California Franchise Tax Board

SUMMARY OF FEDERAL INCOME TAX CHANGES — 1995

Laws Affected

Personal Income Tax

Bank & Corporation Tax

SUMMARY OF

FEDERAL INCOME TAX CHANGES

1995

Prepared by the Staff of the
FRANCHISE TAX BOARD
State of California

Members of the Board:
State Controller
Chairman, State Board of Equalization
Director of Finance

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This report is submitted in fulfillment of the requirement in
Revenue and Taxation Code Section 19522.

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Executive Summary

During 1995, the Internal Revenue Code was changed by:

PUBLIC LAW	TITLE
104-7	DEDUCTION FOR HEALTH INSURANCE COSTS OF SELF-EMPLOYED INDIVIDUALS (Signed April 11, 1995)
104-95	LIMITATION ON STATE INCOME TAXATION OF CERTAIN PENSION INCOME (Signed January 10, 1996)

This report examines each provision by explaining federal law prior to the change, current California law, a discussion of the new federal law (extracted from the House, Senate and Conference Committee reports, if any), the effective date of the federal change and the impact on California revenue were California to conform to the change in federal law. The explanations also contain citations to the section numbers of the Public Law as well as the Internal Revenue Code and California Revenue and Taxation Code sections impacted by the change.

Exhibit A contains a list of expiring provisions in both California and federal law for the years 1996 through 2004. As shown in Exhibit A, the following California provisions expired or became inoperative in 1996:

Rates	-	Temporary 10 and 11 percent brackets for regular tax (now capped at 9.3 percent)
Rates	-	Temporary 8.5 percent bracket for alternative minimum tax (rate is now 7.0 percent)
Credit	-	Clean fuel vehicles
Credit	-	Employer sponsored ridesharing and public transit passes

Credit	-	Employee in a nonemployer sponsored vanpool
Credit	-	Renters (no credit for 1994 or 1995, but credit resumes in 1996 without any limitation based upon AGI)

The 1995 tax return is the last tax return upon which the following voluntary contributions will appear since each expires on 1/1/97, prior to the due date of the 1996 tax return (4/15/97).

Voluntary Contribution	-	California Election Campaign Fund
Voluntary Contribution	-	Children's Trust Fund for the Prevention of Child Abuse
Voluntary Contribution	-	California Fund for Senior Citizens
Voluntary Contribution	-	Veterans' Memorial Account
Voluntary Contribution	-	Rare and Endangered Species Preservation Program
Voluntary Contribution	-	Alzheimer's Disease/Related Disorders Fund

DEDUCTION FOR HEALTH INSURANCE COSTS OF SELF-EMPLOYED INDIVIDUALS (PL 104-7)

Public Law: 104-7

Act Section: 1

Section Title: Permanent extension and increase of deduction for health insurance costs of self-employed individuals

Federal Law Before Change (Sec. 162)

The tax treatment of health insurance expenses depends on whether the taxpayer is an employee and whether the taxpayer is covered under a health plan paid for by the employee's employer. An employer's contribution to a plan providing accident or health coverage for the employee and the employee's spouse and dependents is excludable from an employee's income. The exclusion is generally available in the case of owners of a business who are also employees.

In the case of self-employed individuals (i.e., sole proprietors or partners in a partnership), no equivalent exclusion applies. However, for taxable years beginning before 1994, a deduction was allowed for 25 percent of the amount paid for health insurance for a self-employed individual and the individual's spouse and dependents. The 25 percent deduction was available with respect to the cost of self-insurance, and was not available unless the self-insured plan was in fact insurance (e.g., there was appropriate risk shifting) and not merely a reimbursement arrangement. The 25 percent deduction was not available for any month if the taxpayer was eligible to participate in a subsidized health plan maintained by the employer of the taxpayer or the taxpayer's spouse. In addition, no deduction was available to the extent that the deduction exceeded the taxpayer's earned income. The amount of expenses paid for health insurance in excess of the deductible amount could be taken into account in determining whether the individual was entitled to an itemized deduction for medical expenses.

For purposes of these rules, more than 2% shareholders of S corporations are treated the same as self-employed individuals. Thus, they were entitled to the 25 percent deduction.

Other individuals who purchase their own health insurance (e.g., someone whose employer does not provide health insurance) can deduct their insurance premiums only to the extent that the premiums, when combined with other unreimbursed medical expenses, exceed 7.5% of adjusted gross income.

Current California Law (Sec. 17273)

California is conformed to federal law as it read on January 1, 1993, except that the federal sunset date is not applicable. Thus, **the 25 percent deduction** is a permanent California provision.

New Federal Law (Sec. 162)

The Act makes two changes:

(a) retroactively reinstated the deduction for 25 percent of health insurance costs of self-employed individuals for 1994 and made the deduction permanent; and

(b) increased the percentage from 25 percent to 30 percent for years beginning after December 31, 1994.

Effective Date

The retroactive reinstatement of the 25 percent deduction is effective for taxable years beginning after December 31, 1993.

The increase in the percentage from 25 percent to 30 percent applies to taxable years beginning after December 31, 1994.

Impact on California Revenue

California is automatically conformed to the federal sunset date of this provision. Increasing the deduction from 25% to 30% would result in additional revenue losses.

Based on the department's personal income tax model, the baseline loss is $10 million for 1995-6 fiscal year and $11 million for 1996-7. The tax revenue loss for increasing the deduction from 25% to 30% is estimated to be $2 million annually.

DEDUCTION FOR HEALTH INSURANCE COSTS OF SELF-EMPLOYED INDIVIDUALS (PL 104-7)

Public Law: 104-7

Act Section: 2

Section Title: Repeal of nonrecognition on FCC certified sales and exchanges

Federal Law Before Change (Sec. 1071)

Under current law, absent special rules, the seller of a business, including a broadcast business, recognizes gain to the extent the sale price (and any other consideration received) exceeds the seller's adjusted basis in the property.

Special rules

1. Under section 1031 of the Internal Revenue Code, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like kind" that is to be held for productive use in a trade or business or for investment. The nonrecognition rules do not apply to an exchange of one class or kind of property for property of a different class or kind. Rules are provided for exchanges consisting of other property in addition to like-kind property to recognize gain to the extent of the money and the fair market value of the other property received. Special rules apply to exchanges between related persons, which generally require the parties to the transaction to hold the exchanged property for at least two years after the exchange.

The different classes of property are:

a. depreciable tangible personal property;

b. intangible personal property; and

c. real property.

Corporate stock, partnership interests, other securities and debt do not qualify as like-kind replacement property.

The basis of property received in a like-kind transaction generally is the same as the basis of any property exchanged, decreased by the amount of money received or loss recognized on the exchange and increased by the amount of gain recognized on the exchange.

2. Under section 1033 of the Internal Revenue Code, gain realized by a taxpayer from certain involuntary conversions of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property. The replacement property may be acquired directly or by acquiring control of a corporation (generally, 80 percent of the stock of the corporation) that owns replacement property. The taxpayer's basis in the replacement property generally is the same as the taxpayer's basis in the converted property, decreased by the amount of any money or loss recognized on the conversion, and increased by the amount of any gain recognized on the conversion.

Only involuntary conversions that result from destruction, theft, seizure, or condemnation (or threat or imminence thereof) are eligible for deferral under section 1033. Under Revenue Ruling 58-11 (1958-1, C.B. 273) the term "condemnation" refers to the process by which private property is taken for public use without the consent of the property owner <u>but upon the award and payment of just compensation</u>. Thus, for example, an order by a Federal court to a corporation to divest itself of ownership of certain stock because of anti-trust rules is not a condemnation (or threat or imminence thereof), and the divestiture is not eligible for deferral under section 1033.

3. Under section 1071 of the Internal Revenue Code, if the Federal Communications Commission (FCC) certifies that a sale or exchange of property is necessary or appropriate to effectuate a change in a policy of, or the adoption of a new policy by, the FCC with respect to the ownership and control of "radio broadcasting stations," a taxpayer may elect to treat the sale or exchange as an involuntary conversion. The FCC is not required to determine the tax consequences of certifying a sale or to consult with the Internal Revenue Service about the certification process.

Under section 1071, the replacement requirement in the case of FCC-certified sales may be satisfied by purchasing stock of a corporation that owns broadcasting property, regardless of whether the stock represents control of the corporation. In addition, even if the taxpayer does not reinvest all the sales proceeds in similar or related replacement property, the taxpayer may elect to defer recognition of gain if the basis of depreciable property that is owned by the taxpayer immediately after the sale or that is acquired during the same taxable year is reduced by the amount of deferred gain.

The purchaser of a broadcast business, or any other business, acquires a basis equal to the purchase price paid. In an asset acquisition, a buyer must allocate the purchase price among the purchased assets to determine the buyer's basis in these assets. In a stock acquisition, the buyer generally takes a basis in the stock equal to the purchase price paid, and the business retains its basis in the assets. This treatment applies regardless of whether the seller of the broadcast property has received an FCC certificate exempting the sale transaction from the normal tax treatment.

Current California Law (R&T Sec. 18031 & 24971)

California conforms to the federal rules for deferring gain in the case of an FCC certified sale.

New Federal Law (Sec. 1071 repealed)

The Act repeals section 1071. Thus, a sale or exchange of broadcast properties will be subject to the same rules applicable to all other taxpayers engaged in the sale or exchange of a business.

Effective Date

The federal repeal is effective for (1) sales or exchanges on or after January 17, 1995, and (2) sales or exchanges before that date if the FCC tax certificate with respect to the sale or exchange is issued on or after that date. The repeal does not apply to taxpayers who have entered into a binding written contract (or have completed a sale or exchange pursuant to a binding written contract) before January 17, 1995, and who have applied for an FCC tax certificate by that date. This binding contract exception does not apply if the sale were contingent on January 16, 1995, on issuance of an FCC tax certificate.

DEDUCTION FOR HEALTH INSURANCE COSTS OF SELF-EMPLOYED INDIVIDUALS (PL 104-7)

Impact on California Revenue

Since the FCC will no longer be issuing FCC tax certificates on these sales, taxpayers will report the same way for state tax purposes. Therefore, the revenue impact occurs whether or not California actually conforms. The baseline impact is estimated to be a revenue gain of $12 million for 1995-6 fiscal year, $14 million for 1996-7, $5 million for 1997-8, and $5 million for 1998-9.

No state data are available on which to develop a baseline estimate that has resulted from automatic conformity. Consequently, the above estimates were based on the federal estimate of H.R. 831 and prorated to represent the baseline impact for California.

DEDUCTION FOR HEALTH INSURANCE COSTS OF SELF-EMPLOYED INDIVIDUALS (PL 104-7)

Public Law: 104-7

Act Section: 3

Section Title: Special rules relating to involuntary conversions

Federal Law Before Change (Sec. 1033)

Under current law, absent special rules, the seller of a business recognizes gain to the extent the sale price (and any other consideration received) exceeds the seller's adjusted basis in the property.

Special rules

1. Under section 1031 of the Internal Revenue Code, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like kind" that is to be held for productive use in a trade or business or for investment. The nonrecognition rules do not apply to an exchange of one class or kind of property for property of a different class or kind. Rules are provided for exchanges consisting not only of like-kind property to recognize gain to the extent of the money and the fair market value of the other property received. Special rules apply to exchanges between related persons, which generally require the parties to the transaction to hold the exchanged property for at least two years after the exchange.

The different classes of property are:

a. depreciable tangible personal property;

b. intangible personal property; and

c. real property.

Corporate stock or partnership interests do not qualify as like-kind replacement property.

The basis of property received in a like-kind transaction generally is the same as the basis of any property exchanged, decreased by the amount of money received or loss recognized on the exchange and increased by the amount of gain recognized on the exchange.

2. Under section 1033 of the Internal Revenue Code, gain realized by a taxpayer from certain involuntary conversions of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property. The replacement property may be acquired directly or by acquiring control of a corporation (generally, 80 percent of the stock of the corporation) that own replacement property. The taxpayer's basis in the replacement property generally is the same as the taxpayer's basis in the converted property, decreased by the amount of any money or loss recognized on the conversion, and increased by the amount of any gain recognized on the conversion.

Only involuntary conversions that result from destruction, theft, seizure, or condemnation (or threat or imminence thereof) are eligible for deferral under section 1033. Under Revenue Ruling 58-11 (1958-1, C.B. 273) the term "condemnation" refers to the process by which private property is taken for public use without the consent of the property owner <u>but upon the award and payment of just compensation</u>. Thus, for example, an order by a Federal court to a corporation to divest itself of ownership of certain stock because of anti-trust rules is not a condemnation (or threat or imminence thereof), and the divestiture is not eligible for deferral under section 1033.

Under rulings issued by the Internal Revenue Service to taxpayers, property (stock or assets) purchased from a related person <u>may, in some cases, qualify</u> as property similar or related in service or use to the converted property.

<u>Current California Law (Sec. 18031 & 24941-24949.3)</u>

In general, California conforms to the federal rules relating to involuntary conversions of property.

<u>New Federal Law (Sec. 1033)</u>

The rules relating to deferral of gain for involuntary conversions of property are modified as follows:

DEDUCTION FOR HEALTH INSURANCE COSTS OF SELF-EMPLOYED INDIVIDUALS (PL 104-7)

1. Related party transactions

Corporations (other than S corporations) and certain partnerships will not be entitled to defer gain if the replacement property or stock is purchased from a related person. A person would be treated as related to another person if the person bears a relationship to the other person described in section 267(b) or 707(b)(1). An exception to the general rule provides that a taxpayer could purchase replacement property or stock from a related person and defer gain under section 1033 to the extent the related person acquired the replacement property or stock from an unrelated person within the replacement period. Thus, property acquired from outside the group within the replacement period and transferred to the taxpayer member of the group within the replacement period would qualify in the hands of the taxpayer to the extent that the property's basis or other net tax consequences to the group do not change as a result of the transfer.

The provision applies to a partnership if more than 50 percent of the capital interest, or profits interest, of the partnership are owned, directly or indirectly, by C corporations at the time of the involuntary conversion. If the provision applies to a partnership, the provision applies to all partners of the partnership, including partners that are not C corporations. If a partnership is not subject to this rule, none of the partners of the partnership will be subject to the provision by reason of their interest in the partnership. The determination of whether a partnership is related to another party is to be made at the partnership level.

2. Microwave relocation

Background

In 1993, Congress provided for the orderly transfer of frequencies, including frequencies that can be licensed under competitive bidding procedures. The Federal Communications Commission (FCC) has adopted rules to conduct auctions for the award of more than 2,000 licenses to provide personal communications services (PCS). PCS will be provided by means of a new generation of communication devices that will include small, lightweight, multi-function portable phones, portable facsimile and other imaging devices, new types of multi-channel cordless phones, and advanced paging devices with two-way data capabilities. The PCS auctions, which began in 1994, will constitute the largest auction of public assets in American history and are expected to generate billions of dollars for the United States Treasury.

PCS can operate only on frequencies below 3GHz. However, because that frequency range is currently occupied by various private fixed microwave communications systems (such as those owned by railroads, oil pipelines, and electric utilities), no large blocks of unallocated spectrum are available to PCS. To accommodate PCS, the FCC has reallocated the spectrum. The 1850-1990mhz spectrum will be used for PCS, and the microwave systems will be required to move to higher frequencies. Current occupants of the 1850-1990mhz spectrum allocated to PCS must relocate to higher frequencies not later than three years after the close of the bidding process. In accordance with FCC rules, these current occupants have the right to be compensated for the cost of replacing their old equipment, which can operate only on the 1850-1990mhz spectrum. The amount of these payments and characteristics of the new equipment will be the subject of negotiation between the incumbent microwave operators and the PCS licensees. If no agreement is reached within the three year voluntary negotiation period, the microwave operators will be required by the FCC to vacate the spectrum.

The FCC will employ the tax certificate program for PCS to encourage fixed microwave operators voluntarily to relocate from the 1859-1990mhz band to clear the band for PCS technologies.

Change to Involuntary Conversion Rules

This Act provides that sales or exchanges that are certified by the Federal Communications Commission (FCC) as having been made by a taxpayer in connection with the relocation of the taxpayer from the 1850-1990mhz spectrum by reason of the FCC's reallocation of that spectrum for use for PCS will be treated as involuntary conversions to which section 1033 applies.

Effective Date

1. The related party provision applies to involuntary conversions occurring on or after February 6, 1995.

2. The microwave relocation provision applies to sales or exchanges after March 14, 1995, and before January 1, 2000.

Impact on California Revenue

The vast majority of taxpayers will report the same way for state purposes as federal. The baseline revenue gain is estimated to be minor (less than $500,000) for 1995-6 and 1996-7 fiscal years, $1 million for 1997-8, and $1 million for 1998-9.

No state data are available on which to develop a baseline estimate that has resulted from automatic conformity. Consequently, the above estimates were based on the federal estimate of H.R. 831 and prorated to represent the baseline impact for California.

Public Law: 104-7

Act Section: 4

Section Title: Denial of earned income credit for individuals having excessive investment income

Federal Law Before Change (Sec. 32)

Eligible low-income workers are able to claim a refundable earned income tax credit (EITC). The amount of the credit an eligible taxpayer may claim depends upon whether the taxpayer has one, more than one, or no qualifying children and is determined by multiplying the credit rate by the taxpayer's earned income up to an earned income threshold. The maximum amount of the credit is the product of the credit rate and the earned income threshold. For taxpayers with earned income (or adjusted gross income, if greater) in excess of the phaseout threshold, the credit amount is reduced by the phaseout rate multiplied by the amount of earned income (or adjusted gross income, if greater) in excess of the phaseout threshold. The credit is not allowed if earned income (or adjusted gross income, if greater) exceeds the phaseout limit.
The parameters for the EITC depend upon the number of qualifying children the taxpayer has. For 1995 the parameters are as follows:

	One qualifying child--	Two or more qualifying children--	No qualifying children--
Credit rate	34.00%	36.00%	7.65%
Phaseout rate	15.98%	20.22%	7.65%
Earned income threshold	$ 6,160	$ 8,640	$ 4,100
Maximum credit	$ 2,094	$ 3,110	$ 314
Phaseout threshold	$ 11,290	$ 11,290	$ 5,130
Phaseout endpoint	$ 24,396	$ 26,673	$ 9,230

The earned income threshold and the phaseout threshold are indexed for inflation. Earned income consists of wages, salaries, other employee compensation, and net self-employment income.

DEDUCTION FOR HEALTH INSURANCE COSTS OF SELF-EMPLOYED INDIVIDUALS (PL 104-7)

In order to claim the EITC, a taxpayer must either have a qualifying child or must meet other requirements. A qualifying child must meet a relationship test, an age test, and a residence test. Part of the residence test requires that a qualifying child must have the same principal place of abode as the taxpayer for more than one-half of the taxable year (for the entire taxable year in the case of a foster child), and that this principal place of abode must be located in the United States.

In order to claim the EITC without a qualifying child, a taxpayer must not be a dependent and must be over age 24 and under age 65. In addition, the taxpayer's principal place of abode must be located in the United States for more than one-half of the taxable year.

Current California Law (R&T Sec. None)

California has no credit comparable to the federal Earned Income Tax Credit.

New Federal Law (Sec. 32)

The Act provides that a taxpayer is not eligible for the Earned Income Tax Credit if the aggregate amount of "disqualified income" of the taxpayer for the taxable year exceeds $2,350. Disqualified income is the sum of:

1. interest and dividends includible in gross income for the taxable year,
2. tax-exempt interest received or accrued in the taxable year, and
3. net income (if greater than zero) from rents and royalties not derived in the ordinary course of business.

Tax-exempt interest is defined as amounts required to be reported on the taxpayer's return under section 6012(d).

Effective Date

The provision is effective for taxable years beginning after December 31, 1995.

DEDUCTION FOR HEALTH INSURANCE COSTS OF SELF-EMPLOYED INDIVIDUALS (PL 104-7)

Impact on California Revenue

Not applicable to California.

DEDUCTION FOR HEALTH INSURANCE COSTS OF SELF-EMPLOYED INDIVIDUALS (PL 104-7)

Public Law: 104-7

Act Section: 5

Section Title: Extension of special rule for certain group health plans

Federal Law Before Change (Sec. 13442(b) of the Revenue Reconciliation Act of 1993 (PL 103-66)& Sec. 162(n))

Employers can generally deduct the full cost of health coverage provided to participants under a group health plan. Under New York state law, commercial insurers of inpatient hospital services, group health plans, health maintenance organizations, and Blue Cross and Blue Shield corporations are required to reimburse hospitals for inpatient hospital services at various rates set by the state of New York. In February 1993, a Federal district court invalidated a number of New York statutes imposing inpatient hospital-rate surcharges on the ground that they were preempted by the Employee Retirement Income Security Act of 1974 (ERISA), but ordered insurers of inpatient hospital services to comply with New York's rate-setting statutes pending a final determination of the case. The Revenue Reconciliation Act of 1993 (PL 103-66) disallows employer deductions for any amounts paid or incurred in connection with a group health plan if the plan fails to reimburse hospitals for inpatient services provided in the State of New York at the same rate that licensed commercial insurers are required to reimburse hospitals for inpatient services of individuals not covered by a group health plan. This provision applies with respect to inpatient hospital services provided to participants after February 2, 1993, and on or before May 12, 1995.

Current California Law (R&T Sec. 17201 & 24343)

California is in conformity with the general rule that an employer is allowed to deduct amounts paid or incurred in connection with a group health plan, but has not conformed to the denial of the deductions provided for by the Revenue Reconciliation Act of 1993.

DEDUCTION FOR HEALTH INSURANCE COSTS OF SELF-EMPLOYED INDIVIDUALS (PL 104-7)

New Federal Law (Sec. 13442(b) of the Revenue Reconciliation Act of 1993 (PL 103-66) & Sec. 162(n))

The Act extends the present-law deduction disallowance for expenses in connection with certain New York group health plans through December 31, 1995.

Effective Date

This provision is effective April 11, 1995.

Impact on California Revenue

Any impact on State income tax revenues would be very minor (less than $500,000) and would occur automatically as a result of the federal change.

Public Law: 104-7

Act Section: 6

Section Title: Study of expatriation tax

Federal Law Before Change (Sec. 877)

U.S. citizens and residents generally are subject to U.S. income taxation on their worldwide income. The United States imposes tax on gains recognized by foreign persons that are attributable to dispositions of interests in U.S. real property. Distributions, including lump-sum distributions, that foreign persons receive from qualified U.S. retirement plans generally are subject to U.S. tax at a 30 percent rate.

A U.S. citizen who relinquishes U.S. citizenship with a principal purpose to avoid federal tax may be subjected to an alternative taxing method for 10 years after expatriation. Under this alternative method, the expatriate generally is taxed on his or her U.S. source income (net of certain deductions), as well as on certain business profits, at rates applicable to U.S. citizens and residents.

Current California Law (Sec. 17041 & 17951)

California exercises its taxing powers based on two jurisdictional concepts: (1) the residency of the individual, and (2) the source of the income. Residents of California pay state taxes on all income received regardless of its geographical source. Nonresidents of California are taxed by California only on income derived from sources within California's boundaries ("source income"). Source income includes wages earned from services performed in California, gains from the disposition of property located in California, and profits from business transacted in California. Intangible income, such as investment interest, is considered to originate in the state in which the recipient resides at the time it is earned, unless it is earned in connection with a trade or business.

California also taxes pension and annuity income based on its geographical source. Income, which originally is earned in California, may be deposited for retirement in a nontaxable trust and not taxed until it is distributed by the pension plan administrator. This tax-deferred income remains taxable by California at the time of its distribution, regardless of the recipient's state of residency at the time of the distribution. Similarly, when pension or annuity benefits originally earned in California are transferred to a surviving beneficiary, they remain taxable by California regardless of the beneficiary's residence.

New Federal Law

The Act directs that the staff of the Joint Committee on Taxation undertake a study of the issues presented by any proposals to affect the tax treatment of expatriation, including an evaluation of:

1. the effectiveness and enforceability of current law with respect to the tax treatment of expatriation;
2. the current level of expatriation for tax avoidance purposes;
3. any restrictions imposed by an constitutional requirement that federal income tax apply only to realized gains;
4. the application of international human rights principles to the taxation of expatriation;
5. the possible effects of any such proposals on the free flow of capital into the United States;
6. the impact of any such proposals on existing tax treaties and future treaty negotiations;
7. the operation of any such proposals in the case of interests in trusts;
8. the problems of potential double taxation in any such proposals;
9. the impact of any such proposals on the trade policy objectives of the United States;
10. the administrability of such proposals; and
11. possible problems associated with existing law, including estate and gift tax provisions.

Effective Date

The results of the study are to be reported to the Chairman of the House Committee on Ways and Means and to the Chairman of the Senate Committee on Finance by June 1, 1995. The study was completed and was used as the basis of subsequent legislative action.

Impact on California Revenue

Not applicable.

LIMITATION ON STATE INCOME TAXATION OF CERTAIN PENSION INCOME (PL 104-95)

Public Law: 104-95

Act Section: 1

Section Title: Limitation on state income taxation of certain pension income

Federal Law Before Change (None)

None.

Current California Law (Sec. 17041 & 17951)

California exercises its taxing powers based on two jurisdictional concepts: (1) the residency of the individual, and (2) the source of the income. Residents of California pay state taxes on all income received regardless of its geographical source. Nonresidents of California are taxed by California only on income derived from sources within California's boundaries ("source income"). Source income includes wages earned from services performed in California, gains from the disposition of property located in California, and profits from business transacted in California. Intangible income, such as investment interest, is considered to originate in the state in which the recipient resides at the time it is earned, unless it is earned in connection with a trade or business.

California also taxes pension and annuity income based on its geographical source. Income, which originally is earned in California, may be deposited for retirement in a nontaxable trust and not taxed until it is distributed by the pension plan administrator. This tax-deferred income remains taxable by California at the time of its distribution, regardless of the recipient's state of residency at the time of the distribution. Similarly, when pension or annuity benefits originally earned in California are transferred to a surviving beneficiary, they remain taxable by California regardless of the beneficiary's residence.

New Federal Law (Chapter 4 of Title 4 Sec. 114)

The Act amends title 4 of the United States Code (entitled "Flag and Seal, Seat of Government, and the States"), to prohibit any State, including any political subdivision of a State, the District of Columbia, and the possessions of the United States, from imposing income tax on any retirement income of any individual who is not a resident or domiciliary of the State.

For this purpose, "retirement income" includes any income from a qualified retirement or annuity plan, a simplified employee pension, a tax-sheltered annuity plan, an eligible deferred compensation plan of a tax-exempt or State and local government, an individual retirement arrangement, a governmental plan, a trust created before June 25, 1959, and that is part of a plan funded only by employee contributions, and certain retired or retainer pay of a member or former member of the uniformed services.

The term "retirement income" also includes income from a nonqualified deferred compensation plan, provided such income is:

(1) part of a series of substantially equal periodic payments made over

(a) the life or life expectancy of the recipient (or the joint lives or life expectancies of the recipient and the recipient's beneficiary), or

(b) a period not less than 10 years, or

(2) a payment received after termination of employment under a plan, program, or arrangement (called a "mirror plan") maintained solely for the purpose of providing benefits in excess of limitations on contributions or benefits in the Internal Revenue Code on qualified retirement plans.

The provision has no effect on the application of the provision in the Employee Retirement Income Security Act of 1974 ("ERISA") that generally preempts State laws.

EXPLANATION OF MIRROR PLANS

A mirror plan is a nonqualified retirement plan maintained by an employer solely for the purpose of providing benefits in excess of certain limits on contributions and benefits contained in the Internal Revenue Code which apply to qualified retirement plans.

The benefits provided under a mirror plan are those benefits that would have been provided under the terms of a qualified retirement plan, but for the application of the following limits on contributions and benefits:

(1) Section 401(a)(17): limits to $150,000 the amount of annual compensation that may be taken into account under a qualified retirement plan for purposes of computing benefits and contributions.

(2) Section 401(k): limits the amount of elective deferrals (contributions at the election of the employee) that may be made by a highly compensated employee to a qualified cash or deferred arrangement (commonly called a "401(k) plan") according to a nondiscrimination test based on the amount of elective deferrals made by nonhighly compensated employees.

(3) Section 401(m): limits the amounts of employer matching contributions and after-tax employee contributions that may be made to a 401(k) plan on behalf of highly compensated employees according to a nondiscrimination test based on the amount of such contributions made on behalf of nonhighly compensated employees.

(4) Section 402(g): limits the annual amount of elective deferrals that may be made to a 401(k) plan (or a similar arrangement) generally to $9,240 for 1995 (adjusted for inflation in $500 increments).

(5) Section 403(b): limits the amount of annual contributions that may be made to a tax-sheltered annuity (maintained by certain tax-exempt entities and public educational organizations) generally to the excess of the product of 20 percent of compensation times the participant's years of service over the amount contributed in prior years. In addition, contributions to a tax-sheltered annuity are subject to annual limit of $9,500.

(6) Section 408(k): limits the amount of elective deferrals that may be made by a highly compensated employee to a simplified employee pension (maintained by smaller employers) based on the amount of elective deferrals made by nonhighly compensated employees.

(7) Section 415: limits the amount of annual benefits that may be paid from a defined benefit plan generally to the lesser of $120,000 or 100 percent of the participant's average compensation

for the highest three years of compensation, and limits the amount of annual contributions that can be made to a defined contribution plan to the lesser of $30,000 or 25 percent of compensation.

Effective Date

This provision applies to payments received after December 31, 1995.

Impact on California Revenue

Current federal law provides for this state tax prohibition. Based on tax return data and assumptions discussed below, the estimate of the state baseline impact is as follows:

Effective for Retirement Income Received After 12/31/95 ($ In Millions)			
Taxable Years			
1996	1997	1998	1999
($25)	($26)	($28)	($29)
Fiscal Years			
1995-6	1996-7	1997-8	1998-9
($10)	($26)	($27)	($28)

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The estimate of the impact of the federal legislation is based on nonresident tax return data. Distributions from retirement plans which constitute income from California sources are reported on the Schedule CA (Form 540 NR) as either IRA distributions or pensions and annuities. IRA distributions would include distributions from regular and rollover IRAs, and distributions from Simplified Employee Pensions (SEPs). (A rollover IRA is established in those cases where participation in certain types of plans has been terminated and the vested interest rolled over to an IRA.)

LIMITATION ON STATE INCOME TAXATION OF CERTAIN PENSION INCOME (PL 104-95)

The baseline estimate was derived by using the department's personal income tax sample (1993 base). Reported taxable pension and/or IRA distributions were excluded from tax returns of full-year nonresidents and part-year residents leaving California. Tax liabilities were recalculated for those receiving a tax benefit from the exclusion. For subsequent years, revenue losses were grown annually by an assumed 5% growth in retirement income.

EXHIBIT A

EXPIRING TAX PROVISIONS

California Last Tax Yr*	Calif. Section	Federal Last Tax Yr*	Federal Section	Description and Comments
12/31/95	17041	N/A	N/A	Tax rates: Temporary 10 and 11 percent brackets for regular tax (now capped at 9.3 percent)
12/31/95	17052.11 23603	12/31/04	30	Credit: Clean fuel vehicles
12/31/95	17053 23605	N/A	N/A	Credit: Employer sponsored ridesharing and public transit passes
12/31/95	17053.1	N/A	N/A	Credit: Employee in a nonemployer sponsored vanpool
12/31/95	17053.5	N/A	N/A	Credit: Renters (no credit for 1994 or 1995, but credit resumes in 1996 without any limitation based upon AGI)
12/31/95	17062	N/A	N/A	Tax rates: Temporary 8.5 percent bracket for alternative minimum tax (rate is now 7.0 percent)
12/31/95[1]	18706	N/A	N/A	Voluntary Contribution: California Election Campaign Fund
12/31/95[1]	18715	N/A	N/A	Voluntary Contribution: Children's Trust Fund for the Prevention of Child Abuse
12/31/95[1]	18724	N/A	N/A	Voluntary Contribution: California Fund for Senior Citizens
12/31/95[1]	18734	N/A	N/A	Voluntary Contribution: Veterans' Memorial Account
12/31/95[1]	18745	N/A	N/A	Voluntary Contribution: Rare and Endangered Species Preservation Program
12/31/95[1]	18766	N/A	N/A	Voluntary Contribution: Alzheimer's Disease and Related Disorders Fund
12/31/96	17053.8 17053.11 17276.2 23622 23623 24416.2	N/A	N/A	Apportionment Formula: Enterprise Zones and Program Areas
12/31/96[2]	18796	N/A	N/A	Voluntary Contribution: California Breast Cancer Research Fund

EXHIBIT A

EXPIRING TAX PROVISIONS

California Last Tax Yr*	Calif. Section	Federal Last Tax Yr*	Federal Section	Description and Comments
12/31/97	17052.15 23612.6	N/A	N/A	Credit: Sales and Use taxes paid in the LA Revitalization Zone
12/31/97	17052.17 23617	N/A	N/A	Credit: Employer constructed child care facilities
12/31/97	17052.18 23617.5	N/A	N/A	Credit: Employer paid child care program
12/31/97	17053.10 17053.17 23623.5 23625	N/A	N/A	Credit: Hiring in the LA Revitalization Zone
12/31/97	17233 24385	N/A	N/A	Deduction: Interest earned on loans made to businesses in the LA Revitalization Zone
12/31/97	17266 24356.4	N/A	N/A	Deduction: Expensing of business property in the LA Revitalization Zone
12/31/97	17276.2 24416.2	N/A	N/A	Deduction: Net operating losses in the LA Revitalization Zone
12/31/97[3]	18785	N/A	N/A	Voluntary Contribution: D.A.R.E. California (Drug Abuse Resistance Education) Fund
12/31/97[3]	18804	N/A	N/A	Voluntary Contribution: California Firefighters' Memorial Fund
12/31/97[3]	18816	N/A	N/A	Voluntary Contribution: California Public School Library Protection Fund
12/31/98	18152.5	Permanent	1202	Exclusion: Capital Gain on Sale of Small Business Stock
12/31/98[4]	18844	N/A	N/A	Voluntary Contribution: California Military Museum Fund
12/31/98	19283	N/A	N/A	Collection of Amounts Due a Court
01/01/99	19290.1	N/A	N/A	Collections for the Department of Industrial Relations
12/31/99	17053.66 23666	N/A	N/A	Credit: Restoration of Habitat for Salmon and Steelhead Trout

EXHIBIT A

EXPIRING TAX PROVISIONS

California Last Tax Yr*	Calif. Section	Federal Last Tax Yr*	Federal Section	Description and Comments
12/31/99	17091 24272.3	Permanent	865	Sourcing Rules: Unprocessed timber
12/31/99[5]	18824	N/A	N/A	Voluntary Contribution: Mexican American Veterans' Memorial Account
12/31/99	25135	N/A	N/A	Apportionment Formula: Sales of Unprocessed Timber
12/31/02	17276.2 24416.2	N/A	N/A	Deduction: Net operating losses in the Local Agency Military Base Recovery Area

* In general, this is the last taxable year to which the provision applies. Fiscal years beginning within this taxable year are, in general, also covered by the provision. In some cases, the expiration applies to transactions occurring after this date.

[1] The actual date this provision expires is 1/1/97, prior to the due date of the 1996 tax return (4/15/97).

[2] The actual date this provision expires is 1/1/98, prior to the due date of the 1997 tax return (4/15/98).

[3] The actual date this provision expires is 1/1/99, prior to the due date of the 1998 tax return (4/15/99).

[4] The actual date this provision expires is 1/1/2000, prior to the due date of the 1999 tax return (4/15/99).

[5] The actual date this provision expires is unknown at this time. The law provides that this voluntary contribution will not appear on the tax return until construction has been completed on the Veterans' Memorial. It will continue to be on the tax return for a total of three (3) taxable years.