The following is the Franchise Tax Board's analysis of SB 455 (Alpert) as amended September 5, 1997.

Subject: Conformity Act of 1997

SUMMARY OF BILL

The Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), in general, conform to the Internal Revenue Code (IRC) either by incorporating the IRC by reference or by stand-alone language, which mirrors the federal provision. When applying the IRC for state purposes, the IRC as of the "specified date" of January 1, 1993, must be used, unless a specific provision provides otherwise. This bill would change the specified date from January 1, 1993, to January 1, 1997, for taxable and income years beginning on or after January 1, 1997. Changing the specified date automatically conforms to all changes in the IRC from January 1, 1993, through December 31, 1996, that have been previously incorporated by reference. This bill also would make numerous changes to specifically not conform or modify certain items in the IRC. Additionally, numerous technical changes regarding cross references and the deletion of unnecessary language that was used to conform to federal law changes subsequent to January 1, 1993, and prior to January 1, 1997 are being made by this bill.

This bill conforms to the following items:

1. Rollover of gain from sale of publicly traded securities into specialized small business investment companies.
2. Real estate investments by pension trusts, educational organizations and certain other exempt organizations.
3. Substantiation requirements for the deduction of certain charitable contributions.
4. Disclosure of quid pro quo contributions.
5. Increase in expense treatment for small business.
6. Treatment of storage of product samples.
7. Denial of indirect contributions to political parties.
8. Seven year amortization of reforestation expenses.
9. Class life for gas station convenience stores and similar structures.
10. Treatment of abandonment of lessor improvements at termination of lease.
11. Depreciation under income forecast method.
12. Application of involuntary conversion rules to Presidentially declared disasters.
13. Involuntary conversions and the repeal of nonrecognition on Federal Communications Commission (FCC) certified sales and exchanges.
14. Basis adjustment to property held by a corporation where stock in the corporation is replacement property under involuntary conversion rules.
15. Provisions to prevent conversion of ordinary income into capital gain.
16. Repeal of certain exceptions to the market discount rules.
17. Accrual of income by holders of stripped preferred stock.
18. Treatment of net capital gains as investment income.
19. Treatment of certain appreciated inventory distributions from partnerships.
20. Partnership distributions of marketable securities.
21. Treatment of dues paid to agricultural or horticultural organizations.
22. Treatment of housing provided to employees by academic health centers.
23. Exclusion for energy conservation subsidies limited to subsidies with respect to dwelling units.
24. Nonrecognition treatment for certain transfers by common trust funds to

regulated investment companies.

25. Repeal of exclusion for punitive damages and for damages not attributable to physical injuries or sickness.
26. Merchant marine capital construction fund accounts.
27. Polish bonds exempt from original issue discount treatment.
28. Amortization of child care facilities.
29. Adoption assistance.
30. Exclusion of self-employed insurance benefits from income.
31. Long-term care insurance and services.
32. Exception to penalty for premature distribution from an IRA.
33. Treatment of accelerated death benefits.
34. Repeal of $5,000 exclusion of employees’ death benefits.
35. Reduction in compensation taken into account in determining contributions
36. Treatment of excess pension assets used for retiree health benefits.
37. Pension plan funding requirements and premiums.
38. Repeal of five-year income averaging for lump-sum distributions.
39. Establishment of savings incentive match plans for employees of small employers.
40. Other pension plan provisions.
41. Financial asset securitization investment trusts.
42. Copy of federal form 5471 required to be attached to Californiatax return.
43. Certain informational returns.
44. Modifications to accuracy-related penalty.
45. Individual estimated tax safe harbor based on last year's tax.
46. Corporate estimated tax rules.
47. Waiver of estimated tax penalty.
48. Contributions in aid of construction
49. Publicly Traded Partnerships continuation of partnership treatment.
50. S corporation conformity.
51. Federal changes not being conformed to by this bill.

EFFECTIVE DATE

Unless otherwise specified this bill would apply to taxable and income years beginning on or after January 1, 1997.

BACKGROUND

As stated above the Revenue and Taxation Code (R&TC) conforms to various provisions of the IRC as it read on January 1, 1993. Subsequent to January 1, 1993, and before January 1, 1997, five bills have been enacted into law by Congress that materially affect the IRC. They are:

REVENUE RECONCILATION ACT OF 1993 (RRA)
GENERALL AGREEMENT ON TARIFFS & TRADE ACT OF 1994 (GATT)
SELF-EMPLOYED INSURANCE ACT OF 1995 (SEIA)
SMALL BUSINESS JOB PROTECTION ACT OF 1996 (SBJPA)
HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT OF 1996 (HIPAA)

This bill (and analysis) addresses the changes made by the above federal acts that were not conformed to by California prior to January 1, 1997. This bill also addresses eight federal changes that occurred prior to January 1, 1993, to which California has not conformed.

SPECIFIC FINDINGS

1. Rollover of gain from sale of publicly traded securities into specialized small business investment companies.

In general, gain or loss is recognized on any sale, exchange or other disposition of property. **California and federal law** contain provisions under which taxpayers may elect not to recognize gain realized on certain "like-kind" exchanges or for certain involuntary conversions.

Federal law permits any corporation or individual to elect to roll over without payment of tax any capital gain realized upon the sale of publicly-traded securities where the corporation or individual uses the proceeds from the sale to purchase common stock or a partnership interest in a specialized "small business investment company" (SSBIC) within 60 days of the sale of the securities. To the extent the proceeds from the sale of the publicly-traded securities exceed the cost of the SSBIC common stock or partnership interest, gain will be recognized currently. The taxpayer's basis in the SSBIC common stock or partnership interest is reduced by the amount of any gain not recognized on the sale of the securities.

Estates, trusts, S corporations, and partnerships are not eligible to make this election to roll over gains. In addition, "publicly-traded securities" are defined as stock or debt traded on an established securities market. An SSBIC is defined as certain partnerships or corporations that are licensed by the Small Business Administration.

The amount of gain that an individual may elect to roll over under this provision for a taxable year is limited to the lesser of $50,000 or $500,000 reduced by the gain previously excluded under this provision. For corporations, these limits are $250,000 and $1 million.

Current California law does not provide for the rollover of gain from the sale of publicly-traded securities into a SBIC.

This bill would conform to the rollover of gain from the sale of publicly-traded securities into a SBIC as long as a similar federal provision is applicable.

2. Real estate investments by pension trusts, educational organizations and certain other exempt organizations.

Under California and federal law, in general, a qualified pension trust or an organization that is otherwise exempt from federal income tax is taxed on income from a trade or business that is unrelated to the organization's exempt purposes (unrelated business taxable income or UBTI). Certain types of income, including rents, royalties, dividends, and interest, are excluded from UBTI, except when such income is derived from "debt-financed property."

An exception to the rule treating income from debt-financed property as UBTI is available to pension trusts, educational institutions, and certain other exempt organizations that make debt-financed investments in real property.

Under current California law and federal law prior to January 1, 1994 the real property exception to the debt-financed property rules have several restrictions regarding a fixed purchase price, seller financing, participating loans, purchase and leaseback, related parties, and a "disqualified person," as defined.

The RRA of 1993 liberalized the **federal law** restrictions by allowing certain non-fixed purchase price purchases, seller financing purchases, participating loans and leaseback to related or disqualified persons not to be treated as UBIT.

California law is in conformity with federal law prior to the RRA of 1993 changes.

This bill would conform to the 1993 federal changes.

3. Substantiation requirements for the deduction of certain charitable contributions.

Under California and federal law, an individual taxpayer who itemizes deductions must separately state the aggregate amount of charitable contributions made by cash or check and the aggregate amount of donated property other than cash or check.

Subsequent to 1993, **federal law** additionally provides that no deduction is allowed for a separate contribution of $250 or more unless the taxpayer has written substantiation from the donee organization of the contribution (including an estimate of the value of any good or service the donee provided to the taxpayer in exchange for making the gift to the donee).

Taxpayers must obtain substantiation prior to filing their return. Taxpayers may not rely solely on a canceled check as substantiation for a donation of $250 or more. Substantiation is not required if the donee organization files a return with the IRS (in accordance with Treasury regulations) reporting information sufficient to substantiate the amount of the deductible contribution. Also substantiation is not required for contributions of $250 or more to a religious organization, where a donor receives an intangible religious benefit that generally is not sold in commercial transactions outside the donative context (e.g., admission to a religious ceremony).

Current California law does not require a taxpayer to obtain written substantiation for contributions of $250 or more.

This bill would conform the PITL and B&CTL to federal law requiring taxpayers to obtain and maintain written substantiation of contributions of $250 or more. However, bill would provide that if the federal requirements are met, the state requirements are also met.

4. Disclosure of quid pro quo contributions.

Under federal law, a charitable organization that receives a quid pro quo contribution in excess of $75 (meaning a payment exceeding $75 "made partly as a contribution and partly in consideration for goods or services provided to the payor by the donee organization") is required, in connection with the solicitation or receipt of such a contribution, to provide a written statement to the donor that (1) informs the donor that the amount of the contribution that is deductible for income tax purposes is limited to the excess of the amount of any money (and the value of any property other than money) contributed by the donor over the value of the goods or services provided by the organization, and (2) provides the donor with a good faith estimate of the value of goods or services furnished to the donor by the organization.

The disclosure requirement does not apply if only de minimis, token goods or services are given to a donor or the contributor receives only an intangible religious benefit that generally is not sold in a commercial transaction outside the donative context. Furthermore, the provision does not apply to transactions that have no donative element (e.g., sales of goods by a museum gift shop that are not, in part, donations).

Federal law also provides that penalties ($10 per contribution, but capped at $5,000 per particular fundraising event or mailing) may be imposed upon charities that fail to make the required disclosure, unless the failure was due to reasonable cause. The penalties will apply if an organization either fails to make any disclosure in connection with a quid pro quo contribution or makes a disclosure that is incomplete or inaccurate.

Current California law does not contain any provisions requiring a charitable organization to disclose information regarding quid pro quo contributions.

This bill would conform state law to the federal reporting requirements and penalty provisions. The state requirements are deemed satisfied when an organization demonstrates the federal requirements have been met.

5. Increase in expense treatment for small business.

Federal law provides that in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $18,000 of the cost of qualifying property placed in service in a taxable year beginning after December 31, 1996. In general, qualifying property, commonly referred to as section 179 property, is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The limitation amount is reduced (but not below zero) by the amount by which the cost of section 179 placed in service during the taxable year exceeds $200,000. In addition, the amount eligible to be expensed for a taxable year may not exceed the taxable income of the taxpayer for the year that is derived from the active conduct of any trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

The federal expense amount increases from $18,000 to $25,000. The increase is phased in as follows:

Taxable year

beginning in-	Maximum expensing
1998	$18,500
1999	$19,000
2000	$20,000
2001	$24,000
2002	$24,000
2003 and thereafter	$25,000

Under the PITL, California law conforms to federal law section 179 except for the maximum amount allowable in any one year. Prior to 1997, California allowed a maximum deduction of $10,000 from section 179 property placed in service for the taxable year. In 1996, the amount allowed to be expensed was increased for taxable years beginning on or after January 1, 1997, to $12,500 and again for taxable years beginning on or after January 1, 1998, to $15,000.

Under the B&CTL, California law does not conform to federal law but instead allows “additional first-year depreciation” of 20 % of the cost (up to a maximum of $10,000 per year) of qualifying property. Thus, a maximum expense deduction of $2,000 per year is allowed.

This bill would conform the California PITL to federal law, with temporary modifications. The federal expensing amounts would be phased in over two years. Under the PITL, the maximum amount that could be expensed would be $13,000 in 1997 and $16,000 in 1998. From 1999 and forward the maximum amount would match the federal amounts.

This bill would not conform the B&CTL to federal law. Corporations still would be allowed to use additional first-year depreciation.

6. Treatment of storage of product samples.

Under California and federal law, a taxpayer's business use of the taxpayer’s home may give rise to a deduction for the business portion of expenses related to operating the home (e.g., a portion of rent or depreciation and repairs). Business deductions generally are allowed only for the portion of a home that is used exclusively and regularly in one of the following ways: (1) as the principal place of business for a trade or business; (2) as a place of business used to meet with patients, clients, or customers in the normal course of the taxpayer's trade or business; or (3) in connection with the taxpayer's trade or business, if the portion so used constitutes a separate structure not attached to the dwelling unit. In the case of an employee, the law further requires that the business use of the home must be for the convenience of the employer. These rules apply to houses, apartments, condominiums, mobile homes, boats, and other similar property used as the taxpayer's home.

A special rule permits deductions for expenses related to a storage unit in a taxpayer's home regularly used for inventory of the taxpayer's trade or business of selling products at retail or wholesale, provided that the home is the sole fixed location of such trade or business.

Home office deductions may not be claimed if they create (or increase) a net loss from a business activity, although such deductions may be carried over to subsequent taxable years.

Beginning in 1996, **federal law** expands the special rule relating to a storage unit in a taxpayer's home to include a storage unit used for inventoryor product samples.

Current California law has not conformed to the expansion of the special storage unit rule.

This bill would conform California law to federal law regarding home office deductions without exceptions.

7. Denial of indirect contributions to political parties.

Federal law provides that no deduction is allowed for any amount paid or incurred for advertising in a political party convention or any admission to any dinner or program, if any part of the cost inures or is intended to inure to a political party.

California law has not conformed to the above provision relating to indirect contributions to political parties.

This bill would conform state law to federal law on the denial of any deduction for indirectly contributing to a political party. Direct contributions to a political party are not allowable as a deduction under current federal or state law.

8. Seven year amortization of reforestation expenses.

Federal law permits the amortization ratably over 84 montrhs reforestation expenses for qualified timber property. Qualified timber property must be located in the United States and contain trees in a significant enough number for commercial logging. Reforestation expenses include the site preparation, seed or seedlings, the cost of labor for planting and other direct cost associated with reforestation including but not limited to depreciation of equipment used to plant the trees. A maximum of $10,000 per year may be added to theamortizable basis.

California PITL has conformed to federal without exception. The B&CTL contains stand alone language that permits a five year amortization period with no maximum cap on the amount allowable to be added to the amortizable basis. Under the B&CTL, the property to which the reforestation expenses are incurred on must be located in California.

This bill would conform the B&CTL to federal law. Under both the PITL and the B&CTL, this bill would require the property to be located in California.

9. Class life for gas station convenience stores and similar structures.

For structures placed in service after August 20, 1996, **federal law** provides that for purposes of the Modified Accelerated Depreciation System (MACRS), 15-year property includes generally, any depreciable real property that is a retail motor fuels outlet (regardless of food or other convenience items are sold at the outlet). A retail motor fuels outlet does not include any facility related to petroleum or natural gas pipelines or to any depreciable real property used only to an insubstantial extent in the retail marketing of petroleum or petroleum products.

Under **the PITL**, California law conforms to the MACRS which provides that depreciation for property used in the retail gasoline trade is calculated under a 15-year recovery period and the 150-percent declining balance method.

Starting in 1997, California law provides that nonresidential real property is depreciated using a 39-year recovery period and the straight-line method.

It is understood that taxpayers generally have taken the position that convenience stores and other buildings installed at retail motor fuels outlets have a 15-year recovery period. The IRS, in a position described in a recent Coordinated Issues Paper, generally limits the application of the 15-year recovery period to instances where the structure: (1) is 1,400 square feet or less or (2) meets a 50-percent test. The 50-percent test is met if: (1) 50 percent or more of the gross revenues that are generated from the building are derived from petroleum sales and (2) 50 percent or more of the floor space in the building is devoted to petroleum marketing sales.

The B&CTL does not conform to federal MACRS lives but instead uses the mid-range of the Class Life Asset Depreciation Range (CLADR) system to determine the economic useful life of depreciable assets.

This bill would conform the PITL to the federal law regarding the useful life of a retail motor fuel outlet. This bill would not conform the B&CTL to federal law.

10. Treatment of abandonment of lessor improvements at termination of lease.

The SBJPA codified under **federal law** that a lessor of leased property that disposes of a leasehold improvement which was made by the lessor for the lessee of the property may take the adjusted basis of the improvement into account for purposes of determining gain or loss, if the improvement is irrevocably disposed of or abandoned by the lessee at the termination of the lease. This provision does not apply if the lease is terminated because the building is razed.

Under **California law**, a taxpayer generally recovers the adjusted basis of property for purposes of determining gain or loss upon the disposition of the property. Upon the termination of a lease, the adjusted basis of leasehold improvements that were made, but are not retained, by a lessee are taken into account to compute gain or loss by the lessee.

The proper treatment of the adjusted basis of improvements made by a lessor upon termination of a lease is less clear. It was the position of the IRS prior to the SBJPA that leasehold improvements made by a lessor that constitute structural components of a building must continue to be depreciated in the same manner as the underlying real property, even if such improvements are retired at the end of the lease term. California concurs with the federal position.

Some lessors, prior to the passage of the SBJPA, were taking the position that a leasehold improvement is a property separate and distinct from the underlying building and that an abandonment loss is allowable at the end of the lease term for the adjusted basis of the leasehold improvement property.

This bill would conform California law to federal law codifying the treatment of leasehold improvements made by the lessor and disposed of or abandoned at the end of the lease term.

11. Depreciation under income forecast method.

Generally under **federal and California law**, the "income forecast" method is the depreciation method for certain property such as: motion picture and television films or shows, books, patents, master sound recordings and video games. Under the income forecast method, the depreciation deduction for a taxable year for a property is determined by multiplying the cost of the property (less estimated salvage value) by a fraction, the numerator of which is the income generated by the property during the year and the denominator is the totalforecasted or estimated income to be derived from the property during its useful life. In the case of a film, television show, or similar property, income includes, but is not necessarily limited to, income from foreign and domestic theatrical, television, and other releases and syndications and video tape releases, sales, rentals, and syndications

Under **federal law**, the SBJPA expanded the definition of "income" used in the computation, clarified what amounts are to be included in the cost of the property and provided for a "look back" rule for re-computing depreciation under certain conditions.

Income that is to be taken into account under the income forecast method includes all estimated income to be generated by the property. Generally, income expected to be generated after the close of the tenth taxable year after the year the property was placed in service is not taken into account. Income was expanded to include the financial exploitation of characters, designs, scripts, scores, and other incidental income associated with films or shows, but only to the extent the income is earned in connection with the ultimate use of such items by, or the ultimate sale of merchandise to, persons who are not related to the taxpayer.

Special rules are provided for a television series that initially is not anticipated to be syndicated.

The adjusted basis of property under the income forecast method only includes amounts that satisfy the economic performance test. For this purpose, if the taxpayer incurs a noncontingent liability to acquire, from another person, property subject to the income forecast method, economic performance will be deemed to occur with respect to such noncontingent liability when the property is provided to the taxpayer.

Any costs that are taken into account after the property is placed in service are treated as a separate piece of property to the extent (1) such amounts are significant and are expected to give rise to a significant increase in the income from the property that was not included in the estimated income from the property, or (2) such costs are incurred more than 10 years after the property was placed in service. To the extent costs are incurred more than 10 years after the property was placed in service and give rise to a separate piece of property for which no income is generated, such costs may be written off and deducted as they are incurred.

Any costs that are not recovered by the end of the tenth taxable year after the property was placed in service may be taken into account as depreciation in such year.

Taxpayers using the income forecast method are required to pay (or would receive) interest based on the recalculation of depreciation under a "look-back" method. The look-back method is applied in any "recomputation year" by (1) comparing depreciation deductions that had been claimed in prior periods to depreciation deductions that would have been claimed had the taxpayer used actual, rather than estimated, total income from the property; (2) determining the hypothetical overpayment or underpayment of tax based on this recalculated depreciation; and (3) applying the overpayment rate (interest rate on amounts owed by the IRS to taxpayers as refunds) as specified in the IRC. Property that has a cost basis of $100,000 or less is not subject to the look-back method.

Except as provided in Treasury regulations, a recomputation year is the third and tenth taxable year after the taxable year the property was placed in service.

The SBJPA provides a simplified look-back method for pass-through entities.

This bill would conform California law to the changes made to the federal income forecast method of depreciation by the SBJPA. This bill would provide that the interest paid or received under the look-back rule would be computed under the state statute in lieu of the federal rate.

12. Application of involuntary conversion rules to Presidentially declared disasters.

Generally under **California and federal law,** 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% 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. The taxpayer generally has two years from the date of the disposition of the converted property (or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is earlier) to replace the property.

Only involuntary conversions that result from destruction, theft, seizure, or condemnation (or threat or imminence thereof) are eligible for deferral under the involuntary conversion rules. The term "condemnation" refers to the process by which private property is taken for public use without the consent of the property owner but upon the award and payment of just compensation. 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) because the property is not ultimately held for public use, and the divestiture is not an involuntary conversion.

A gain from an involuntary conversion from property destroyed or damaged by a casualty or theft occurs when the insurance proceeds exceed the adjusted basis of the destroyed property in the hands of the taxpayer.

Additionally, **California and federal law** contains special provisions applicable to taxpayers whose principal residence (or any of its contents) is involuntarily converted as a result of a Presidentially declared disaster. In such cases, no gain is recognized by reason of the receipt of insurance proceeds for unscheduled personal property that was part of the contents of such residence. In the case of any other insurance proceeds for such residence or its contents, the proceeds may be treated as a common pool of funds. If such pool of funds is used to purchase any property similar or related in service or use to the converted residence (or its contents), the taxpayer may elect to recognize gain only to the extent that the amount of the pool of funds exceeds the cost of the replacement property. In addition, the replacement period is extended for property involuntarily converted as a result of a Presidentially declared disaster to four years after the close of the first taxable year in which any part of the gain upon conversion is realized.

Under **federal law**, if property held for productive use in a business or for investment is involuntarily converted as a result of a Presidentially declared disaster, any tangible property held for productive use in a trade or business qualifies as similar or replacement property (e.g., insurance proceeds from the destruction of store fixtures could be used to purchase a delivery vehicle). Business assets must be replaced under the general replacement period of two years.

California law has not conformed to federal law as its relates to the involuntary conversions of tangible business or investment property due to a Presidentially declared disaster.

This bill would conform California law to federal law relating to involuntary conversions as a result of of a Presidentially declared disaster without exception.

13. <u>Involuntary conversions and the repeal of nonrecognition on FCC sales and exchanges.</u>

The federal law relating to involuntary conversions was modified as follows:

a. Radio broadcasting stations

Prior to January 15, 1995, **federal law** provided that if the 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. This federal law was repealed in 1995.

California law still conforms to the elective involuntary conversion treatment of certain radio broadcasting stations; however, the FCC is no longer certifying sales or exchanges of radio broadcasting stations.

b. Related party transactions

In general, corporations (other than S corporations) and certain partnerships are not be entitled to defer gain if the replacement property or stock is purchased from a related person (as defined under the losses between related party in the IRC). An exception is provided where a taxpayer purchases replacement property or stock from a related person when the related person acquired the replacement property or stock from an unrelated person within the replacement period.

The provision applies to a partnership if more than 50% 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.

Current **California law** has not conformed to the federal law regarding involuntary conversions as they relate to related party transactions.

c. Microwave relocation

In 1993, Congress provided for the orderly transfer of frequencies, including frequencies that can be licensed under competitive bidding procedures. The FCC has adopted rules to conduct auctions for the award of more than 2,000 licenses to provide personal communications services (PCS). PCS would provide for the rapid increase of wireless communication devices, such as multi-function portable phones, portable facsimile and other imaging devices. 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 only operate on certain frequencies that are 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 for PCS. To accommodate PCS, the FCC has reallocated the spectrum. Current occupants of targeted 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 will not work at their new spectrum.

The FCC will employ a tax certificate program for PCS to encourage fixed microwave operators voluntarily to relocate from targeted band to clear the band for PCS technologies.

Beginning in 1995, **federal law** provides that sales or exchanges that are certified by the FCC as having been made by a taxpayer in connection with the FCC's reallocation of that spectrum for use by PCS will be treated as involuntary conversions.

Current **California law** has not conformed to the federal law regarding involuntary conversions as they relate to FCC certified microwave frequency sales or exchanges.

This bill would conform California law to federal law as it relates to involuntary conversions.

14. Basis adjustment to property held by a corporation where stock in the corporation is replacement property under involuntary conversion rules.

Under **federal and California law**, in general, 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 within a specified replacement period of time (normally two years).

The replacement property may be acquired directly or by acquiring control of a corporation (generally, 80% 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 not expended on replacement property or loss recognized on the conversion, and increased by the amount of any gain recognized on the conversion

Under current **federal law,** where the taxpayer satisfies the replacement property requirement by acquiring stock in a corporation, the corporation generally will reduce its adjusted bases in its assets by the amount by which the taxpayer reduces its basis in the stock. The corporation's adjusted bases in its assets will not be reduced, in the aggregate, below the taxpayer's basis in its stock (determined after the appropriate basis adjustment for the stock). In addition, the basis of any individual asset will not be reduced below zero. The basis reduction first is applied to: (1) property that is similar or related in service or use to the converted property, then (2) to other depreciable property, then (3) to other property.

Current **California law** allows replacement property to be acquired through a corporation and requires the taxpayer’s basis in the stock generally to be reduced by the amount any unrecognized gain. California does not require the reduction of the basis of the underlying assets. Thus, the reduction in the basis of the stock generally does not result in reduced depreciation deductions where the corporation holds depreciable property and may result in the taxpayer having more aggregate depreciable basis after the acquisition of replacement property than before the involuntary conversion.

This bill would conform state law to federal law and require a reduction in the basis of the underlying assets in a corporation acquired as replacement property under an involuntary conversion..

15. Provisions to prevent conversion of ordinary income into capital gain.

Federal law provides that capital gain from the disposition of property that was part of a "conversion transaction" is to be recharacterized as ordinary income, with certain limitations. A conversion transaction is a transaction, generally consisting of two or more positions taken with regard to the same or similar property, where substantially all of the taxpayer's return is attributable to the time value of the taxpayer's net investment in the transaction. In a conversion transaction, the taxpayer is in the economic position of a lender that has an expectation of a return from the transaction (which in substance is in the nature of interest) and he undertakes no significant risks other than those typical of a lender. However, a transaction is not a conversion transaction subject to this provision unless it also satisfies one of the following four criteria: (1) the transaction consists of the acquisition of property by the taxpayer and a substantially contemporaneous agreement to sell the same or substantially identical property in the future; (2) the transaction is a straddle; (3) the transaction is one that was marketed or sold to the taxpayer on the basis that it would have the economic characteristics of a loan, but the interest-like return would be taxed as capital gain; or (4) the transaction is described as a conversion transaction in regulations promulgated by the Secretary of the Treasury. Property or positions may be part of a conversion transaction, and transactions of options dealers and commodities traders in the normal course of their trade or business of dealing in options generally will not be considered to be conversion transactions, except as provided in special rules.

Federal law provides that gain realized by a taxpayer from a conversion transaction that would otherwise be treated as capital gain will be treated as ordinary income (but not as interest) for all purposes of the IRC. The amount of gain so recharacterized will not exceed the amount of interest that would have accrued on the taxpayer's net investment for the relevant period at a yield equal to 120% of the "applicable rate" (which is specified in the IRC).

Current California law does not contain a provision that would recharacterize any type of reported capital gain into ordinary income.

This bill would conform California law to the federal provisions regarding the recharacterization of the capital gain from a conversion transaction to ordinary income.

16. Repeal of certain exceptions to the market discount rules.

Generally, a market discount bond is a bond that is acquired for a price that is less than the principal amount of the bond. Market discount generally arises when the value of a debt obligation declines after issuance (typically, because of an increase in prevailing interest rates or a decline in the credit-worthiness of the borrower).

Under **federal law**, the gain on the disposition of a tax-exempt obligation or any other market discount bond purchased by the taxpayer after April 30, 1993 (regardless of the date the bond was issued), and acquired for a price that is less than the principal amount of the bond generally will be treated as ordinary income (instead of capital gain) to the extent of accrued market discount.

Current California law, gains from tax-exempt bonds and market discount bonds issued on or before July 18, 1984, are treated as capital gains if the bonds were held as capital assets.

This bill would conform state law to the federal provision treating gains from the disposition of bonds purchased after April 30, 1993 (regardless of the date the bond was issued), as ordinary income to the extent of the accrued market discount.

17. Accrual of income by holders of stripped preferred stock.

In general, if a bond is issued at a price approximately equal to its redemption price at maturity, the expected return to the holder of the bond is in the form of periodic interest payments. In the case of original issue discount (OID) bonds, however, the issue price is below the redemption price, and the holder receives part or all of the expected return in the form of price appreciation. The difference between the issue price and the redemption price is the OID, and a portion of the OID is required to be accrued and included in the income of the holder annually. Similarly, for certain preferred stock that is issued at a discount from its redemption price, a portion of the redemption premium must be included in income annually.

Under federal law a stripped bond (i.e., a bond issued with interest coupons some of which are subsequently "stripped" so that the ownership of the bond is separated from the ownership of the interest coupons) generally is treated as a bond issued with OID equal to (1) the stated redemption price of the bond at maturity minus (2) the amount paid for the stripped bond. Stripped preferred stock is stripped of some or all of its dividend rights. Stripped preferred stock purchased after April 30, 1993, is subject to the same rules that apply to stripped bonds or to the rules that apply to bonds and certain preferred stock issued at a discount.

Current California law is conformed to the federal treatment of stripped bonds: however, California has not conformed to the similar treatment of stripped preferred stock.

This bill would conform state law to the federal provision regarding the treatment of stripped preferred stock acquired after April 30, 1993.

18. Treatment of net capital gains as investment income.

Under **federal law** prior to 1993, and **current California law,** in the case of a taxpayer other than a corporation, deductions for interest on indebtedness that is allocable to property held for investment (investment interest) are limited to the taxpayer's net investment income for the taxable year. Disallowed investment interest is carried forward to the next taxable year. Investment income includes gross income from investment property and the sale or disposition of investment property.

Subsequent to 1992, under **federal law**, investment income generally does not include any capital gain from the disposition of property. An exception applies to taxpayers who elect to have the capital gain taxed at their regular tax rate (the federal highest regular tax rate is 38.5%: the highest tax rate on capital gains is 28%). Taxpayers who elect to use the regular tax rate may include the capital gain from the disposition of investment property as investment income.

California law has not conformed to the above provision and does not provide a differential tax rate between ordinary and capital gain income.

This bill would conform state law to federal law regarding the definition of net investment income.

19. Treatment of certain appreciated inventory distributions from partnerships.

Under **California and federal law**, amounts received by a partner in exchange for his interest in a partnership are treated as ordinary income to the extent they are attributable to substantially appreciated inventory of the partnership. In addition, distributions by a partnership in which a partner receives substantially appreciated inventory in exchange for his interest in certain other partnership property are treated as a taxable sale or exchange of property, rather than as a nontaxable distribution. For these purposes, inventory is treated as substantially appreciated if the value of the partnership's inventory exceeds 120% of its adjusted basis.

Current California law additionally requires that substantially appreciated inventory exceed 10% the value of all partnership property, other than money.

This bill would conform state law to federal law by removing the requirement that substantially appreciated inventory exceed 10% of the value of all partnership property, other than money.

20. Partnership distributions of marketable securities.

Under **federal law,** neither a partnership nor its partners generally recognize gain upon a distribution to a partner of partnership property other than cash and "marketable securities." A partner generally recognizes gain to the extent that the sum of the fair market value of marketable securities and money received exceeds the partner's basis in its partnership interest immediately before the distribution.

The value of the marketable securities is their fair market value as of the date of the distribution. Marketable securities generally means financial instruments and foreign currencies that, as of the date of the distribution, are actively traded. For purposes of the definition of marketable securities, a financial instrument includes financial products such as stocks and other equity interests, evidences of indebtedness, options, futures and forward contracts, notional principal contracts and derivatives. Marketable securities are treated as cash equivalents in this context. Additionally, federal law contains several provisions regarding expanding and contracting the definition of marketable securities, securities not marketable when acquired, securities contributed to the partnership by the distributee, and distributions by investment partnerships.

California law provides that the distribution of marketable securities from a partnership will not cause the recognition of gain by the partner. When the fair market value (FMV) of marketable securities exceeds the partner's basis in the partnership, the basis of the marketable securities in the hands of the partner is the partner's basis in the partnership immediately before the distribution and the partner's basis in the partnership is reduced to zero (after the distribution). The gain (FMV of the market securities minus the partner's basis in the partnership) is deferred until the partner disposes of the marketable security.

This bill would conform California law to federal law as it relates to partnership distributions of marketable securities to partners.

21. Treatment of dues paid to agricultural or horticultural organizations.

Under California and federal law, tax-exempt organizations generally are subject to the unrelated business income tax (‘UBIT’) on income derived from a trade or business regularly carried on that is not substantially related to the performance of the organization's tax-exempt functions.

Dues payments made to a membership organization generally are not subject to the UBIT. However, several courts have held that dues payments by “associate” members in postal labor organizations were subject to the UBIT when paid by non-postal workers for the purpose of obtaining health insurance available to members of the organization. Subsequent to the court cases and prior to 1996, the IRS released procedures stating that dues payments received by a labor, agricultural or horticultural exempt organization generally will be treated as subject to the UBIT.

A retroactive **federal law** was passed in 1996 which provides that if an agricultural or horticultural organization requires annual membership dues not exceeding $100, then in no event will any portion of those dues be subject to the UBIT by reason of any benefits or privileges to which members of such organization are entitled. For taxable years beginning after 1995, the $100 amount will be indexed for inflation. The term ‘dues’ is defined as “any payment required to be made in order to be recognized by the organization as a member of the organization.” This federal provision applies retroactively to taxable years beginning after December 31, 1986.

In general, **California law** conforms to the federal rules for UBIT as those rules read on January 1, 1993, but substitutes references to state law sections describing tax-exempt organizations in-lieu offederal references.

This bill would conform California law to federal law as it relates to exempt agricultural and horticultural organization’s treatment of dues and UBIT.

22. Treatment of housing provided to employees by academic health centers.

The SBJPA expanded the **federal law** definition of “educational institutions” by treating certain medical research institutions (academic health centers) that engage in basic and clinical research, have a regular faculty and teach a curriculum in basic and clinical research to students in attendance at the institution, as an educational institution. In addition, an entity organized under state law and composed of public educational institutions (university systems)will qualify as an educational institution.

California law is conformed to federal law as it read January 1, 1993, which provides that employees of an educational institution, as defined, do not have to include in income the fair market value of campus housing as long as the rent is at least 5% of the appraised value of the housing.

This bill would conform California law to federal by expanding the definition of an educational institution to include the above.

23. Exclusion for energy conservation subsidies limited to subsidies with respect to dwelling units.

Federal law provides an exclusion from the gross income of a customer of a public utility for the value of any subsidy provided by the utility for the purchase or installation of an energy conservation measure for that dwelling unit. In addition, for subsidies received after 1994, federal law provided a partial exclusion from gross income for property that is not a dwelling. For non-dwellings, the amount of the exclusion is 40% of the value for subsidies received in 1995, 50% of the value for subsidies received in 1996, and 65% of the value for subsidies received after 1996.

The SBJPA repealed the partial exclusion for any subsidy provided by a utility for the purchase or installation of an energy conservation measure with respect to property that is not a dwelling unit.

For amounts received before January 1, 1995, **California** partially conformed to this federal provision by allowing the exclusion for energy conservation subsidies on dwelling units only. For amounts received on or after January 1 1995, no exclusion is allowed.

This bill would conform state law to federal law regarding the exclusion from income of the amounts received from a public utility company for the installation of an energy conservation measure in dwelling units.

24. Nonrecognition treatment for certain transfers by common trust funds to regulated investment companies.

Under **federal and California law**, a common trust fund is a fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed by the bank in its capacity as a trustee or other fiduciary custodian of certain accounts and in conformity with rules and regulations of the Board of Governors of the Federal Reserve System or the Comptroller of the Currency pertaining to the collective investment of trust funds by national banks. The common trust fund is not subject to tax and is not treated as a corporation. Each participant in a common trust fund includes their proportional share of common trust fund income, regardless of whether the income is distributed or distributable. No gain or loss is realized by the fund upon admission or withdrawal of a participant. Participants generally treat their admission to the fund as the purchase of an interest. Withdrawals from the fund generally are treated as the sale of an interest by the participant.

A Regulated Investment Company (RIC) also is treated as a conduit for federal income tax purposes under certain circumstances. Conduit treatment is accorded by allowing the RIC a deduction for dividend distributions to its shareholders.

If specified dividends are not distributed, the RIC becomes taxable as a corporation.

Under **federal law**, a common trust fund can transfer substantially all of its assets to one or more RICs without gain or loss being recognized by the fund or its participants. The fund must transfer its assets to the RICs solely in exchange for shares of the RICs, and the fund must then distribute the RIC shares to the fund's participants in exchange for the participants' interests in the fund. The basis of any asset received by a RIC will be the basis of the asset in the hands of the fund prior to transfer (increased by the amount of gain recognized by reason of the rule regarding the assumption of liabilities). In addition, the basis of any RIC shares that are received by a fund participant will be an allocable portion of the participant's basis in the interests exchanged. If stock in more than one RIC is received in exchange for assets of a common trust fund, the basis of the shares in each RIC shall be determined by allocating the basis of common fund assets used in the exchange among the shares of each RIC received in the exchange on the basis of the respective fair market values of the RICs. The tax-free transfer is not available to a common trust fund with assets that are not diversified.

California law fully conforms to the federal rules for common trust funds as they read on January 1, 1993. California law (as was federal law prior to the change) is unclear as to the tax consequences when a common trust fund transfers its assets to one or more RICs.

This bill would conform state law to federal law regarding nonrecognition of gain or loss for transfers by common trust funds to RICs.

25. <u>Repeal of exclusion for punitive damages and for damages not attributable to physical injuries or sickness.</u>

Under **federal and California law**, gross income does not include any damages received (whether by suit or agreement and whether as lump-sum or as periodic payments) on account of personal injury or sickness. Prior to the passage of the SBJPA, courts differed in the treatment of punitive damages received on account of personal injury or sickness suits. The IRS issued rulings taking a position that punitive damages in general are not excludable from gross income. This was based on the narrow interpretation of the statute allowing compensatory damages due to physical injury or sickness to be excludable from gross income. California has followed the IRS rulings.

The exclusion from gross income specifically does not apply to amounts received as compensatory or punitive damages for non-physical injury or non-sickness cases.

Under **federal law**, the SBJPA codified the treatment of punitive damages received on account of physical injury or sickness. The SBJPA provides that generally punitive damages are not to be excluded from income.

The SBJPA also provides that the exclusion from gross income only applies to damages received on account of a personal physical injury or physical sickness. If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness regardless of whether the recipient of the damages is the injured party.

The SBJPA also specifically provides that emotional distress is not considered a physical injury or physical sickness. The exclusion from gross income does not apply to any damages received (other than for medical expenses to treat the emotional distress) based solely on a claim of emotional distress. This is because the damages are received on account of a non-physical injury or non-physical sickness.

The exclusion from gross income would apply to any damages received based on a claim of emotional distress that is attributable to a physical injury or physical sickness. In addition, the exclusion from gross income specifically applies to the amount of damages received that is not in excess of the amount paid for medical care attributable to emotional distress.

This bill would conform California law to the codified changes made by the SBJPA to the exclusion from gross income of damages received on account of personal injury or sickness. However, California has treated punitive damages as taxable under current law.

26. Merchant marine capital construction fund accounts.

Federal law provides for commercial fisherman and certain carriers to enter into an agreement with the U.S. Department of Commerce to deposit part of their earnings into a fund to acquire or construct vessels. Some carriers have used the funds to double hull their existing ships.

Federal law provides that deposits to the fund up to certain limits are deductible from income. Earnings on the deposits are deferred from income until the amounts are withdrawn. Qualified withdrawals are included in income. Disqualified withdrawals are generally taxed at the highest marginal tax rate. A vessel’s basis must be reduced under certain situations.

California law has not conformed to the above federal provision.

This bill would conform state law to federal law regarding the establishment, operation and closing of a merchant marine capital construction accounts. This bill would substitute the state’s highest marginal tax rate for the federal highest marginal tax rate.

27. Polish bonds exempt from original issue discount treatment.

Federal law provides special treatment of interest from bonds issued by Israel and Poland where the bonds have below-market interest.

California law conforms to the federal law in respect to the treatment of Israeli bonds. California has not conform to the federal treatment of Polish bonds.

This bill would conform state law to federal law regarding the treatment of Polish bonds issued at below-market interest rates.

28. Amortization of child care facilities.

Federal law from 1972 through 1981 allowed an election, for capital expenditures pertaining to child care facilities, to amortize expenses over five years (as opposed to a depreciable life of 30 years or more). This federal provision was repealed.

California law conformed to the provision allowing capital improvements to child care facilities to be amortized or depreciated over a five year period. The PITL conformed by date change and was repealed by date change in 1991. The B&CTL conformed to the federal provision with stand alone language. The B&CTL stand alone language is operative today.

This bill would conform state law to federal law by repealing the B&CTL provision allowing the election to depreciate child care facilities over five years.

29. Adoption assistance.

Federal law excludes a maximum $5,000 ($6,000 for certain special needs adoptions) from the gross income of an employee for qualified adoption expenses paid by the employer. The limit is a per child limit, not an annual limitation. The exclusion is phased out ratably for taxpayers with modified AGI above $75,000 and is fully phased out at $115,000 of modified AGI. Qualified adoption expenses are reasonable and necessary adoption fees, court costs, attorney fees and other expenses directly connected to the adoption of a child. Qualified adoption expenses do not include expenses incurred in violation of state or federal law, incurred in carrying out any surrogate parenting arrangement, or in connection with the adoption of a child of the taxpayer's spouse.

Federal law also allows a credit with a maximum $5,000 ($6,000 for certain special needs adoptions) for qualified adoption expenses paid or incurred by a taxpayer for the adoption of a qualified child .

California law does not have a comparable exclusion for qualified expenses paid or incurred by a employer on behalf of an employee adopting a child.

Since 1994, **California law** allows a credit equal to 50% of the cost of adopting a minor child who is an American citizen and is in the custody of a California public agency or a political subdivision of California. The maximum allowable credit can not exceed $2,500 per minor child.

This bill would conform California law to federal law as it relates to the exclusion from the gross income of an employee the qualified adoption expenses paid by the employer.

This bill would not conform California law to the federal adoption credit discussed above.

30. Exclusion of self-employed insurance benefits from income.

Federal law provides that payments for personal injury or sickness through an arrangement having the effect of accident or health insurance (and that is not merely a reimbursement arrangement) are excludable from income. In order for the exclusion to apply, the arrangement must be insurance (e.g., there must be adequate risk shifting). This provision equalizes the treatment of payments under commercial insurance and arrangements other than commercial insurance that have the effect of insurance. Under this provision, a self-employed individual who receives payments from such an arrangement could exclude the payments from income.

California law does not have a comparable provision that would exclude from gross income payments received by a self-employed individual through an arrangement having the effect of an accident or health insurance.

This bill would conform state law to federal law.

31. Long term care insurance and services.

Under **both federal and California law**, prior to the HIPAA and California's enactment of SB 38 in 1996, no explicit rules were provided for the tax treatment of premiums paid for long-term care insurance contracts or the expenses of long-term care services. Those long-term care expenses qualifying as medical expenses could be deducted under that provision. The medical expense deduction, however, is limited to expenses paid for the diagnosis, cure, mitigation, treatment, or prevention of disease (including prescription medicines or drugs and insulin) and the cost of transportation primarily for medical care. Medical insurance premiums are also deductible as medical expenses. These medical expenses are deductible as an itemized deduction to the extent that they exceed a floor of 7.5% of adjusted gross income.

Under **federal law**, HIPAA specifically allows a deduction for medical expenses for the unreimbursed expenses for qualified long-term care services provided to the taxpayer, the taxpayer's spouse or the taxpayer's dependents (subject to the present-law floor of 7.5% of adjusted gross income). Amounts received under a long-term care insurance contract (regardless of whether the contract reimburses expenses or pays benefits on a per diem or other periodic basis) are treated as reimbursement for expenses actually incurred for medical care.

Long-term care insurance premiums, like medical care insurance premiums, are explicitly treated as medical expenses and are deductible on a graduated scale based on the individual's age before the close of the taxable year. This scale ranges from $200 of premium being treated as medical expenses at age 40 to a maximum of $2,500 of premium being treated as medical expenses when the individual's age is more than 70.

Federal law also excludes from gross income of the employee employer contributions to accident and health plans, except for contributions to cafeteria plans or "flexible spending arrangements," as defined. In addition, the receipt of benefits from long-term care insurance is excluded from gross income.

Starting in 1997, SB 38 conformed **California law** to the new federal provisions which allow a deduction for medical expenses for the unreimbursed expenses of qualified long-term care services provided to the taxpayer, the taxpayer's spouse or the taxpayer's dependents (subject to the present-law floor of 7.5% of adjusted gross income) and provides that long-term care insurance premiums are explicitly treated as medical expenses and the same portion is deductible for state purposes as allowed under federal law.

California, however, **has not conformed to**: (1) the exclusion from income for certain employer contributions to an employee benefit plan; (2) the exclusion from income for benefits received under long-term care insurance; (3) the requirements on insurance companies issuing long-term care insurance; and (4) the reporting requirements contained in federal law (discussed in item 43 of this analysis).

This bill would conform state law to federal law regarding the four items mentioned above.

32. Exception to penalty for premature distribution from an IRA.

California and federal law provide for an exception to the 10% federal and 2.5% state penalty tax for a premature distribution from a tax deferred retirement account. The exception applies to premature distributions from a employer-sponsored pension plan used for medical expenses in excess of 7.5% of adjusted gross income (AGI).

Beginning in 1997, the **federal** exception was extended to premature distributions from IRAs used for medical expenses in excess of 7.5 percent of AGI. In addition, federal law provides that the 10-percent additional tax does not apply to withdrawals for medical insurance (without regard to the 7.5 percent of AGI floor) if the individual (including a self-employed individual) has received unemployment compensation under federal or state law for at least 12 weeks, and the withdrawal is made in the year such unemployment compensation is received or the following year. Special rules apply if a self-employed individual is not eligible for unemployment compensation under applicable law.

California law, as stated above, provides an exception only to the penalty tax for the premature distribution from qualified employer-sponsored pension plans for medical expenses in excess of 7.5 percent of AGI. California has not conformed to the two other exceptions.

This bill would conform state law to federal law regarding the exceptions to the penalty tax on early distributions from tax deferred pension plan arrangements.

33. Treatment of accelerated death benefits.

Federal law provides an exclusion from gross income as an amount paid by reason of the death of an insured for (1) amounts received under a life insurance contract and (2) amounts received for the sale or assignment of a life insurance contract to a qualified viatical settlement provider, provided that the insured under the life insurance contract is either terminally ill or chronically ill.

Since 1991, **California law** excludes from gross income certain advance payments received in exchange for a reduction of death benefits by a person having a terminal illness under a "living benefits" life insurance policy.

This bill would conform state law to federal law regarding exclusions of accelerated death benefits. This bill also would repeal the separate state election.

34. Repeal of $5,000 exclusion of employees' death benefits.

Under **federal law**, effective for individuals dying after August 20, 1996, the SBJPA repealed the $5,000 exclusion for employer-provided death benefits.

California law provides that the beneficiary or estate of a deceased employee generally can exclude up to $5,000 in benefits paid by or on behalf of an employer by reason of the employee's death

This bill would conform state law to federal law by eliminating the $5,000 exclusion paid by or on behalf of an employer by reason of the employee's death.

35. Reduction in compensation taken into account in determining contributions and benefits under qualified retirement plans.

Under **federal law** prior to 1994, and **current California law,** the amount of a participant's compensation that can be taken into account under a tax-qualified pension plan is limited. The limit applies for determining the amount of the employer's deduction for contributions to the plan as well as for determining the amount of the participant's benefits. The limit on includible compensation is $235,840 for 1993 and is adjusted annually for inflation. The limit in effect at the beginning of a plan year applies for the entire plan year.

Subsequent to 1993, under federal law, the compensation limit taken into account under a qualified plan is $150,000. This limit is indexed for inflation in increments of $10,000. Corresponding reductions to the $150,000 compensation limit will made to other provisions (e.g., individual retirement accounts) that also take into account the compensation limit under a qualified pension plan. **California law** has not conformed to the compensation limit reduction.

This bill would conform state law to federal law reducing the compensation limit to $150,000 for purposes of determining employer's deductions and participant's benefits under a tax-qualified pension plan and certain other provisions relating to compensation limits.

36. Treatment of excess pension assets used for retiree health benefits.

Under **state and federal law**, defined benefit pension plan assets generally may not revert to an employer prior to the termination of the plan and the satisfaction of all plan liabilities. Certain procedural requirements also must be met. Any assets that revert to the employer upon such termination are includible in the gross income of the employer and subject to an excise tax. Upon plan termination, the accrued benefits of all plan participants are required to be 100% vested.

Certain pension plans may provide medical benefits to retirees. Qualified transfers of certain excess assets from the pension plan for medical benefits of retirees are permitted. The assets transferred are not includible in the gross income of the employer and are not subject to the excise tax on reversions. Assets transferred in a qualified transfer cannot exceed certain limits. The amount that can otherwise be transferred is reduced by a percentage of the amount previously contributed to a health benefits account or welfare benefit fund to pay for the qualified current retiree health liabilities. The transferred assets (and any income thereon) are required to be used to pay qualified current retiree health liabilities for the taxable year of the transfer. Transferred amounts are generally required to benefit all participants in the pension plan who are entitled upon retirement to receive retiree medical benefits (other than key employees). Retiree health benefits of key employees may not be paid (directly or indirectly) from transferred assets. For the transfer to be qualified, accrued retirement benefits under the pension plan must be nonforfeitable as if the plan terminated on the date of transfer. Amounts not used to pay qualified current retiree health liabilities for the taxable year of the transfer are to be returned at the end of the taxable year to the general pension assets of the plan.

Under a maintenance of effort requirement, an employer that makes a transfer to a health benefits account from the defined benefit plan assets is required to maintain employer provided retiree health expenditures for covered retirees at a “minimum dollar level” for the taxable year of the transfer and the following 4 taxable years. The minimum dollar level of coverage that must be maintained will be based on coverage provided in the year immediately preceding the taxable year of the transfer.

Federal law allows for qualified transfers from a defined benefit plan to a retiree health benefits account made before taxable years beginning on or after January 1, 2001. Prior to GATT, qualified transfers from a defined benefit plan to a retiree health benefits account had to be made before taxable years beginning on or after January 1, 1996. GATT also change the requirement of minimum dollar level to be based on the preceding tax year as opposed to the preceding two tax years and clarified rules regarding the calculation of amounts previously contributed to a health benefits account.

California law was in full conformity with federal law regarding qualified transfers of excess pension assets used for retiree health benefits made prior to income years beginning on or after January 1, 1996.

This bill would conform state law to federal law regarding the qualified transfers of excess pension assets used for retiree health benefits

37. <u>Pension plan funding requirements and premiums</u>.

GATT made several changes to **federal law** as it relates to defined benefit plans funding effective for plan years beginning after December 31, 1994. Pension plan sponsors are required to meet their existing pension commitments in a reasonable period of time. Employers that sponsor both underfunded defined benefit pension plans and defined contribution plans are required to fully fund their underfunded defined benefit plans more rapidly. Plan sponsors are required to provide participants in defined benefit pension plans that are underfunded with a simple explanation each year of the extent to which the plan is underfunded and an explanation of which benefits will or will not be guaranteed by the PBGC, and the extent of the PBGC's guarantee, if the plan is terminated. The PBGC was empowered to better access to the records of certain troubled plans that it insures. The premium for underfunded plans was significantly raised through phases to insure high risk underfunded plans pay their fair share of premiums. The phase-in of higher premiums is to encourage underfunded plans to contribute more or otherwise reduce underfunding in order to avoid the payment of additional premiums.

California law is conformed as of January 1, 1993, by reference to federal law and does not have a state duplication of federal enforcement and regulation of pension plans by the Internal Revenue Service or the Department of Labor enforcement and regulation under ERISA.

This bill would conform California law to the changes made by GATT to the federal pension law provisions.

38. <u>Repeal of five-year income averaging for lump-sum distributions</u>.

Under **Federal law**, effective for years beginning after December 31, 1998, the SBJPA repeals the five-year averaging for lump-sum distributions from qualified plans, thus repealing the separate tax paid on a lump-sum distributions and the deduction from gross income for taxpayers who elect to pay the separate tax on a lump-sum distribution. Certain individuals still may elect ten-year averaging and capital gain treatment as provided under the Tax Reform Act of 1986.

California law is conformed to federal law as it read January 1, 1993, which provides in general that a distribution of benefits from a tax-favored retirement arrangement (i.e., a qualified plan, or qualified annuity plan) generally is includible in gross income in the year it is paid or distributed under the rules relating to the taxation of annuities. However, California provides a deduction from the amount taxable under federal law for the pre-1987 "California basis" (if any) in the qualified plan. "California basis" is the difference between the amount deductible on the federal and state tax returns for years prior to 1987. California law provides that lump-sum distributions from qualified plans and qualified annuity plans are eligible for special five-year forward averaging. In general, a lump-sum distribution is a distribution within one taxable year of the balance to the credit of an employee that becomes payable to the recipient first, on account of the death of the employee; second, after the employee attains age 59 1/2; third, on account of the employee's separation from service; or fourth, in the case of self-employed individuals, on account of disability. Lump-sum treatment is not available for distributions from a tax-sheltered annuity.

A taxpayer is permitted to make an election with respect to a lump-sum distribution received on or after the employee attains age 59 1/2 to use five-year forward income averaging under the tax rates in effect for the taxable year in which the distribution is made. In general, this election allows the taxpayer to pay a separate tax on the lump-sum distribution that approximates the tax that would be due if the lump-sum distribution were received in five equal installments. If the election is made, the taxpayer is entitled to deduct the amount of the lump-sum distribution from gross income. Only one such election on or after 59 1/2 may be made with respect to any employee.

Individuals who attained age 50 by January 1, 1986, can elect to use ten-year averaging in lieu of five-year averaging. In addition, such individuals may elect to retain capital gains treatment with respect to the pre-1974 portion of a lump sum distribution.

This bill would conform state law to federal law by repealing the five-year income averaging for lump-sum distributions. Certain individuals would still be able to elect ten-year averaging and capital gain treatment.

39. Establishment of savings incentive match plans for employees of small employers.

Under **federal law**, the SBJPA created a simplified retirement plan for small business called the “savings incentive match plan for employees” (SIMPLE) retirement plan. SIMPLE plans can be adopted by employers who employ 100 or fewer employees with at least $5,000 in compensation for the preceding year and who do not maintain another employer-sponsored retirement plan. Employers who no longer qualify are given a two-year grace period to continue to maintain the plan. A SIMPLE plan can be either an “individual retirement account” IRA for each employee or part of a qualified cash or deferred arrangement (“401(k) plan”). Generally, if established under an IRA, SIMPLE plans are not subject to the nondiscrimination rules that are applicable to other qualified plans. If adopted as part of a 401(k) plan, SIMPLE plans are not subject to the top-heavy nondiscrimination rules, but are subject to other nondiscrimination tests applicable to 401(k) plans.

An employee can elect to defer up to $6,000 per year in a SIMPLE plan, and this amount will be indexed for inflation in the future. Under a IRA established plan, the employer generally is required to match up to $6,000 per year of the employee elective contributions on a dollar-for-dollar basis up to 3% of the employee's compensation. Under a special rule, the employer can elect a lower percentage matching contribution for all employees (but not less than 1% of each employee's compensation). A lower percentage cannot be elected for more than two out of any five years. Under a 401(k) SIMPLE plan a safe harbor rule may apply and is satisfied if, for the year, the employer does not maintain another qualified plan and (1) employees' elective deferrals are limited to no more than $6,000, (2) the employer matches employees' elective deferrals up to 3% of compensation (or, alternatively, makes a 2% of compensation nonelective contribution on behalf of all eligible employees with at least $5,000 in compensation), and (3) no other contributions are made to the arrangement. The employer cannot reduce the matching percentage below 3% of the employee’s compensation.

All contributions to an employee's SIMPLE account have to be fully vested.

Contributions to a SIMPLE account generally are deductible by the employer. In the case of matching contributions, the employer is allowed a deduction for a year only if the contributions are made by the due date (including extensions) for the employer's tax return. Contributions to a SIMPLE account are excludable from the employee's income. SIMPLE accounts are not subject to tax. Distributions from a SIMPLE plan are includible in taxable income when withdrawn. Early withdrawals from a SIMPLE plan are subject to the 10% early withdrawal tax applicable to all (with exceptions) salary reduction pension plans; however, early withdrawals within the two-year period beginning on the date the employee first participated in the SIMPLE plan are subject to a 25% early withdrawal tax.

The SBJPA repealed "salary reduction simplified employee pensions" (SARSEPs). Under SARSEPs, which are not qualified plans, employees could have elected to have contributions made to the SARSEP or to receive the contributions in cash. The amount the employee elected to have contributed to the SARSEP was not currently includible in income.

California law does not contain rules relating to SIMPLE retirement plans. However, state law does provide a number of ways in which individuals can save for retirement on a tax-favored basis. These include employer-sponsored retirement plans that meet the requirements of the Internal Revenue Code (a 'qualified plan'), IRAs, and SARSEPs. In order to receive tax-favored treatment, such plans must comply with a variety of rules, including complex nondiscrimination and administrative rules (including top-heavy rules). Early withdrawals from an IRA generally are subject to a 2% early withdrawal tax instead of the 10% federal early withdrawal tax.

This bill would conform state law to federal law regarding the establishment of SIMPLE plans and the repeal of SARSEP plans. This bill would assess a 6% tax, in lieu of the federal 25% rate, on early withdrawals made by an employee within the first two years after the employee first participated in the SIMPLE plan.

40. Other pension plan provisions.

This bill will conform to 22 other pension related provisions that have been enacted by the federal government subsequent to January 1, 1993, and have not been previously discussed in this analysis or conformed to in a prior state act. Except for tax rates and the imposition of some excise taxes California was in full conformity to the various pension provisions as of January 1, 1993. California does not have a separate program dedicated to monitoring and enforcing pension plan rules. By being fully conformed to the federal provisions, California benefits from the federal government's monitoring and enforcement of pension plans.

The 22 additional items this bill would conform to are:

a. Simplified method of taxing annuity distributions.
   If a taxpayer made after-tax contributions to a retirement plan, the portion of the distribution that represents return of these after-tax contributions is not taxable. The simplified method excludes from income a portion of each annuity equal to the recipient's original after-tax investment, divided by an expected number of payments. The number of expected payments is based on the taxpayer's age.

b. Age at which pension distributions are required.
   Under prior law, distributions from pension plans and IRAs had to begin by age 70 ½, even if the individual was still working. The new federal law states that an individual aged 70 ½ who has not yet retired is not required to take a distribution from a pension plan. Distributions are still required from an IRA.

c. Tax-exempt organizations permited to offer 401(k) plans.

This provision removes the prohibition on 401(k) plans for tax-exempt organizations. States and local governments are still prohibited from forming 401(k) plans unless they had elected to do so before May 1986.

d. Definition of highly-compensated employee changed.
This provision changes the definition of "highly compensated employee" – which is used to test if benefits plans discriminate in favor of higher-paid employees – from an employee who received more than $100,000 in compensation or who received more than $66,000 and was one of the top 20% in pay of all employees to an employee who received more than $80,000 of pay in the prior year and was in the top 20% of pay. The $80,000 amount shall be adjusted for inflation in the future. The old rule that required the highest paid officer to be treated as a highly compensated employee was repealed.

e. Modification of participation requirements.
Under prior law, a retirement plan was not qualified for tax benefits unless it benefited the lesser of 50 employees or 40% of all employees. The SBJPA changed the minimum participation rule only as it applies to defined benefit plans. The participation rule is changed so that at least two employees (one employee if the firm has only one employee) must participate.

f. 401(k) nondiscrimination rules.
The new law allows the nondiscrimination tests to be based on prior-year, rather than current-year, deferrals made by non-highly-compensated employees.

g. Compensation definition.
Changed the definition of compensation to include deferrals made to a 401(k) or 457 plan or a cafeteria plan.

h. Plans for self-employed individuals.
Eliminates special aggregation rules for retirement plans maintained by self-employed individuals.

i. Distributions for rural co-operative.
Expanded the definition of rural co-operative to include public utility district. Allows rural co-operative retirement plans to permit distributions after age 59 ½ or on account of hardship.

j. Treatment of governmental pension plans.
Modifies limits on contributions and benefits in defined benefit plans.

k. Contributions for disabled employees.
Allows continued contributions on behalf of permanently and totally disabled employees if they are highly compensated if continued contributions are available for all employees who become permanently and totally disabled.

l. Deferred compensation for government and tax-exempt organizations.
Allows indexing (in $500 increments) of the dollar limit on contributions to 457 plans.

m. Trust requirement for 457 plans.
Requires that 457 retirement plans held by government employers be held in trust for the exclusive benefit of its employees.

n. Interest rate assumptions in the GATT bill.

Corrects interest rate and actuarial assumptions used in adjusting benefits and retirement limitations that were originally contained in GATT legislation. This bill adopts the federal correction.

o. Salary reduction agreements under 403(b).
Uses the same rules relating to compensation limits for salary reduction agreements that are used for 401(k) arrangements.

p. Waive 30-day period for distributions.
Under prior law, there was a minimum waiting period between the time an explanation of the benefits available under a joint and survivor annuity was sent and the annuity starting date. The new law waives the waiting period if waived by the participant and if applicable, the participant's spouse.

q. Repeal combined plan limit.
Repeals overall limits on contributions and benefits if individual participates in both a defined benefit plan and a defined contribution plan. This change is effective in the year 2000.

r. Volunteer firefighters.
Clarifies that 457 plan requirements do not apply to length-of-service awards to volunteers.

s. Alternative nondiscrimination rules.
Makes technical changes to nondiscrimination rules used in certain pension plans.

t. Pension plans for self-employed clergy.
Allows self-employed ministers to set up a qualified church pension plan.

u. Church pension plans.
Makes technical changes to pension plans administered by churches.

v. Indexing of amounts for 401(k), employee annuities and IRAs.
Under the 1993 RRA: (1) the dollar limit on benefits under a defined benefit pension plan is indexed in $5,000 increments, (2) the dollar limit on annual additions under a defined contribution plan is indexed in $5,000 increments, (3) the limit on elective deferrals is indexed in $500 increments, and (4) the minimum compensation limit for SEP participation is indexed in $50 increments. In addition, the provision provides that the cost-of-living adjustment with respect to any calendar year is based on the increase in the applicable index as of the close of the calendar quarter ending September 30 of the preceding calendar year so that the adjusted dollar limits would be available before the beginning of the calendar year to which they apply. No limit is reduced below the limit in effect for plan years beginning in 1994.

41. <u>Financial asset securitization investment trusts.</u>

Effective September 1, 1997, the SBJPA creates a new type of statutory entity called a "financial asset securitization investment trust" (FASIT) to facilitate the securitization of debt obligations such as credit card receivables, home equity loans, and auto loans. An entity must elect to be treated as a FASIT and cannot terminate that election without the consent of the IRS. A FASIT is not subject to tax and is not treated as partnership, trust, corporation, or taxable mortgage pool. Interests in a FASIT can only be held by one “ownership interest” and by one or more “regular interests.” The holder of ownership interest is taxed on the income of the FASIT. A regular interest is treated as a debt instrument and amounts includible in gross income with respect to such interest shall be determined under the accrual method of accounting.

The ownership interest must be designated as such and be held by an eligible domestic C corporation. The C corporation cannot be exempt from tax, a REIT, RIC, REMIC or a cooperative. All assets, liabilities, and items of income, gain, deduction, loss and credit of the FASIT are treated as those of the holder of the ownership interest. The Secretary of the Treasury may prescribe regulations to defer gain with respect to property that supports any regular interest in a FASIT.

A regular interest entitles the holder to an unconditional specified principal amount and is treated as a debt instrument of the FASIT. The issue price for the regular interest cannot be more than 125% of the principal amount. The regular interest cannot have a maturity date in excess of 30 years. Special rules apply based on the interest rate specified.

A FASIT is permitted to hold: 1) cash or cash equivalents, 2) certain debt instruments, 3) contract rights to acquire debt instruments, 4) certain foreclosure property, 5) certain letters of credit, and 6) any “regular interest” in another FASIT or REMIC.

A 100% excise tax is assessed on the holder of the ownership interest on the net income from a “prohibited transaction”. A prohibited transaction is defined as the receipt of income derived from 1) an asset that is not a permitted asset, 2) the disposition of certain assets, 3) any loan originated by the FASIT, and 4) compensation from certain services or fees.

For alternative minimum tax purposes, the alternative minimum taxable income (AMTI) of the holder of the ownership interest or a high-yield interest is computed without regard to the income of the FASIT; however, the AMTI of the ownership interest holder cannot be less than the FASIT’s net income.

The SBJPA made nine conforming amendments to other provisions of the Internal Revenue Code (IRC) to make a FASIT’s treatment consistent with the treatment of a REMIC under current law. A transition rule applies for entities that were in existence between June 10, 1996, and August 31, 1997, that subsequently elect to be treated as a FASIT. Under this transition rule, gain is not recognized on property contributed to the FASIT by the holder of the ownership interest to the extent the property is allocable to interests issued prior to August 31, 1997.

California law does not provide for a statutory entity that facilitates the securitization of revolving, non-mortgage debt obligations. California law does provide for securitization of mortgage or trust deed debt obligations through a REMIC or REIT.

This bill would conform state law to federal law by adopting the federal provisions regarding FASITs with exceptions. This bill would provide that all the activities of a FASIT are to be treated as activities of the holder of the ownership interest and a FASIT would be subject to the minimum franchise tax (presently $800). This bill also would provide that no excise tax is imposed on the net income of a prohibited transaction, however, the net income from a prohibited transaction is included in the income of the holder of the ownership interest. Additionally, this bill would make the applicable conforming amendments and allow the transitional rule.

Elections made for federal purposes are generally treated as being made in the same manner for state purposes. Therefore, under **this bill,** if an entity makes an election to be a FASIT for federal purposes, it would automatically be a FASIT for state purposes unless a separate election is filed requesting separate treatment. For purposes of determining whether the holder of the ownership's interest in the FASIT is "doing business" in California, the activities of the FASIT shall be attributed to the holder.

This provision of the bill would have the same effective date as federal of September 1, 1997.

42. Copy of federal form 5471 required to be attached to California tax return.

Federal law requires each United States taxpayer, who controls a foreign corporation, to file an information return containing specific information about the foreign corporation such as post 1986 undistributed earnings, a balance sheet and related party transactions. Federal law provides for a penalty of $1,000 for failure to file the information return. An additional penalty is assessed if the taxpayer fails to furnish the information return 90 days after the taxpayer has being notified of the original failure. The additional penalty is $1,000 for each 30 day period or fraction thereof after the 90 day period. The total penalty that may be assessed for failure to file the information return is $25,000.

California has no comparable law.

For income years beginning on or after January 1, 1997, **this bill** would require a taxpayer to attach a copy of the federal form to the California tax return. This bill also would provide for a penalty, computed under federal law, for failure to attach a copy of the federal form to the California tax return. The penalty would not apply until income years beginning on or after January 1, 1998. The penalty would not be assessed if the failure was due to reasonable cause, the taxpayer provides a copy of the form within 90 days of request from the FTB and the taxpayer agrees to attach a correct copy for subsequent years to all subsequent timely filed tax returns.

43. Certain informational returns.

Generally, persons engaged in a trade or business are required to report certain activities with third parties on information returns to the IRS. Information returns include but are not limited to the payment or receipt of interest, receipt of services, the payment of rent, royalties, salaries or wages and sale of partnership interest. Treasury regulations provide that payments for "merchandise" are not required to be reported on information returns. Generally, the third party identified in the information return must receive a copy of the return. The information return must contain pertinent information regarding the person filing the return and certain information relating to the third party (e.g., amount paid or received and the third party's taxpayer identification number).

Under current **California law,** the FTB may request from the return filer copies of several different information returns filed by a taxpayer with the IRS. **This bill** would add three additional returns that are presently being filed with the IRS to be filed with the FTB upon request by the FTB.

Returns relating to the cancellation of indebtedness by certain financial entities:

A taxpayer's gross income includes income from the discharge of indebtedness. The IRC requires lenders to file information returns with respect to discharged debt. The determination of when a discharge of indebtedness occurs is a question of fact. In general, a debtor has discharge of indebtedness income where a debt is repurchased, extinguished, or otherwise deemed satisfied for less than its outstanding balance. Discharge of indebtedness income is generally not deemed to result merely because the lender (1) has not actively pursued its claim against the debtor, provided a legal claim still exists, (2) claims a deduction for financial or regulatory reporting purposes, or (3) claims a partial or full bad debt deduction for tax purposes. However, the existence of several factors such as these may, when considered collectively, indicate that a discharge of indebtedness has occurred.

Certain "applicable financial entities" are required to file information returns with the IRS regarding any discharge of indebtedness of $600 or more, including the amount of debt discharged and the date on which the debt was discharged. Such information returns are required regardless of whether the debtor is subject to tax on the discharged debt. Financial institutions and agencies are not required to determine whether the debtor qualifies for an exclusion from including the cancellation of debt in income.

Returns relating to the purchasers of fish:

Beginning in 1998, persons engaged in the trade or business of purchasing fish for resale who pay more than $600 in cash in a calendar year for fish or other forms of aquatic life from any seller engaged in the trade or business of catching fish are required to file information reports with the Secretary regarding those purchases.

Returns relating to long term care benefits:

Payors of long term care benefits are required to file information returns on persons receiving the benefits and are also required to report the type of policy under which the payments are made.

Federal law generally provides for penalties for failing to file the information returns and/or providing a copy to the third party. Generally, the penalty is $50 for each return not or incorrectly filed with a maximum of $250,000 per year.

This bill also would impose penalties ($50 for each omission) for not filing information returns and/or providing a copy to the FTB upon request or for not providing a copy to the third party (normally the recipient).

44. <u>Modifications to accuracy-related penalty</u>.

California and federal laws provide for a 20% accuracy related penalty for any portion of an underpayment of tax required to be shown on a return that is due to one or more of the following: (a) negligence or disregard of rules or regulations, (b) any substantial understatement of income tax, (c) any substantial valuation misstatement of property or services, or (d) any substantial overstatement of pension liabilities.

Subsequent to 1993, federal law regarding items (b) and (c) above were modified. Prior to the modifications, the rules were:

> Substantial understatement of income tax.
> An understatement is considered "substantial" if it exceeds the greater of 10% of the tax required to be shown on the return or $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company). Generally, the amount of an "understatement" of income tax is the excess of the tax required to be shown on the return, over the tax actually shown on the return (reduced by any rebates of tax). The substantial understatement penalty does not apply if there was a reasonable cause for the understatement and the taxpayer acted in good faith with respect to the understatement (the "reasonable cause exception"). The determination as to whether the taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. Additionally, in determining whether an understatement is substantial, the understatement generally is reduced by the portion of the understatement that is attributable to an item for which there was substantial authority or adequate disclosure. In the case of tax shelter items, however, the understatement is reduced only by the portion of the understatement that is attributable to an item for which there was substantial authority and, with respect to which, the taxpayer reasonably believed that the claimed treatment of the item was more likely than not the proper treatment. Disclosure made with respect to a tax shelter item does not affect the amount of an understatement.
>
> Substantial valuation misstatement of property or services.
> A substantial valuation misstatement occurs if property is valued at 200% or more than the correct valuation or the net "section 482 transfer price adjustment" for the taxable year exceeds $10 million. The law provides for an analogous "gross valuation misstatement" which is a 400% or more overstatement of value or a net section 482 transfer price adjustment of $20 million. The net section 482 transfer price adjustment is the net increase in taxable income for a taxable year resulting from adjustments under section 482 in the price for any property or services (or use of property). However, a net increase in taxable income attributable to a price redetermination is disregarded, for this purpose, if it is shown that there was a reasonable cause for the taxpayer's determination of the price, and that the taxpayer acted in good faith with respect to the price.
> A "substantial" valuation misstatement results in a penalty of 20% of the understatement of tax attributable to the substantial valuation misstatement. The penalty for a "gross" valuation misstatement is 40% of the tax understatement. No valuation misstatement penalty is imposed if it is shown that there was reasonable cause for the underpayment and that the taxpayer acted in good faith.

California is in conformity to the above rules with respect to valuation misstatement of the accuracy-related penalty.

The **federal law** changes regarding the two items above involves more stringent disclosure requirements and the lowering of the threshold for the net section 482 adjustments. The adequate disclosure exception now also requires a taxpayer to have a "reasonable basis" for the tax treatment. Reasonable basis has not been defined in the IRC; however, Congress, in the committee report, stated that it is to "be a relatively high standard of tax reporting, that is significantly higher than patently improper." Additionally, corporations involved in tax shelters may no longer use the substantial authority exception to avoid the penalty; it may now use only the reasonable cause exception.

The threshold for the net section 482 adjustment has been lowered from $10 million to $5 million for substantial valuation misstatement. The gross valuation misstatement for a net section 482 adjustment remains the same at $20 million.

California law has not conformed to these changes.

This bill would conform California law to federal law as it relates to the accuracy-related penalty.

45. <u>Individual estimated tax safe harbor based on last year's tax</u>.

Under **federal law**, an individual taxpayer generally is subject to an addition to tax for any underpayment of estimated tax. Income tax withholding from wages is considered to be a payment of estimated taxes. An individual generally does not have an underpayment of estimated tax if he or she makes timely estimated tax payments at least equal to:

1) 90% of the tax shown on the return for the current year, or

2) 100% of the tax shown on the return of the individual for the preceding year. The Taxpayer Relief Act of 1997 (P.L. 105-34) revised the special rule affecting taxpayers with AGI over $150,000 ($75,000 if married filing a separate return). Effective for the 1997 tax year, 110% of the tax shown on the preceding year's return is required. For 1998, 100% of the preceding years tax is required. For tax years 1999 through 2001, 105% is required. For tax years 2002 and 2003, 112% and 110% is required, respectively. Prior to the enactment of P.L. 105-34, federal law required taxpayers with AGI in excess of %150,000 to make payments of 110% for tax years 1997, and thereafter.

For estimated tax purposes, some trusts and estates are treated as individuals.

Current California law conforms, in general, with federal rules relating to the payment of estimated tax by individuals. However, there are several significant differences:

- The "required payment" is based upon 80% of the current year tax instead of 90%.
- The "required payment" does not include alternative minimum tax.

- Estimated payments are required, unless the tax due for the year is less than $100.
- No penalty will be assessed if 80% of the current or prior year tax is subject to withholding.
- No penalty will be assessed if 80% of the adjusted gross income consists of wages subject to withholding.
- California provides for 100% of the preceding year's tax paid exception, but does not require 110% of the preceding year's tax to be paid if the taxpayer's AGI is over $150,000 ($75,000 if married filing a separate return).

This bill would require taxpayers with AGI greater than $150,000 ($75,000 if married filing a separate return) to pay 11%0 of the preceding year's tax liability for 1997, 100% for 1998 and 110% thereafter to qualify under the preceding tax year exception to the underpayment of estimated tax penalty. Because of the waiver of estimated tax penalty provision contained in this bill (item 47), effectively, only 100% of the prior year's liability for the 1997 tax year needs to be paid to qualify for the exception.

46. Corporate estimated tax rules.

Under **federal law**, a corporation is subject to an addition to tax (a penalty) for any underpayment of estimated tax. To avoid the penalty, a corporation is required to base its estimated tax payments on 100% (prior to 1993, 97% applied) of the tax shown on its return for the current year, whether such tax is determined on an actual or annualized basis. For certain small corporations there is also an exception to the penalty if the small corporation makes four timely estimated tax payments each equal to at least 25 percent of the tax liability shown on its return for the preceding taxable year.

California law generally conforms to the corporate estimated tax. Prior to 1996, to avoid the penalty, a corporation was required to base its estimated tax payments on 95% of the tax shown on its return for the current year. In 1996, a phased-in conformity was enacted which replaced the 95% with 98% for years beginning in 1998 and to 100% for years beginning on or after January 1, 1999. California conforms to the small corporation federal exception noted above.

California law additionally requires that the first estimated tax payment be at least equal to the minimum tax amount of $800.

Effective for income years beginning on or after January 1, 1998, **this bill** would conform state law to federal law by requiring corporations to make estimated tax payments based on 100% of its actual or annualized income.

47. Waiver of estimated tax penalty.

This bill would waive additions to tax imposed for any underpayments of tax or estimated tax for any period before April 15, 1998, with respect to any underpayment for the 1997 taxable or income year to the extent the underpayment was created or increased by any provision of this bill.

48. <u>Contributions in aid of construction</u>.

Under federal law, a shareholder's contribution to capital of a corporation is not income to the corporation. Generally, contributions to capital of a corporation do not include contributions in aid of construction (CIAC) by customers or potential customers. An exception is provided for CIAC made to regulated public water and sewerage disposal utilities. In order for the CIAC not to be considered income the contribution must be used within two taxable years of receipt to acquire tangible property used 80% or more to furnish water or sewerage disposal services. The amount of the CIAC can not be included in the public utility's rate base for rate-making purposes.

Under the B&CTL, California law is conformed to federal law as it read January 1, 1993, thus, the gross income of a corporation does not include contributions to its capital. A contribution to the capital of a corporation does not include any contribution in aid of construction or any other contribution as a customer or potential customer. Therefore, the receipt by a utility of a contribution in aid of construction is includible in the gross income of the utility, and the basis of property received or constructed pursuant to the contribution is not reduced.

This bill would conform the B&CTL to federal law relating to contributions in aid of construction made to regulated public water and sewerage disposal utilities.

49. <u>Publicly Traded Partnerships continuation of partnership treatment</u>.

The federal Revenue Reconciliation Act of 1987 created publicly traded partnerships (PTP) (California conformed without exception in 1990). Under **both current** federal and California law, a PTP is a partnership whose interests are (1) traded on an established securities market or (2) "readily tradable on a secondary market" (or the substantial equivalent thereof). Generally, an interest is treated as readily tradable on a secondary market or the substantial equivalent if, taking into account all of the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market.

A PTP generally is treated as a corporation for tax purposes (taxed as a corporation). An exception to this rule applies if 90% of the partnership's gross income consists of passive-type income, which includes (1) certain interest, (2) dividends, (3) certain real property rents, (4) gain from the sale or other disposition of real property, (5) certain income and gains relating to minerals and natural resources, and (6) gain from the sale or disposition of certain assets held for the production of income of the foregoing types (subject to an exception for certain commodities income). Other rules apply to "regulated investment companies" (RICs).

When the federal PTP rules were enacted in 1987, a 10-year grandfather rule provided that corporate tax treatment would not apply to certain "existingPTPs" for taxable years beginning before January 1, 1998. An existing PTP is any partnership if (1) it was a PTP on December 17, 1987, (2) a registration statement indicating that the partnership was to be a PTP was filed with the Securities and Exchange Commission with respect to the partnership on or before December 17, 1987, or (3) with respect to the partnership, 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 otherwise would be treated as an existing PTP ceases to be so treated as of the first day after December 17, 1987, on which there has been an addition of a substantial new line of business with respect to such partnership. A coordination rule (between the grandfather rule and the 90% of passive-type income exception) provides that the gross income exception applies only after the grandfather rule expires.

Effective for taxable years beginning after December 31, 1997, **federal law** provides that an "existing PTP" that is presently exempt from corporate tax under the grandfather rule may elect to continue its partnership status indefinitely. An "electing 1987 partnership" would lose its partnership status on the first day it adds a substantial new line of business. A PTP that previously used the 90% of passive-type income exception cannot elect to continue to be treated as a partnership (but still may qualify for the 90% of passive-type income exception).

Federal law provides that an electing 1987 partnership must consent to pay an annual tax of 3.5% of its trade or business gross income. The tax cannot be offset by any credits. Trade or business gross income includes the electing 1987 partnership's distributive share of the trade or business income of any other partnership in which the electing 1987 partnership has an interest. A similar rule applies to lower-tiered partnerships. The election to remain a partnership and the consent to be taxed on gross income remains in effect until revoked by the partnership (the Internal Revenue Service's consent is not required). Once revoked, the election cannot be reinstated.

Current California law has not conformed to the changes made by the Taxpayer Relief Act of 1997 as it relates to electing 1987 partnerships. Under present California law, PTPs that were "grandfathered in" and treated as a partnership for California purposes will be taxed as corporations effective for income years beginning on or after January 1, 1998.

The September 5, 1997, amendment to **this bill** would conform California law to federal law as it relates to electing 1987 partnerships, with one exception. In lieu of the 3.5% federal tax, a 1% tax on trade or business gross income would be assessed. This bill would also require that the federal treatment of a PTP (corporation or partnership) be binding for California tax law. A separate state election would not be allowed.

50. <u>S corporation conformity.</u>

This bill contains provisions that would conform California law to federal law as it relates to S corporations. However, these provisions would only become operative if SB 5 is enacted into law. SB 5 would conform state law to federal law as it relates to S corporation law and more particularly to the changes made by the SBJPA to federal S corporation tax law. This bill has taken the provisions of SB 5, which is written in "stand alone" conformity language, and rewrote the provisions to "date change" conformity language.

51. <u>Other federal changes not being conformed to by this bill</u>.

This bill does not conform to the following federal income tax law changes that have occurred subsequent to January 1, 1993, which may impact California's income tax laws and to which California has not conformed in any other act:

a. The creation of or changes in all tax credits including: work opportunity, adoption assistance, targeted jobs, research and development,biomass, orphan drug, Indian employment, and earned income tax credits.

b. Until May 31, 1997, federal law permitted a charitable contribution deduction for contributions of appreciated stock to certain private foundations of the full fair market value of appreciated stock that is listed on a established securities exchange market. California generally only allows the basis of that stock as a charitable contribution.

c. Federal law provides that the dependent exemption and other tax benefits conditioned on having a dependent can be denied if the taxpayer does not provide the proper taxpayer identification number (TIN) for the dependent. California does not require a dependent's TIN be shown on the return and does not deny dependent credits or other tax benefits for lack of a dependents TIN.

d. Under federal law, beginning in 1996, thrift savings associations can no longer use reserve method for accounting for their bad debts. Presently, the only financial type institution that may use the reserve method of accounting for bad debts under federal law is small banks (assets under $500 million). California allows all financial institutions to use the reserve method of accounting. California does not distinguish between large or small banks, savings and loans or thrifts for purposes of the reserve method of accounting.

e. Federal law allows tax-exempt status to a qualified state tuition program and under certain conditions amounts distributed are not included in the gross income of the beneficiary of the program. California has no comparable provisions.

f. Beginning in 1997, federal law allows a self-employed individual to deduct from gross income 40% of their health insurance cost. The 40% will increase gradually to 80% in the year 2006. California permits 25% of a self-employed person's health insurance cost to be deducted from gross income.

g. Under federal law, the passive activity limitations (PAL) and rules do not apply to taxpayers who are substantially engaged in a real property trade or business. Under California law taxpayers, otherwise subject toPALs, substantially engaged in rental real estate activities is currently subject to PALs.

h. Federal law does not require the unrecognized gain portion of a charitable contribution of appreciated capital gain property be treated as an alternative minimum tax preference item. California treats this item as a preference item.

i. Federal law provides that for purposes of the regular and alternative minimum tax, the otherwise allowable deduction for compensation paid or accrued with respect to a covered employee of a publicly held corporation is limited to no more than $1 million per year. California allows the deduction for reasonable compensation to exceed $1 million per year.

j. Federal law does not permit a deduction for any amount paid or incurred in connection with (1) influencing federal or state legislation (2) any communication with certain covered Federal executive branch officials in an attempt to influence the official actions or positions of such officials, (3) business deductions for expenses of grass roots lobbying and participation in political campaigns, or (4) lobbying of foreign governments. California law is conformed to items three and four only.

k. Federal law allows a shorter depreciable life for property used in a trade or business conducted within an Indian reservation. California law does not provide for special depreciation for trades or businesses conducted on a Indian reservation.

l. Under federal law no deduction is allowed for club dues, including but not limited to business, social, athletic, luncheon, or sporting clubs. Specific business expenses (e.g., meals) incurred at the club are deductible if they are otherwise deductible. California permits the deduction of club dues if the expense is primarily for the furtherance of the taxpayer’s trade or business and the club does not restrict membership based on age, sex, race, religion, color, ancestry or national origin.

Policy Considerations

Conforming to federal tax law is generally desirable because it is less confusing for the taxpayer. With conformity, the taxpayer would be required to know only one set of rules. Conformity also eases FTB’s administration of the law by utilizing many dollar amounts taken from federal forms, as well as instructions. This bill substantially conforms to the income tax law changes made to the IRC between January 1, 1993 and January 1, 1997.

FISCAL IMPACT

Departmental Costs

Unless otherwise specified, the provisions of this bill would not materially impact the department’s costs.

Tax Revenue Estimate

Tax revenue losses of $0, $0 and $29 million for fiscal years 1997-98, 1998-99, and 1999-00, respectively.

Tax Revenue Discussion

The following table reflects the estimated impacts of the various provisions of this bill:

	SB 455		(in millions)					
		F	Personal Income Tax Law			Bank & Corporation Tax Law		
Number	Provision	N	1997-8	1998-9	1999-0	1997-8	1998-9	1999-0
1	Rollover gain from sale of public traded securities	f	Minor Loss	Minor Loss	Minor Loss	---	---	---
2	Real estate investment by pension funds	f	($5)	($5)	($5)	---	---	---
3	Requirement for certain charitable contributions	a	---	---	---	---	---	---
4	Disclosure on quid pro quo contributions	a	---	---	---	---	---	---
5	Increase in expense treatment for small business (PITL)	f	($2)	($5)	($11)	---	---	---
6	Treatment of storage of product samples	f	Negl. loss	Negl. loss	Negl. loss	---	---	---
7	Denial of indirect contributions to political parties	f	Minor gain	Minor gain	Minor gain	---	---	---
8	Seven year amortization of reforestation expenses	f	---	---	---	Minor loss	Minor loss	Minor loss
9	Class life for gas station convenience stores	b	---	---	---	---	---	---
10	Treatment of abandonment of lessor improvements	c	---	---	---	---	---	---
11	Depreciation under income forecast method	f	$1.5	$0.5	$0.5	$1.5	$0.5	$0.5
12 & 13	Modification to involuntary conversions	f	($1)	Minor loss	Minor loss	($1)	($1)	($1)
14	Corporation basis adjustment for involuntary conversions	f	---	---	---	Minor gain	Minor gain	Minor gain
15 – 19	Prevent conversion of ordinary income to capital gain	f	$1	$1	$1	---	---	---
20	Partnership distributions of marketable securities	f	$2	$2	$2	---	---	---
21	Treatment of dues paid to agricultural or horticultural	f	---	---	---	Negl. loss	Negl. loss	Negl. loss
22	Housing provided to employees by academic health centers	f	---	---	---	Negl. loss	Negl. loss	Negl. loss
23	Exclusion for energy conservation subsidies	f	---	---	---	($1)	($1)	($1)
24	common trust funds transfers to RICs	f	Minor loss	Minor loss	Minor loss	Minor loss	Minor loss	Minor loss
25	Repeal of exclusion for punitive damages	f	Negl. gain	Negl. gain	Negl. gain	---	---	---
26	Merchant marine capital construction fund accounts.	f	---	---	---	Minor loss	Minor loss	Minor loss
27	Polish bonds exempt from original issue discount treatment.	f	Minor loss	Minor loss	Minor loss	---	---	---
28	Amortization of child care facilities.	L	---	---	---	$0.5	$1.0	$1.5
29	Adoption assistance.	f	Minor loss	Minor loss	Minor loss	Minor loss	Minor loss	Minor loss
30	Exclusion of self-employed insurance benefits from income.	f	Minor loss	Minor loss	Minor loss	---	---	---
31	Long-term care insurance and services.	f	Negl. loss	Negl. loss	Negl. loss	---	---	---
32	Exception to penalty for premature distribution from an IRA.	f	Minor loss	Minor loss	Minor loss	---	---	---
33	Treatment of accelerated death benefits.	n	No Impact	No Impact	No Impact	---	---	---
34	Repeal of $5,000 exclusion of employees' death benefits.	f	$2	$2	$2	---	---	---
35	Compensation taken into account in determining contributions	g	---	---	---	---	---	---
36	Excess pension assets used for retiree health benefits.	f	Minor gain	Minor gain	Minor gain	---	---	---
37	Pension plan funding requirements and premiums.	n	No Impact	No Impact	No Impact	No Impact	No Impact	No Impact
38	Repeal of 5-year income averaging for lump-sum distrib.	h	---	---	$2	---	---	---
39	Establish SIMPLE pension plan	f	($3)	($2)	($2)	($1)	($1)	($1)
40	Other pension plan provisions	f	$1	($0.5)	($1)	($1)	($2)	($8)
41	Treatment of FASIT's	f	---	---	---	$3	$2	Minor gain
42	Copy of federal form 5471 required	I	---	---	---	---	---	---
43	Certain informational returns	j/k	---	---	---	---	---	---
44	Modifications to accuracy-related penalty	f	Minor gain	Minor gain	Minor gain	Minor gain	Minor gain	Minor gain
45	Individual estimated tax safe harbor	m	$0	$8	$2	---	---	---
46	Corporate estimated tax rules	o	---	---	---	$5	$3	($8)
47	Waiver of estimated tax penalty	n	No Impact	No Impact	No Impact	No Impact	No Impact	No Impact
48	Contributions in aid of construction	f	-	-	-	($2.5)	($2.5)	No Impact
49	Publicly Traded Partnerships	p	-	-	-	$0	$0	$0
	TOTALS		($3.5)	($1)	($9.5)	$3.5	$1	($19.5)

Minor gain = Gain less than $500,000
Minor loss = Loss less than $500,000
Negl. Gain = Negligible gain less than $250,000
Negl. Loss = Negligible loss less than $250,000

Tax Revenue Discussion

The revenue impact for the provisions were developed from various data and assumptions, please see the explanations below.

Footnotes

The following items (listed under FN in the preceding chart) represent "baseline" revenue effects in that most of the impact will occur automatically at the state level due to (a) a change in taxpayer reporting of income/deductions as a result of the new federal tax law (e.g. improved self-compliance, additional distributions of pension income, etc.) or (b) clarification through federal law of a complex and/or controversial point of tax law in which the state has previously followed federal positions.

a/ Revenue has already been realized at the state level as a result of federal substantiation requirements enacted in 1993.

b/ Revenue losses from this MACRS-related provision are considered to be baseline since an IRS position paper and now federal law provide guidance on what constitutes qualified 15-year property for such convenience stores.

c/ This provision is a clarification of how taxpayers are generally reporting their gain or loss on leasehold improvements for state tax purposes. The state revenue implications represent a baseline issue and no significant additional effects will occur as a result of clarifying state legislation. These baseline losses total $4 million during the three fiscal years, beginning with fiscal year 1997-8.

d/ Baseline revenue gains would automatically occur. Any additional revenue by conforming would be negligible. State practice has consistently followed federal treatment.

e/ This is primarily a baseline revenue issue since federal law clarifies the tax treatment of long-term care benefits. Most taxpayers will report similarly for both state and federal tax purposes.

f/ Revenue estimates for these provisions were based on federal projections. A proration factor was used based on state-to-nation comparisons of income/expenses and average marginal tax rates.

g/ This requirement was considered to be a baseline revenue gain issue at the time of the 1993 federal legislation. For consistency between state and federal tax law reporting, taxpayers will apply the same limits.

h/ The provision repealing five-year income averaging for lump-sum distributions has baseline revenue gains due to additional distributions that would not otherwise occur for years before the effective date of the repeal in 2000.

i/ Unknown revenue gains from improved compliance by CFC's.

j/ Revenue gains from this provision are considered to be baseline at the state level due to improved voluntary compliance as a result of the federal requirement.

k/ Due to enactment of this provision at the federal level, it has been projected previously that a $5 million baseline gain is occurring due to improved taxpayer compliance at the state level as well.

l/ The revenue estimate was based on 25-year depreciation for total expenses not exceeding $50 million per year.

m/ The revenue estimate was based on an analysis of PIT estimated tax data modified to reflect a 110% safe-harbor for certain high income taxpayers.

n/ No revenue impact.

o/ The revenue estimate was based on actual state tax return data for corporations.

p/ The revenue estimate was based on partnership tax return data.

POSITION

Support.

The Franchise Tax Board voted at its April 14, 1997, meeting to support this legislation.