State of California
Franchise Tax Board

SUMMARY OF FEDERAL INCOME TAX CHANGES — 1987

Laws Affected

Personal Income Tax
Bank & Corporation Tax

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

SUMMARY OF
FEDERAL INCOME TAX CHANGES
1987

Prepared by Staff of the

FRANCHISE TAX BOARD

State of California

February 5, 1988

Executive Officer: Gerald H. Goldberg

TABLE OF CONTENTS

Executive Summary

On December 22, 1987 the President signed into law the Omnibus Budget Reconciliation Act (P.L. 100-203) which contains within it the Revenue Act of 1987. That Act makes changes to the Internal Revenue Code with the primary focus being the raising of federal revenue.

Only five issues directly affect individuals. These include denying overnight camp expenses as being eligible for the child care credit, limiting the deduction for interest on home mortgages, clarifying the treatment of federal judges for IRA deductions, providing relief (for 1987) to holders of mutual funds from the two percent floor on indirect expenses, and modifying pension plan provisions with emphasis on tightening the minimum funding requirements.

The changes which affected business entities include changes in the accounting rules for long-term contracts, limitations on the use of the installment method of reporting sales, treatment of certain publicly traded partnerships as corporations subject to corporate taxation of their income, imposition of an excise tax on the receipt of greenmail, and revision of corporate estimated tax provisions.

Title IX, Subtitle D. Pension Provisions

ACTION: MODIFY PENSION PLAN ADMINISTRATION UNDER ERISA

Act Section 9301 - 9346

CURRENT CALIFORNIA LAW (Sec. 17501)

The state is in complete conformity to the federal rules for contributions made to pension plans and the deductibility of those contributions.

NEW FEDERAL LAW (IRC Sec. 401, 404, 411, 412, and 4971) (ERISA Sec. 101, 103-104, 204, 302-304, 306, 307, 403, 407, 413, 502, 3001, 4001, 4005-4007, 4022, 4041, 4042, 4044, 4049, 4062, 4068, and 4071)

The Act reduces the losses to the Pension Benefit Guaranty Corporation by strengthening the funding rules for defined benefit pension plans and ensures that excessive contributions are not made to the plan. A number of modifications are made to the provisions allowing funding waivers, increased funding is required where liabilities to beneficiaries exceed the value of the plan's assets and quarterly installments of estimated plan contributions are required. Notice must be given to plan participants and beneficiaries if an employer fails to make an installment or other plan contribution required to meet the minimum funding standard.

The Act modifies the rules for termination of a plan under a standard termination so that only if it can pay all benefit liabilities may it be terminated. Also, a bankruptcy reorganization will not be recognized as a distress criterion which enables a plan to terminate in a distress termination unless the employer maintaining the plan is unable to pay its debts or continue in business.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provisions are generally effective for plan years after 1987; however, individual provisions have specific effective dates.

Title IX, Subtitle E. Miscellaneous Provisions

ACTION: 6 MONTH EXTENSION OF COLLECTION OF NON-TAX DEBTS OWED TO FEDERAL AGENCIES

Act Section 9402

BACKGROUND

Certain federal agencies are authorized to notify the IRS that a person (who has received proper notification from the agency) owes a past due, legally enforceable, debt to the agency. The IRS then must reduce the amount of any tax refund due the person by the amount of the debt and pay that amount to the agency. Under Treasury regulations, the debt collection program applies with respect to refunds due individuals but not to refunds due corporations. This federal program was scheduled to expire on December 31, 1987.

CURRENT CALIFORNIA LAW (Sec. 12419.2, 12419.3, 12419.5, 12419.7, 12419.8 and 12419.9 of the Government Code and Sec. 1384 of the Unemployment Insurance Code)

A similar program exists in California under the authority of the State Controller with the contractual processing of these offsets to state income tax refunds being made by the Franchise Tax Board.

Under the offset program, the Controller will offset delinquent accounts against personal income tax refunds which have been certified by the Franchise Tax Board in the following priority:

- o Nonpayment of child support accounts.
- o Benefit overpayment accounts administered by EDD if no signed reimbursement agreement exists, or if two consecutive payments on a reimbursement agreement are delinquent as of September 30 of the taxable year.
- o Other offset accounts in the priority determined by the Controller.

An income tax refund is certified by FTB only after departmental offset adjustments have been made (i.e., the refund has been first offset against liabilities that may exist in any one of the department's various programs).

NEW FEDERAL LAW (Act Sec. 9402 amending Section 2653 (c) of the Deficit Reduction Act of 1984)

The Act extends the tax refund offset program for six months (i.e., through June 30, 1988). In addition the program is expanded to apply to debts owed to all federal agencies and to debts owed by corporations as well as individuals. The Comptroller General and the

Secretary of the Treasury are to conduct a study on the effect of this program on voluntary compliance with the income tax laws. The report on that study is due April 1, 1989.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective on December 22, 1987.

ACTION: DENY ELIGIBILITY OF OVERNIGHT CAMP EXPENSES FOR CHILD CARE CREDIT

Act Section 10101

CURRENT CALIFORNIA LAW (Sec. 17052.6)

The California credit is equal to 30 percent of the allowable federal child care credit. Expenses eligible for the credit include costs incurred by the taxpayer for day care, nursery school, a housekeeper or other home care, and summer camps, including overnight camps.

NEW FEDERAL LAW (Sec. 21)

Expenses incurred by a taxpayer for an overnight camp are ineligible for the child care credit.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision is effective for taxable years beginning on or after January 1, 1988.

Title X, Subtitle A. Individual Income Tax Provisions

ACTION: LIMIT DEDUCTION FOR QUALIFIED RESIDENCE INTEREST

Act Section 10102

CURRENT CALIFORNIA LAW (Sec. 17201)

California and federal laws are the same regarding the deduction for qualified residence interest. Interest paid on debt secured by a principal or second residence is deductible as long as the debt does not exceed the cost of the residence (plus improvements made to the residence), plus debt incurred for educational and medical expenses (up to the fair market value of the residence). A special rule is provided for those taxpayers who had refinanced their residence before August 16, 1986 to enable them to substitute the outstanding mortgage balance as of August 16, 1986 for the cost plus improvements amount in order to determine the amount of debt on which interest was deductible.

NEW FEDERAL LAW (Sec. 163)

The Act limits the deduction for qualified residence interest to amounts paid on debt to acquire or substantially improve a principal or second residence up to a total debt of $1 million ($500,000 in the case of a separate return by a married individual) plus other debt secured by a principal or second residence not in excess of $100,000 ($50,000 in the case of a separate return by a married individual), without restriction on its use. All indebtedness incurred on or before October 13, 1987 which was secured by a qualified residence on that date is considered qualified acquisition indebtedness. A special rule is provided for refinancings after October 13, 1987 of the pre-October 13, 1987 debt. That rule generally provides that the refinancing will be qualified debt until the expiration of the term of the pre-October 13, 1987 loan or 30 years from the first refinancing.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision is effective for taxable years beginning on or after January 1, 1988.

Title X, Subtitle A. Individual Income Tax Provisions

ACTION: <u>CLARIFY THAT FEDERAL JUDGES ARE ACTIVE PARTICIPANTS FOR IRA PURPOSES</u>

Act Section 10103

CURRENT CALIFORNIA LAW (Sec. 17201)

California and federal law provide the same deduction for Individual Retirement Account (IRA) contributions made for taxable years beginning on or after January 1, 1987. Contributions to an IRA up to the lesser of $2,000 or 100 percent of compensation (earned income, in the case of a self-employed individual) are deductible if the individual was not an active participant in an employer-maintained retirement plan for any part of the plan year ending with or within that person's taxable year. For active participants the deduction is phased out based on AGI.

For purposes of the active participant rule, an employer-maintained retirement plan means:

1. A qualified pension, profit-sharing, or stock bonus plan;

2. A qualified annuity plan;

3. A simplified employee pension (SEP);

4. A plan established for its employees by the United States, by a State or political subdivision, or by any agency or instrumentality of the United States or a State or political subdivision (other than an unfunded deferred compensation plan of a State or local government);

5. A plan described in Section 501(c)(18) of the Internal Revenue Code; or

6. A tax-sheltered annuity.

NEW FEDERAL LAW (Act Sec. 10103)

In a recent Tax Court decision (Porter v. Commissioner, 88 T.C. No. 28 (March 5, 1987)), it was held that Article III judges are not employees of the United States and, therefore, are not active participants in a plan established for its employees by the United States. Whether or not an individual is an employee also is relevant for other purposes under the Code, such as for the exclusion of certain benefits from income the eligibility for certain deductions.

The Act, in a non-Code provision, provides that a Federal judge shall be treated as an active participant for purposes of IRA deductions and are treated as employees for income tax purposes.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective for taxable years beginning on or after January 1, 1988.

ACTION: <u>ONE YEAR DELAY IN APPLYING 2 PERCENT FLOOR TO INDIRECT DEDUCTIONS THROUGH A REGULATED INVESTMENT COMPANY</u>

Act Section 10104

<u>CURRENT CALIFORNIA LAW (Sec. 17076)</u>

Both state and federal laws, for taxable years beginning on or after January 1, 1987, generally allow a deduction for miscellaneous itemized deductions only to the extent that they exceed two percent of the taxpayer's federal adjusted gross income (AGI). The two percent floor applies with respect to indirect deductions through certain pass-through entities, including regulated investment companies (RICs), commonly called "mutual funds." The two percent floor does not apply with respect to certain other pass-through entities, including real estate investment trusts, cooperatives, and certain trusts and estates.

<u>NEW FEDERAL LAW (Act Sec. 10104)</u>

The Act, in a non-Code provision, provides (1) that the two percent floor applies to indirect deductions through a publicly offered RIC only for taxable years beginning on or after January 1, 1988; (2) defines a publicly offered RIC; and (3) increases the required distribution from a RIC (formerly 90 percent) to 98 percent to avoid an excise tax on undistributed income.

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

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

Title X, Subtitle B. Business Provisions - Accounting Provisions

ACTION: REPEAL OF RESERVE FOR ACCRUAL OF VACATION PAY

Act Section 10201

CURRENT CALIFORNIA LAW (Sec. 17501, 17551, 24274, 24609, 24615, 24685 and 24686.2)

California conforms to federal law which allowed an accrual method taxpayer to elect to deduct an amount representing a reasonable addition to a reserve for vacation pay earned during the year if the amount is paid to employees during the year or within 8 1/2 months after the end of the year.

NEW FEDERAL LAW (Sec. 81, 404, 419, 461 and 463)

The Act repeals the deduction for additions to a reserve for vacation pay. The deduction for vacation pay for any taxable year is generally now limited to the amount of vacation pay earned during the year to the extent that (1) the amount is paid to employees during the year or (2) the amount that is vested as of the last day of the taxable year and is paid to employees within 2 1/2 months after the end of the year. Vacation pay earned during any taxable year which is not paid within 2 1/2 months after the end of that year is deductible in the taxable year in which it is paid to employees.

The change is treated as a change in accounting method initiated by the taxpayer and made with the consent of the IRS. The net amount, as defined, of the adjustment required by the change in method is taken into account over four years as follows:

Change Year....................	25 %
First year after change........	5 %
Second year after change.......	35 %
Third year after change........	35 %

However, if the period of adjustment required to be taken into account under Section 5.06 of Rev. Proc. 84-74 (Cumulative Bulletin 736, 1984-2) is less than four years, the adjustment is to be taken into account ratably over the shorter period.

These adjustments may be offset by net operating losses and tax credit carryforwards for the tax attributable to the adjustment. For estimated tax purposes, the adjustment will be included in income ratably throughout the year in question.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision is effective for taxable years beginning on or after January 1, 1988.

Title X, Subtitle B. Part I Business Provisions - Accounting Provisions

ACTION: REPEAL PROPORTIONATE DISALLOWANCE RULE AND INSTALLMENT SALES BY DEALERS

Act Section 10202

CURRENT CALIFORNIA LAW (Sec. 17551, 17560, and 24667)

California follows the federal installment sale rules except that corporations are allowed a one year delay in applying those rules until income years which begin on or after January 1, 1988 and an election is provided for non-corporate taxpayers to not use the proportional disallowance rule even though the general rules apply to them for taxable years beginning on or after January 1, 1987.

Under these rules a taxpayer who sells property ordinarily must recognize gain or loss at the time of the sale. However, a taxpayer who is eligible to use the installment method may defer the payment of tax and recognize gain from a sale of property in proportion to the payments received.

Use of the installment method is not allowed for sales pursuant to a revolving credit plan and for sales of publicly traded property.

Dealers in Property, Etc.

In general, the installment method may be used to report gain from the sale of personal property by dealers in personal property who regularly sell on the installment plan or from the sale of other property where at least one payment is to be received after the end of the taxable year of the sale.

Proportionate Disallowance Rule

Use of the installment method generally is limited under the "proportionate disallowance rule" for dealer sales of real property and dealer sales of personal property eligible to be reported on the installment method, as well as for sales of real property used in the taxpayer's trade or business or held for the production of rental income where the selling price of such real property is greater than $150,000. Under the proportionate disallowance rule, a pro rata portion of the taxpayer's indebtedness is allocated to, and is treated as a payment on, the installment obligations of the taxpayer.

Residential Lots and Timeshares

At the election of the seller, installment obligations arising from certain sales of residential lots and "timeshares" are not subject to the proportionate disallowance rule. Rather, such taxpayers may compute their tax liability under the installment method and are required to pay interest on the amount of deferred tax attributable to the use of the installment method.

Alternative Minimum Tax

The installment method may not be used for purposes of the alternative minimum tax for sales that are subject to the proportionate disallowance rule. The installment method may be used, however, for purposes of the alternative minimum tax for sales of residential lots and "timeshares" with respect to which a taxpayer elects to use the installment method and pay interest on the deferred tax.

Pledging of Nondealer Real Property Installment Obligations

Generally, if an installment obligation is disposed of, gain (or loss) is recognized equal to (1) in the case of a satisfaction at other than face value or a sale or exchange of the obligation, the difference between the amount realized and the basis of the obligation or (2) in the case of any other disposition (other than by sale or exchanges), the difference between the fair market value of the obligation at the time of the disposition and the basis of the obligation. The basis of the obligation is equal to the basis of the property sold plus the amount of gain previously recognized. In general, the mere pledge of an installment obligation as collateral for a loan is not treated as a disposition.

NEW FEDERAL LAW (Sec. 56, 381, 453, 453A, 453C, and 691)

Dealers in Property

Effective for installment obligations arising from dispositions occurring after December 31, 1987, dealers in real and personal property may no longer use the installment method. The definition of installment sale no longer includes any dealer disposition. Thus, generally, all payments to be received from a dealer disposition of property are treated as received in the year of disposition.

However, the following dispositions on the installment plan will remain subject to the current rules applicable to dealers using the installment method and for these items the installment method may still be used.

- A sale on the installment plan of any property used or produced in the trade or business of farming.

- A sale in the ordinary course of the taxpayer's trade or business to an individual of residential lots, if the taxpayer (or any related person) is not to make any improvements to the lot.

- A sale in the ordinary course of the taxpayer's trade or business to an individual of timeshare rights to use, or a timeshare ownership interest in, residential real property for not more than six weeks per year, or a right to use specified campgrounds for recreational purposes.

For the exceptions from the general repeal to apply to the sale on the installment plan of timeshares or residential lots, the taxpayer must elect to pay interest determined on the amount of the tax attributable to payments received during the tax year on installment obligations that arise from such dispositions for the period beginning on the date of sale and ending on the date such payment is received. No interest is determined for any payment received during the tax year in which the installment obligation arises. The election for residential lots or timeshares will not apply if an installment obligation is guaranteed by any person other than an individual.

Proportionate Disallowance Rule Repealed

The proportionate disallowance rule, relating to treating certain indebtedness as equivalent to a payment on installment obligations, is repealed generally effective for dispositions in tax years beginning on or after January 1, 1988. A taxpayer who is a nondealer may elect, as prescribed in regulations, to have the repeal apply to tax years ending after December 31, 1986, with respect to dispositions and pledges occurring after August 16, 1986 (i.e. FY 1986/87, FY 1987/88 and calendar year 1987).

Alternative Minimum Tax

For dispositions in tax years beginning on or after January 1, 1987, the installment method may be used in determining alternative minimum taxable income for all nondealer dispositions of property.

Installment Obligations of Nondealers of Real Property

Installment obligations arising from the sale of nonfarm real property that is used in a taxpayer's trade or business or that is held for the production of rental income where the sales price of the property is greater than $150,000 are subject to an interest charge (imposed as additional tax for the year under a complex set of rules) if the face amount of deferred payments arising from all dispositions of such real property during any year exceeds $5 million. The following types of installment obligations are not included in the definition of "nondealer real property installment obligation":

- Those arising out of a disposition by an individual of personal use property or the disposition of any property used or produced in the trade or business of farming, and

- Those arising out of the disposition of a residential lot or timeshare by a nondealer, but the taxpayer must elect to pay interest on the amount of the deferred tax attributable to the use of the installment method in the same manner as if they were a dealer.

If any nondealer real property installment obligation to which the interest payment rules apply is pledged to secure other indebtedness, the net proceeds of the secured indebtedness will be treated as a payment received on that installment obligation on the later of the date that the obligation is pledged or the date the net proceeds are received by the taxpayer. Rules are provided which limit the amount of gain recognized to the total gain from the installment sale.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Dealers in Property

The repeal of the installment method for dealer dispositions generally applies to installment obligations arising from dispositions after December 31, 1987. The new rules do not affect the treatment of an installment obligation arising out of a dealer disposition occurring before March 1, 1986. Special rules apply to obligations arising between those two dates (i.e. after February 28, 1986 but before January 1, 1988). Those special rules provide:

1. Those obligations will still be subject to the proportionate disallowance rule for tax years ending after December 31, 1986, and beginning before January 1, 1988 (i.e. FY 1986/87, FY 1987/88 and calendar year 1987 returns).

2. Any gain from an installment obligation arising between those dates is not to be recognized as payments are received in a later tax year, but instead is to be treated as a change in accounting method which requires the net adjustment to be taken into account over a period not longer than four taxable years (beginning with the first tax year that begins after December 31, 1987).

Proportionate Disallowance Rule Repealed

The repeal is generally effective for dispositions in tax years beginning on or after January 1, 1988. A taxpayer who is a nondealer may elect, as prescribed in regulations, to have the repeal apply to tax years ending after December 31, 1986, with respect to dispositions and pledges occurring after August 16, 1986 (i.e. FY 1986/87, FY 1987/88 and calendar year 1987).

Alternative Minimum Tax

The change applies to dispositions in tax years beginning on or after January 1, 1987 for all nondealer dispositions of property.

Installment Obligations of Nondealers of Real Property

The interest charge applies to nondealer real property installment obligations arising out of disposition occurring in tax years beginning on or after January 1, 1988. For tax years ending after December 31, 1986 (i.e. FY 1986/87, FY 1987/88 and calendar year 1987 returns), a taxpayer may elect to apply the interest charge rules to dispositions occurring after August 16, 1986. If the taxpayer makes such an election, the proportionate disallowance rule will not apply to installment obligations that arise from dispositions occurring after August 16, 1986.

Pledging of Nondealer Real Property Installment Obligations

The pledge rule generally applies to any nondealer real property installment obligations that are pledged to secure other indebtedness after December 17, 1987, in tax years ending after that date. For tax years ending after December 31, 1986 (i.e. FY 1986/87, FY 1987/88 and calendar year 1987 returns), a taxpayer may elect to apply the pledge rules to pledges occurring after August 16, 1986. If the taxpayer makes such an election, the proportionate disallowance rule will not apply to installment obligations that arise from dispositions occurring after August 16, 1986.

ACTION: FURTHER REDUCE PERCENTAGE OF LONG TERM CONTRACT ELIGIBLE FOR DEFERRAL UNDER COMPLETED CONTRACT METHOD

Act Section 10203

CURRENT CALIFORNIA LAW (Sec. 17551 and 24673.2)

California is conformed to the federal method of accounting for contracts which take more than one year to complete (long term contracts). A taxpayer must use either the percentage of completion method of accounting, which brings into income and deducts as expenses amounts based on the percentage of the contract which has been completed during the year, or a hybrid method called the percentage-of-completion capitalized-cost method. That hybrid method provides that 40 percent of items (income and expenses) with respect to a long term contract must be reported under the percentage of completion method, while the remaining 60 percent of the items with respect to the contract must be taken into account under the taxpayer's normal method of accounting (such as the completed contract method which defers the reporting of items until the year the contract is completed).

NEW FEDERAL LAW (Sec. 460)

For contracts entered into after October 13, 1987, the percentage of the items for taxpayer's electing the hybrid method which must be reported under the percentage of completion method is raised from 40 percent to 70 percent. An exception to this change is provided for certain "qualified ship contracts". Consistent with this new rule the calculation of interest for underpayments and overpayments with respect to these contracts during a "look back period" will be based on 70 percent of the items taken into account under the percentage of completion method.

EFFECTIVE DATE OF FEDERAL PROVISIONS

Applies to contracts entered into after October 13, 1987.

Title X, Subtitle B. Part I Business Provisions - Accounting Provisions

ACTION: AMORTIZATION OF PAST SERVICE PENSION COSTS

Act Section 10204

CURRENT CALIFORNIA LAW (Sec. 17201, 17551, 24422.3, and 24673.2)

California is conformed to the Uniform Capitalization Rules enacted in federal law by the Tax Reform Act of 1986. In general, those rules govern the inclusion in inventory or capital accounts of all costs incurred in manufacturing, construction, and other types of activities involving the production of real or tangible personal property, or incurred in acquiring or holding property for resale. Regulations implementing this provision require capitalization of all direct costs and an allocable portion of indirect costs (i.e. general and administrative and overhead costs). However, an exception is provided for contributions to a pension or annuity plan to the extent those contributions represent past service costs (for actuarial funding of pension plans which distinguish between current and past service costs). Those contributions, subject to certain other limitations, remain currently deductible and are not required to be capitalized.

NEW FEDERAL LAW (Sec. 263A and 460)

The portion of pension expense that represents past service costs is now subject to the uniform capitalization rules and the long term contract cost allocation rules. This means that an allocable portion of all pension costs, whether current or past services are involved, will be included in the basis of property produced (or held for resale by the taxpayer), including property purchased under a long term contract subject to the cost allocation rules.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective:

- o For (1) non-inventory property produced by the taxpayer, and (2) for long term contract allocation rules, for costs incurred after December 31, 1987, in taxable years ending after that date, and

- o For inventory in the hands of the taxpayer, for taxable years beginning on or after January 1, 1988 and is considered a change in accounting method (initiated by the taxpayer with the consent of the Commissioner). The net amount of any adjustment is to be taken into account over a period not to exceed four years and may be offset by net operating loss and tax credit carryforwards. For estimated tax payments the adjustment is to be recognized ratably throughout the year.

Title X, Subtitle B. Part I Business Provisions – Accounting Provisions

ACTION: LIMITATION ON CASH METHOD OF ACCOUNTING FOR LARGE FAMILY FARMS

Act Section 10205

CURRENT CALIFORNIA LAW (Sec. 24652)

California is conformed to the federal rules relating to the method of accounting for corporations engaged in farming. Those corporations, generally, may use the cash method of accounting. A corporation (other than an S corporation) having gross receipts in excess of $1 million for any year after 1975 must use an accrual method of accounting unless it is a "family corporation". In general, a "family corporation" is one where 50 percent or more of the stock is owned by two or three families on October 4, 1976, and which at all times thereafter qualifies as a family corporation. A tax shelter farming corporation, whether or not a "family corporation", is required to use the accrual method of accounting.

NEW FEDERAL LAW (Sec. 447)

The Act requires a family farming corporation to use the accrual method of accounting unless that corporation (and any predecessor corporation) did not have gross receipts in excess of $25 million for each prior taxable year beginning after 1985. A family farming corporation includes those family-owned and closely held corporations engaged in farming that were previously allowed to use the cash method of accounting. Special rules are provided to determine gross receipts when the corporation owns an interest in a pass-through entity or is part of a controlled group.

If a family farming corporation must change from the cash to the accrual method of accounting under these new rules, a suspense account is established which contains the adjustment amount attributable to the change in accounting method. The amounts in the suspense account are to be taken into income when certain events happen. A portion is taken into income when gross receipts in any year are less than the gross receipts in the last year the cash method was used. Any balance remaining in the suspense account will be included in income (1) when the business is sold or otherwise transferred outside of the family group which owned the corporation on December 15, 1987, or (2) when the corporation fails to meet the definition of a family farming corporation.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective for taxable years beginning on or after January 1, 1988.

Title X, Subtitle B. Part I Business Provisions – Accounting Provisions

ACTION: ENTITIES MAY ELECT TAXABLE YEARS OTHER THAN THE CALENDAR YEAR

Act Section 10206

CURRENT CALIFORNIA LAW (Sec. 17551.5 and 24633.5)

California conformed to the federal requirements in the 1986 Tax Reform Act which required partnerships, S corporations and personal service corporations to change their taxable years to end at the same time as their owners. This requirement generally resulted in the change from a fiscal year period to a calendar year and is to be effective starting with the 1987 year. The state law is constructed in such a way that only if the entity is required to change taxable years for federal purposes will it be required to change taxable years for California purposes.

NEW FEDERAL LAW (Sec. 280H, 444, and 7519)

Effective for tax years beginning on or after January 1, 1987, a partnership, S corporation, or a personal service corporation is eligible to elect to retain the tax year it had for its tax year which began in 1986. Alternatively it may elect to adopt or change to a tax year with a deferral period not exceeding three months or its previous tax year deferral period, whichever produces the shortest deferral period. The election, to be effective at all, must be made for the first tax year beginning on or after January 1, 1987 but that election need not be made until March 21, 1988. If no election is made, partnerships, S corporations and personal service corporations must use the tax year required by statute or regulation.

Partnerships and S Corporations

Those entities electing under this provision must make an annual "required payment", phased in over a four year period, due on April 15th of the calendar year following the calendar year in which the election begins, unless a later date is permitted by the Internal Revenue Service. The payment is equal to the excess of:

1. The amount computed by multiplying the net base year income of the entity by its adjusted highest tax rate (the tax rate for the entity under Section 1 of the Internal Revenue Code plus one percent).

   The purpose of paragraph 1, for election made with respect to 1987, the adjusted highest tax rate is set by statute at 36 percent; over

2. The amount of the "required payment" for the preceding election year.

Thus, if the amount determined in 2. is less than the amount in 1., the additional amount must be paid. However, if the amount determined in 2. is more than the amount computed in 1., the electing entity is entitled to receive a refund (without interest) of the difference.

No payment has to be made until the required payment for an election year is more than $500. Rules are provided for calculating net base year income and the deferral ratio.

Willfully failing to comply with these rules will result in the revocation of the election, effective from the year in which the failure takes place.

Personal Service Corporations

Electing personal service corporations are limited in the amount of deductions they can take for payments for employee-owners unless the corporation makes certain minimum distributions to those employee-owners before the end of the calendar year.

If a personal service corporation is denied a deduction for all or part of a payment to an employee-owner, the amount denied will be carried to the next year.

No carryback of net operating losses is allowed either from or to an applicable election year of a personal service corporation.

Tiered Structure

In general, this new election rule will not be available for a partnership or S corporation that is part of a tiered structure unless all of the members of that structure have the same tax year.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision generally is effective for taxable years beginning on or after January 1, 1987. Required payments are to be made respectively by partners and shareholders of electing partnerships and S corporations with respect to applicable election years beginning on or after January 1, 1987.

Title X, Subtitle B. Part II Business Provisions – Partnership Provisions

ACTION: PUBLICLY TRADED PARTNERSHIPS TREATED AS CORPORATIONS

Act Section 10211

CURRENT CALIFORNIA LAW (Sec. 17851)

California is conformed to federal law in that a partnership is not subject to tax at the partnership level, but rather, income and loss of the partnership is subject to tax at the partner's level. Regulations distinguishing partnerships from corporations provide that whether a business entity is taxed as a corporation depends on which form of enterprise the entity "more nearly" resembles. These regulations list six corporate characteristics,two of which are common to corporations and partnerships, and the other four of which are:

1. Continuity of life,

2. Centralization of management,

3. Liability for corporate debts limited to corporate property, and

4. Free transferability of interests.

The regulations provide that an association is treated as a corporation (rather than a partnership) for tax purposes if it has more corporate than non-corporate characteristics. The effect of the regulation is, thus, to classify an entity as a partnership if it lacks any two of these four corporate characteristics, without regard to how strong or weak a particular characteristic is or how the evaluation of the factors might affect overall resemblance (Larson v. Commissioner, 66 T.C. 159 (1976), acq 1979-1 C.B. 1).

NEW FEDERAL LAW (Sec. 7704)

The Act treats a publicly traded partnership (PTP) as being taxable as a corporation. A PTP is a partnership whose interests are traded on an established securities market or are readily tradeable on a secondary market. A PTP includes master limited partnerships. An exception to the general rule is provided for PTPs with 90 percent or more of their income meeting the definition of "qualifying income". Qualifying income consists of specially defined interest, dividends, specially defined real property rents, gain from the sale or other disposition of real property, income and gains from certain natural resources, gain from the sale of capital assets or business assets, and, for certain commodity pools, certain income and gains from commodities and futures, options and forward contracts.

On the day that a partnership is first treated as a corporation, it will be regarded as having transferred all of its assets (subject to all of its liabilities) to a newly formed corporation in exchange for that corporation's stock and as having distributed the stock to the partners in liquidation of their interests in the partnership. The Committee Report states that existing rules applicable to recognition of income upon recapture of tax benefits also apply.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision generally applies to taxable years beginning on or after January 1, 1988. In the case of an "existing partnership," however, it applies to tax years beginning on or after January 1, 1998. An "existing partnership" is any one of the following:

1. A partnership that was publicly traded on December 17, 1987.

2. A certain partnership for which a registration statement was filed with the SEC on or before December 17, 1987.

3. A certain partnership for which an application was filed with a state regulatory commission on or before December 17, 1987, seeking permission to restructure a portion of a corporation as a PTP.

A partnership that is not an "existing partnership" will be treated as a corporation on the first day it is publicly traded. An "existing partnership" will be treated as a corporation on the first day of its first taxable year beginning on or after January 1, 1998 (as long as it continues to be publicly traded on that date).

An "existing partnership" will no longer be under the exception, if it adds a substantial new line of business after December 17, 1987, but dropping a line of business will have no effect on its status under the exception. An "existing partnership" that ceases to qualify for the exception will be treated as a corporation on the first day after it loses its exemption (assuming it continues to be publicly traded on that date).

Title X, Subtitle B. Part II Business Provisions - Partnership Provisions

ACTION: SEPARATE TREATMENT OF PUBLICLY TRADED PARTNERSHIPS UNDER THE PASSIVE LOSS RULE AND DESIGNATION OF NET INCOME AS PORTFOLIO INCOME

Act Section 10212

CURRENT CALIFORNIA LAW (Sec. 17551, 17561 and 24692)

The state is conformed to the federal rules which limit deductions and credits from passive trade or business activities, to the extent they exceed income from that activity. Suspended losses and credits are carried forward and treated as deductions and credits from passive activities in the next year. Suspended losses from an activity are allowed in full when the taxpayer disposes of his or her entire interest in the activity.

Income from passive activities does not include compensation for services or portfolio income (including interest, dividends, royalties, annuities, and gains from the sale of property held for investment). For this purpose, property held for investment generally does not include an interest in a passive activity.

A passive activity generally is an activity involving the conduct of a trade or business in which the taxpayer does not materially participate. Present law provides that, except as provided in regulations, no interest in a limited partnership as a limited partner is treated as an interest with respect to which the taxpayer materially participates. A provision exists which provides that, by regulation, income from limited partnerships may be treated as portfolio income. Thus, except as provided by regulation, income from limited partnerships, including publicly traded partnerships, may be offset by passive losses from other sources.

NEW FEDERAL LAW (Sec. 469)

The Act provides that the passive loss rules are to be applied separately for the items attributable to each publicly traded partnership (PTP). A partner's share of the net income of a PTP (both portfolio and business income) will generally not be treated as income from a passive activity (i.e. it will generally be treated as portfolio income). However, a partner's share of the net business (nonportfolio) income of a PTP will be treated as passive income for carryover purposes.

Net losses of a partner from a PTP are to be suspended at the partner level, carried forward and netted against the partner's share of the nonportfolio income of that PTP in a later year or years. Generally, these losses may not be applied against passive income from other activities. Similarly, a partner's share of the credits of a PTP in excess of the tax liability attributable to his or her interest in the PTP are to be suspended, carried forward, and applied against the tax liability of a subsequent year or years attributable to that PTP. Generally these credits may not be applied against tax liability attributable to other activities.

When the taxpayer completely disposes of the entire interest in the PTP in a fully taxable transaction, any remaining suspended losses are allowed in the following manner.

- o First, against the gain, if any, from the disposition.
- o Next, the excess against other income or gain from other passive activities.
- o Finally, if the losses have still not been absorbed, against any other income or gain.

The current law rules applicable to transfers by reason of death and to gifts will apply in the case of transfers of interests in PTPs.

Although a partner's share of the credits from a PTP may generally be applied only to offset the partner's income tax liability attributable to his or her interest in the PTP, the partner will be entitled to the $25,000 (deduction equivalent) allowance for rehabilitation and low-income housing credits from certain rental real estate activities. The $25,000 allowance is determined at the partner level to the extent that the amount of such credits exceeds the partner's regular tax liability attributable to income from the partnership. Such credits are allowable under the partner's $25,000 allowance to the extent that the partner has not fully utilized the allowance with respect to losses and credits from passive activities otherwise allowed under present law. A partner may elect to increase the basis of the interest in the PTP for unused credits when a complete disposition of the partner's interest in the PTP occurs.

EFFECTIVE DATE OF FEDERAL PROVISIONS

These new rules are made effective as if included in the Tax Reform Act of 1986. Generally, therefore, they are effective for taxable years beginning on or after January 1, 1987.

ACTION: EXEMPT ORGANIZATION'S INCOME FROM PUBLICLY TRADED PARTNERSHIP IS UNRELATED BUSINESS INCOME (UBI)

Act Section 10213

CURRENT CALIFORNIA LAW (Sec. 17651 and 23732)

Both California and federal laws impose tax on tax-exempt organizations when the organization derives income from activities which are unrelated to the exempt purpose of the organization (referred to as UBI tax). Certain types of income (such as interest and certain rental income) are, however, not treated as unrelated business income. Present law provides that a partner's distributive share of income from a partnership retains the same character as in the hands of the partnership. Thus, a tax-exempt organization's share of income from a partnership (including a publicly traded partnership) may be treated as UBI, or not, depending on the underlying character of the income to the partnership.

NEW FEDERAL LAW (Sec. 512)

Under the Act, partnership income (regardless of whether it is distributed) earned by an exempt organization from its interest in a publicly traded partnership (not otherwise treated as a corporation) will be treated as gross income derived from an unrelated trade or business, subject to the organization's share of the partnership deductions.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective for partnership interests acquired after December 17, 1987.

ACTION: PARTNERSHIP ALLOCATIONS - INCOME FROM DEBT FINANCED REAL PROPERTY MAY BE TAXABLE TO A TAX EXEMPT PARTNER

Act Section 10214

CURRENT CALIFORNIA LAW (Sec. 17651 and 23735)

Under both state and federal laws tax-exempt organizations generally are subject to tax on unrelated business income (UBI). In general, income from debt-financed property is treated as UBI. An exception from the tax on UBI is provided to tax-exempt partners of a partnership having some taxable partners in the case of debt-financed real property. The exception to tax exempt partners applies as long as the property is not leased back to the seller and as long as the principal purpose of any disproportionate allocation (of income, deductions, credit or basis) to a tax exempt organization is not the avoidance of income tax.

NEW FEDERAL LAW (Sec. 514)

Tax exempt organizations in partnership with taxable entities will have to treat income from debt-financed real property as UBI if partnership allocations are neither (1) qualified allocations nor (2) permissible disproportionate allocations.

A "qualified allocation" is an allocation to a tax exempt entity that:

- Is consistent with the entities being allocated the same distributive share of income, gain, loss, deduction, credit, and basis during the entire period the entity is a partner, and

- Has substantial economic effect.

This is the same definition of "qualified allocation" that is used for depreciation (modified ACRS) rules dealing with partnerships and tax exempt entity leasing.

For purposes of the "disproportionate allocation" rule, items allocated under partnership rules governing the allocation of income, gain, loss, and deductions with respect to property contributed to the partnership by a partner are not taken into account. The allocation of items of credit and basis is to be made in a manner that is consistent with the limitation on loss allocations.

These rules are to be met by each partner. Separate allocations of items of income, gain, loss, and deduction are allowed. The determination of whether the rule is satisfied is made on the basis of each partner's distributive share of overall partnership income or overall partnership loss for each taxable year, taking into account any specific item allocation.

Changes in a partnership's allocation provision that result in impermissible allocations will cause the tax exempt members of the partnership to lose their UBI exemption for all open years.

A partnership is not disqualified under the disproportionate allocation rules if it provides for chargebacks of income or loss to particular partners to offset the amount of prior disproportionate allocations of loss or income that complied with the general rule.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision applies to property acquired by a partnership after October 13, 1987, and to partnership interests acquired after October 13, 1987, except that property of partnership interest acquired under a written binding contract in effect on that date are not covered.

Title X, Subtitle B. Part II Business Provisions — Partnership Provisions

ACTION: TREASURY STUDY OF PUBLICLY TRADED PARTNERSHIPS (PTP)

Act Section 10215

NEW FEDERAL LAW (Act Sec. 10215)

The Act requires the Secretary of the Treasury to conduct a study of the question of treating PTPs (and other partnerships that significantly resemble corporations) as corporations, including the issue of disincorporation and opportunities for avoidance of the corporate tax. Also, the study is to examine issues of compliance and tax administration relating to the tax treatment of PTPs and other large partnerships, including collection and withholding of tax at the partnership level, and to recommend means of simplifying and improving procedures for audit and assessment of PTPs and other partnerships and their partners.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The results of the study are to be reported (with recommendations for statutory change) to the Senate Finance Committee and the House Ways and Means Committee on or before January 1, 1989. An interim report on compliance and administration is due on or before May 1, 1988.

Title X, Subtitle B. Part III Business Provisions - Corporate Provisions

ACTION: REDUCTION OF DIVIDENDS RECEIVED DEDUCTION FOR CERTAIN CORPORATIONS

Act Section 10221

CURRENT CALIFORNIA LAW (Sec. 24402 and 24411)

California does not conform to the federal dividends received deduction but has its own unique provisions. Under California law a corporation may deduct the dividends received during the year declared from income which has been included in the measure of the California Bank and Corporation tax upon the taxpayer declaring the dividend. Also, under the new "water's edge" provisions, a 75 percent dividends received deduction is allowed for certain foreign dividends.

Under federal law, corporations owning less than 80 percent of the stock of a corporation are entitled to a deduction equal to 80 percent of the dividends received from a domestic corporation. Corporations which own 80 percent or more of a subsidiary may deduct 100 percent of the dividends received.

NEW FEDERAL LAW (Sec. 243-246A, 805, 854, and 861)

The Act provides that corporations that own less than 20 percent of the distributing corporation may only deduct 70 percent (versus 80 percent under prior law) of dividends received or accrued. Corporations which own 20 percent but less than 80 percent will continue to deduct 80 percent of dividends received or accrued.

For purposes of the limitations on the aggregate amount of dividends received deductions, ordering rules are provided.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective for dividends received or accrued after December 31, 1987, in taxable years ending after that date.

Title X, Subtitle B. Part III Business Provisions - Corporate Provisions

ACTION: COMPUTATION OF EARNINGS AND PROFITS FOR PURPOSES OF INTERCORPORATE DIVIDENDS AND STOCK BASIS ADJUSTMENTS

Act Section 10222

CURRENT CALIFORNIA LAW (Sec. 24454.2)

California does not have a counterpart to Section 1503 of the Internal Revenue Code (relating to the computation and payment of tax on federal consolidated returns).

California is conformed to the special federal rules relating to taxability of distributions by corporations which are received by a 20 percent corporate shareholder. Those rules basically provide that dividends are taxable to the extent made out of accumulated earnings and profits. In determining the amount of earnings and profits for income and basis purposes of a 20 percent corporate shareholder, no adjustment is to be made for a series of items which are normally required to be adjusted. That is, the earnings and profits treatment of the items is conformed to the taxable income treatment. These special rules do not apply, however, to depreciation.

NEW FEDERAL LAW (Sec. 301, 1503)

The Act expands the scope of the special rules for computing earnings and profits in the case of distributions to a 20 percent or more corporate shareholder, to include adjustments for accelerated depreciation.

Also, it provides that, for purposes of determining gain or loss on disposition, a parent corporation's basis in the stock of a subsidiary with which it files a consolidated return (intragroup stock) will be determined by computing the earnings and profits of the subsidiary without taking into account the special adjustments (including accelerated depreciation) otherwise required to be made. Earnings and profits for this purpose do not include any cancellation of indebtedness income of the subsidiary excluded under the law to the extent that such income did not reduce tax attributes (other than basis in property).

EFFECTIVE DATE OF FEDERAL PROVISIONS

The amendments to the rules for distributions to a 20 percent or more corporate shareholder applies to distributions after December 15, 1987. A binding written contract exception is provided.

The amendment, relating to adjustments in the stock of a consolidated subsidiary, applies to any intragroup stock disposed of after December 15, 1987. A binding written contract exception is provided. For purposes of determining adjustments to the basis of intragroup stock disposed of after December 15, 1987, the amendment is deemed to have been in effect for all periods (whether before, on, or after December 15, 1987).

Title X, Subtitle B. Part III Business Provisions - Corporate Provisions

ACTION: <u>REDUCTION IN TAX AVOIDANCE IN CERTAIN "MIRROR" SUBSIDIARY TRANSACTIONS</u>

Act Section 10223

<u>CURRENT CALIFORNIA LAW (Sec. 24512, 24532 and 24533)</u>

California is generally conformed to federal law where gains on certain distributions to a controlling corporate shareholder (an 80 percent distributee) are not taxed to the distributing corporation, provided that certain statutory and other constraints are met, including a condition that the transaction not be a device for the distribution of earnings and profits and certain other requirements.

<u>NEW FEDERAL LAW (Sec. 304, 337, and 355)</u>

The general rule for non-recognition of gain for certain distributions to a corporation owning 80 percent or more of the stock of the distributing corporation has not been changed. The Act amends the definition of 80 percent ownership, however, to include only direct stock ownership. Also, the determination as to whether any corporation is an 80 percent distributee must be made without regard to any consolidated return regulation.

In addition, a new rule is provided so that these non-recognition rules will not apply if control of the distributing corporation was acquired by a corporate distributee within five years prior to the distribution. For purposes of this rule, all members of an affiliated group are treated as a single corporate distributee.

New rules for intragroup transactions are also enacted. If stock of a member of an affiliated group is transferred to another member of the group, in certain transactions, proper adjustments are to be made to the adjusted basis of intragroup stock and to the earnings and profits of any member to the group. Intragroup stock, for this purpose, means any stock in one corporate member of an affiliated group that is held by another member of the group.

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

The provisions generally apply to distributions or transfers made after December 15, 1987. They will not apply to distributions made after December 15, 1987 (and before January 1, 1993) if 80 percent or more of the stock of the distributing corporation was acquired by the distributee before December 15, 1987, or certain binding contracts existed on that date.

The provisions for intragroup transactions will not apply to any transfer made after December 15, 1987 (and before January 1, 1993) if the transfer is between corporations that are members of the same affiliated group on that date, or become members later pursuant to a binding written contract or tender offer in effect on December 15, 1987.

Title X, Subtitle B. Part III Business Provisions - Corporate Provisions

ACTION: DENY BENEFIT OF GRADUATED CORPORATE RATE TO PERSONAL SERVICE CORPORATIONS

Act Section 10224

CURRENT CALIFORNIA LAW (Sec. 23151, 23181, 23183 and 23501)

The California Bank and Corporation Tax Law does not provide for a graduated tax rate for any category of corporation. The following tax rates apply (for the 1987 year) to corporations subject to either the corporation franchise tax or the corporation income tax.

1. General Tax Rate - The tax rate for corporate taxpayers other than banks and financial corporations is 9.3 percent. The tax rate for S corporations is 2.5 percent.

2. Bank Tax Rate - The tax rate for banks and financial corporations is 11.058 percent.

Under federal law, a corporation is subject to a tax at the rate of 15 percent on the first $50,000 of taxable income, 25 percent on taxable income over $50,000 but not over $75,000, and 34 percent on taxable income over $75,000. The benefits of the graduated rates are phased out for corporations with income in excess of $100,000.

NEW FEDERAL LAW (Sec. 11)

The Act provides that the taxable income of a qualified personal service corporation is taxed at a flat rate of 34 percent. A qualified personal service corporation for this purpose is one in which substantially all of the activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting and substantially all of the stock of which is held by employees (or their estates) or retired employees.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision is effective for taxable years beginning on or after January 1, 1988.

Title X, Subtitle B. Part III Business Provisions - Corporate Provisions

ACTION: NET OPERATING LOSS (NOL) LIMITATIONS STRENGTHENED

Act Section 10225

CURRENT CALIFORNIA LAW (Sec. 24592)

California is conformed to the federal law special limitations which apply to the use of NOLs following an ownership change of the loss corporation. Generally, where there has been an increase of more than 50 percentage points in ownership of a loss corporation by certain persons, it will be considered an ownership change. Built-in losses that are recognized following an ownership change are treated as losses subject to limitation if the net built-in loss exceeds a threshold amount. Depreciation deductions with respect to built-in loss property, however, are not treated as losses subject to limitation following an ownership change except for federal purposes in certain narrow circumstances under the consolidated return regulations.

NEW FEDERAL LAW (Sec. 382)

The Act provides that built-in depreciation is subject to the special limitations on the use of built-in losses following an ownership change. In addition, a new rule for purposes of determining whether an ownership change has occurred with respect to a worthless stock deduction by shareholders is provided.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This built-in depreciation provision is effective for ownership changes occurring after December 15, 1987. A binding contract exception is provided.

The worthless stock rule applies in the stock treated as becoming worthless in tax years beginning on or after January 1, 1988.

ACTION: LIMITATION ON USE OF PREACQUISITION LOSSES TO OFFSET BUILT-IN GAINS

Act Section 10226

CURRENT CALIFORNIA LAW (Sec. 24431)

California conforms to federal law with respect to limiting the use of a loss corporation's losses in cases where the principal purpose of acquiring another corporation is evasion or avoidance of tax. It appears that Congress was concerned that these restrictions were not broad enough to cover certain transaction so a new provision, in addition to the current provision, is added to provide a bright line test for these transactions.

NEW FEDERAL LAW (Sec. 384)

The Act provides that loss corporations will not be allowed to use their losses to shelter built-in gains of an acquired company that are recognized within five years of acquisition. An exception is provided for a consolidation or merger of corporations previously under common control for a five-year period.

Built-in gains for this purpose include any item of income that was attributable to a period prior to the acquisition date. Thus, built-in gains include so-called "phantom" gains on property for which depreciation had been taken prior to the acquisition. Also included would be income recognized after an acquisition in which the fair market value of the acquired property is less than the present value of the taxes that would be due on the income associated with the property. An example of that would occur in the case of a "burnt-out" leasing subsidiary with built-in income transferred to a loss corporation.

Preacquisition losses that may not be used to shelter built-in gains include built-in losses or items of deduction that have economically accrued prior to acquisition.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision applies in cases where the acquisition date is after December 15, 1987. A binding contract exception is provided.

ACTION: <u>LIFO RECAPTURE ON CONVERSION FROM C TO S CORPORATION</u>

Act Section 10227

<u>CURRENT CALIFORNIA LAW (Sec. 23800, 23802)</u>

California has conformed to federal law for taxation of built-in gains of C corporations which elect S status. In general, gain realized when a C corporation liquidates is subject to corporate level taxation. If a C corporation elects to become an S corporation and holds appreciated assets (i.e., a value in excess of basis) at that time, that "built-in gain" is subject to a separate corporate level tax to the extent of the gain if the asset is sold or otherwise disposed of within ten years after the date of the change to S status. The inventory method used by a taxpayer for tax purposes is to be used in determining whether goods disposed of following the change to S corporation status were held by the corporation at the date of change. A C corporation using the LIFO (last-in, first-out) method of accounting for its inventory is not taxed on the built-in gain attributable to LIFO inventory to the extent it does not invade LIFO layers during the ten-year period following the change.

<u>NEW FEDERAL LAW (Sec. 1363)</u>

The Act requires the recapture of the excess of the value of inventory using the FIFO (first-in, first-out) method over its LIFO value as of the close of the corporation's last taxable year in which it was a C corporation. The tax attributable to the inclusion in income of the recapture amount is payable in four equal installments. The first installment must be paid on or before the due date of the return for the corporation's last year as a C corporation, and the remaining installments are due on the due dates of the returns for the three succeeding taxable years.

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

This provision is generally effective for corporations which elect S status after December 16, 1987. An exception is provided for a particular corporation.

Title X, Subtitle B. Part III Business Provisions — Corporate Provisions

ACTION: <u>EXCISE TAX IMPOSED ON RECEIPT OF GREENMAIL</u>

Act Section 10228

<u>CURRENT CALIFORNIA LAW (Sec. None)</u>

California and federal laws have no excise tax on the receipt by a taxpayer of consideration paid for the redemption of corporate stock held less than 2 years when a taxpayer-shareholder made or threatened a public tender offer for stock in the corporation during that period (so-called "greenmail").

Gain on the sale or exchange of corporate stock is generally taxed at the regular state tax rates. Also, a deduction is generally allowed for interest paid or incurred during the taxable year.

<u>NEW FEDERAL LAW (Sec. 5881)</u>

Persons involved in hostile corporate takeovers are subject to a new 50 percent excise tax on gains they realize as a result of any "greenmail" payments they receive. "Greenmail" is defined as any amount that a corporation pays to a shareholder to redeem its stock if:

- o The shareholder held the stock for less than two years at the time of the redemption,
- o At some time, within that two year period, the shareholder (or any related person or person acting in concert with the shareholder) made or threatened a public tender offer for stock in the corporation, and
- o The acquisition is pursuant to an offer that was not made on the same terms to all shareholders.

The tax applies whether or not the realized gain is recognized for tax purposes. Also, the payment of this excise tax is not deductible by the taxpayer.

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

This provision is effective for greenmail payments received after December 22, 1987. A binding contract exception is provided.

ACTION: <u>DENIAL OF FOREIGN TAX CREDITS FOR SOUTH AFRICAN TAXES</u>

Act Section 10231

<u>CURRENT CALIFORNIA LAW (Sec. None)</u>

California does not allow a tax credit for taxes paid to any foreign national government.

<u>NEW FEDERAL LAW (Sec. 901)</u>

Foreign tax credits and the deferral of U.S. tax on income of controlled foreign corporations with respect to South African income are denied from January 1, 1988 until the date that the Secretary of State certifies to the Secretary of the Treasury that the South African government has taken the steps that trigger termination of the measures in the Comprehensive Anti-Apartheid Act of 1986 (P.L. 99-440, 22 U.S.C. Sec. 5001) to undermine apartheid.

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

The provision is applicable to taxable years beginning on or after January 1, 1988.

Title X, Subtitle B. Part V Business Provisions - Insurance Provisions

ACTION: VARIOUS CHANGES TO TAXATION OF INSURANCE COMPANIES

Act Section 10241-10244

CURRENT CALIFORNIA LAW

Under the California Constitution insurance companies are subject to a gross premiums tax and are not subject to the Bank and Corporation Tax Law.

NEW FEDERAL LAW (Sec. 56, 807, 812, 813, 816, 842, and 864)

A series of provisions are enacted which modify the method of calculating the interest rate for insurance reserves, tax foreign insurance companies as domestic companies on income effectively connected to the U.S., modify the book income preference for AMT purposes and require the IRS to perform a study of the proper tax treatment of certain United Kingdom insurance companies.

EFFECTIVE DATE OF FEDERAL PROVISIONS

These provisions are effective generally for taxable years beginning on or after January 1, 1988.

Title X, Subtitle C. Estimated Tax Provisions

ACTION: CORPORATE ESTIMATED TAX PROVISIONS REVISED

Act Section 10301

CURRENT CALIFORNIA LAW (Sec. 25561-25565, 25901-25901c, and 25951-25956)

The California law concerning the corporate estimated tax provisions is similar to the federal law. However, the state law provides unique provisions which require the first installment to be at least equal to the corporate minimum tax. For federal purposes installment payments are not required if the tax is less than $40.

Under both state and federal laws, a corporation that fails to pay an installment of estimated tax on or before the due date generally is subject to a penalty computed at the rate of interest for tax underpayments. The penalty may not be waived.

The penalty is computed by applying the underpayment interest rate to the amount of the underpayment of the installment for the period of the underpayment. The amount of the underpayment is the difference between the payments made on or before the due date of each installment and 90 percent of the total tax shown on the return for the year, divided by the number of installments that should have been made. The penalty on underpayments of estimated tax that are between 80 percent and 90 percent of the actual tax due is imposed at three-quarters of the full rate.

There are generally three exceptions to the penalty. No penalty is imposed if the installment is based on the lesser of:

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

2. The tax computed by using the facts shown on the prior year's return under the current year's tax rates; or

3. Ninety percent of the taxes which would be due if certain income already recognized during the current year was annualized.

Large corporations under both state and federal law may not use the first and second exceptions. California has a unique provision which allows a "large worldwide corporation" to meet and use exceptions one and two if (for exception 1.) it pays 100 percent of the prior year's tax, or 70 percent of the current year's tax liability, whichever is greater; and (for exception 2.) if it pays 100 percent of the tax on prior year's income using current year tax rates, or 70 percent of the current year's tax liability, whichever is greater.

A large corporation is defined as a corporation or bank (other than a "large worldwide corporation") having at least $1 million of California net income for any income year during the three income years immediately preceding the income year involved.

A "large worldwide corporation" is any corporation or bank which:

- o Had a California net income of $1 million or more for any one of its three preceding income years; and
- o Included during the prior three income years, for purposes of the tax imposed by the California Bank and Corporation Tax Law, income and apportionment factors of one or more banks or corporations which derive all of their income from sources outside the United States and which are not subject to the income taxes imposed by Subtitle A of the Internal Revenue Code.

NEW FEDERAL LAW (Sec. 585, 6154, 6201, 6425, 6601, 6651, and 6655)

The Act consolidates all the corporate estimated tax rules into one section of the Code, similar to the estimated tax provisions enacted in 1984 for individuals. Also, several modifications are made.

The reduced rate of penalty for underpayments that are between 80 percent and 90 percent of the actual tax is repealed.

The exception from the penalty that is based on the previous year's facts and the current year's rates (exception 2.) is repealed.

No penalty is imposed if the tax for any tax year is less than $500.

Both large and small corporations may base their first estimated tax payment of any taxable year on 100 percent of the tax shown on the preceding year's return; however, the prior year exception continues to be unavailable for large corporations. In determining whether a corporation is a large corporation, net operating loss and capital loss carryforwards and carrybacks are disregarded.

The full rate of the penalty is imposed regarding any payment only to the extent that the total payments for the year up to the required installment amount are below 90 percent of the taxes that would be due if the income already received during the current year were placed on an annual basis (or, if less, the adjusted seasonal installment). Where there is a reduction in an estimated tax payment or payments resulting from the use of the annualization (or adjusted seasonal installment) exception, 90 percent of the amount otherwise required to be made up must be included in the next payment for which the corporation does not use that exception.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision applies to taxable years beginning on or after January 1, 1988.

Title X, Subtitle C. Estimated Tax Provisions

ACTION: EMPLOYERS REQUIRED TO MORE PROMPTLY PUT REVISED W-4 INTO EFFECT

Act Section 10302

BACKGROUND

Wage withholding is administered by the Employment Development Department (EDD) and is not within the jurisdiction of the Franchise Tax Board.

NEW FEDERAL LAW (Sec. 3402)

The Act requires employers to give faster effect to revised withholding allowance certificates (Form W-4 or W-4A) furnished by employees. The revised withholding certificates must take effect no later than the start of the first payroll period ending (or the first payment of wages made without regard to a payroll period) on or after the 30th day after the day on which the employee furnishes the certificate to the employer. Employers may elect to give earlier effect to revised withholding certificates (any day between the date it is furnished by the employee and the statutorily mandated effective date).

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective for revised withholding allowance certificates furnished by employees after January 21, 1988.

Title X, Subtitle C. Estimated Tax Provisions

ACTION: ONE YEAR DELAY IN ESTIMATED TAX PAYMENT REQUIREMENT AND NON-CODE WAIVER OF CERTAIN PENALTIES

Act Section 10303

CURRENT CALIFORNIA LAW (Sec. 18682 and 25951-25956)

California did not conform to the increase, from 80 percent to 90 percent of the current year's tax liability, in the amount of estimated tax required to be paid to avoid a penalty for underpayment of estimated tax.

NEW FEDERAL LAW (Act Sec. 10303)

A provision in the Act (which is not placed in the Internal Revenue Code) delays for one year the increase from 80 percent to 90 percent in amounts required to be paid to avoid the penalty for underpayment of estimated tax. In addition, this non-code provision grants corporations relief from penalties for estimated tax payments that were due before July 1, 1987 and ratifies the temporary Treasury regulations that permit corporations to base payments due before July 1, 1987 on 120 percent of 1986 taxable income.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The one year delay in the estimated tax payment amount is effective for taxable years beginning on or after January 1, 1987. The remainder of the section is effective with respect to corporate estimated tax payments due before July 1, 1987.

Title X, Subtitle D. Estate and Gift Tax Provisions

ACTION: FEDERAL ESTATE AND GIFT TAX MODIFIED

Act Section 10401 - 10413

CURRENT CALIFORNIA LAW (Sec. None)

California voters several years ago repealed the state gift and inheritance tax law. The state has a "pick up tax" administered by the State Controller's Office. That tax is equal to the amount allowed as a credit for state taxes on the federal estate tax return.

NEW FEDERAL LAW (Sec. 2001 et seq)

Several changes to the estate tax are made by the Act, including a five year extension of existing rates, phase-out of the benefit of graduated rates and unified credit under the unified transfer tax system when transfers rise above $10 million, limitations on valuation freezes and provisions relating to employee stock ownership plans.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provisions are generally effective for transfers occurring after 1987 although several provisions are to be applied as though included in the Tax Reform Act of 1986.

Title X, Subtitle E. Provisions Relating to Excise Taxes and User Fees

ACTION: EXCISE TAXES AND FEES FOR IRS RULINGS, DETERMINATION, AND SIMILAR LETTERS IMPOSED

Act Section 10501 - 10512

CURRENT CALIFORNIA LAW (Sec. None)

The Franchise Tax Board does not charge any fee for the issuance of rulings, opinion letters and similar requests.

NEW FEDERAL LAW (Sec. 4251, 4091-4093, 4121, 4131-4132, 4982, and Act Sec. 10511)

Beginning February 1, 1988, the Act requires the IRS to charge fees for letter rulings, opinion letters, determination letters and similar requests.

The fee schedule is as follows:

Chief counsel ruling..............................	$200
Employee plan ruling and opinion...............	$250
Exempt organization determination..............	$275
Employee plan determination......................	$300
Exempt organization ruling.......................	$350

The IRS may provide exemptions and reduced fees under certain conditions. The fees are not refundable (unless the IRS refuses to respond to the request) and are payable in advance.

The Act also extends the telephone excise taxes and imposes diesel fuel and aviation fuel taxes at the wholesale level. A new trust fund is established under the vaccine compensation program which provides for a no-fault federal insurance system created to compensate individuals who are injured or die due to the administration (after September 30, 1988) of commonly prescribed vaccines and provides an excise tax on those vaccines sold after December 31, 1987. The alcohol, tobacco and firearms taxes are also increased.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The IRS fee provision is effective beginning February 1, 1988.

Title X, Subtitle F. Other Revenue Provisions — Targeted Jobs Credit

ACTION: <u>DENY ELIGIBILITY OF WAGES PAID DURING LABOR DISPUTE FOR TARGETED JOBS CREDIT</u>

Act Section 10601

CURRENT CALIFORNIA LAW (Sec. 17053.7)

Although both state and federal laws provide for a targeted jobs credit, numerous differences exist.

The California credit is 10 percent (versus 40 percent for the federal credit) of wages not exceeding $3,000 ($6,000 for the federal credit) for the first 24 months (first 12 months for the federal credit). California also limits the credit to a maximum of $600 for each qualified employee. Other differences also exist.

NEW FEDERAL LAW (Sec. 51)

The Act changes the definition of wages to exclude wages paid to an individual for services rendered at the employer's plant or facility that are substantially similar to services performed by employees who are participants in a strike or who are affected by a lockout. Thus, employers will no longer be eligible for the targeted jobs credit for those wages.

EFFECTIVE DATE OF FEDERAL PROVISIONS

This provision is effective for wages paid after 1986.

ACTION: CERTAIN ILLEGAL IRRIGATION SUBSIDIES INCLUDED IN INCOME

Act Section 10611

BACKGROUND

The federal government makes available water from reclamation and irrigation projects for agricultural purposes. Pursuant to the Reclamation Reform Act of 1982, this water must be provided at "full cost" in certain situations. In other situations, the amount charged for the water may be less than its full cost. If water is provided at less than full cost, the difference between the full cost amount and that actually charged for the water is not an item of income for Federal income tax purposes.

CURRENT CALIFORNIA LAW (Sec. 17081)

California is conformed to federal law and does not include the difference between the full cost amount of the water and that amount actually charged for that water as an item of income.

NEW FEDERAL LAW (Sec. 90)

The Act provides that gross income includes any illegal Federal irrigation subsidy received by a taxpayer during the taxable year. An illegal Federal irrigation subsidy is the excess (if any) of the amount required by law to be paid for any Federal irrigation water delivered to, or for the benefit of, the taxpayer over all the amounts actually paid for that water (whether or not paid in the same taxable year as the water is delivered). A taxpayer receiving an illegal water subsidy is required to include the amount of that subsidy in gross income in the taxable year in which the water is provided. No deduction is allowed with regard to any amount included in income as a result of this provision.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision is effective for water delivered to the taxpayer after December 31, 1987.

Title X, Subtitle F. Other Revenue Provisions – Compliance

ACTION: STATE ESCHEAT LAWS DO NOT APPLY TO FEDERAL TAX REFUNDS AND THE "SENSE OF CONGRESS RESOLUTION" ON INCREASED FUNDING FOR IRS TAXPAYER ASSISTANCE AND ENFORCEMENT)

Act Section 10621 - 10622

BACKGROUND

Some States have sued the Federal Government, asserting that in the absence of a specific federal provision that requires unclaimed refunds to escheat (revert) to the Federal Government, those refunds escheat to the State.

With regard to IRS funding, the 1986 filing season required processing of 110 million federal tax returns and approximately 55 million request for assistance were handled by the IRS.

NEW FEDERAL LAW (Sec. 6408 and Act Sec. 10622)

Federal tax refunds and the interest they earn will remain in the federal treasury if they would otherwise escheat or become the property of a state under any law relating to the disposition of unclaimed or abandoned property. Furthermore, no refund will be made to the estate of a deceased taxpayer unless it is shown that the payment will not escheat to a state or become its property under such a state law.

It is the sense of the Congress that increased funding should be provided to the IRS in fiscal years 1989 and 1990 in the areas of taxpayer assistance and enforcement. The IRS must issue a report to the Congress on the extent of the "tax gap" by April 15, 1989, and the IRS must report annually on improvements to the audit rate, taxpayer assistance and enforcement efforts. The Act also expresses that the IRS be one of the first agencies to be provided with a two-year budget cycle.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The provision relating to unclaimed federal refunds is effective on December 22, 1987.

Title X, Subtitle F. Other Revenue Provisions - Tax Exempt Bond Provisions

ACTION: BOND ISSUES USED TO ACQUIRE CERTAIN FACILITIES AND ISSUES OF INDIAN TRIBAL GOVERNMENTS)

Act Section 10631 - 10632

CURRENT CALIFORNIA LAW (Sec. 17133 and 17143)

California specifically does not conform to federal law provisions relating to private activity bonds. Under the California Constitution all interest on bonds issued by the state or a local municipality in California is exempt from income tax regardless of the facilities acquired with those bonds.

NEW FEDERAL LAW (Sec. 141 and 7871)

The Act limits the issuance of bonds for the purpose of government acquisition of existing electric and gas generating and transmission systems by classifying them as private activity bonds subject to the State volume limitations.

Restrictions are also placed on Indian tribal units issuing tax-exempt bonds for the purpose of financing off-reservation commercial or industrial facilities.

EFFECTIVE DATE OF FEDERAL PROVISIONS

These provisions are generally effective for bonds issued after October 13, 1987.

Title X, Subtitle G. Lobbying and Political Activities of Tax-Exempt Organizations

ACTION: NEW DISCLOSURE REQUIREMENTS AND CLARIFICATION OF POLITICAL ACTIVITY PROVISIONS

Act Section 10701 - 10714

CURRENT CALIFORNIA LAW (Sec. 23701d, 23704.5, 23704.6, 23736, and 23740)

California provisions are similar to federal law with regard to the activities permitted organizations which are exempt from tax.

NEW FEDERAL LAW (Sec. 170, 501, 504, 4912, 4955, 6104, 6033, 6113, 6652, 6711, 6852, and 7409)

The Act imposes a host of new requirements on tax exempt organizations regarding: notification of contributors that donations are not tax deductible, provision for public inspection (at the organization's principal office) of a copy of its three most recent annual information returns and a copy of its exemption application and determination letter, requirements for additional information on annual information returns, and requirements that disclosure be made when an exempt organization sells services that are available free from the government.

Also, clarification is provided that prohibited political activity will include opposition to candidates for public office and that a charity disqualified for political activities may not qualify as a social welfare organization.

A new excise tax is imposed with respect to political expenditures of certain charitable organizations. In addition, the IRS is authorized to make termination assessments of income tax or the excise tax on political expenditures of certain charitable organizations that make flagrant political contributions, and to seek injunctive relief prohibiting continued political expenditures by such organizations.

EFFECTIVE DATE OF FEDERAL PROVISIONS

The effective date of these provisions is generally on or after December 22, 1987 (or for tax years beginning after December 22, 1987) although those dealing with solicitations are effective January 1, 1988. The public inspection of annual returns provision is effective for annual returns for years beginning on or after January 1, 1987.