisions are effective for qualified trade show or convention activities conducted in taxable years beginning on or after October 23, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Based on a proration of the Joint Committee on Taxation's estimate for the nation, the revenue loss under the Bank and Corporation Tax Law from conformity would be in the $300,000 range for 1987-88 and $500,000 range for 1988-89. A proration of 4 percent was used which represents the general relationship between California's corporate tax collections and federal corporate tax collections over the past few years.

ACTION: GRANTS TAX EXEMPTION FOR CERTAIN TITLE HOLDING COMPANIES

Act Section 1603 | Conference Report Page 824

Form 540 Line No. N/A | Form 109 Line No. N/A

BACKGROUND

A corporation organized to hold title to property, and to distribute the income therefrom to one or more related tax-exempt organizations, may itself be tax exempt (IRC Sec. 501(c)(2), Rev. and Tax. Code Sec. 23701h). The IRS has taken the position that such a title-holding company is not tax exempt if two or more of its parent organizations are unrelated.

Any income of an exempt organization from debt-financed property generally is subject to the unrelated business income tax (IRC Sec. 514, Rev. and Tax. Code Sec. 23735). However, under an exception in the law, certain educational institutions and pension plans generally are not subject to the unrelated business income tax on income from certain debt-financed real property (IRC Sec. 514(c)(9), Rev. and Tax. Code Sec. 23735(c)(8)), subject to specific limitations (including these limitations applicable to pass-through entities pursuant to IRC Section 514(c)(9)(D), Rev. and Tax. Code Section 23735(c)(8)(D)).

CURRENT CALIFORNIA LAW (Sections 17631, 17651, 23701-23701t, and 23735)

California does not provide a tax-exempt status for any organization which issues stock or which distributes its net earnings to private shareholders, individuals, or to another entity which is not a tax-exempt organization.

In addition, current law does not provide for an exception from the unrelated business income tax imposed on debt-financed property (now granted to certain pension plans and educational organizations) to title-holding companies.

NEW FEDERAL LAW (Sections 501 and 514)

The Act adds a new category of Section 501(c) tax-exempt organizations, consisting of certain corporations or trusts that are organized for the exclusive purposes of acquiring and holding title to property, collecting income from the property, and remitting the income to certain tax-exempt organizations. Tax-exempt status in this category applies only if the corporation or trust (1) has no more than 35 shareholders or beneficiaries, (2) has only one class of stock or beneficial interest, and (3) is organized for the exclusive purpose of acquiring property and holding title to, and collecting income from, such property, and remitting the entire amount of income from such property (less expenses) to one or more eligible tax-exempt organizations that are shareholders or beneficiaries of such corporation or trust.

A corporation or trust that meets all of these requirements also is entitled to use the exception to the tax on unrelated business income under the debt-financed property rules for real property (Section. 514(c)(9)), subject to the limitations contained in Section 514(c)(9)(B), as applied to pass-through entities (Section 514(c)(9)(D)).

In order to qualify for exemption under the new category, a title-holding company must permit its shareholders or beneficiaries (1) to dismiss, after reasonable notice, the corporation's or trust's investment adviser by majority vote of the shareholders or beneficiaries, and (2) to terminate their interest by (a) selling or exchanging their stock or beneficial interest (subject to federal or state securities law) to any other eligible organization, as long as such sale or exchange would not increase the total number of shareholders or beneficiaries to more than 35, or (b) redeeming their stock or beneficial interest after providing 90 days notice to the corporation or trust.

The tax-exempt organizations eligible to hold interests in a title-holding company under the Act are (1) a qualified pension profit-sharing, or stock bonus plan (Section 401(a)); (2) a governmental pension plan (Section 414(d)); (3) the United States, a state or political subdivision, or governmental agencies or instrumentalities; and (4) tax-exempt charitable, educational, religious, or other organizations described in Section 501(c)(3).

The Act does not amend present law with respect to title-holding corporations (described in Section 501(c)(2)) holding title to property for one or more related tax-exempt organizations.

EFFECTIVE DATE OF FEDERAL PROVISIONS

These provisions apply for taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

It appears from the administrative concerns expressed below that the conformity issue may be inappropriate. However, if California were to conform, the fiscal impact would be revenue losses in the $200,000 range for 1987-88 and $500,000 range for 1988-89 under the Personal Income Tax (PIT) Law, and revenue losses in the $500,000 range for 1987-88 and $900,000 range for 1988-89 under the Bank and Corporation (B&C) Tax Law. The basis for the state estimates is the national estimates prepared by the

Joint Committee on Taxation (JCT). A 4.1 percent factor was used for the PIT estimate which reflects the Policy Economic Group's (PEG) conformity estimates for California for those provisions analyzed relative to the nation. The PEG has not specifically estimated this provision. A 4 percent proration factor was used for the B&C estimate which represents the general relationship between California's corporate tax collections and federal corporate tax collections over the past few years.

ADMINISTRATIVE CONCERNS

The exempt corporation provisions of the Bank and Corporation Tax Law provide that one of the qualifications for exemption is that no part of net earnings of the organization inure to any private shareholder; i.e., it cannot issue stock.

IRC Section 501(c)(25), added by the Act, provides in part in subparagraph (A) thereof that an organization qualifies for exemption if it has no more than 35 shareholders and has only one class of stock.

In addition, conformity to the new federal provisions would conflict with the Corporations Code.

IRC Section 501(c)(25) provides, in subparagraph (A)(iii)(II) thereof, that all income (less expenses) derived from real property be distributed to the shareholders or beneficiaries of the exempt title-holding organization; and subparagraph (D)(ii)(II) thereof, provides that the exempt title-holding organization must permit its shareholders or beneficiaries to terminate their interest in the organization by having their stock or interest redeemed by the organization after the shareholder or beneficiary has provided 90 days notice to the organization.

Section 7411 of the Corporations Code prohibits any distributions except upon dissolution; Section 7412 also prohibits a distribution if such distribution would result in the organization's failure to meet its liabilities; and Section 7413 imposes restrictions on the purchase or redemption of a membership of the parent or subsidiary if the articles of the corporation contain a provision requiring that, upon dissolution, the assets of the corporation be distributed to the head organization.

Title XVIG: Exempt and Nonprofit Organizations

ACTION: ADDS EXCEPTION TO MEMBERSHIP ORGANIZATIONS

Act Section 1604 Conference Report Page 826

Form 540 Line No. N/A Form 109 Line No. A-2

BACKGROUND

A membership organization generally may deduct expenses relating to the furnishing of goods or services to members only from income derived from members or transactions with members (IRC Sec. 277). This rule does not apply to certain financial institutions, insurance companies, securities or commodity exchanges, or certain other organizations.

The Associated Press (AP) is a taxable nonprofit membership cooperative devoted principally to the gathering and dissemination of news. It is subject to both federal and state income tax and specifically to the provisions of IRC Section 277 (Rev. & Tax. Code Sec. 24437).

Other news organizations against which AP competes are entitled to pool revenues and expenses regardless of their source and pay taxes on the net results.

Like many other news organizations, in recent years AP has expanded its information distribution activities beyond the traditional newspaper and broadcasting industries. AP now derives revenue from domestic nonmedia companies and from distributing financial information abroad. Under pre-1986 TRA law, AP could not compete on the same basis as its competitors. The amendment to IRC Section 277 eliminates a competitive disadvantage and allows AP to compete on the same basis as its competitors.

CURRENT CALIFORNIA LAW (Sec. 24437)

California law conforms to federal law (Sec. 277(a)) in limiting the deduction for expenses relating to the furnishing of goods or services to members only to income derived from members or transactions with members. The exceptions to this rule, applicable to financial institutions, insurance companies, securities and commodity exchanges, etc. are the same as in federal law (Sec. 277(b)).

NEW FEDERAL LAW (Sec. 277)

The Act adds an additional exception to IRC Section 277(b) which permits membership organizations engaged primarily in the gathering and distribution of news to their members for publication to deduct expenses relating to the furnishing of goods and services to members from income whether or not derived from members or transactions with members.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective for taxable years beginning on or after January 1, 1987.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Joint Committee on Taxation estimates revenue losses of less than $5 million annually. Based on this projected low level of impact for the nation, conformity would result in minor revenue losses annually of less than $200,000 under the Bank and Corporation Tax Law.

The next page of this report is page 1700.

TITLE XVII

MISCELLANEOUS PROVISIONS

Title XVIIA: Miscellaneous Provisions

ACTION: <u>EXTEND SUNSET AND LIMIT SCOPE OF TARGETED JOBS TAX CREDIT</u>

Act Section 1701 Conference Report Page 828

Form 540 Line No. 71 Form 100 Line No. 18

<u>CURRENT CALIFORNIA LAW (Sec. 17053.7, 24330)</u>

Although similar in intent and structure, California's jobs tax credit does not conform to federal law.

Current California law allows employers to claim a credit against net tax for wages paid to certain economically disadvantaged employees. These employees must be certified by the Employment Development Department as meeting the requirements of Section 328 of the Unemployment Insurance Code.

The credit is 10 percent of the amount of wages paid to each certified employee, during the first 24 months of employment, limited to $300 per taxable year and $600 per employee. In addition to taking the credit against the net tax, the employer may deduct the salaries on which the credit is computed. There is no carryover or carryback feature provided for excess credits not used during the taxable year. Taxpayers who qualify for the credit may elect to take the credit, or revoke their election, at any time during the four year statute of limitations for that year.

The California Jobs Tax Credit provisions will expire after December 31, 1989.

<u>NEW FEDERAL LAW (Sec. 51)</u>

The targeted jobs tax credit is extended for three years. The credit for second year wages is repealed. The credit for first year wages is reduced from 50 percent to 40 percent of the first $6,000 of qualified wages. In the case of qualified summer youth employees, the credit is equivalent to 85 percent of up to $3,000 of wages. The Act also adds a new minimum employment requirement that qualified (employees must be employed for at least 90 days (14 days in the case of qualified summer youth), or have completed 120 hours of work performed for the employer (20 hours in the case of qualified summer youth) in order for the employer to claim the credit.

<u>EFFECTIVE DATE OF FEDERAL PROVISIONS</u>

These provisions apply to qualified persons who begin work for the employer between January 1, 1986 and December 31, 1988.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Since California has targeted its own eligible group of employees independently of federal law and at appropriate levels of state tax relief, conformity is not strictly applicable.

The existing state jobs tax credit has recently been extended through December 31, 1989. Revenue losses under the Personal Income Tax and Bank and Corporations Tax Laws have been estimated at $600,000 - $800,000 annually.

TAX POLICY ISSUES

Although there are numerous differences between state and federal law, California could give consideration to conforming in the following areas:

(1) Limiting the credit to the first 12 months of employment (rather than 24); and

(2) Adding a minimum employment period.

Conformity to the minimum employment period would not significantly affect revenues; however, limiting the credit to the first 12 months of employment would probably reduce current revenue losses by 25 to 35 percent.

ACTION: <u>ELIMINATE DETAILED RECORD KEEPING REQUIREMENT PERTAINING TO EXPENSES INCURRED BY CARE PROVIDER FOR EACH FOSTER CHILD</u>

Act Section 1707 Conference Report Page 838

Form 540 Line No. 27 Form 100 Line No. N/A

<u>CURRENT CALIFORNIA LAW (Sec. 17131)</u>

Current California law conforms to federal law which permits certain reimbursements received from a state or political subdivision for expenses incurred in caring for a foster child, to be excluded from gross income. In order for the income to be eligible for exemption, it must be paid to the foster care provider for a child under age 19, who has been placed in the foster home by a government agency or a state-licensed, tax-exempt child placement agency. The exclusion also applies to certain difficulty of care payments paid for providing care to a handicapped foster child, but not to the extent that they are made for more than 10 children in the foster home for the same period of time.

Because the exclusion applies to <u>reimbursement</u> paid for qualified foster case expense, the foster child care provider is required to maintain a detailed accounting of all expenses incurred on behalf of each foster child in his or her care.

<u>NEW FEDERAL LAW (Sec. 131)</u>

The requirement of detailed record keeping is eliminated, by providing that the exclusion applies to amounts <u>paid</u> for qualified foster care. The requirement that the foster child be age 19 or younger is also eliminated. However, foster care payments, including difficulty of care payments, are not excludible to the extent that they are received for more than five such recipients over the age of 19 for the same period of time. This extension of the exclusion for providing adult care is limited to those foster care recipients who have been placed in the caretaker's responsibility by an agency of the state, or by a political subdivision of the state which is responsible for this placement function. The exclusion does not apply to adults who have been placed in a foster care environment by any other means than through an agency of the state or political subdivision thereof.

<u>EFFECTIVE DATE OF FEDERAL PROVISIONS</u>

This provision is effective for taxable years beginning on or after January 1, 1986.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Revenue losses under the Personal Income Tax Law would be minor, estimated to be in the $300,000 - $500,000 range annually. This estimate was based on a proration of national estimates prepared by the Joint Committee on Taxation. The proration (4.1%) reflects The Policy Economics Group (PEG), California estimates relative to the nation for those provisions analyzed. The PEG did not specifically estimate this provision.

ACTION: REINSTATE RULES FOR SPOUSES OF VIETNAM MIA'S

Act Section 1708 Conference Report Page 839

Form 540 Line No. 12 Form 100 Line No. N/A

CURRENT CALIFORNIA LAW (Sec. 17046, 17131, 18434, 18470, 18471)

California was generally conformed to federal law which provided tax relief to members of the United States Armed Forces listed as missing in action (MIA) in the Vietnam conflict. Both laws exempt from income tax, for all taxable years ending after entering the combat zone, a member of the Armed Forces determined to have died while in MIA status. Both laws limit the forgiveness of taxes with respect to Vietnam to taxable years ending prior to January 1, 1983.

Both laws also allow the spouse of an MIA to file a joint return and postpone the filing of tax returns, and payment of taxes. Federal (but not California) law also limits the filing of joint returns, postponement of filing returns, and payment of taxes to taxable years ending prior to January 1, 1983.

NEW FEDERAL LAW (Sec. 2, 692, 6013, 7508)

The expired provisions pertaining to Vietnam MIA's and their spouses are retroactively reinstated and made permanent.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Taxable years beginning on or after January 1, 1983.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

The Joint Committee on Taxation estimates revenue losses for the nation of less than $5 million annually. For reasons stated below under Tax Policy, the impact under conformity would be negligible revenue losses.

TAX POLICY ISSUES

On the surface it appears that conformity to federal law would require the forgiveness of taxes for the 1983, 1984, 1985, and 1986 taxable years. However, a California resident who is absent from California under military orders is considered to be a nonresident. Thus, there may be no tax to be forgiven. Only a few persons, if any, would be affected, since they would have to have significant nonmilitary income subject to California tax.

Title XVIIG3: Miscellaneous Provisions

ACTION: EXEMPT CERTAIN REINDEER RELATED INCOME FROM FEDERAL TAXATION

Act Section 1709 Conference Report Page 839

Form 540 Line No. 27 Form 100 Line No. N/A

BACKGROUND

The Reindeer Industry Act of 1937 provided that all reindeer herds and improvements held by non-Alaskan natives were to be purchased and held in trust by the United States Government for Alaskan natives. Until 1985, income derived from the herds managed by the Alaskan natives was not taxable to them. In 1985, the United States Court of Appeals ruled that reindeer-related income derived by Alaskan natives from herds held in trust by the United States Government is not exempt from taxation.

CURRENT CALIFORNIA LAW (Sec. 17631)

While California does not specifically conform to the federal provision that income received by an Alaskan native from reindeer herds is exempt from taxation, federal preemption of state law provides that all income earned by Native Americans on native lands (i.e. reservation source income earned on reservation land) is exempt from taxation. Alaskan natives are not generally California residents. As nonresidents, they are subject to taxation only on California source income.

NEW FEDERAL LAW (Sec. 8 of the 1937 Reindeer Industry Act

Income derived by native Alaskans from the sale of reindeer or reindeer products is exempt from taxation, for the duration of the trust held by the United States Government.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision applies as if it had been originally included in the 1937 Reindeer Industry Act. Thus, this provision is immediately and retroactively effective.

REVENUE IMPACT OF CONFORMITY TO FEDERAL LAW

Not applicable to California.

The next page of this report is page 1800.

TITLE XVIII

TECHNICAL CORRECTIONS

INTRODUCTION

The following section of this report relates to technical corrections which add, change, and clarify specific sections of the:

- o Tax Reform Act of 1984
- o Deficit Reduction Act of 1984
- o Federal Unemployment Tax Act
- o Trade and Tariff Schedules
- o Consolidated Omnibus Budget Reconciliation Act of 1985
- o Child Support Enforcement Amendments of 1984

This section is comprised of two parts. The first is an analysis of the technical corrections that are applicable to California Law. The second part includes those corrections that are not applicable to California.

The format of the analysis is different from the previous sections of this report in that:

1) California law is not discussed

2) the revenue discussed in this introduction applies to all technical corrections

3) effective dates are not discussed

REVENUE DISCUSSION

No specific data, state or federal, is available to estimate the impact of these provisions. The Joint Committee on Taxation provided a single estimate for all technical correction provisions pertaining to prior federal legislation. The national estimate for individuals was a $68 million loss for 1987-88 and for corporations was a $99 million loss for 1987-88, but cannot be prorated to California since it includes the nonapplicable items.

SECTION ONE-- APPLICABLE CHANGES

See Table of Contents on page 1804.

SECTION TWO-- NONAPPLICABLE CHANGES

See Table of Contents on page 1811.

TITLE XVIII - TECHNICAL CORRECTIONS

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SUMMARY OF FEDERAL TECHNICAL CORRECTIONS -- 1986

Title XVIII: Technical Corrections

Act Section: 1804 Sections Affected: 246, 246A, 280G, 291, 312, 332, 337, 338, 341, 361, 368, 562, 852, of the Code;

3.60 of the 84 Tax Reform Act

SUBJECT: Debt-Financed Portfolio Stock

EXPLANATION

The act clarifies the rules for reducing the deduction in cases in which dividends are received from certain foreign corporations engaged in business in the United States.

SUBJECT: Holding Period Rules For Dividend Received Deduction

EXPLANATION

The act disallows the dividend received deduction where the holding period requirement is not met, without regard to whether the stock has been disposed of. Therefore, when the holding period requirement has not been met on the 45th day (90th day in the case of certain preference dividends) after the ex-dividend date, the dividend received deduction will not be allowed.

In addition, the act clarifies that the 1984 Act did not change the principle that the dividend received deduction is not disallowed by reason of an out-of-money call option that affords the corporation no protection against loss in the event the stock declines in value.

SUBJECT: Application of Related Party Rule to Section 265(2) of the Code

PRIOR FEDERAL LAW

The '84 Tax Reform Act (Code sec. 7701(f) provides that the Treasury Department is to prescribe such regulations as may be necessary or appropriate to prevent the avoidance of Federal tax provisions which deal with (i) the linking of borrowing to investment, or (2) diminishing risks, through the use of related persons, pass-through entities, or other intermediaries. This provision was specifically intended to apply to (but not to be limited to) the disallowance rule for deducting expenses and interest relating to tax-exempt income.

Under the 1984 Act, the provision regarding related persons, pass-through entities, and other intermediaries was effective on the date of enactment (July 18, 1984).

EXPLANATION

Under the act, the provision regarding related parties, pass-through entities, and other intermediaries generally remains effective as of July 18, 1984 (i.e., the date of enactment). However, it clarifies that this provision, insofar as it relates to the disallowance of deductions for certain expenses and interest relating to tax-exempt income only, is effective for (1) term loans made after July 18, 1984, and (2) demand loans outstanding after July 18, 1984 (other than any loan outstanding on July 18, 1984, and repaid before September 18, 1984). "Demand loans" mean any loan which is payable in full at any time on the demand of the lender. For purposes of this effective date rule, any loan renegotiated, extended, or revised after July 18, 1984, is treated as a loan made after such date.

SUBJECT: Exempt-Interest Dividends From Regulated Investment Companies

EXPLANATION

Under the act, if a taxpayer holds stock of a regulated investment company for 6 months of less, any loss on the sale or exchange of that stock is disallowed to the extent the taxpayer received exempt-interest dividends with respect to that stock. Conforming amendments are made, and an exception is provided for dispositions pursuant to a periodic liquidation plan.

In addition, the Secretary is given authority to shorten the 6 months requirement to a period of not less than the greater of 31 days or the period between regular dividend distributions where the RIC regularly distributes at least 90 percent of its net tax-exempt interest. The distribution period is to be shortened only where the purpose of the holding period requirement can be adequately fulfilled without requiring that the stock be held 6 months.

SUBJECT: Accumulated Earnings Tax

EXPLANATION

This provision is not applicable to California law.

SUBJECT: Definition of Affiliated Group

EXPLANATION

The act excludes from the term "stock", as it relates to affiliated groups, stock that has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium).

Under the act, any DISC or any other corporation that has accumulated DISC income derived after 1984 will not be an includible corporation.

SUBJECT: Effective Date of Affiliated Group Provisions

EXPLANATION

The act makes several technical changes with respect to the effective date rules as follows:

- o provides that the grandfather rule ceases to apply as of the first day after June 22, 1984, on which the corporation involved would not qualify as a member of the group under prior law.

- o clarifies the "sell-down" exception to the grandfather rule. Therefore, the exception does not apply, and the grandfather rule continues to apply, if the percentage interest (by fair market value) in the stock of the involved corporation that held by other members of the group), in general, does not decline as a result of the sale, exchange, or redemption of that corporation's stock. Also, the act provides that the "sell down" exception applies in certain cases where there is a letter of intent between a corporation and securities underwriter entered into on or before June 22, 1984.

- o allows a common parent corporation to elect to have this provision apply to taxable years beginning after December 31, 1983.

- o delays the effective date for one specified corporation until the earlier of January 1, 1994, or the date on which the voting power of certain preferred stock terminates, and exempts one specified corporation from the new rules.

SUBJECT: Complete Liquidations of Subsidiaries, Etc.

EXPLANATION

Under the act, a corporation will not be subject to the gain or loss rules for distribution as a result of liquidation, unless, among other things, the corporation receiving the liquidating distribution was, on the date of the adoption of the plan of liquidation, and continued to be at all times until receipt of the liquidating distributions, the owner of stock in the liquidating corporation meeting the ownership requirements of an affiliated group. The new rule applies even if one (or both) of the corporations involved is not an includible corporation. Also under the act, the term:

- o "distributee corporation" is changed to mean any corporation which receives a distribution in a complete liquidation of the selling corporation, including each other corporation "up the line" which receives a distribution in complete liquidation of another distributee corporation.

- o "qualified stock purchase" as it relates to certain stock purchases treated as asset acquisitions is conformed to the definition as it relates to affiliated groups. The change will apply where the 12 month acquisition period begins after March 1, 1986.

SUBJECT: Earnings and Profits

EXPLANATION

The act provides that the distribution by a corporation of property the fair market value of which exceeds its adjusted basis, increases the earnings and profits of the distributing corporation by the amount of such excess.

In addition:

1) with respect to distributions of appreciated property, the amount of decrease is determined by using the fair market value the property instead of the adjusted basis,

2) with respect to adjustments for installment sales, the moratorium is extended for foreign corporations.

SUBJECT: Treatment of Transferor Corporation

EXPLANATION

The act provides that the transferor corporation does not recognize gain or loss on the transfer to the acquiring corporation pursuant to the plan of reorganization, without regard to whether properties received are distributed pursuant to the plan of reorganization.

In addition it:

- o clarifies that certain dispositions relating to liquidations are not applicable to transfers of property pursuant to the plan of reorganization, but that rules requiring recognition of gain, is applicable to distributions of property pursuant to a plan of reorganization by any corporation which is a party to the reorganization;

- o provides that: (1) any property received by a transferor corporation in a reorganization will have a fair market value and (2) in the case of a C reorganization, no gain or loss will be recognized on any disposition pursuant to the reorganization of stock or securities which were received pursuant to the plan of reorganization and which are in another corporation that is a party to the reorganization.

- o clarifies that the distribution requirement relating to reorganizations will be satisfied where distributions are made to creditors, as well as shareholders of the transferor corporation.

- o clarifies that a reorganization, involving a "drop-down" of assets to a subsidiary, which qualifies as a "C" reorganization, without regard to certain reorganizations rules, will continue to qualify as a reorganization.

SUBJECT: Collapsible Corporations

EXPLANATION

The act applies the collapsible corporation provisions whether or not the stock has been held 6 months.

SUBJECT: Golden Parachutes

EXPLANATION

This provision is not applicable to California law.

SUBJECT: Corporate Tax Preferences

EXPLANATION

This provision is not applicable to California Law.

SUMMARY OF FEDERAL TECHNICAL CORRECTIONS -- 1986

Title XVIII: Technical Corrections

Act Section: 1805 Sections Affected: 368, 706, 707, 761, 1031, of the Code

SUBJECT: Retroactive Allocations

EXPLANATION

The act clarifies that the rule described in present law applies to all cases in which the rule is necessary to allocate cash basis items to the period to which the items are attributable, even though no change in partnership interests occurs during the current taxable year.

SUBJECT: Disguised Sale Transactions

EXPLANATION

The act specifies that "disguised sale" treatment is to apply to cases in which the transfers to and from the partnership (as described above), when viewed together, are properly characterized as an exchange of property, as well as to cases in which such transfers are properly characterized as a sale.

SUBJECT: Transfer of Partnership Interests by Corporations

EXPLANATION

The act changes miscellaneous corporation provisions to specifically limit the amount of gain recognized by a corporation upon a distribution of a partnership interest in a nonliquidating distribution to which taxation of corporation on distribution applies. The maximum amount of gain recognized is the gain that would have been recognized upon the sale of the distributed interest at its fair market value. Thus, for example, a corporation that acquired its interest by making a cash contribution to an existing partnership would recognize no gain if it immediately distributed the interest to its shareholders, regardless of the basis of the partnership property attributable to its interest.

The amendment to miscellaneous corporate provisions does not affect the recognition of recapture income by a distributing corporation. Under unrealized receivable, a partner is required to treat the sale and inventory items of a partnership interest as a sale or exchange of property other than a capital asset to the extent of the unrealized receivables (including recapture property) and inventory of the partnership attributable to the transferred interest. Thus, a corporation making a distribution of a partnership interest will recognize depreciation recapture with respect to the partnership recapture property attributable to the distributed interest.

SUBJECT: Distributions Treated as Exchanges for Purpose of Partnership Provisions

EXPLANATION

The act limits the application of the sale or exchange treatment rule to partnership interests which are distributed. The act also allows the Secretary to provide exceptions to these rules.

SUBJECT: Like-Kind Exchanges

EXPLANATION

The act specifies that like-kind property includes property identified as the property to be received by the taxpayer on or before (rather than only before) the date which is 45 days after the date on which the taxpayer relinquishes property.

SUMMARY OF FEDERAL TECHNICAL CORRECTIONS -- 1986

Title XVIII: Technical Corrections

Act Section: 1806 Sections Affected: 643

SUBJECT: Multiple Trusts

EXPLANATION

The act provides that this provision is not applicable to any trust which was irrevocable on March 1, 1984, except to the extent corpus is transferred to the trust after that date.

SUBJECT: Trust Distributions

EXPLANATION

The act clarifies that the election applies to all distributions during a taxable year unless the election is revoked with the consent of the Secretary.

SUMMARY OF FEDERAL TECHNICAL CORRECTIONS -- 1986

Title XVIII: Technical Corrections

Act Section: 1807   Sections Affected: 461, 467, 468, 468A and 468B

SUBJECT: Settlement Funds

PRIOR FEDERAL LAW

Prior law provided that liabilities were not treated as incurred prior to the time when economic performance occurs.

In the case of the taxpayer's liability to another person, arising under any workers compensation act or any tort, economic performance occurred as payments to such person are made, except to the extent provided in regulations. It was unclear whether an irrevocable payment to a court ordered settlement fund, which extinguishes the tort liability of the taxpayer to a person (or class of persons), constitutes economic performance under the Act.

EXPLANATION

The act clarifies that under certain limited circumstances, an irrevocable payment to a court-ordered settlement fund that extinguishes tort liability of the payor (the "taxpayer") constitutes economic performance with respect to such liability. This provision applies only to qualified payments made to a designated settlement fund.

A designated settlement fund means a fund (1) which is established pursuant to a court order, (2) which extinguishes completely the taxpayer's tort liability with respect to a class of claimants, as determined by the court, (3) which is managed and controlled by persons unrelated to the taxpayer, (4) in which the taxpayer does not have a beneficial interest in the income or corpus, and (5) to which no amount may be transferred other than qualified payments.

A qualified payment means cash or property, other than the stock or indebtedness of the taxpayer (or a related party), which is irrevocably contributed to a designated settlement fund pursuant to a court order.

A designated settlement fund is not qualified if the taxpayer may benefit from the corpus or income of the fund. Thus, if the taxpayer's future liability to claimants (or other parties) is contingent on the income of a settlement fund created by the taxpayer, then the taxpayer may benefit from the fund's income, and the fund is not qualified.

A designated settlement fund is taxed as a separate entity at the maximum trust rate. Gross income of a designated settlement fund includes income from investment of fund assets, but excludes qualified payments made to the fund. No deductions are permitted except for certain administrative and incidental expenses. Thus, distributions to claimants are not deductible.

A contribution of property to a designated settlement fund is treated as if the taxpayer sold the property for fair market value and donated the proceeds to the fund. Thus, the taxpayer's deduction is limited to fair market value. The taxpayer recognizes gain or loss at the time property is contributed, and the fund takes a fair market value basis in the property.

No deduction is allowed under this provision for payment to a fund of an amount received from the settlement of an insurance claim, if the amount received is excluded from the taxpayer's gross income. The act clarifies that payments to a trust or escrow fund, other than a designated settlement fund, do not constitute economic performance with respect to any tort liability of the taxpayer.

These provisions do not apply to liability arising from any workers compensation act or contested liabilities moreover, no inference about the prior law treatment of such liabilities is intended.

Transition rule.--A corporation that filed for reorganization under chapter 11 of the Bankruptcy Reform Act of 1978 on August 26, 1982, and which filed with the U. S. Bankruptcy Court a first amended and restated plan of reorganization prior to March 1, 1986, may elect to be taxed under a transition rule.

The act clarifies that: (1) the provision does not affect the treatment of payments made for certain personal injury liability assignment; (2) payments from a designated settlement fund to a claimant are treated as having been made by the taxpayer for purposes of determining the claimant's taxable income; and (3) taxpayers may not both exclude an amount recovered and deduct (under this provision) an amount paid to the extent such amount is attributable to the same liability.

The act provides that except as provided in regulations escrow accounts, settlement funds, or similar funds are subject to current taxation. If the contribution to such an account or fund is not deductible, then the account or fund is taxable as a grantor trust. This provision is effective for accounts or funds established after August 16, 1986.

SUBJECT: Premature Accruals

EXPLANATION

The act provides that accrual basis taxpayers which have made a payment to an insurance company to indemnify themselves from tort claims arising from personal injury or death caused by the inhalation or ingestion of dust from asbestos-containing products will be treated as having satisfied the economic performance test if the payment is paid to an unrelated third party insurer prior to November 28, 1985, and such payment is not refundable. The provision is not to apply to any company which mined asbestos.

SUBJECT: Tax Shelters

PRIOR FEDERAL LAW

Generally, a cash basis tax shelter is not allowed a deduction with respect to an amount any earlier than the time at which economic performance occurs. An exception is provided under which prepaid expenses are deductible when paid if economic performance occurs within 90 days after the close of the taxable year.

In the case of the trade or business of farming, the farming syndicate rules apply to any tax shelter described in section 6661(b)(i.e., the principal purpose of which is the avoidance or evasion of Federal income tax). For purposes of applying farming syndicate limitations to these tax shelters, it is unclear whether the exceptions relating to holdings attributable to active management apply.

EXPLANATION

The act clarifies that the 90-day exception applies if economic performance occurs before the close of the 90th day after the close of the taxable year. Thus, for example, if a well is spudded in the last month of the taxable year, the requirement that economic performance occur before the close of the 90th day after the close of the taxable year's satisfied.

The bill also clarifies that any tax shelter described in section 6661(b) will generally be treated as a farming syndicate. However, any person meeting the requirements of violations attributable to active management will not be subject to the with respect to that person's interest in a tax shelter.

SUBJECT: Mine Reclamation and Similar Costs

PRIOR FEDERAL LAW

The 1984 Tax Reform Act provided electing taxpayers with a uniform method for deducting, prior to economic performance, certain reclamation costs which are mandated by Federal, State, or local law. Deductions accrued under this method must be accounted for in a book reserve and are subject to recapture to the extent that reclamation costs are less than accumulated reserves.

EXPLANATION

The act clarifies that a reserve balance must be increased by the amount of deductions accrued in each year that are allocable to the reserve. The act also clarifies that this provision is effective for taxable years ending after July 18, 1984.

SUBJECT: Nuclear Power Plant Decommissioning Expenses

PRIOR FEDERAL LAW

Prior law permitted electing taxpayers to accrue a deduction for contributions made to a qualified nuclear decommissioning fund (a "fund").

EXPLANATION

The act clarifies that a taxpayer shall be deemed to have made a payment to a fund at the end of a taxable year provided that payment is made within 2 1/2 months after the close of that taxable year. Under a transitional rule, the Secretary of the Treasury is provided regulation authority to relax, and appropriately adjust, this 2 1/2 month rule for payments allocable to a taxable year beginning before January 1, 1987, and to provide that no interest will be allowed with respect to periods before payment is made. The act clarifies that the tax treatment of fund income provided is in lieu of any other Federal income tax, that a fund's tax liability is not deductible from its gross income, and that for purposes of subtitle F ("Procedure and Administration") a fund shall be treated as a corporation and taxes imposed on the fund shall be treated similarly to corporate income taxes. The act clarifies that a fund may invest only in those assets in which the Code permits a Black Lung Trust Fund to invest. The act also clarifies that this provision is effective for taxable years ending after July 18, 1984.

SUBJECT: Treatment of Deferred Payments For Services

EXPLANATION

The act clarifies that the regulations to be issued relating to deferred payments for services will not apply to amounts deducted for contributions of an employer to an employees' trust or annuity plan and compensation under a deferred payment plan, and deducted for certain foreign deferred compensation plans, or to amounts subject to any other provision specified in regulations.

In addition, the act permits a specified taxpayer whose primary business is providing architectural reserves to use the cash method of accounting.

SUMMARY OF FEDERAL TECHNICAL CORRECTIONS -- 1986

Title XVIII: Technical Corrections

Act Section: 1808 Sections Affected: 108, 263(g), 1092(d) of the Code

SUBJECT: Treatment of Subchapter S Corporations

EXPLANATION

This provision is not applicable to California law.

SUBJECT: Treatment of Amounts Received for Loaning Securities

EXPLANATION

The act provides for the inclusion of compensating payments to a lender of securities used in a short sale in those taxable amounts that reduce interest and other costs required to be capitalized under, certain interest and carrying costs in the case of straddles.

SUBJECT: Clarification of the Exception for Straddles Consisting of Stock

EXPLANATION

The act clarifies that the exception for stock does not operate to except straddles involving exchange traded stock options (other than qualified covered calls that offset stock).

SUBJECT: Treatment of Losses from Pre-1981 Straddles

EXPLANATION

This provision is not applicable to California law.

SUMMARY OF FEDERAL TECHNICAL CORRECTIONS -- 1986

Title XVIII: Technical Corrections

Act Section: 1809 Sections Affected: 48, 57, 167, 168, 312

SUBJECT: Straight-Line Election For Low-Income Housing

EXPLANATION

The act clarifies that taxpayers may elect to recover the cost of low-income housing using a straight-line method of depreciation over 15 years (but not 18 years).

SUBJECT: Mid-Month Convention for Real Property

EXPLANATION

The act clarifies that the mid-month convention is to be applied whenever a depreciation computation with respect to 18-year real property is required under ACRS (relating to accelerated cost recovery deductions as items of tax preference), or earnings and profits depreciation (relating to the effect of depreciation on earnings and profits). Thus for example, if a taxpayer elects different recovery period to depreciate 18-year real property on a straight-line basis over 18, 35, or 45 years, the mid-month convention applies in computing the deductions. Similarly, the mid-month conventions applies in determining what cost recovery deductions "would have been allowable" under ACR deduction. Numerous conforming changes are also made.

SUBJECT: Board-Financed 18-year Real Property

EXPLANATION

The act clarifies that, in general, the cost of 18-year real property (which does not include low-income housing) financed by the proceeds of an industrial development bond cannot be recovered more rapidly than on a straight-line basis over 18 years, using a mid-month convention. This rule does not apply if the property is either (i) low-income housing, or (ii) property which is placed in service in connection with a project for residential rental property financed with the proceeds of obligations of certain exempt activities but which is not low-income housing. Costs of the former can be recovered on an accelerated basis under ACRS over 15 years, using a first-of-the month convention, and costs of the latter can be recovered on an accelerated basis under ACRS over 18 years, using a mid-month convention.

The act also clarifies that the provision of the Act relating to property financed with tax-exempt bonds does not apply to certain property excepted from the bond rules added in 1982.

SUBJECT: Treatment of Certain Transferees of Recovery Property

EXPLANATION

The act amends transferees bound by transferor rules with respect to recovery property placed in service by the transferor. In a case where the acquisition is from a related person or a leaseback present law, the transferee starts depreciating the property as would any other new owner of it. However, to the extent of the adjusted basis of the property in the hands of the transferor, the transferee is treated as having made any election made by the transferor with respect to the property under election of different recovery periods and percentages. For purposes of this rule, if the transferor was depreciating 15-year real property on a straight-line basis, the transferee would be treated as having elected 18-year straight line depreciation. If the transferee's basis exceeded the transferor's adjusted basis the transferee can depreciate the excess under the general rules. The act is not intended to affect the treatment of transactions between members of an affiliated group of corporations filing a consolidated return.

With one exception, the act does not amend transferee bound by transfereror's period and method in certain cases. Thus, for example, in a transfer to corporations controlled by transferor, the transferee steps into the transferor's shoes to the extent basis does not increase. However, the act amends the law to provide that it does not apply in the case of the termination of a partnership relating to the sale or exchange of 50 percent or more of the total interest in a partnership's capital and profits within a 12-month period.

SUBJECT: Films, Videotapes and Sound Recordings

EXPLANATION

Under the act, films, videotapes, and sound recordings are not eligible for the accelerated depreciation methods available. Those methods are the declining balance method, sum-of-the years digits and any other method productive of an annual allowance, as specified. However, the income forecast method or similar methods of depreciation are available.

SUBJECT: Investment Tax Credit

EXPLANATION

The act reinstates the provision that section 38 property the reconstruction of which is completed by the taxpayer qualifies as new 88 property. The act also provides that the 3-month rule is not applicable to section 38 property the reconstruction of which is completed by the taxpayer. Thus, property reconstructed by a taxpayer and then sold and leased back by the taxpayer within 8 months of the date actually placed in service is to be treated as placed in service on the date actually placed in service.

The act also clarifies the applicability of the 8-month rule in the case of certain sale-leasebacks.

Under the act, the 3-month rule does not apply if the leasee and lessor so elect.

SUMMARY OF FEDERAL TECHNICAL CORRECTIONS -- 1986

Title XVIII: Technical Corrections

Act Section: 1811 Sections Affected: 6031, 6050H, 6050K, 6652, 6660, 6678, and 7502.

SUBJECT: Reporting, Penalty, and Other Ccompliance Provisions

EXPLANATION

The act makes the following changes to these compliance provisions:

(1) Requires that a cooperative housing corporation must report to both its tenant-stockholder and the Internal Revenue Service on the tenant-stockholder's proportionate share of mortgage interest paid to the cooperative housing corporation. The act also corrects the effective date of a related penalty provision.

(2) Corrects the provision relating to reporting on exchanges of certain partnership interest.

(3) Makes a conforming amendment to the law that provides for penalties for failing to file statements to include failures to report the substitute payments. The act also clarifies that the penalty for intentional disregard of the requirement to report these substitute payments to the IRS is 10 percent of the aggregate amount required to be reported.

(4) Provides a cross-reference to the definition of underpayment for purposes of the penalty for valuation understatements with respect to estate or gift taxes.

(5) Clarifies that the new deposit rules apply to any taxpayer required to deposit any tax more than once a month (e.g. employers depositing withheld income taxes).

(6) Improves information reporting by partnerships where a partner's interest is held by a nominee.

SUMMARY OF FEDERAL TECHNICAL CORRECTIONS -- 1986

Title XVIII: Technical Corrections

Act Section: 1812 Sections Affected: 111, 246, 267, 280F, 1351, 1398, 7872, 4941, 707, 4064

SUBJECT: Tax Benefit Rule

EXPLANATION

The act provides that an amount is excludible from income only to the extent that it does not reduce a taxpayer's income tax. Therefore, where a deduction reduces taxable income but does not reduce tax (because, for example, the taxpayer is subject to the alternative minimum tax), recovery of the amount giving rise to the deduction may be excludible from income under the law relative to recovery of tax benefit items.

SUBJECT: Low Interest Loans

EXPLANATION

These provisions are not applicable to California law.

SUBJECT: Transactions With Related Persons

EXPLANATION

The act directs the Secretary of the Treasury to issue regulations applying the matching principle generally applicable to related party transactions in cases where the person to whom the payment is to be made is not a United States person.

The act also provides that the special exception with respect to the loss deferral rules between related taxpayers for sales of inventory to or from foreign corporations applies where the party related to the foreign corporation is a partnership.

For transfers after September 27, 1985, the act provides that the provisions relating to transactions between partner and partnership will apply whether or not the person constructively holding a 50-percent partnership interest was himself a partner. In addition, the act provides that the deferral provisions relating to transactions between related taxpayers will apply to two partnerships in which the same persons hold a more than 50-percent of the capital interests or profits interests.

SUBJECT: Federal Home Loan Mortgage Corporations

EXPLANATION

The act makes several adjustments in the dividends received deduction for dividends allocable to post-1984 Freddie Mac income, as follows:

1) It adds an explicit statutory rule stating that no dividends received deduction is to be allowed with respect to dividends paid by Freddie Mac out of earnings and profits accumulated before January 1, 1985 (i.e., the date of taxability). In conjunction with this amendment, the act repeals the rule under which Freddie Mac is treated as having no accumulated profits as of January 1, 1985.

2) In the case of income distributed via a Federal Home Loan Bank the act clarifies that no dividends paid by Freddie Mac may serve as the basis for more than one deduction for dividends received from a Federal Home Loan Bank. This clarification applies both to dividends paid by a Federal Home Loan Bank in different years, or when two or more dividends are paid during the same year.

3) In the case of dividends paid directly by Freddie Mac to taxable corporate shareholders, the act permits a deduction for dividends received in 1985, as well as later years.

4) It provides that the earnings and profits of the Federal Home Loan Bank, for purposes of section 246(a)(2), is to be determined as reported in its annual financial statement.

In addition the act provides that the distribution of preferred stock by Freddie Mac to the Federal Home Loan Banks to their member institutions in January, 1985, are to be treated as if they were distributions of money in an amount equal to the fair market value of the stock on the date of the distribution by the Federal Home Loan Banks, followed by the payment of such money by the member institutions to Freddie Mac in return for its stock.

Under the special rule, the earnings and profits of Freddie Mac will be reduced by the amount deemed distributed to the Federal Home Loan Banks. If Freddie Mac later makes distributions to the member institutions out of its pre-1985 income, these distributions will be treated as dividends (and will not qualify for a dividends received deduction) to the extent (if any) that pre-1985 earnings and profits of Freddie Mac exceeded the amount deemed distributed at the time of the preferred stock distribution.

SUBJECT: Personal Use Property

EXPLANATION

The act clarifies:

1) The definition of passenger automobile by providing that the weight of the automobile shall not include the weight of the passengers or the weight of any cargo. A similar clarification is made for purposes of the gas guzzler excise tax.

2) The the requirements that, in order to take a deduction or credit, employee use of listed property be for the convenience of the employer and required as a condition of employment also apply to the amount of any deduction allowable to the employee for rentals or other payments under a lease of listed property.

3) That computers eligible for the exception from the definition of listed property must be owned or leased by the person operating the business establishment, in addition to being used exclusively at a regular business establishment.

In addition, the act provides that, except to the extent provided in regulations, listed property used as a means of transportation (with respect to credits and deductions for luxury automobiles) does not include property substantially all the use of which is in the business of providing unrelated persons services consisting of the transportation of persons or property for hire.

SUMMARY OF FEDERAL TECHNICAL CORRECTIONS -- 1986

Title XVIII: Technical Corrections

Act Section: 1825 Sections Affected: 7702 of the Code and 221 of 84 TRA

SUBJECT: Definition of Life Insurance Contract; Computational

EXPLANATION

The act:

- clarifies the second computational rule by specifically stating that the maturity date shall be deemed to be no earlier than age 95 and no language of the second computational rule to that of the first and third.

- adds an additional computation rule which provides that for purposed of applying the second computational rule and for purposes of determining the cash surrender value on the maturity date under the third computational rule, the death benefits shall be deemed to be provided until the maturity date described in the second computational rule. This rule combined with the second computational rule will generally prevent contracts endowing at face value before age 95 from qualifying as life insurance. However, it will allow an endowment benefit at ages before 95 for amounts less than face value.

- clarifies that these computational rules do not apply for purposes of determining qualification under the cash value corridor test.

SUBJECT: Reduction In Future Benefits

EXPLANATION

Under the act, a portion of the cash distributed to a policyholder as a result of a change in future benefits will be treated as paid first out of income in the contract rather than as a return of the policyholder's investment in the contract, only if the reduction in future benefits occurs during the 15-year period following the issue date of the contract:

- Changes during the first five years--For the first five years following the issuance of the contract, the amount that will be treated as having been paid first out of income in the contract will be equal to the amount of the required distribution. This amount will depend on whether the contract meets the cash value accumulation test or the guideline premium/cash value corridor test. In the case of a contract to which the cash value accumulation test applies, the excess of the cash surrender value of the contract over the net single premium determined immediately after the reduction shall be required to be distributed to the policyholder. In the case of a contract to which the guideline premium/cash value corridor test applies, the amount of the required distribution is equal to the greater of (1) the excess of the aggregate premiums paid under the contract over the redetermined guideline premium limitation, or (2) the excess of the cash surrender value of the policy immediately before the reduction over the redetermined cash value corridor. The guideline premium limitation shall be redetermined by using an "attained-age-decrement" method.

Under this method, when benefits under the contract are reduced, the guideline level and single premium limitations are each adjusted and redetermined by subtracting from the original guideline premium limitation a "negative guideline premium limitation" which is determined as of the date of the reduction in benefits and at the attained age of the insured on such date. The negative guideline premium limitation is the guideline premium limitation for an insurance contract that, when combined with the original insurance contract after the reduction in benefits, produces an insurance contract with the same benefit as the original contract before such reduction.

To the extent that the redetermined guideline premium limitation requires a distribution from the contract, the amount of the distribution will also be an adjustment to premiums paid under the contract, to be specified in regulations. Any adjustment to premiums paid as part of the definitional determinations will be independent of, and may differ in amount from, the determination of investment in the contract for purposes of computing the amount of income in the contract.

- Changes during years six to fifteen--For cash distributions occurring between the end of the fifth year and the end of the fifteenth year from the issuance date of the policy, a single rule applies for all contracts. Under this rule, the maximum amount that will be treated as paid first out of income in the contract will equal the amount by which the cash surrender value of the contract (determined immediately before the reduction in benefits) exceeds the maximum cash surrender value that would not violate the cash value corridor (determined immediately after the reduction in benefits).

Any distribution up to two years before a reduction in benefits occurs will be treated as having been made in anticipation of such a reduction. The Secretary of the Treasury is authorized to issue regulations specifying other instances when a distribution is in anticipation of a reduction of future benefits. In addition, the regulations may specify the extent to which the rules governing the calculation of the maximum amount that will be treated as paid first out of income in the contract will be adjusted to take into account the prior distributions made in anticipation of the reduction of benefits.

Under the act, premiums paid would be computed in the same manner as under present law, except that the premiums actually paid under the contract will be further reduced by amounts treated as paid first out of income in the contract under the revised adjustment rule. This reduction in premiums paid is limited to the amounts that are included in gross income of the policyholder solely by reason of the fact that a reduction in benefits has been made.

SUBJECT: Treatment of Contracts That Do Not Qualify As Life Insurance Contracts

EXPLANATION

Under the act, income in the contract is computed without reduction by the amount of policyholder dividends paid under the contract during the taxable year.

SUBJECT: Treatment of Flexible Premium Contracts Issued During 1984 Which Meet New Requirements

EXPLANATION

The act clarifies the definition of life insurance transition rules so that any contract issued during 1984 which meets the definitional requirements of present-law will be treated as meeting the requirements of prior-law, which was extended through 1984.

SUBJECT: Treatment of Certain Contracts Issued Before October 1, 1984.

EXPLANATION

The act clarifies the transitional rule so that, in applying the cash value accumulation test by substituting 3 percent of 4 percent as the minimum interest rate, the taxpayer should not only assume that the rate or rates guaranteed on issuance of the contract can be determined without regard to any mortality charges, but should be determined without regard to any initial interest rate guaranteed in excess of the stated minimum rate.

SUMMARY OF FEDERAL TECHNICAL CORRECTIONS -- 1986

Title XVIII: Technical Corrections

Act Section: 1826 Sections Affected: 72(e),(q), and (s) of the Code

SUBJECT: Amendments Related to Annuity Contracts

EXPLANATION

The act:

- clarifies:

  1) the requirement that an annuity contract need not include distribution provisions in order to be treated as an annuity if the contract is one that is used as part of a qualified pension plan or for an IRA by adopting a specific statutory exemption for these purposes.

  2) the application of the required distribution rules, which provides that the primary annuitant shall be treated as the holder of the contract, if the contractholder is not an individual. For these purposes, the term "primary annuitant" means the individual whose events in his or her life are of primary importance in affecting the timing or amount of the pay-out under the contract.

  3) the application of the penalty exception for distributions at death so that the penalty does not apply to any distribution made on or after the death of the contractholder or, if the contractholder is not an individual, the death of the primary annuitant. Therefore, the additional income tax on early withdrawals is not imposed on the required after-death distribution.

- adds a provision that states if an individual holding an annuity contract transfers it by gift or, in the case of a holder other than an individual when there is any change in the primary annuitant, then such transfer or change shall be treated as an assignment of the contract. The value of the assigned contract, in general, will equal the net surrender value of the contract, determined with regard to any policy loan.

- addresses the issue of how joint contractholders should be treated when one holder dies and clarifies that the after-death distribution requirements apply upon the death of any holder to such contract.

- provides that any annuity used as a qualified funding asset in a structured settlement will not be subject to the 5 percent additional income tax imposed on the portion of any premature distribution from an annuity that is included in gross income.

SUMMARY OF FEDERAL TECHNICAL CORRECTIONS -- 1986

Title XVIII: Technical Corrections

Act Section: 1827 Sections Affected: 79 and 83(e) of the Code

SUBJECT: Amendments Related to Group-Term Insurance

EXPLANATION

The act:

o provides that, in the case of a discriminatory group-term life insurance plan, the cost of group-term life insurance on the life of any key employee shall be the greater of the actual cost of the insurance or the cost determined based on the uniform premium table.

o revises the definition of key employee to include any former employee if such employee, at the time of separation from service, was a key employee. An employee is a key employee at separation from service if the employee was a key employee for the year in which separation occurs or for any of the 4 preceding years. For purposes of applying the nondiscrimination requirements of the group-term life insurance provisions, the act also clarifies that, to the extent provided in regulation, coverage and benefit tests are applied separately to active and former employees.

o makes a clerical correction so that, when an employee retires, the present value of any future group-term life insurance coverage which may become nonforfeitable upon retirement (or the value of an amount set aside by an employer to fund such coverage) will not be taxed immediately to the employee upon retirement. Rather, if the coverage constitutes group-term life insurance (e.g., the employee does not receive a permanent guarantee of life insurance coverage from the insurance company), the cost of the coverage will be taxable annually to the retired employee. This rule also applies in the case of an employee who also applies in the case of an employee who separates from service with a vested right to continuing group-term life insurance coverage.

o provides that the extension of the $50,000 cap to retired employees and the extension of the nondiscrimination provisions to former employees do not apply to any group-term life insurance plan of the employer in existence on January 1, 1984. However this does apply only with respect to an individual who attained age 55 on or before

January 1, 1984, and was employed by such employer (or a predecessor employer) at any time during 1983 also shall not apply to any employee who retired from employment on or before January 1, 1984, and who when he retired, was covered by a group-term life insurance plan of the employer (or a predecessor plan).

- amends the rules with respect to grandfathered individuals to provide that, in applying the nondiscrimination rules under section 79, such individuals may be disregarded at the employer's election.

- clarifies what qualifies as a comparable successor plan for purposes of the grandfather provision in that a comparable successor plan includes, with respect to a grandfathered individual, any plan that does not provide increased benefits. If the benefits of a grandfathered individual are increased, the grandfather rule no longer applies to that individual.

- modifies the provision relating to a grandfathered group-term life insurance program to provide that grandfather treatment is retained with respect to any employee whose benefits do not increase under the plan.

SUMMARY OF FEDERAL TECHNICAL CORRECTIONS -- 1986

Title XVIII: Technical Corrections

Act Section: 1828 Sections Affected: 1035(b)

SUBJECT: Policy Excnanges

EXPLANATION

The act amends the definition of an endowment contract and a life insurance contract by merely requiring that the contracts be issued by any insurance company, whether or not such company is a taxable entity under the Code.

SUMMARY OF FEDERAL TECHNICAL CORRECTIONS -- 1986

Title XVIII: Technical Corrections

Act Section: 1834 Sections Affected: 31(a)(3)(A)

SUBJECT: Amendment to Taxability of Corporation Distribution

EXPLANATION

The act clarifies that the only State law to which the provision is intended to apply is a North Dakota law originally enacted on April 22, 1977.

SUMMARY OF FEDERAL TECHNICAL CORRECTIONS -- 1986

Title XVIII: Technical Corrections

Act Section: 1841-1848 Sections Affected: 30, 39, 46, 47, 48, 55, 71, 86, 108, 146, 151, 267, 280C, 401, 404, 415, 422A, 453B, 665, 1041, 2039, 4973, 6047, 6411, 6501, 6511, 6654, 6699, 6704, 7701

SUBJECT: Amendments Related to Title IV of the Act

EXPLANATION

The act makes numerous nonsubstantive clerical and conforming amendments to provisions related to the individual estimated tax, domestic relations, at-risk, administrative provisions, distilled spirits, the Tax Court, income tax credits and deadwood.

The act specifically:

o requires that certain non-resident aliens will continue to make estimated tax payments in three, rather than four installments of which one-half of the estimated tax will be due with the first payment.

o restores the principles of prior law relating to the carryover of credits (including the foreign tax credit) by taxpayers subject to the alternative minimum tax.

o amends the domestic relation provisions to provide that alimony payments under certain support decrees will not be disqualified solely because the decree does not specifically state that the payments will terminate at the payee's death. The act also reduces the recapture period to three years for those divorce decrees and agreements not covered by the requirement that the divorce instrument specifically state there is no liability to make payments after death.

o clarifies that in the case of the transfer of property to a trust for the assumption of (or subject to) liabilities in excess of basis, gain will be recognized to the extent of that excess. Gain will also be recognized on the transfer of installment obligations to a trust.

o revises the front-loading alimony rules, so that if the alimony payments in the first year exceed the average payments in the second and third year by more than $15,000, the excess amounts are recaptured in the third year by requiring the payor to include the excess in income and allowing the payee who previously included the alimony in income a deduction for that amount in computing adjusted gross income. A similar rule applies to the extent the payments in the second year exceed the payments in the third year by more than $15,000. The rule does not apply to temporary support payments or to payments which fluctuate as a result of a continuing liability to pay, for at least three years, a fixed portion or portions of income from the earnings of a business, property or services. liabilities in excess of basis, gain will be recognized to the extent of that excess. Gain will also be recognized on the transfer of installment obligations to a trust.

SUMMARY OF FEDERAL TECHNICAL CORRECTIONS -- 1986

Title XVIII: Technical Corrections

Act Section: 1851 Sections Affected: 419, 419A, 505, 512 & 4976

SUBJECT: Funded Welfare Benefit Plans

PRIOR FEDERAL LAW

Under prior law, a fund is defined as any tax-exempt social club, voluntary employees' beneficiary association (VEBA), supplemental unemployment compensation benefit trust (SUB), or group legal services organization; and trust corporation, or other organization not exempt from income tax; and, to the extent provided by Treasury regulations, any account held for an employer by any person. A fund includes a retired life reserve account maintained by an insurance company on behalf of an employer. Further, if an employer contributes amounts to an insurance company for benefits and under that arrangement the employer is entitled to a rebate if the amount paid exceeds benefit claims or is liable if the benefit claims exceed the amount paid, then such contributions are considered to have been made to a welfare benefit fund.

Finally, under prior law, an employer is not permitted a deduction for premiums paid on a life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the employer, if the employer is directly or indirectly a beneficiary of the policy.

EXPLANATION

The act modifies the exclusion from the term "fund" for amounts held by an insurance company under certain "qualified, nonguaranteed insurance contracts." A qualified, nonguaranteed insurance contract is defined as an insurance contract (including a reasonable premium stabilization reserve) under which (1) there is not a guarantee of a renewal of the contract at guaranteed premium rates, and (2) other than current insurance protection, the only payments to which the employer or employees are entitled under the contract are refunds or policy dividends that are not guaranteed, that are experience rated and that are determined by factors other than the amount of welfare benefits paid to (or on behalf of) the employees of the employer or their beneficiaries.

Thus, amounts that are held by an insurance company for an employer generally are not to be treated as a fund to the extent that the amounts are subject to a significant current risk of economic loss that is determined, in part, by factors other than the amount of welfare benefits paid to (or on behalf of) the employees of the employer. Experience refunds or policy dividends are determined by additional factors where they reflect a charge for pooling of large individual claims, where the insurance company's retention reflects a risk charge related to the insurer's actual or anticipated experience under the class of business to which the contract belongs, or where the claims experience of other policyholders is otherwise taken into account.

In addition, the bill provides that even an arrangement that satisfies the definition of a qualified, nonguaranteed insurance contract will not be excluded from treatment as a fund, unless the amount of any experience rated refund or policy dividend payable with respect to a policy year is treated by the employer as paid or accrued in the taxable year in which the employer's contributions for the policy year were deductible. If the actual amount of the refund or dividend is not known by the due date of the employer's tax return for the year, Treasury regulations could permit the use of a reasonable estimate of the amount of such refund or dividend. In addition, Treasury regulations could require insurance companies to submit information (including proprietary information of the insurance company) relating to the basis for the calculation of experience refunds and policy dividends.

To the extent that the general rules for the exclusion of amounts held by an insurance company are satisfied, amounts held by an insurance company for a reasonable premium stabilization reserve for an employer are not treated as a fund. Thus, a premium stabilization reserve, if limited to a reasonable amount, such as 20 percent of premiums for the year, would not be treated as a fund to the extent that (1) such amounts are subject to a significant current risk of economic loss, and (2) experience rated refunds and policy dividends payable by the reserve with respect to a policy year are treated by the employer as paid or accrued in the taxable year in which the employer's contributions for such policy year were deductible. Solely for purposes of these provisions, the amounts released from a premium stabilization reserve to purchase current insurance coverage are to be treated as experience rated refunds or policy dividends.

Whether amounts are subject to a significant current risk of loss depends upon the facts and circumstances. For example, if an employer does not have a guaranteed right under an insurance contract to policy dividends based solely on the employer's experience but the insurance company has, in practice, consistently paid such dividends based solely on the employer's experience, it is anticipated that Treasury regulations would provide that the amounts held under the contract constitute a fund because they are not subject to a significant current risk of economic loss.

SUBJECT: Coordination of Post-Retirement Medical Benefits with Limits on Contributions Under Qualified Plans

EXPLANATION

The act provides that the amount treated as an annual addition under the rules for coordinating the post-retirement medical benefits with the overall limits on qualified plans is not subject to the 25-percent-of-compensation limit usually applicable to annual additions. For example, assume the compensation of an employee is $100,000 for a year and $5,000 is treated as an annual addition under the limits for the employee under rules for post-retirement medical benefits under a qualified plan. Assume further that the employee's annual addition for the year under a qualified defined contribution plan, without regard to the post-retirement medical benefit, is $25,000 (a contribution equal to the maximum percentage of compensation limit). Under the act, the total annual addition for post-retirement medical benefits does not cause the annual addition to exceed the 25-percent limit on annual additions even though the annual addition would exceed that limit if the amount added for post-retirement medical benefits were taken into account. The annual addition on $30,000 would, however, be subject to the separate dollar limit for defined contribution plans for the year and, if the employer also maintains a defined benefit plan for the employee, the full annual addition of $30,000 would be taken into account in determining whether the combined plan limits of a defined benefit plan and defined contribution plan for the same employee are satisfied.

The effect of this rule also is to permit the funding of post-retirement medical benefits on behalf of a key employee during periods when the employee has no compensation from the employer (e.g., after retirement).

SUBJECT: Separate Accounting Required for Certain Amounts

EXPLANATION

The act clarifies the requirement for separate accounting with respect to post-retirement medical benefits and post-retirement life insurance benefits. Under the act, the requirement does not apply until the first taxable year for which a reserve is computed using the special provisions applicable to these benefits (or assets of a fund held before the effective date are allocated to a separate account). The separate account requirement applies for that first year and for all subsequent taxable years.

SUBJECT: Reserves for Discriminatory Post-Retirement Benefits Disregarded

EXPLANATION

The act provides that no reserve generally may be taken into account in determining the account limit for a welfare benefit fund for post-retirement medical benefits or life insurance benefits (including death benefits) unless the plan meets the nondiscrimination requirements with respect to those benefits, whether or not those nondiscrimination requirements apply in determining the tax-exempt status of the fund. The bar against taking post-retirement medical benefits and life insurance benefits into account in determining the account limit does not apply, under the act, in the case of benefits provided pursuant to a collective bargaining agreement between one or more employee representatives and one or more employers if the Secretary of the Treasury finds that the agreement is a collective bargaining agreement and that post-retirement medical benefits or post-retirement life insurance benefits (as the case may be) were the subject of good faith bargaining between the employee representatives and the employer or employers.

The act clarifies that certain post-retirement group-term life insurance benefits that fail to satisfy the nondiscrimination requirements may, nevertheless, be taken into account in determining the account limit to the extent that the group-term life insurance benefits are provided under an arrangement with respect to individuals grandfathered under the provision that allows the inclusion of former employees in the case of existing group term insurance plans.

SUBJECT: Account Limit for Life Insurance Benefits

EXPLANATION

The act clarifies that life insurance benefits are not to be taken into account in determining the account limit under a welfare benefit fund to the extent that the aggregate amount of such benefits to be provided with respect to an employee exceeds $50,000. Accordingly, under the bill, the $50,000 limit applies with respect to the aggregate of self-insured and insured life insurance benefits under all funds maintained by the employer. The bill does not change the rules of the Deficit Reduction Act (DEFRA) under which certain post-retirement life insurance benefits in excess of $50,000 may be taken into account in determining the account limit for certain individuals under plans in existence on January 1, 1984.

SUBJECT: Actuarial Certification

EXPLANATION

The act provides that the requirement for an actuarial certification also applies to post-retirement medical benefits and post-retirement life insurance benefits, unless a safe harbor computation is used.

SUBJECT: Aggregation of Funds

EXPLANATION

The act provides that, in computing the dollar limits applicable to the amount of reserves for disability benefits, post-retirement medical benefits, and post-retirement life insurance benefits for which reserves may be accumulated for any participant, all welfare benefit funds of an employer are treated as a single fund. In the absence of Treasury regulations to the contrary, the limit is allocated proportionately to the amount of the death benefit in each plan.

SUBJECT: Transition Rules

EXPLANATION

The act provides that, under the transition rules for existing excess reserves, the amount of existing excess reserves for any year is the excess (if any) of (1) the amount of assets set aside at the close of the first taxable year ending after July 18, 1984, to provide disability benefits, medical benefits, supplemental unemployment compensation benefit trust (SUB) or severance pay benefits, or life insurance benefits, over (2) the account limit (without regard to the transition rules) for the taxable year for which the excess is being computed. The act further provides that the transition rule allowing an increase in the account limit because of existing excess reserves applies only to a welfare benefit fund which, on July 18, 1984, had assets set aside to provide the enumerated benefits.

Accordingly, in the case of an employer that maintains a funded plan which had assets set aside to provide disability benefits, medical benefits, SUB or severance pay benefits, or life insurance benefits on July 18, 1984, and to which the deduction limits first apply for the taxable year beginning January 1, 1986, the increase in the account limit for 1986 attributable to existing excess reserves is 80 percent of the excess, if any, of the amount of assets set aside at the close of 1984 (the first taxable year ending after July 18, 1984) over the account limit determined under the general rules for 1986. For 1987, however, the increase attributable to existing excess reserves is 60 percent of the excess, if any, of the amount of assets set aside at the close of 1984 over the account limit determined for 1987.

SUBJECT: Tax on Unrelated Business Income

EXPLANATION

The act makes it clear that the tax on unrelated business income applies in the case of a 10-or-account limit is to be determined as if the rules limiting deductions for employer contributions applied.

In addition, the act provides that the transition rule for pre-existing reserves for post-retirement medical and life insurance benefits applies to the greater of the amount of assets set aside as of (1) July 18, 1984, or (2) the close of the last plan year ending before July 18, 1984, rather than only to assets set aside as of the end of the plan year ending before July 18, 1984.

The act deletes the provision of the Code barring a set aside for certain assets used in the provision of permissible benefits (facilities). Treasury regulations are to provide that facilities used to provide permissible benefits are disregarded in determining whether fund assets exceed the account limit for a qualified asset account.

In addition, the act provides that if any amount is included in the gross income of an employer for a taxable year as deemed unrelated income with respect to a welfare benefit fund, then the amount of the income tax imposed on the deemed unrelated income is to be treated as a contribution paid by the employer to the fund on the last day of the taxable year and, thus, is deductible, subject to the limits on deductions for fund contributions. The tax attributable to the deemed unrelated income is to be treated as if it were imposed on the fund for purposes of determining the after-tax income of the fund.

SUBJECT: Tax on Disqualified Benefits Provided Under Funded Welfare Benefit Plans

EXPLANATION

This provision is not applicable to California law.

SUBJECT: Application of Account Limits to Collectively Bargained Plans

EXPLANATION

The act permanently exempts collectively bargained Voluntary Employee's Beneficiary Associations (VEBAs) from the account limits applicable to welfare benefit funds without regard to any

Treasury regulations providing special account limits for such funds. Thus, employer contributions to such VEBAs are deductible and earnings on assets of such VEBAs are tax exempt.

SUBJECT: Application of Account Limits to Welfare Benefit Plans Funded Solely with Employee Contributions

PRIOR FEDERAL LAW

Under prior law, the account limits for welfare benefit funds apply whether a plan is funded with employer or employee contributions. In the case of a plan funded solely by employee contributions, the primary effect of the account limits is to treat earnings on plan assets in excess of the account limits as unrelated business taxable income.

EXPLANATION

The act exempts certain employee pay-all Voluntary Employees' Beneficiary Associations (VEBAs) with at least 50 employees from the welfare benefit fund provisions if the amount of any refund or rebate to an employee is determined by factors other than the employee's experience. Under the act, an employee pay-all VEBA is not considered to fail to qualify for this exemption merely because an employee's refund or rebate may vary depending upon the number of years the employee contributed to the fund. For example, if a VEBA provides a set employee contribution rate that applies for 3 years, the mere fact that an employee who contributes for 3 years may receive a larger refund or rebate than an employee who contributes for less than 3 years does not cause the fund to fail to meet the requirements for exemption as long as there is a significant current risk of economic loss (i.e., the amount of the refund or rebate is also determined by factors other than any employee's experience).

SUMMARY OF FEDERAL TECHNICAL CORRECTIONS -- 1986

Title XVIII: Technical Corrections

Act Section: 1852 Sections Affected: 72, 401, 402, 403, 408, 414, 415, 416, 2039, and 2517 of the Code.

SUBJECT: Qualified Pension Profit Sharing and Stock Bonus Plans

EXPLANATION

Distribution prior to age 59 1/2. - Under the act, the 10 percent additional income tax on distributions prior to age 59 1/2, death, or disability (within the meaning of Sec. 72(m)(7) is applied to amounts received from or under a qualified plan by a 5 percent owner. However, the act provides that the tax does not apply to benefits accrued before January 1, 1985. In apply the rule, distributions will be made first out of benefits accrued before January 1, 1985.

The act removes the requirement of present law that each plan distribution must be examined to determine whether it is attributable to contributions made on behalf of a participant while the participant was a 5 percent owner. Instead, the status of an individual at the time of a plan distribution is the relevant factor for imposition of the tax.

A 5 percent owner is defined as any individual who at any time during the 5 plan years preceding the plan year in which the distribution is made was a 5 percent owner.

Before-death and after-death distribution rules. The act clarifies the required beginning date for distributions from or under qualified plans and IRAs. The act clarifies that an individual is considered to be a 5 percent owner for a calendar year if the individuals was a 5 percent owner at any time during the plan year ending in the calendar year in which the individual attains age 70 1/2, or during any of the four preceding plan years. If an employee becomes a 5 percent owner in a plan year subsequent to the plan year ending in the calendar year in which the employee attained age 70 1/2, the required beginning date is April 1 of the calendar year following the calendar year in which ends the plan year that the employee becomes a 5 percent owner.

The act also provides that the rule disregarding benefits of an employee after 5 plan years applies to employees who have not performed services for the employer maintaining the plan at any time during the 5 year period ending on the determination date. This provision is added to relieve the administrative difficulties associated with determining whether or not amounts an individual might receive after separation from service are in the nature of compensation.

The act clarifies that distributions from IRAs are to commence no later than April 1 of the calendar year following the year in which the owner of the IRA attains age 70 1/2, without regard to whether the owner has retire. In addition, distributions from IRAs are subject to the incidental death benefit rules applicable to qualified plans.

The act repeals the exception to the required distribution rules applicable to amounts held by an ESOP, which are subject to the 84-month rule of Code Section 409(a). Instead, the bill provides an exception to the 84-month rule for amounts required to be distributed under the required distribution rules for qualified plans.

Further, the act provides that amounts required to be distributed from a qualified plan or IRA under the required distribution rules are not eligible for rollover treatment. The rule ensures that an individual will not be able to circumvent the required distribution rules by taking a required distribution at year's end and rolling over that distribution before or after the beginning of the next year. This restriction would apply only to the amounts required to be distributed. Thus, individuals would not be prevented from rolling over those distributions that (1) exceed the minimum required distribution, or (2) occur during a year in which no minimum distribution is required. For this purpose, the first amounts distributed to an individual during a taxable year are treated as amounts required to be distributed.

Tax-sheltered annuities. - The provision in the House bill requiring that distributions commence under a tax-sheltered annuity no later than when the employee attains age 70 1/2 is adopted.

Qualifying rollover distributions. - The act clarifies that the distribution of the entire balance to the credit of an employee in a qualified plan may be treated as a distribution eligible for rollover under the partial distribution does not constitute a "qualified total distribution." Thus, a total distribution that is not made on account of plan termination, is not eligible for lump sum treatment and does not consist of accumulated deductible employee contributions, would be eligible for rollover under the partial distribution rollover rules.

The act clarifies that accumulated deductible employee contributions (within the meaning of Sec. 72(o)(5) are not taken into account for purposes of calculating the balance to the credit of an employee under the partial distribution rollover rules. In addition, the act clarifies that a self-employed individual is generally treated as an employee for purposes of the rules governing the tax treatment of distributions, including the rules relating to rollover distributions.

The act provides that the rules relating to rollovers in the case of a surviving spouse of an employee who received distributions after the employee's death apply to permit rollover to an IRA but not to another qualified plan. Also, the act clarifies that partial distributions are to be rolled over within 60 days of the distribution to be eligible for rollover under the partial distribution rollover rules.

SUBJECT: Treatment of Distributions if Substantially All Contributions are Employee Contributions

EXPLANATION

Under the act , a plan is defined as one in which substantially all of the contributions are employee contributions if 85 percent or more of the total contributions during a representative period are employee contributions. Also, the act provides that the 5 percent additional income tax on premature distributions from annuity contracts does not apply to distributions from a plan substantially all of the contributions of which are derived from employee contributions.

The act clarifies that deductible employee contributions are not taken into account as employee contributions for purposes of testing whether 85 percent or more of the total contributions to a plan during a representative period are employee contributions.

SUBJECT: Provisions Relating to Top-Heavy Plans

EXPLANATION

The act amends the definition of a key employee to exclude any individual who is an officer or employee of an entity relating to governmental plans. The effect of this provision is to clarify that certain separate accounting and nondiscrimination provisions do not apply to employees of a State or local government or certain other governmental entities. the act does not repeal the provision that exempts governmental plans from the top-heavy plan requirements.

The act also provides that the rule disregarding benefits of an employee after 5 plan years applies to employee who have not performed services for the employer maintaining the plan at any time during the 5 year period ending on the determination date. This provision is added to relieve the administrative difficulties associated with determining whether or not amounts an individual might receive after separation from service are in the nature of compensation.

SUBJECT: Provisions Related to Estate and Gift Taxes With Respect to Qualified Plan Benefits

EXPLANATION

This provision is not applicable to California law.

SUBJECT: Affiliated Service Groups and Employee Leasing Arrangements

EXPLANATION

Under the act, the special regulatory authority provided to the Secretary of the Treasury with respect to abuses through the use of affiliated service groups is repealed in favor of the broader general authority provided under the Act (Sec. 414(o)). In addition, the act clarifies that the other definitions relating to affiliated service groups (Sec. 414(m)(6)) continue to apply.

SUBJECT: Discrimination Standards Applicable to Cash or Deferred Arrangements

EXPLANATION

Under the act, if an employee participates in more than one cash-or-deferred arrangement of an employer, all such cash-or-deferred arrangements are treated as one arrangement for purposes of determining the employee's actual deferral percentage. Thus, an employee's actual deferral percentage taken into account for purposes of applying the special deferral percentage tests under any plan of the employer is the sum of the elective deferrals for that employee under each plan of the employer which provides a cash-or-deferred arrangement, divided by the participant's compensation from the employer.

In addition, the act clarifies that a plan which includes an otherwise qualified cash-or-deferred arrangement that satisfies the special tests will be treated as satisfying the general nondiscrimination test with respect to the elective deferrals.

SUBJECT: Treatment of Certain Medical, Etc., Benefits Under A Pension Plan

EXPLANATION

The act clarifies that the special rules for post-retirement medical benefits apply to any pension or annuity plan under which such benefits are provided.

In addition, the act changes the definition of employees for whom separate accounting is required under a pension plan to conform to the definition provided to the separate accounting for post-retirement medical and life insurance benefits under a welfare benefit fund. Thus, separate accounting is required with respect to any employee who is a key employee.

Further, the act provides that the amount treated as an annual addition under the rules for coordinating the post-retirement medical benefits with the overall limits on qualified plans is not subject to the 25 percent-of-compensation limit usually applicable to annual additions.

For example, assume the compensation of an employee is $100,000 for a year and $5,000 is treated as an annual addition under the limits for the employee under the rules for post-retirement medical benefits under a qualified plan. Assume further that the annual addition for the year under a qualified defined contribution plan, without regard to the post-retirement medical benefit is $25,000 (a contribution equal to the maximum percentage of compensation limit). Under the act, the annual addition for post-retirement medical benefits does not cause the annual addition to exceed the 25-percent limit on annual additions, even though the annual addition would exceed that limit if the amount added for post-retirement medical benefits were taken into account. The annual addition of $30,000 would, however, be subject to the separate dollar limit for the year and, if the employer also maintains a defined benefit plan for the employee, the full annual addition of $30,000 would be taken into account in determining whether the combined plan limits are satisfied (Sec. 4159(e)).

SUBJECT: Transitional Rules for Effective Date of Multi-Employer Pension Plan Amendments Act of 1980

EXPLANATION

The act modifies the effective date of the withdrawal liability provisions of MPPAA in two instances. First, in the case of an employer who entered into a collective bargaining agreement that was effective on January 12, 1979, and that remained in effect through May 15, 1982, and under which contributions to a multiemployer plan were to cease on January 12, 1982, the act changes the effective date of the withdrawal liability provision of MPPAA from September 26, 1980 to January 12, 1982.

Second, in the case of an employer engaged in the grocery wholesaling business that had ceased all covered operations under the plan before June 30, 1981, and had relocated its operations to a new facility in another state and that meets certain other conditions listed in the bill, the bill modifies the effective date of the withdrawal liability provisions of MPPAA September 26, 1980 to June 30, 1981.

SUMMARY OF FEDERAL TECHNICAL CORRECTIONS -- 1986

Title XVIII: Technical Corrections

Act Section: 1853 Sections Affected: 125, 132 and 4977

SUBJECT: Clarification of Line of Business Requirements

EXPLANATION

The act clarifies that a leased section of a department store which, in connection with the offering of beautician services, customarily makes sales of beauty aids in the ordinary course of business is to be treated as engaged in over-the-counter sales of property, and thus is to be treated as a part of the line of business of the person operating the store. This treatment is to be available without requiring that a specific percentage of he beauty salon's revenue must be earned through the sale of such beauty products because beauty salons have traditionally occupied such leased sections (even though the bulk of their revenue is attributable to performing services rather than selling property.) This is contrasted with businesses (such as insurance companies) that have not traditionally occupied such leased sections.

SUBJECT: Definition of Dependent Children

EXPLANATION

The act fines dependent child to mean any child of the employee (1) who is a dependent of the employee, or (2) both of whose parents are decreased and who has not attained age 25.

SUBJECT: Clarification of Cross-Reference

EXPLANATION

To clarify the mechanics of the cross-reference with respect to fringe benefits. Accordingly, the qualified employee discount exclusion applies in certain circumstances where the price at which property or services are provided to the employee by the employer for use by such employee (or the spouse or dependent children or parents of the employee) is less than the price to nonemployee customers.

SUBJECT: Cross-Reference Definition of Customer

EXPLANATION

The act provides that this exception to the definition of customers also applies for purposes of defining the ter "gross profit percentage."

SUBJECT: Excise Tax on Certain Fringe Benefits

EXPLANATION

This provision is not applicable to California law.

SUBJECT: Applicability of Certain Fringe Benefit Exclusions to Certain Pre-Divestiture Retired Telephone Employees

EXPLANATION

The act applies an intended transitional rule under which the fair market value of free telephone service provided to employees of the bell system who had retired prior to divestiture of the system on January 1, 198r is excluded from income and wages of such pre-divestiture retired employees. The exclusion pursuant to the provision does not apply to the furnishing of any property or to the furnishing of any type of service that was not furnished to such retirees as of January 1, 1984.

The provision applies in the case of an employee who, prior to January 1, 1984, separated from the service (by reason of retirement or disability) of an entity subject to the modified final judgment. The provision does not apply to any employee who separated from such service on or after January 1, 1984. No inference is intended from adoption of this transitional rule as to the interpretation of the no-additional-cost service exclusion in any other circumstances. Under the provision, all entities subject to the modified final judgment are treated as a single employer in the same line of business for purposes of determining whether telephone service provided to the employee is a no-additional-cost service. Also, payment by an entity subject to the modified final judgment of all or part of the cost of local telephone service provided to the employee by a person other than an entity subject to the modified final judgment (including rebate of the amount paid by the employee for the service and payment to the person providing the service) is treated as telephone service provided to the employee by such single employer for purposes of determining whether the telephone service is a no-additional-cost service.

For purposes of this provision, the term "employee" has the meaning given to such retired and disabled employees and a surviving spouse who is treated as an employee. Except as otherwise provided, the general requirements for the exclusion apply to officers, owners, or highly compensated employees only if the no-additional-cost service is available to employees on a nondiscriminatory basis.

SUBJECT: Cafeteria Plans

EXPLANATION

Under the act the definition of permissible cafeteria plan benefits is clarified. The effect of the provision, which changes, the reference in section 125 from nontaxable benefits to qualified benefits is to (1) eliminate any possible implication that a taxable benefit provided through a cafeteria plan is nontaxable, and (2) clarify that certain taxable benefits, as permitted under Treasury regulations, can be provided in a cafeteria plan.

The act makes two changes to the transition relief provided to certain cafeteria plans of the Tax Reform Act of 1984. The first change provides that a cafeteria plan, in existence on February 10, 1984, maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers will be granted relief under the transition rules until the expiration of the last collective bargaining agreement relating to the cafeteria plan. when a collective bargaining agreement terminates is determined without regard to any extension of the agreement agreed to after July 18, 1984. Also, if a cafeteria plan is amended to conform with either the requirements of the Act or the requirements of any cafeteria plan regulations, the amendment is not treated as a termination of the agreement.

Second the act provides that a cafeteria plan which suspended a type or amount of benefit after February 19, 1984, and subsequently reactivated the benefit is eligible for transition relief under either the general or special transition relief provision.

SUBJECT: Working Condition Fringe

EXPLANATION

The committee clarifies the application of the product testing provision for purposes of the working condition fringe exclusion in the coarse of automobile testing. As described above, the product testing exclusion rule does not apply unless the employer imposes limitations on the employee's use of the item that significantly reduce the value of any personal benefit to the employee. This particular requirement is satisfied if the employer charges the employee a reasonable amount for any personal use of the automobile; thus, the product testing exclusion rule applies in such a case if all the other requirements for the rule are met.

An employer is treated as having imposed a sufficient charge for any personal benefits to an employee from the use of an evaluation product if the charge exceeds the cost to the employer in making the product available to employees.

The provision also clarifies the exception to the working condition fringe benefit rule for full-time automobile salesmen. This exception is not intended to be restricted to employees who have the formal job title of salesperson. Rather, the term is intended to apply to full-time employees of an automobile dealer who are automobile salesmanagers; or to other employees who, as an integral part of their employment, regularly perform the functions of a floor salesperson or salesmanager, directly engage in the promotion and negotiation of sales to customers, and derive a significant part of their compensation from such activity. This provision, however, does not apply to owners of large automobile dealerships who do not customarily engage in significant sales activities.

SUBJECT: Clarification of Deminimis Fringe Benefits

EXPLANATION

The provision clarifies that the de minimis fringe benefit exclusion includes tokens, vouchers, and reimbursements to cover the costs of commuting by public transit, as long as the amount of such reimbursement, etc., provided by the employer does not exceed $15 a month ($180 a year). The value of all such transit benefits (including any discounts on passes) furnished to the same individual are aggregated for purposes of determining whether the $15 limit is reached.

SUBJECT: Transitional Rules for Treatment of Certain Reductions In Intuition

EXPLANATION

Under the act, for purposes of testing whether the tuition reduction program of Oberlin College is nondiscriminatory, a plan is treated as nondiscriminatory if it is nondiscriminatory taking into account certain special rules. First, with respect to all tuition reduction plans of Oberlin College, the plans are nondiscriminatory if the plans meet the nondiscrimination requirement when employees not included in the plan (who are included in a unit of employees covered by an agreement that the Secretary of the Treasury finds to be a collective bargaining agreement between employee representatives and one or more employers, if there is evidence that such benefits were the subject of good faith bargaining) are excluded from consideration.

A tuition reduction benefit provided by Oberlin College is treated as being provided under a separate plan if the level of the benefit was frozen before July 18, 1984. With respect to benefits for which the level of benefit is frozen, the plan is nondiscriminatory if the plan met the nondiscrimination requirements (taking into account the exclusion of union employees) on the day on which eligibility to participate in the plan closed and at all times thereafter, the tuition reductions available under the plan are available on substantially the same terms to all employees eligible to participate in the plan.

In addition, the act provides that any tuition reduction provided with respect to a full-time course of education furnished at the graduate level before July 1, 1988, is not included in gross income if (1) the reduction would not have been included in income under Treasury Regulations in effect on July 18, 1984, and (2) the reduction is provided with respect to a student who was accepted for admission to such course of education before July 1, 1984, and began the course of education before June 30, 1985.

SUMMARY OF FEDERAL TECHNICAL CORRECTIONS -- 1986

Title XVIII: Technical Corrections

Act Section: 1855 Sections Affected: 555 and 556 of the 1984 TRA

SUBJECT: Incentive Stock Option Provision

EXPLANATION

The act clarifies that, under the transitional rule, the amendment to the minimum tax provision relating to incentive stock options will not apply to options exercised before January 1, 1985, if the option was granted pursuant to a plan adopted or corporate action taken by the board of directors of the grantor corporation before May 15, 1984.

SUBJECT: Time for Making Certain Elections Where Property is Transferred

PRIOR FEDERAL LAW

The Act extended the time for making certain elections where property was transferred to the taxpayer after June 30, 1976 and before November 18, 1982, where the taxpayer paid fair market value (determined without regard to certain restrictions).

EXPLANATION

The Act extends the provision of that 1984 Act to transfers made before July 1, 1976.

SUMMARY OF FEDERAL TECHNICAL CORRECTIONS -- 1986

Title XVIII: Technical Corrections

Act Section: 1875 Sections Affected: 58, 62, 219, 304, 402, 404, 408, 415, 1248, 3405, 6229, 6230, 2213, 6034A of the Code;

Secs. 713,714 of '84 TRA.

SUBJECT: Miscellaneous Corporate Provision

EXPLANATION

The act provides that the contribution to capital rule will not apply if the shareholder is treated as having exchanged its stock. Thus, where rules for the distributions in redemption of stock applies, the acquiring corporation will be treated as purchasing the stock.

SUBJECT: Miscellaneous Pension Provisions

EXPLANATION

Rollerovers The act coordinates the rules relating to qualifying rollover distributions with those applicable to the additional income tax on early withdrawals. Distributions made after the date of enactment of this act to or on behalf of an individual who is a 5 percent owner at the time of distribution may not be rolled over to a qualified plan.

The act provides that distributions after December 31, 1983, but before July 18, 1984, may not be rolled over to a qualified plan if any part of the distribution is attributable to contributions made on behalf of an owner-employee. In addition, distributions made after July 18, 1984, but before the enactment of this bill, may not be rolled over to a qualified plan if any part of the distribution is a benefit attributable to contributions made on behalf of an employee while a key employee (but only if the individual is a key employee on account of status as a 5 percent owner) in a top-heavy plan.

Excess contributions The act makes it clear that the repeal by DEFRA of the rule relating to the return of excess contributions made on behalf of a self-employed individual applies with respect to contributions made in taxable years beginning after December 31, 1983.

IRAs, SEPs - The act conforms the limits on certain distributions of excess IRA contributions and the limits on employer contributions on behalf of certain officers, shareholders, or owner employees to SEPs to the dollar limit on annual additions to a qualified defined contribution plan. This provision is effective as if enacted in TEFRA.

Overall limits - The act makes it clear that the rule precluding deductions based on anticipated cost-of-living adjustments to the overall benefit limits applies to limit benefits payable as a single life annuity commencing at age 62, as well as benefits paid in alternate forms, those commencing prior to age 62, and those commencing after age 65.

Tax-sheltered annuities - The provision requiring that distributions commence under a tax-sheltered annuity no later than when the employee attains age 70 1/2 is adopted.

Deduction limits for self-employed individuals - The act makes it clear that the DEFRA amendment to the definition of earned income did not change the TEFRA definition of earned income for purposes of the 15 or 25 percent limits on deductions. Rather, the change permitting earned income of a self-employed individual to be determined without regard to the deductions allowable for contributions to a qualified plan is to apply solely for purposes of determining the extent to which contributions made to a qualified plan are ordinary and necessary business expenses for purposes of the deduction rules.

This provision is effective as if enacted in TEFRA. The DEFRA amendment, which had the effect of increasing the amount deductible on behalf of a self-employed individual to 15 or 25 percent of earned income before reduction for contributions to the plan on behalf of the self-employed individual, rather than 15 or 25 percent of earned income after reduction for contributions to the plan on behalf of the self-employed individual, is repealed, effective for taxable years beginning after December 31, 1984.

The act also clarifies that the deduction available to a self-employed individual for contributions to a qualified plan is not necessarily limited to the cost of actual benefits provided for, or allocations to, the individual. Rather, subject to the usual deduction rules, a self-employed individual is permitted to deduct the allocable share of contributions to a qualified plan. This clarification is effective as if enacted in TEFRA.

Pension withholding - The act includes distributions of dividends for which employer is permitted a deduction in the list of distributions to which the withholding rules do not apply.

Contributions on behalf of disabled individuals - The act provides that deductible contributions may be continued on behalf of a permanently and totally disabled employee to any defined contribution plan, including a money purchase pension plan.

SUMMARY OF FEDERAL TECHNICAL CORRECTIONS -- 1986

Title XVIII: Technical Corrections

Act Section: 1878 Sections Affected: 51, 514, 852, 4041, 462 and 4261 of the Code

Sec. 1001, 1028, 1041, 1063, and 1065 of the 1984 TRA.

SUBJECT: Certain Helicopter Uses Exempt from Aviation Excise Taxes

EXPLANATION

This provision is not applicable to California law.

SUBJECT: Acquisition Indebtedness of Certain Exempt Organizations

EXPLANATION

The act provides that the Secretary may treat the qualified allocation rule as met if it is shown to the satisfaction of the Secretary that there is no potential for tax avoidance. For example, if the partnership elects 40-year straight-line depreciation on leased real estate and if the failure to meet the qualification allocation rule is caused by the allocation of an increased share of a loss or deduction to the exempt organization in order to meet the substantial economic effect requirement it is expected that the Secretary would treat the new rule as having been met.

SUBJECT: Military Housing Rollover

EXPLANATION

The extended nonrecognition period is not to expire before the day which is one year after the last day on which the taxpayer is stationed outside the United States or is required to reside in government quarters at a remote base site within the United State. The exception that this extended nonrecognition period cannot exceed eight years after the date of the sale of the old residence.

SUBJECT: Regulated Investment Companies

EXPLANATION

This provision is not applicable to California law.

SUMMARY OF FEDERAL TECHNICAL CORRECTIONS -- 1986

Title XVIII: Technical Corrections

Act Section: 1879 Sections Affected: 28, 29, 48, 368, 401, 501, 1361, 1368, 2523, 4991, 6030D 6405, 6654, 6655 and 7652 of the Code

TEFRA Sec. 292.

SUBJECT: Waiver of Estimated Tax Penalties

EXPLANATION

This provision is not applicable.

SUBJECT: Orphan Drug Act

EXPLANATION

This provision is not applicable to California law.

SUBJECT: Credit for Producing Fuel From Nonconventional Source

EXPLANATION

This provision is not applicable to California law.

SUBJECT: Reports of Refunds by Joint Committee of Congress

EXPLANATION

This provision is not applicable to California law.

SUBJECT: Rural Electric Cooperative Cash or Deferred Arrangements

EXPLANATION

The act clarifies that any organization that is exempt from tax and that is engaged primarily in providing electric service on a mutual or cooperative basis is eligible to maintain a qualified cash or deferred arrangement. This provision also applies to a national association of such tax-exempt organizations.

SUBJECT: Definition of Newly Discovered Oil

EXPLANATION

This provision is not applicable to California law.

SUBJECT: Refunds with Respect to Medicinal Alcohol

EXPLANATION

This provision is not applicable to California law.

SUBJECT: Allowance of Investment Tax Credit to Members of Certain Tax-Exempt Religious Organizations

EXPLANATION

This provision is not applicable to California law.

SUBJECT: Reorganization of Investment Companies

EXPLANATION

The act provides that the stock of a RIC, REIT or diversified investment company will not be treated as stock of a single issuer for purposes of determining whether the holder is diversified. This provision is intended to permit an investment company to be treated as a diversified investment company only if it would be so defined if it were deemed to own its ratable share of the assets of any RIC, REIT, or diversified investment company in which it owns stock (without regard to whether its percentage ownership is 50 percent or more).

SUBJECT: Mutual Savings Banks

EXPLANATION

The act provides that a stock association which is treated as a mutual savings bank for purposes of computing a bad debt deduction is also treated as a mutual savings bank for purposes of the exemption for mutual organizations insuring these banks. The provision is effective as if enacted in ERTA.

SUBJECT: Subchapter S Provisions

EXPLANATION

This provision is not applicable to California law.

SUBJECT: Qualified Terminable Interest Property

EXPLANATION

This provision is not applicable to California law.

SUBJECT: Windfall Profit Tax

EXPLANATION

This provision is not applicable to California law.

SUBJECT: Suspension of Audits, Time to File Petitions and Interest and Penalties

EXPLANATION

This provision is not applicable to California law.

SUMMARY OF FEDERAL TECHNICAL CORRECTIONS -- 1986

Title XVIII: Technical Corrections

Act Section: 1898 Sections Affected: 72, 401, 402, 411, 414, 417, 2503

203-206, 408 of 74 ERISA

302, 303 of '84 REA

SUBJECT: Minimum Participation, Vesting and Benefit Accrual Standards

EXPLANATION

1. Break-in-Service Rules

The act generally conforms the break-in-service rules applicable to class-year plans to the break-in-service rules provided for other types of plans. Under the act a class-year plan generally is to provide that 100 percent of each participating employee's right to benefits derived from employer contributions for a plan year (the contribution year) is to be nonforfeitable as of the close of the fifth plan year of service (whether or not consecutive) with the employer following the contribution year. A plan year is a plan year of service with the employer if the participant has not separated from service with the employer as of the close of the year.

The act provides that, if a participant incurs five consecutive one-year breaks in service before the completion of five plan years of service with respect to a contribution year, then the plan may provide that the participant forfeits any right to or derived from the employer contributions for the contribution year.

The provision is effective for contributions made for plan years beginning after the date of enactment, except that the provision is not effective with respect to a collectively bargained plan until the applicable effective date of the Act '84 REA for that plan.

Lump-sum distributions. The act conforms the rules relating to the taxation of lump-sum distributions to the break-in-service rules. In determining whether any distribution payable on account of separation from service is a lump sum distribution, the balance to the credit of the employee is determined without taking into account any increase in vesting that could occur if the employee is reemployed by the employer.

However, if the employee is reemployed by the employer before the occurrence of five consecutive one-year breaks in service and the nonforfeitable interest of the employee in the amount of the pre-break accrued benefits is thereby increased, then the reduction in tax attributable to the treatment of the distribution as a lump-sum distribution is to be recaptured. Such a reduction in tax could occur on account of an election to use 10-year forward averaging with respect to a lump-sum distribution, the special treatment of net unrealized appreciation of employer securities, or long-term capital gains treatment for a portion of a lump-sum distribution. In addition, if such a recapture is made, the participant's previous lump sum distribution election is not taken into account in determining whether the employee is eligible to make another election.

o <u>Rollovers</u>: The act provides that, in determining whether a distribution to an employee on account of separation from service is eligible to be rolled over to another plan or to an IRA, the balance to the credit of the employee is determined without regard to any increased vesting that may occur if the employee returns to service with the employer. However, if (1) the employee excluded the distribution from income on account of a rollover, (2) the employee returns to service with the employer before incurring five consecutive one-year breaks in service and (3) the vested percentage of benefits accrued before the separation from service is increased, then any subsequent distributions to the employee from the plan in which the increased vesting occurs are not eligible for 10-year income averaging or capital gains treatment.

The rule denying eligibility for 10-year forward averaging or capital gains treatment on subsequent distributions does not apply if the distribution that was rolled over was made without the consent of the participant (e.g., the amount distributed did not exceed $3,500).

o <u>Elapsed time</u> The treasury Department is directed to provide, method of within a reasonable period of time after the date crediting of enactment, additional guidance to taxpayers on the application of the break in service rules to plans that use the elapsed time method of crediting service.

2. Mandatory Employee Contributions

The act conforms the rule relating to the period for repayment of mandatory contributions to the repayment of accrued benefits after separation from service. Additionally it extends both rules to apply in the case of a defined benefit plan as well as a defined contribution plan. The provision clarifies that the repayment period during which a plan must permit an employee to repay mandatory contributions does not end before a participant has five consecutive one-year breaks in service.

A plan may provide that repayment of withdrawn amounts is required to be made no later than (1) five years after the date of the withdrawal or (2) in the case of a distribution on account of separation from service the earlier of (a) five years after the date the individual is reemployed by the employer or (b) the date upon which the individual incurs five consecutive one-year breaks in service.

3. Maximum Age Requirement

The act reduces from 25 to 21 the maximum age requirement that a SEP may impose as a condition of plan participation. Thus, a SEP may not require, as a condition of participation, attainment of an age greater than 21 or the performance of service during more than three of the immediately preceding five calendar years (whichever occurs later).

SUBJECT: Coordination Between Qualified Preretirement Survivor Annuity and Joint and Survivor Annuity

EXPLANATION

The act clarifies and coordinates the application of the qualified preretirement survivor annuity and the qualified joint and survivor annuity provisions if an individual:

(1) dies before or after the annuity starting date, and
(2) receives a disability benefit under the plan.

Coordination of Annuities

The act provides that the survivor benefit payable to the participant's spouse is to be a qualified joint and survivor annuity if the participant dies after the annuity starting date (unless the benefit is waived with spousal consent).

If a participant dies after separation from service or after the normal retirement age, but before the participant's annuity starting date, the survivor benefit payable to the participant's spouse would be a preretirement survivor annuity.

This act clarifies coordination of events and which type of annuity a surviving spouse is to receive.

Disability Benefits

The bill amends the definition of a participant's annuity starting date to exclude the commencement of auxiliary disability benefits. An auxiliary disability benefit is a plan whose participant is receiving disability benefits when the participant reaches early or normal retirement age, will receive an annuity benefit that satisfies the accrual and vesting rules.

SUBJECT: Transferee Plan Rules

EXPLANATION

This act clarifies that the transferee plan is not a transferee plan on account of a transfer completed before January 1, 1985.

In addition, if separate accounting is not maintained for the transferred assets (and allocable investment yield) with respect to an employee, then the survivor benefit requirements apply to all benefits of the employee.

SUBJECT: Rules Relating to Qualified Preretirement Survivor Annuity

This act clarifies the following:

o If a participant separates from service prior to death, the amount of the preretirement survivor annuity is calculated using the actual date the participant separated from service. Therefore, a participant does not accrue benefits after separation from service.

o Under a defined contribution plan, a qualified preretirement survivor payable to a surviving spouse is required to be 50 percent or more of the account balance to which the participant had a nonforfeitable right. For purposes of determining who is a vested participant subject to the survivor benefit provisions, a participant's accrued benefit includes accrued benefits derived from employee contributions.

- o A plan that is exempt from the survivor benefit provisions may provide for the payment of the participant's nonforfeitable accrued benefit, without spousal consent, to a beneficiary other than a spouse, if the couple has been married less than 1 year as of the date of the participant's death (or annuity starting date, whichever is the earliest.)

- o The committee intends that employee contributions to a preretirement survivor annuity be made in proportion to the employee contributions to the total accrued benefit of the participant. Thus, a plan is not permitted to allocate a preretirement survivor annuity only to employee contributions.

SUBJECT: Spousal Consent Requirements of a Qualified Joint and Survivor Annuity

EXPLANATION

Under the act a spouse's consent to waive a qualified joint and survivor annuity or a qualified preretirement annuity is not valid unless the consent:

- o names a designated beneficiary who would receive survivor benefits under the plan, including the form of benefits,

- o acknowledges that the spouse has the right to limit consent to a specific beneficiary or specific from of benefit and that the spouse voluntarily relinquishes one or both.

The spousal consent from is to contain information regarding the relinquished rights. This consent form must be completed if there are changes to the direct beneficiary of the form of benefit. Spousal consent would not be required if a participant dies and the designated beneficiary (other than the spouse, with spousal consent) receives the participant's death benefits elects to receive a benefit not specified in the waiver.

The spousal consent rules will apply to a spouse who resides outside of the United States. The spouse may have their consent witnessed by the equivalent of a notary republic of that jurisdiction.

A participant will be treated has having no spouse, if the participant has been abandoned, as specified. If the participant has a court order or a qualified domestic relations order specifying abandonment then the spousal consent requirements maybe waived.

Spousal Consent Regarding Loans

In addition, any plan that is subject to the requirements of a joint and preretirement survivor annuity must have spousal consent, if applicable, for using plan assets as security for loans. The spouse consents in writing 90 days prior to the security of the loan, as specified, and the spouse's consent acknowledges the effect of the election. The document shall be signed by a plan representative or a notary republic.

If a spouse consents, then the assets can be secured should the participant default on the loan, even if the participant is married to a different spouse. Similarly, if a participant is not married at the time of the loan then spousal consent rules do not apply if the participant's default on the loan subsequently occurs after the participant is married.

SUBJECT: Notice Requirements for Individuals Who Become Qualified Joint and Survivor Annuity Participants After 35

EXPLANATION

The new federal law expands the notice requirements for individuals who become qualified joint and survivor annuity participants after age 35, to include that an explanation, provided within the applicable period after:

- the end of the subsidization of a survivor benefit with a participant by a plan
- the survivor benefit provisions become applicable to a participant
- separation from service in the case of a participant who separates from service before age 35,

whichever of the above periods is the latest.

SUBJECT: Rule for Subsidized Benefits of A Defined Plan

EXPLANATION

The act clarifies that a plan that fully subsidizes the cost of the benefit is not required to provide a participant with a right to waive a qualified joint and survivor annuity or qualified preretirement survivor annuity.

The current law exception to the notice requirement only applies if:

(1) the plan fully subsidizes the benefit, and

(2) the plan does not permit a participant to waive the benefit or to designate another beneficiary.

SUBJECT: Definition of Annuity Starting Date

This act amends the definition of the annuity starting date to provide that, in the case of a benefit, not payable in the form of an annuity, the starting date is the date on which the benefit is paid or commences being paid. For benefits that are payable as a joint and survivor annuity, the starting date is the first day of the first period for which the amount is payable has an annuity regardless of when or whether payment is actually made.

SUBJECT: Change in Reporting Income From Pensions Subject to A Domestic Relations Order

EXPLANATION

The federal change would provide that the special rules for determining the taxability of benefits under a qualified domestic order would apply only to a spouse or former spouse. A child or a dependent of a participant who receives distribution of benefits would not claim the benefits for tax purposes. The participant would claim the benefits in his/her adjusted gross income and would be recoverable under the general basis recovery rules applicable to the participant. Lump sum disbursements to a child or a dependent would be treated as part of the balance to the credit of the participant.

SUBJECT: Changes for Qualifying a Domestic Relations Order

EXPLANATION

o If the plan administrator determines that the order is not qualified, but has received a notice that the parties are attempting to rectify the problem, then the administrator must not make payment to the participant until expiration of the 18 month period. Additionally the plan administrator will honor a restraining order prohibiting the distribution of benefits pending resolution of the dispute.

o In addition, the change deletes the requirement that an escrow account be established for amounts that would have otherwise been paid during the 18 months. Instead the plan administrator is required only to account separately for the amount.

The federal change intends that an order will not fail to be a qualified domestic relations order even if the form of the benefit does not continue to be a form permitted by (1) an amendment to the plan, or (2) a change of law.

(1) If the plan has been amended the alternate payee is still entitled to receive the benefits as originally stated in the order. The alternate payee may elect to receive benefits in another form as long as the form does not affect the benefits the participant is entitled to.

(2) If there is a change in the law and the order is now impermissible the alternate payee may elect another form of benefit offered in the plan that would not affect the participant's benefits.

Changes to the 18 month period for determining the qualifications of a domestic relations order:

- o Clarifies that the 18 month period during which benefits may be deferred begins on the date payments are due to commence under the order.

SUBJECT: Clarifies Payment of Benefits Through A Qualified Domestic Relations Order Regarding A Qualified Joint and Survivor Annuity

EXPLANATION

This change would clarify that a domestic relations order may not require payments made before or after a participant's separation from service be made in the form of a joint and survivor annuity to the alternate payee and his/her subsequent spouse.

SUBJECT: Clarifies Application of Domestic Relations Orders to Plans Not Subject to Assignment or Alienation

EXPLANATION

The act clarifies that a qualified domestic relations order does not apply to pension plans to which the assignment or alienation restrictions do not apply. For example, a domestic relations order regarding a government employee's pension plan is not required to meet the provisions of the order because the pension payments to a spouse or former spouse, according to the plan, are not a prohibited assignment or alienation of the participant's benefits.

SUBJECT: Clarifies Payment of Benefit Through A Qualified Domestic Relations Order is Not the Same as A Garnishment of Wages

EXPLANATION

This act insures that a provision of the Employee Retirement Income Security Act of 1974 does not treat payment of benefits pursuant to a qualified domestic relations order as garnishment.

SUBJECT: Clarifies Requirements of Distribution of Benefits of A Pension Plan Through A Qualified Domestic Relations Order

EXPLANATION

A plan which has a vested accrued benefit that exceeds $3,500 meets the distribution requirements if the plan provides that distribution may not be immediately distributed without the consent of the participant.

This act also provides that under a qualified domestic relations order, a current spouse of a participant is not treated as a spouse if a prior order allows distribution of plan benefits to a former spouse, as specified. The order could further provide that the former spouse is not entitled to receive survivor benefits as specified under the participant's plan. In this case the plan administrator would not be required to obtain consent from the former spouse if the participant elected to waive survivor benefits.

SUBJECT: Changes the Term "Earliest Retirement Age" Regarding A Qualified Domestic Relations Order

The term "earliest retirement age" under a defined plan or contribution plan subject to a qualified domestic relations order is changed to the earlier of the date under the plan on which the participant is entitled to a distribution or the later of the two following dates:

- The date the participant reaches the age of 50, or
- The earliest date the participant could begin receiving benefits under the plan if the participant separated from service.

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PART II-- NONAPPLICABLE TECHNICAL CORRECTIONS

SUMMARY OF FEDERAL TECHNICAL CORRECTIONS -- 1986

Title XVIII: Technical Corrections - Part II (Nonapplicable)

Act Section: 1801 Sections Affected: 12(c)(1), 27 of the 1984 Tax Reform Act;

Sec. 4251(b), 5061, 5703(b) of the Code

SUBJECT: DEFERRAL OF CERTAIN TAX REDUCTIONS

EXPLANATION

These provisions are not applicable to California law.

Act Section: 1802 Sections Affected: 469(e)(4), 47(a), 48(a)(g), 168(j), 7701(e) of the Code,

Sec. 31(g), 32 of the 1984 Tax Reform Tax.

SUBJECT: Tax-Exempt Entity Leasing Provisions

EXPLANATION

This provision is not applicable to California law.

Act Section: 1803 Sections Affected: 1271-1273, 1276, 1278, 1281-1282, 483, 171, 163(e) of the Code

44(b) of the 84 Tax Reform Act

SUBJECT: Treatment of Bonds and Other Debt Instruments

EXPLANATION

These provisions are not applicable to California law.

Act Section: 1810 Sections Affected: 163, 269B, 367, 651, 552, 864, 871, 881, 897, 904, 954, 956, 1248, 1441, 1442, 1445, 6039C, 6652, 7701

SUBJECT: PROVISIONS RELATING TO FOREIGN ENTITIES

EXPLANATION

This provision is not applicable to California law.

Act Section: 1821 Sections Affected: 211, of 1984 TRA; 505, 807, 808, 809, 812, 813, 815, 816, 817, 818 of the Code

SUBJECT: Amendments Related to Section 211 of the Tax Reform Act of 1984

EXPLANATION

This provision is not applicable to California law.

Act Section: 1822 Sections Affected: 216 of 1984 TRA

SUBJECT: Amendments related to Section 216 of the Tax Reform Act of 1984

EXPLANATION

This provision is not applicable to California law.

Act Section: 1823 Sections Affected: 217 of 1984 TRA

SUBJECT: Amendments Related to Section 217 of the Tax Reform Act of 1984

EXPLANATION

This provision is not applicable to California law.

Act Section: 1824 Sections Affected: 218 of 1984 TRA

SUBJECT: Amendment Related to Section 218 of the Tax Reform Act of 1984

EXPLANATION

This provision is not applicable to California law.

Act Section: 1829 Sections Affected: None

SUBJECT: Waiver of Interest on Certain Under Payments of Tax

EXPLANATION

This provision is not applicable to California law.

Act Section: 1830 Sections Affected: None

SUBJECT: Scope of Section 255 of the Tax Equity and Fiscal Responsibility Act of 1982

EXPLANATION

This provision is not applicable to California law.

Act Section: 1832 Sections Affected: 494(e)(2)

SUBJECT: Amendments Related to Section 303 of the Act

EXPLANATION

This provision is not applicable to California law.

Act Section: 1854   Sections Affected: 133, 402, 404, 409, 1042, 2210 and 4979A of the Code

SUBJECT: Amendments Related to Employee Stock Ownership Plans

EXPLANATION

This provision is not applicable to California law.

Act Section: 1861   Sections Affected: 103A, 611

SUBJECT: Amendments Related to Section 611 of the Act

EXPLANATION

This provision is not applicable to California law.

Act Section: 1862   Sections Affected: 103A, 612

SUBJECT: Amendment Related to Section 612 of the Act

EXPLANATION

This provision is not applicable to California law.

Act Section: 1863   Sections Affected: 613

SUBJECT: Amendment Related to Section 613 of the Act

EXPLANATION

This provision is not applicable to California law.

Act Section: 1864 Sections Affected: 103A, 621

SUBJECT: Amendments Related to Section 621 of the Act

EXPLANATION

This provision is not applicable to California law.

Act Section: 1865 Sections Affected: 103, 622

SUBJECT: Amendment Related to Section 622 of the Act

EXPLANATION

This provision is not applicable to California law.

Act Section: 1866 Sections Affected: 623

SUBJECT: Transitional Rule for Limit on Small Issue Exception

EXPLANATION

This provision is not applicable to California law.

Act Section: 1867 Sections Affected: 624

SUBJECT: Amendments Related to Section 624 of the Act

EXPLANATION

This provision is not applicable to California law.

Act Section: 1868 Sections Affected: 625

SUBJECT: Amendments Related to Section 625 of the Act

EXPLANATION

This provision is not applicable to California law.

Act Section: 1869 Sections Affected: 626

SUBJECT: Amendments Related to Section 626 of the Act

EXPLANATION

This provision is not applicable to California law.

Act Section: 1871 Sections Affected: 103, 628

SUBJECT: Amendments Relating to Sec. 628 of the Act

EXPLANATION

This provision is not applicable to California law.

Act Section: 1872 Sections Affected: 631

SUBJECT: Amendments Related to Section 631 of the Act

EXPLANATION

This provision is not applicable to California law.

Act Section: 1873 Sections Affected: 632

SUBJECT: Amendments Related to Section 632 of the Act

EXPLANATION

This provision is not applicable to California law.

Act Section: 1876 Sections Affected: 245, 291, 902, 904, 906, 923, 924, 927, 995, 996, and 1248

SUBJECT: Amendments to Title VIII of the Act

EXPLANATION

This provision is not applicable to California law.

Act Section: 1877 Sections Affected: 6427(b) of the Code.

SUBJECT: Amendments to Title IX of the Act

EXPLANATION

This provision is not applicable to California law.

Act Section: 1882 Sections Affected: 1402(g), (j), 3121(w) of the Code

SUBJECT: Coverage of Church Employees (Sections 2603 of the Deficit Reduction Act

EXPLANATION

This provision is not applicable to California law.

Act Section: 1883 Sections Affected: 402, 408 of the Act

SUBJECT: Other Provisions Relating to Social Security Act Programs

EXPLANATION

This provision is applicable to California law.

Act Section: 1884 Sections Affected: 3302(f) of the Code

SUBJECT: Federal Unemployment Tax Act

EXPLANATION

This provision is not applicable to California law.

Act Section: 1885 Sections Affected: 111, 112, 113, 123, 124, 146, 182 of the 1984 Trade and Tariff Act

SUBJECT: Tariff Scnedules

EXPLANATION

This provision is not applicable to California law.

Act Section: 1886 Sections Affected: 702(b)(1), 704, 732(b)(1), 751(b)(1), 771(a), 777, 7369(c)(1) of Title IV of the 1930 Trade and Tariff Act

611(a)(2)(B)(iii), 613, 619, 626(b), of the 1984 Trade and Tariff Act.

SUBJECT: Counter Vailing and Antidumping Duty Provisions

EXPLANATION

This provision is not applicable to California law.

Act Section: 1887 Sections Affected: 504(C)(3)(D)(ii) of the 1974 Trade and Tariff Act

SUBJECT: Trade Act of 1974

EXPLANATION

This provision is not applicable to California law.

Act Section: 1888 Sections Affected: 304(c), 313(j), 514(a), 516(a)(2) of the 1930 Trade and Tariff Act

202, 207 of the 1984 Trade and Tariff Act

SUBJECT: Tariff Act of 1930

EXPLANATION

This provision is not applicable to California law.

Act Section: 1889 Sections Affected: 126, 174(b), 212, 234(a), 304(d)(2)(A), 307(b)(3), and 504 of the Trade and Tariff Act of 1984

SUBJECT: Amendments to the Trade and Tariff Act of 1984

EXPLANATION

This provision is not applicable to California law.

Act Section: 1890 Sections Affected: 213 of the Caribbean Basin Economic Recovery Act

235 of the Trade and Tariff Act of 1984

SUBJECT: Amendments to the Caribbean Basin Economic Recovery Act

EXPLANATION

This provision is not applicable to California law.

Act Section: 1891 Sections Affected: Title 28 of the United States Code
212(b) of the Trade and Tariff Act of 1984

SUBJECT: Customs Brokers

EXPLANATION

This provision is not applicable to California law.

Act Section: 1892 Sections Affected: 112, 115, 118, 167, and 179 of the Trade and Tariff Act of 1984

SUBJECT: Effective Date Provisions for Certain Articles Given Duty-Free Treatment under the Trade and Tariff Act of 1984

EXPLANATION

This provision is not applicable to California law.

Act Section: 1893 Sections Affected: 13031(b), (e)(1), (g), (h)(2) of the Consolidated Omnibus Budget Reconciliation Act of 1985

53 of the Airport and Airway Development Act of 1970

SUBJECT: Custom User Fees

EXPLANATION

This provision is not applicable to California law.

Act Section: 1894 Sections Affected: Provisio of Sec. 81(c) of the Foreign Trade Zone Act of 1934

SUBJECT: Foreign Trade Zones

EXPLANATION

This provision is not applicable to California law.

Act Section: 1895 Sections Affected: None

SUBJECT: COBRA Technical Corrections Relating to Social Security Act

EXPLANATION

This provision is not applicable to California law.

Act Section: 1896 Sections Affected: None

SUBJECT: Extension of Time for Filing for Credit or Refund with Respect to Certain Changes Involving Insolvent Farmers

EXPLANATION

This provision is not applicable to California law.

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TITLE IXX

CONSOLIDATED OMNIBUS BUDGET RECONCILIATION ACT OF 1985

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CONSOLIDATED OMNIBUS BUDGET RECONCILIATION ACT OF 1985

ITEM I: ONLY RAILROAD RETIREMENT BENEFITS EQUIVALENT TO SOCIAL SECURITY BENEFITS TREATED AS TIER 1 BENEFITS

Act Section 13204 Section Affected 86

CURRENT CALIFORNIA LAW (Sec 17087)

California specifically does not conform to federal law with respect to the tax treatment of railroad retirement benefits. Under state law no portion of Railroad Retirement is taxable.

Under current federal law, a portion of Railroad Retirement System benefits computed by using the social security benefit formula (tier 1 benefits) are subject to Federal income tax for taxpayers whose income generally exceeds $25,000 for unmarried individuals and $32,000 for married individuals filing a joint return. Under the Railroad Retirement System these benefits are available at an earlier age than under the social security system. Other Railroad Retirement System benefits are subject to Federal income tax to the extent the payments exceed the amount of the individual's previously taxed contributions to the plan.

NEW FEDERAL LAW (Sec. 86)

Provides for a definition of the term "tier 1 railroad retirement benefit." Tier 1 railroad retirement benefit means the amount of the annuity under the Railroad Retirement Act of 1974 equal to the amount of the benefit the taxpayer would have been entitled to under the Social Security Act if all of the service after December 31, 1936 had been included in the term "employment" as defined in the Social Security Act and a monthly annuity amount under section 3(f)(3) of the Railroad Retirement Act of 1974.

EFFECTIVE DATE

This provision is effective for any monthly benefit for which the generally applicable payment date is after December 31, 1985.

CONSOLIDATED OMNIBUS BUDGET RECONCILIATION ACT OF 1985

ITEM II: PARENTS OF AIRLINE EMPLOYEES TREATED AS EMPLOYEES IN APPLYING FRINGE BENEFIT RULES

Act Section 13207 Section Affected 132

CURRENT CALIFORNIA LAW (Sec. 17071)

California conforms to federal law with respect to excluding from gross income "no-additional-cost" services and qualified employee discounts provided by an employer to an employee for the use of the employee or employee's spouse or dependent children.

NEW FEDERAL LAW (Sec. 132)

This provision provides that any use of commercial air transportation by a parent of an employee is treated as use by the employee.

EFFECTIVE DATE

Effective beginning January 1, 1985.

CONSOLIDATED OMNIBUS BUDGET RECONCILIATION ACT OF 1985

ITEM III: CERTAIN INSOLVENT TAXPAYERS ALLOWED TO REDUCE CAPITAL GAINS PREFERENCE ITEM FOR PURPOSES OF THE INDIVIDUAL MINIMUM TAX

Act Section 13208 Sections Affected 57

CURRENT CALIFORNIA LAW (Sec. 17062-64.8)

California generally conforms to the federal "add-on" preference tax applicable to years before 1983. The Federal "add-on" tax was repealed for years after 1982; however most of the old tax preference items are in effect for purposes of the "alternative minimum tax."

California law defines the capital gain tax-preference item as the difference between:

(1) the taxpayer's total net capital gains and losses (excluding capital loss carryover) for the taxable year, and

(2) the taxpayer's recognized net capital gains and losses

The effect of this is that the tax-preference item is the sum of:

(1) 35 % of net gain or loss on capital assets held more than 1 but less than 5 years, plus

(2) 50 % of net gain or loss on capital assets held for more than 5-years.

This differs from the Federal tax preference item which is equal to the net capital gain deduction allowed for the tax year.

CURRENT FEDERAL LAW (Sec. 57)

This provision provides that an insolvent taxpayer who transferred real property, used in the active conduct of a trade or business of the taxpayer, to a creditor in cancellation of indebtedness or to any third party under threat of foreclosure, would not be required to treat certain capital gain, excluded from income for regular tax purposes, as a minimum tax preference item. This applies only to individuals, and would not apply to property held for investment.

EFFECTIVE DATE

This provision is effective for transfers or sales or exchanges made after on or after January 1, 1982.

CONSOLIDATED OMNIBUS BUDGET RECONCILIATION ACT OF 1985

ITEM IV: TREATMENT OF THE NETTING OF GAINS AND LOSSES BY COOPERATIVES

Act Section 13210 Section Affected 1388

CURRENT CALIFORNIA LAW (Sec. 24404 - 24406)

California generally conforms to prior federal law, which allows cooperatives, including tax-exempt farmer's cooperatives, to exclude from taxable income amounts paid as patronage dividends, or certain other amounts paid or allocated to members, to the extent of net income. In addition, farmer's cooperatives are permitted to exclude such amounts to the extent of all net income, and may also exclude to a limited degree, dividends paid on common stock.

Tax-exempt farmer's cooperatives are generally operated for the purpose of either marketing the products of the cooperative's members, or others; or for the purpose of purchasing supplies and equipment for members or other persons. Farmer's cooperatives that market products generally turn over the proceeds from sales, less expenses, to the members or other producers. Farmer's cooperatives that purchase equipment or supplies, make them available to members at the cooperative's cost, plus expenses. Netting the gains and losses resulting from purchasing and marketing operations, or from operations in different products or geographic areas is considered to be inconsistent with the statutory definition of a tax exempt farmer's cooperative. Offsetting gains and losses may also be inappropriate for purposes of computing a cooperative's net income and inconsistent with requirements regarding payment of patronage dividends.

NEW FEDERAL LAW (Sec. 1388)

This provision permits the netting of earnings and losses without sacrificing eligibility for treatment as a tax-exempt farmer's cooperative. Losses that are attributable to one or more allocation units may be offset against earnings of one or more other allocation units (including a loss carried over from another year). However, only earnings derived from business done with or for patrons may be offset by such losses.

The netting of gains and losses by cooperatives may be used to determine the cooperative's net income for the purpose of

patronage dividends. The cooperative must notify patrons affected by this offset whether or not it affects the distribution of patronage dividends.

It is not intended that a cooperative's ability to use net operating loss deductions available under current law be affected by enactment of this provision, nor is any inference regarding offsetting of patronage and non-patronage earnings and losses intended to be drawn.

EFFECTIVE DATE

The provisions relating to cooperative's netting gains and losses is effective for taxable years beginning on or after January 1, 1963. The notification requirement applies to taxable years beginning on or after April 8, 1986.

The next page of this report is page 2000.

OMNIBUS RECONCILIATION ACT OF 1986

INCREASE PENALTY FOR SUBSTANTIAL UNDERSTATEMENT OF LIABILITY

Act Section 8002 Section Affected 6661

CURRENT CALIFORNIA LAW (Sec. 18684.4)

California conforms to federal law prior to the enactment of this law (PL 99-509), which provided that a penalty shall be assessed when the taxpayer substantially understates tax liability. Substantial understatement occurs when the taxpayer understates liability by the greater of $5,000 or 10 percent of tax required to be shown on the return. The penalty imposed, in the the form of an addition to the tax, is an amount equal to 10 percent of the amount of any underpayment of tax attributable to such understatement.

NEW FEDERAL LAW (Sec. 6661)

The penalty for substantial understatement of liability is raised from 10 percent of the understated amount to 25 percent of the amount of the underpayment of tax attributable to the understatement. There is no ceiling on the amount of the penalty.

This act provides for the repeal of Section 1504 of the Tax Reform Act of 1986, which increased the penalty for substantial understatement of liability from 10 percent to 20 percent of the underpayment of tax attributable to the understatement.

EFFECTIVE DATE

This provision applies to penalties assessed after October 21, 1986.

The next page of this report is page 2100.

SUMMARY OF STATE REVENUE ESTIMATES

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SUMMARY OF STATE REVENUE ESTIMATES

Federal Tax Reform Act of 1986 (HR 3838)
Recap of State Revenue Effects
Under Existing Tax Rates*

	Fiscal Years (In Millions)	
Personal Income Tax	**1987-88**	**1988-89**
Direct Budget Impact (Table I)	$ -283.0	$ -256.0
Conformity Impact (Table II)	+1,690.2	+1,742.1
Total	$ +1,407.2	$ +1,486.1
Bank & Corporation Tax	**1987-88**	**1988-89**
Direct Budget Impact (Table I)	$ +4.0	$ -117.5
Conformity Impact (Table II)	+480.6	+431.4
Total	$ +484.6	$ +313.9
CONFORMITY REPORT TOTALS	$ +1,891.8	$ +1,800.0
OTHER CONFORMITY ISSUES (Pre-existing differences not Included in HR 3838 Analysis) (Table III)	$ -2,072.0	$ -2,297.0
NET EFFECT OF FULL CONFORMITY	$ -180.2	$ -497.0

(+) = Revenue Increases (-) = Revenue Decreases

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* Even though estimates presented in the Conformity Report include both interactive and noninteractive estimates, this recap shows the order of magnitude of revenue effects for the first two full fiscal years from adopting those federal provisions analyzed in the Report . The "direct budget impact" reflects anticipated changes in taxpayer behavior at the federal level that will be carried over to the state level. The "conformity impact" reflects the summation of conformity estimates in the Report. Existing state tax rates, personal exemptions, standard deductions, and credits are retained. In addition, estimates for other conformity issues not analyzed in the Report are provided for a total conformity projection.

TABLE I
FEDERAL TAX REFORM ACT OF 1986
DIRECT STATE BUDGET IMPACT
FROM BEHAVIORAL EFFECTS

Provisions	Personal Income Tax (in millions) 1987-88	Personal Income Tax 1988-89	Bank & Corp. Tax 1987-88	Bank & Corp. Tax 1988-89
Two Earner Deduction	$ + 2	$ + 2		
Capital Gains	- 521	- 573		
At-Risk Rules	+ 8	+ 15	$ - 8	$ - 13
Passive Loss Limitations	+ 180	+ 300	- 60	- 105
Regulated Investment Co.	+ 35	+ 6	+ 2	+ 0.5
Reserve for Bad Debts (non-financials)			+ 70*	
Tax Year-Partnerships-Etc.	+ 24	+ 18		
Interest on Debt - Tax Exempt Securities	- 15	- 28		
Tax Year Change-Trust	+ 4	+ 4		
TOTALS	$ - 283	$ - 256	$ + 4	$ -117.5

* SB 85 (Chapter 660 Stats. 1986) makes this provison effective for 1988. However, since taxpayers at the federal level will have to make these changes beginning in 1987, it is anticipated that state changes will also be adopted in 1987.

TABLE II
FEDERAL TAX REFORM ACT OF 1986
CONFORMITY IMPACT
UNDER EXISTING STATE TAX RATES

	Personal Income Tax		Bank & Corp. Tax	
	(in millions)			
Provision	1987-88	1988-89	1987-88	1988-89
Individual Income Tax				
Income Averaging Repeal	$ + 174	$ + 187		
Taxing Unemployment Compensation	+ 55	+ 55		
Scholarships and Fellowships	+ 3	+ 5		
Prizes and Awards	- 2	- 3		
Sales Tax Deduction Repeal	+ 256	+ 269	$ + 13	$ + 11
Medical Deduction Limitation	+ 56	+ 63		
Adoption Expenses	+ 0.2	+ 0.2		
Meals, Entertainment and Travel Expenses	+ 38	+ 46	+ 45	+ 51
Employee Business Expenses and Misc.	+ 225	+ 240		
Political Contributions Repeal	+ 2.5	+ 2.6		
Capital Cost Deduction				
Cost Recovery Depreciation	- 33	- 30	- 312	- 301
Research Expenditures Tax Credit	- 9	- 7	- 88	- 62
Trademark and Trade Name Expenditures	+ 0.2	+ 0.3	+ 0.4	+ 0.7
Low Income Housing Credit	- 36	- 79		
Capital Gains and Losses				
Capital Gains Repeal	+ 523	+ 575		
Incentive Stock Options	- 0.2	- 0.2		
Straddles	+ 0.2	+ 0.2		
Agriculture, Timber Energy and Natural Resources				
Soil and Water Expenditures	+ 1	+ 1	+ 0.5	+ 0.5
Land Clearing Expenditures	+ 0.8	+ 0.8		
Converted Wetlands and Erodible Croplands	+ 0.2	+ 0.2		

TABLE II

Provision	Personal Income Tax (in millions) 1987-88	Personal Income Tax 1988-89	Bank & Corp. Tax 1987-88	Bank & Corp. Tax 1988-89
Preproductive Period Expenses	$ + 7	$ + 6	$ + 3	$ + 2
Prepayment Expenses	+ 1.2	+ 0.4		
Discharge of Indebtness Income	− 0.4	− 0.3		
Capital Gains on Timber	+ 5	+ 5		
Intangible Drilling Costs			+ 25	+ 27
Oil, Gas & Geothermal Properties	+ 2	+ 2		
Exploration and Development Costs			+ 4	+ 3
Hard Minerals Percentage Depletion			+ 2.6	+ 2.4
Tax Shelters; Interest Expense				
At Risk Rules on Real Estate	+ 1.6	+ 3		
Passive Loss Limitations	+ 20	+ 30		
Consumer Interest Deduction	+ 185	+ 257		
Corporate Taxation				
Stock Redemption Payments			+ 0.2	+ 0.2
Gain/Loss on Liquidating Sales and Distribution			+ 8	+ 15
Purchase Price Allocation − Sales of Assets	+ 0.1	+ 0.4	+ 2	+ 2
Related Party Sales			+ 0.2	+ 0.2
Co-op Housing Corps	− 0.2	− 0.2		
Real Estate Investment Trusts	+ 0.2	+ 0.2		
Mortgage Backed Securities			− 0.9	− 1.5
Alternative Minimum Tax (Assumes no capital gains)	+ 56	− 10	+ 233	+ 223
Accounting Provisions				
Limitations on Cash Method			+ 24	+ 25
Small Business-Simplified Dollar Value LIFO	− 0.7	− 1.1	− 8	− 12
Installment Sales	+ 1.5	+ 1.5	+ 69	
Capitalization of Inventory, Etc.	+ 20	+ 24	+280	+ 295
Long-Term Contracts	+ 4	+ 4	+127	+ 87
Bad Debt-Repeal (non-financials)	+ 4	+ 4		
Qualified Discount Coupons			+ 1.2	+ 1.4
Utilities Using Accrual Accounting			+ 21	+ 20
Contributions in Aid of Construction			+ 5	+ 4
Discharge of Indebtedness	+ 0.2	+ 0.1	+ 3	+ 2.5

TABLE III
OTHER CONFORMITY ISSUES NOT INCLUDED
IN HR 3838 ANALYSIS
(PIT & B&C)

(in millions)

Provisions	1987-88	1988-89
Net Operating Loss Carryover	$ 0	$ - 212
Sub Chapter S Corporations	- 220	- 245
Federal Personal Exemption Amounts	- 800	- 830
Child Care Credit	- 400	- 450
Elderly & Disabled Tax Credit	- 10	- 10
Renters Credit	+ 500	+ 510
Military Exclusion	+ 7	+ 7
Charitable Contribution (50% Max.)	- 60	- 65
State Income Tax Deduction Net	-800 to -900	-720 to -810
Taxation - Social Security & Railroad Retirement	+ 90	+ 95
Federal Standard Deduction Amounts	- 320	- 335
Imputed Interest	+ 38	+ 51
Maximum Keogh Deduction ($30,000)	- 45 to - 50	- 45 to - 50
TOTALS	$- 2,072	$- 2,297

End of report.