California
Franchise
Tax
Board

SUMMARY OF FEDERAL INCOME TAX CHANGES ---- 2003

Laws Affected:

Personal Income Tax Laws
Corporation Tax Laws
Administration of Franchise and Income Tax Laws

SUMMARY OF

FEDERAL INCOME TAX

CHANGES

2003

Prepared by the Staff of the

FRANCHISE TAX BOARD

State of California

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

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SUMMARY OF FEDERAL INCOME TAX CHANGES - 2003

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

During 2003, the Internal Revenue Code or its application was changed by:

PUBLIC LAW	TITLE
108-7	Consolidated Appropriations Resolution, 2003
108-27	Jobs and Growth Tax Relief Reconciliation Act of 2003
108-81	Museum and Library Services Act of 2003
108-89	To Extend the Temporary Assistance for Needy Families Block Grant Program, and Certain Tax and Trade Programs, and for Other Purposes
108-121	Military Family Tax Relief Act of 2003
108-173	Medicare Prescription Drug, Improvement, and Modernization Act of 2003
108-189	Servicemembers Civil Relief Act

This report explains the new federal laws along with the effective dates, the corresponding California law, if any, including an explanation of any changes made in response to the new federal law, and the impact on California revenue were California to conform to the federal changes. This Report also contains citations to the section numbers of the Public Law, the Internal Revenue Code, and the California Revenue and Taxation Code impacted by the federal changes.

EXECUTIVE SUMMARY

Following is a list of California tax provisions that expire in 2004.

California Sunset	California Section	Federal Section	Federal Sunset	Description and Comments
05/31/04	17053.46 23646	N/A	N/A	Credit: Hiring in the Local Agency Military Base Recovery Area
05/31/04	17268 24356.8	N/A	N/A	Deduction: Expensing Business Property in Local Agency Military Base Recovery Areas
05/31/04	17276.2 24416.2	N/A	N/A	Deduction: Net Operating Losses in the Local Agency Military Base Recovery Areas
12/31/04	17053.80	N/A	N/A	Credit: Caregiver
12/31/04	18766	N/A	N/A	Voluntary Contribution: Alzheimer's Disease & Related Disorders Research Fund

Exhibit A contains a complete listing of expiring provisions in California law.
Exhibit B contains revenue tables.
Exhibit C contains a glossary of abbreviations used in this report.

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Consolidated Appropriations Resolution, 2003
(P.L. 108-7)

Section	Section Title
211	Legislative Branch Providing Information Returns Electronically

Background

Information returns regarding numerous types of payments (e.g., W-2s and 1099s) are filed with the Internal Revenue Service (IRS). The payor must also provide a written statement reflecting the information provided to the IRS to the recipient of the payment.

New Federal Law

The act provides that each office in the Legislative branch, except the Senate and the House, which is required to provide a written statement to a recipient of a payment, must also provide the statement in electronic form if requested by the recipient. The electronic statement must be in a format that enables the recipient to provide it to a tax preparer.

Effective Date

The provision is effective for statements prepared for taxable years ending on or after December 31, 2004.

California Law (Government Code Section 19849.7)

California agencies are required to provide written statements to payment recipients. In 2003, California law was amended (AB 385, Stats. 2003, Ch. 433) to require each state agency to furnish each employee, at his or her discretion, the required statement itemizing deductions made from salary or wages in writing or electronically. The requirement to provide the itemized statement electronically is contingent on funding and implementation of a specified program and certain other conditions.

Impact on California Revenue

Not applicable.

Section Section Title
101 Acceleration of the Increase in the Child Tax Credit

Background

In general

For 2003, an individual may claim a $600 tax credit for each qualifying child under the age of 17. In general, a qualifying child is an individual for whom the taxpayer can claim a dependency exemption and who is the taxpayer's son or daughter (or descendent of either), stepson or stepdaughter (or descendent of either), or eligible foster child.

The child tax credit is scheduled to increase to $1,000, phased-in over several years.

Table 1, below, shows the scheduled increases of the child tax credit as provided under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

TABLE 1 - SCHEDULED INCREASE OF THE CHILD TAX CREDIT

Taxable Year	Credit Amount per Child
2003-2004	$ 600
2005-2008	$ 700
2009	$ 800
2010+	$1,000

The child tax credit is phased-out for individuals with income over certain thresholds. Specifically, the otherwise allowable child tax credit is reduced by $50 for each $1,000 (or fraction thereof) of modified adjusted gross income over $75,000 for single individuals or heads of households, $110,000 for married individuals filing joint returns, and $55,000 for married individuals filing separate returns.[1] The length of the phase-out range depends on the number of qualifying children. For example, the phase-out range for a single individual with one qualifying child is between $75,000 and $87,000 of modified adjusted gross income. The phase-out range for a single individual with two qualifying children is between $75,000 and $99,000. The amount of the tax credit and the phase-out ranges are not adjusted annually for inflation.

[1] Modified adjusted gross income is the taxpayer’s total gross income plus certain amounts excluded from gross income (i.e., excluded income of: U.S. citizens or residents living abroad (IRC Section 911), residents of Guam, American Samoa, and the North Mariana Islands (IRC Section 931), and residents of Puerto Rico (IRC Section 933)).

Refundability

For 2003, the child credit is refundable to the extent of 10% of the taxpayer's earned income in excess of $10,500.[2] The percentage is increased to 15% for taxable years 2005 and thereafter. Families with three or more children are allowed a refundable credit for the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit, if that amount is greater than the refundable credit based on the taxpayer's earned income in excess of $10,500 (for 2003). The refundable portion of the child credit does not constitute income and is not treated as resources for purposes of determining eligibility or the amount or nature of benefits or assistance under any federal program or any state or local program financed with federal funds. For taxable years beginning after December 31, 2010, the sunset provision of EGTRRA applies to the rules allowing refundable child credits.

Alternative minimum tax liability

The child credit is allowed against the individual's regular income tax and alternative minimum tax (AMT). For taxable years beginning after December 31, 2010, the sunset provision of EGTRRA applies to the rules allowing the child credit against the AMT.

New Federal Law (IRC Sections 24(a) and 6429)

This provision increases the amount of the child credit to $1,000 for 2003 and 2004. After 2004, the child credit will revert to the levels provided under prior law. For 2003, the increased amount of the child credit will be paid in advance beginning in July 2003, on the basis of information on each taxpayer's 2002 return filed in 2003. The IRS is not expected to issue advance payment checks to an individual who did not claim the child credit for 2002. Such payments will be made in a manner similar to the advance payment checks issued by the Treasury in 2001 to reflect the creation of the 10% regular income tax rate bracket.

Effective Date

This provision is effective for taxable years beginning after December 31, 2002.

California Law

California does not have a child tax credit. Instead, California allows a nonrefundable augmented dependent exemption credit. For the 2003 year, the dependent exemption credit for California is $257.

Impact on California Revenue

Not applicable.

[2] The $10,500 amount is indexed for inflation.

Section	Section Title
102	Accelerate the Expansion of the 15% Rate Bracket for Married Couples Filing Joint Returns

Background

In general

Under the federal individual income tax system, an individual who is a citizen or resident of the United States generally is subject to tax on worldwide taxable income. Taxable income is total gross income less certain exclusions, exemptions, and deductions. An individual may claim either a standard deduction or itemized deductions.

An individual's income tax liability is determined by computing his or her regular income tax liability and, if applicable, AMT liability.

Regular income tax liability

Regular income tax liability is determined by applying the regular income tax rate schedules (or tax tables) to the individual's taxable income and then is reduced by any applicable tax credits. The regular income tax rate schedules are divided into several ranges of income, known as income brackets, and the marginal tax rate increases as the individual's income increases. The income bracket amounts are adjusted annually for inflation. Separate rate schedules apply based on filing status: single individuals (other than heads of households and surviving spouses), heads of households, married individuals filing joint returns (including surviving spouses), married individuals filing separate returns, and estates and trusts. Lower rates may apply to capital gains.

In general, the bracket breakpoints for single individuals are approximately 60% of the rate bracket breakpoints for married couples filing joint returns.[3] The rate bracket breakpoints for married individuals filing separate returns are exactly one-half of the rate brackets for married individuals filing joint returns. A separate, compressed rate schedule applies to estates and trusts.

15% regular income tax rate bracket

EGTRRA increased the size of the 15% regular income tax rate bracket for a married couple filing a joint return to twice the size of the corresponding rate bracket for a single individual filing a single return. The increase is phased-in over four years, beginning in 2005. Therefore, this provision is fully effective (i.e., the size of the 15% regular income tax rate bracket for a married couple filing a joint return is twice the size of the 15% regular income

[3] Under present law, the rate bracket breakpoint for the 38.6% marginal tax rate is the same for single individuals and married couples filing joint returns.

tax rate bracket for an unmarried individual filing a single return) for taxable years beginning after December 31, 2007. Table 2, below, shows the increase in the size of the 15% bracket during the phase-in period.

TABLE 2 - SCHEDULED INCREASE IN SIZE OF THE 15% RATE BRACKET FOR MARRIED COUPLES FILING JOINT RETURNS

Taxable Year	End Point of 15% Rate Bracket for Married Couples Filing Joint Returns as Percentage of End Point of 15% Rate Bracket for Unmarried Individuals
2005	180
2006	187
2007	193
2008 through 2010	200

New Federal Law (IRC Section 1)

This provision increases the size of the 15% regular income tax rate bracket for joint returns to twice the width of the 15% regular income tax bracket for single returns for taxable years beginning in 2003 and 2004. For taxable years beginning after 2004, the applicable percentages will revert to those allowed under present law, as described above.

Effective Date

This provision is effective for taxable years beginning after December 31, 2002.

California Law (R&TC Sections 17041 and 17048)

California tax rates, exemptions, deductions, phase-outs, etc., do not contain a “marriage penalty.”

Impact on California Revenue

Not applicable.

Section	Section Title
103	Standard Deduction Marriage Penalty Relief

Background

Marriage penalty

A married couple generally is treated as one tax unit that must pay tax on the couple's total taxable income. Although married couples may elect to file separate returns, the rate schedules and other provisions are structured so that filing separate returns usually results in a higher tax than filing a joint return. Other rate schedules apply to single persons and to single heads of households.

A "marriage penalty" exists when the combined tax liability of a married couple filing a joint return is greater than the sum of the tax liabilities of each individual computed as if they were not married. A "marriage bonus" exists when the combined tax liability of a married couple filing a joint return is less than the sum of the tax liabilities of each individual computed as if they were not married.

Basic standard deduction

Taxpayers who do not itemize deductions may choose the basic standard deduction (and additional standard deductions, if applicable),[4] which is subtracted from adjusted gross income (AGI) in arriving at taxable income. The size of the basic standard deduction varies according to filing status and is adjusted annually for inflation.[5] For 2003, the basic standard deduction for married couples filing a joint return is 167% of the basic standard deduction for single filers. (Alternatively, the basic standard deduction amount for single filers is 60% of the basic standard deduction amount for married couples filing joint returns.) Thus, two unmarried individuals have standard deductions whose sum exceeds the standard deduction for a married couple filing a joint return.

EGTRRA increased the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return.[6] The increase in the standard deduction for married taxpayers filing a joint return is scheduled to be phased-in over five years beginning in 2005 and will be fully phased-in for 2009 and thereafter.

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[4] Additional standard deductions are allowed with respect to any individual who is elderly (aged 65 or over) or blind.

[5] For 2003, the basic standard deduction amounts are: (1) $4,750 for unmarried individuals; (2) $7,950 for married individual filing a joint return; (3) $7,000 for heads of households; and (4) $3,975 for married individuals filing separately.

[6] The basic standard deduction for a married taxpayer filing separately will continue to equal one-half of the basic standard deduction for a married couple filing jointly; thus the basic standard deduction for unmarried individuals filing a single return and for married couples filing separately will be the same after the phase-in period.

Table 3, below, shows the standard deduction for married couples filing a joint return as a percentage of the standard deduction for single individuals during the phase-in period.

TABLE 3 - SCHEDULED PHASE-IN OF INCREASE OF THE BASIC STANDARD DEDUCTION FOR MARRIED COUPLES FILING JOINT RETURNS

Taxable Year	Standard Deduction for Married Couples Filing Joint Returns as Percentage of Standard Deduction for Unmarried Individual Returns
2005	174
2006	184
2007	187
2007	190
2009 and 2010	200

New Federal Law (IRC Section 63)

This provision increases the basic standard deduction amount for joint returns to twice the basic standard deduction amount for single returns effective for 2003 and 2004. For taxable years beginning after 2004, the applicable percentages will revert to those allowed under present law, as described above.

Effective Date

This provision is effective for taxable years beginning after December 31, 2002.

California Law (R&TC Section 17073.5)

California tax rates, exemptions, deductions, phase-outs, etc., do not contain a “marriage penalty.”

Impact on California Revenue

Not applicable.

Section	Section Title
104 - 105	Accelerate Reductions in Individual Income Tax Rates

Background

In general

Under the Federal individual income tax system, an individual who is a citizen or a resident of the United States generally is subject to tax on worldwide taxable income. Taxable income is total gross income less certain exclusions, exemptions, and deductions. An individual may claim either a standard deduction or itemized deductions.

An individual's income tax liability is determined by computing his or her regular income tax liability and, if applicable, AMT liability.

Regular income tax liability

Regular income tax liability is determined by applying the regular income tax rate schedules (or tax tables) to the individual's taxable income. This tax liability is then reduced by any applicable tax credits. The regular income tax rate schedules are divided into several ranges of income, known as income brackets, and the marginal tax rate increases as the individual's income increases. The income bracket amounts are adjusted annually for inflation. Separate rate schedules apply based on filing status: single individuals (other than heads of households and surviving spouses), heads of households, married individuals filing joint returns (including surviving spouses), married individuals filing separate returns, and estates and trusts. Lower rates may apply to capital gains.

For 2003, the regular income tax rate schedules for individuals are shown in Table 4, below. The rate bracket breakpoints for married individuals filing separate returns are exactly one-half of the rate brackets for married individuals filing joint returns. A separate, compressed rate schedule applies to estates and trusts.

TABLE 4 - INDIVIDUAL REGULAR INCOME TAX RATES FOR 2003

If taxable income is over:	But not over:	Then regular income tax equals:
Single Individuals		
$ 0	$ 6,000	10% of taxable income
$ 6,000	$ 28,400	$ 600.00, plus 15% of the amount over $ 6,000.00
$ 28,400	$ 68,800	$ 3,960.00, plus 27% of the amount over $ 28,400.00
$ 68,800	$143,500	$14,868.00, plus 30% of the amount over $ 68,800.00
$143,500	$311,950	$37,378.00, plus 35% of the amount over $143,500.00
Over $311,950		$96,235.50, plus 38.6% of the amount over $311,950.00

If taxable income is over:	But not over:	Then regular income tax equals:
Head of Households		
$ 0	$ 10,000	10% of taxable income
$ 10,000	$ 38,050	$ 1,000.00, plus 15% of the amount over $ 10,000.00
$ 38,050	$ 98,250	$ 5,207.50, plus 27% of the amount over $ 38,050.00
$ 98,250	$159,100	$21,461.50, plus 30% of the amount over $ 98,250.00
$159,100	$311,950	$39,716.50, plus 35% of the amount over $159,100.00
Over $311,950		$93,214.00, plus 38.6% of the amount over $311,950.00
Married Individuals Filing Joint Returns		
$ 0	$ 12,000	10% of taxable income
$ 12,000	$ 47,450	$ 1,200.00, plus 15% of the amount over $ 12,000.00
$ 47,450	$114,650	$ 6,517.50, plus 27% of the amount over $ 47,540.00
$114,650	$174,700	$24,661.50, plus 30% of the amount over $114,650.00
$174,700	$311,950	$42,676.50, plus 35% of the amount over $174,700.00
Over $311,950		$90,714.00, plus 38.6% of the amount over $311,950.00

10% regular income tax rate

Under present law, the 10% rate applies to the first $6,000 of taxable income for single individuals, $10,000 of taxable income for heads of households, and $12,000 for married couples filing joint returns. Effective beginning in 2008, the $6,000 amount will increase to $7,000 and the $12,000 amount will increase to $14,000.

The taxable income levels for the 10% rate bracket will be adjusted annually for inflation for taxable years beginning after December 31, 2008. The bracket for single individuals and married individuals filing separately is one-half for joint returns (after adjustment of that bracket for inflation).

The 10% rate bracket will expire for taxable years beginning after December 31, 2010, under the sunset provision of the EGTRRA.

Reduction of other regular income tax rates

Prior to EGTRRA, the regular income tax rates were 15%, 28%, 31%, 36%, and 39.6%.[7] EGTRRA added the 10% regular income tax rate, described above, and retained the 15% regular income tax rate. Also, the 15% regular income tax bracket was modified to begin at

[7] The regular income tax rates will revert to these percentages for taxable years beginning after December 31, 2010, under the sunset of EGTRRA.

the end of the 10% regular income tax bracket. EGTRRA also made other changes to the 15% regular income tax bracket.

Also, under EGTRRA, the 28%, 31%, 36%, and 39.6% rates are phased down over six years to 25%, 28%, 33%, and 35%, effective after June 30, 2001. The taxable income levels for the rates above the 15% rate in all taxable years are the same as the taxable income levels that apply under the prior-law rates.

Table 5, below, shows the schedule of regular income tax rate reductions.

TABLE 5 - SCHEDULED REGULAR INCOME TAX RATE REDUCTIONS

Taxable Year	28% rate reduced to:	31% rate reduced to:	36% rate reduced to:	39.6% rate reduced to:
2001 - 2003	27%	30%	35%	38.6%
2004 - 2005	26%	29%	34%	37.6%
2006 - 2010	25%	28%	33%	35.0%

New Federal Law (IRC Section 1)

10% regular income tax rate

This provision accelerates the increase in the taxable income levels for the 10% rate bracket previously scheduled for 2008 to be effective on 2003 and 2004. Specifically, this provision increases the taxable income level for the 10% regular income tax brackets for unmarried individuals from $6,000 to $7,000 and for married individuals filing jointly from $12,000 to $14,000. The taxable income levels for the 10% regular income tax bracket will be adjusted annually for inflation for taxable years beginning after December 31, 2003.

For taxable years beginning after December 31, 2004, the taxable income levels for the 10% rate bracket will revert to the levels allowed under prior law. Therefore, for 2005, 2006, and 2007, the levels will revert to $6,000 for unmarried individuals and $12,000 for married individuals filing jointly. In 2008, the taxable income levels for the 10% regular income tax rate brackets will be $7,000 for unmarried individuals and $14,000 for married individuals filing jointly. The taxable income levels for the 10% rate bracket will be adjusted annually for inflation for taxable years beginning after December 31, 2008.

Reduction of other regular income tax rates

This provision accelerates the reductions in the regular income tax rates in excess of the 15% regular income tax rate that are scheduled for 2004 and 2006. Therefore, in 2003, and thereafter, the regular income tax rates in excess of 15% under the bill are 25%, 28%, 33%, and 35%.

Effective Date

These provisions are effective for taxable years beginning after December 31, 2002.

California Law (R&TC Section 17041)

California does not have the same income tax brackets as federal. California has six tax rates ranging from 1% to 9.3%.

Impact on California Revenue

Not applicable.

Section	Section Title
106	Minimum Tax Relief to Individuals

Background

The AMT is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is an amount equal to (1) 26% of the first $175,000 ($87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income (AMTI) in excess of a phased-out exemption amount and (2) 28% of the remaining AMTI. The maximum tax rates on net capital gain used in computing the tentative minimum tax are the same as under the regular tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments. The exemption amounts are: (1) $49,000 ($45,000 in taxable years beginning after 2004) in the case of married individuals filing a joint return and surviving spouses; (2) $35,750 ($33,750 in taxable years beginning after 2004) in the case of other unmarried individuals; (3) $24,500 ($22,500 in taxable years beginning after 2004) in the case of married individuals filing a separate return; and (4) $22,500 in the case of an estate or trust. The exemption amounts are phased out by an amount equal to 25% of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

New Federal Law (IRC Section 55)

This provision increases the AMT exemption amount for married taxpayers filing a joint return and surviving spouses to $58,000, and for unmarried taxpayers to $40,250 for taxable years beginning in 2003 and 2004.

Effective Date

This provision is effective for taxable years beginning after December 31, 2002.

California Law (R&TC Section 17062)

California law generally conforms to the computation of AMT. However, California's AMT exemption amounts differ from federal amounts. In 1998, California increased the AMT exemption amounts and indexed them for inflation. For 2003, the exemption amounts are $66,547 for married couples filing a joint return or qualifying widow(er) with dependent child and $49,910 for single filers.

Impact on California Revenue

Not applicable.

Section	Section Title
107	Application of EGTRRA Sunset to Sections 101-106

Background

Budget reconciliation is a procedure under the Congressional Budget Act of 1974 (the Budget Act) by which Congress implements spending and tax policies contained in a budget resolution. The Budget Act contains numerous rules enforcing the scope of items permitted to be considered under the budget reconciliation process. One such rule, the so-called "Byrd rule," was incorporated into the Budget Act in 1990. The Byrd rule, named after its principal sponsor, Senator Robert C. Byrd, is contained in Section 313 of the Budget Act. The Byrd rule generally permits members to raise a point of order against extraneous provisions (those which are unrelated to the goals of the reconciliation process) from either a reconciliation bill or a conference report on such bill.

Under the Byrd rule, a provision is considered to be extraneous if it falls under one or more of the following six definitions: (1) it does not produce a change in outlays or revenues; (2) it produces an outlay increase or revenue decrease when the instructed committee is not in compliance with its instructions; (3) it is outside of the jurisdiction of the committee that submitted the title or provision for inclusion in the reconciliation measure; (4) it produces a change in outlays or revenues which is merely incidental to the nonbudgetary components of the provision; (5) it would increase the deficit for a fiscal year beyond those covered by the reconciliation measure; or (6) it recommends changes in Social Security.

New Federal Law

This provision simply states that the provisions of EGTRRA modified by this act will have the same sunset date as stated under EGTRRA. Generally, the provisions are not applicable to taxable years beginning after December 31, 2010.

California Law

Not applicable.

Impact on California Revenue

Not applicable.

Section	Section Title
201	Special Depreciation Allowance for Certain Property

Background

In general

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system (MACRS). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from three to 25 years. The depreciation methods generally applicable to tangible personal property are the 200% and 150% declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

Internal Revenue Code (IRC) Section 280F limits the annual depreciation deductions with respect to passenger automobiles to specified dollar amounts, indexed for inflation.

IRC Section 167(f)(1) provides that capitalized computer software costs, other than computer software to which IRC Section 197 applies, are recovered ratably over 36 months.

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment generally may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year (IRC Section 179). In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.

Additional first year depreciation deduction

The Job Creation and Worker Assistance Act of 2002[8] (JCWAA) allows an additional first-year depreciation deduction equal to 30% of the adjusted basis of qualified property.[9] The amount of the additional first-year depreciation deduction is not affected by a short taxable year. The additional first-year depreciation deduction is allowed for both regular tax and AMT purposes for the taxable year in which the property is placed in service.[10]

The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there are no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's AMTI with respect to property to which the provision applies. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

In order for property to qualify for the additional first-year depreciation deduction it must meet all of the following requirements. First, the property must be property (1) to which MACRS applies with an applicable recovery period of 20 years or less, (2) water utility property (as defined in IRC Section 168(e)(5)), (3) computer software other than computer software covered by IRC Section 197, or (4) qualified leasehold improvement property (as defined in IRC Section 168(k)(3)).[11] Second, the original use[12] of the property must commence with the taxpayer on or after September 11, 2001.[13] Third, the taxpayer must purchase the property

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[8] Pub. Law No. 107-147, Section 101 (2002).

[9] The additional first-year depreciation deduction is subject to the general rules regarding whether an item is deductible under IRC Section 162 or subject to capitalization under IRC Section 263 or 263A.

[10] However, the additional first-year depreciation deduction is not allowed for purposes of computing earnings and profits.

[11] A special rule precludes the additional first-year depreciation.

[12] The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. If in the normal course of its business a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first user of each fractional interest (i.e., each fractional owner is considered the original user of its proportionate share of the property).

[13] A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to the taxpayer within three months after the date that the property was placed in service, the property would be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback. If property is originally placed in service by a lessor (including by operation of IRC Section 168(k)(2)(D)(i)), such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of such sale. A technical correction may be needed so the statute reflects this intent.

within the applicable time period. Finally, the property must be placed in service before January 1, 2005. An extension of the placed in service date of one year (i.e., to January 1, 2006) is provided for certain property with a recovery period of ten years or longer and certain transportation property.[14]

Transportation property is defined as tangible personal property used in the trade or business of transporting persons or property.

The applicable time period for acquired property is (1) after September 10, 2001, and before September 11, 2004, but only if no binding written contract for the acquisition is in effect before September 11, 2001, or (2) pursuant to a binding written contract which was entered into after September 10, 2001, and before September 11, 2004.[15]

With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after September 10, 2001, and before September 11, 2004. Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer. For property eligible for the extended placed in service date, a special rule limits the amount of costs eligible for the additional first year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred before September 11, 2004 ("progress expenditures") is eligible for the additional first-year depreciation.[16]

Property does not qualify for the additional first-year depreciation deduction when the user of such property (or a related party) would not have been eligible for the additional first-year depreciation deduction if the user (or a related party) were treated as the owner.[17]

For example, if a taxpayer sells to a related party property that was under construction prior to September 11, 2001, the property does not qualify for the additional first-year depreciation deduction. Similarly, if a taxpayer sells to a related party property that was subject to a binding written contract prior to September 11, 2001, the property does not qualify for the additional first-year depreciation deduction. As a further example, if a taxpayer (the lessee) sells property in a sale-leaseback arrangement, and the property otherwise would not have qualified for the additional first-year depreciation deduction if it were owned by the taxpayer-lessee, then the lessor is not entitled to the additional first-year depreciation deduction.

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[14] In order for property to qualify for the extended placed in service date, the property is required to have a production period exceeding two years or an estimated production period exceeding one year and a cost exceeding $1 million.

[15] Property does not fail to qualify for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to September 11, 2001.

[16] For purposes of determining the amount of eligible progress expenditures, it is intended that rules similar to IRC Section 46(d)(3) as in effect prior to the Tax Reform Act of 1986 shall apply.

[17] A technical correction may be needed so that the statute reflects this intent.

The limitation on the amount of depreciation deductions allowed with respect to certain passenger automobiles (IRC Section 280F) is increased in the first year by $4,600 for automobiles that qualify (and do not elect out of the increased first year deduction). The $4,600 increase is not indexed for inflation.

New Federal Law (IRC Section 168(k))

This provision provides an additional first-year depreciation deduction equal to 50% of the adjusted basis of qualified property.[18]

Qualified property is defined in the same manner as for purposes of the 30% additional first-year depreciation deduction provided by the JCWAA except that the applicable time period for acquisition (or self construction) of the property is modified. In addition, property must be placed in service before January 1, 2005, to qualify.[19]

Property for which the 50% additional first-year depreciation deduction is claimed is not eligible for the 30% additional first year depreciation deduction.

In order to qualify the property must be acquired after May 5, 2003, and before January 1, 2005, but only if no written binding contract for the acquisition is in effect before May 6, 2003.

With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after May 5, 2003. For property eligible for the extended placed in service date (i.e., certain property with a recovery period of ten years or longer and certain transportation property), a special rule limits the amount of costs eligible for the additional first-year depreciation. With respect to such property, only progress expenditures properly attributable to the costs incurred before January 1, 2005, shall be eligible for the additional first-year depreciation.[20]

This provision clarifies that the adjusted basis of qualified property acquired by a taxpayer in a like-kind exchange or an involuntary conversion is eligible for the additional first-year depreciation deduction.

This provision also increases the limitation on the amount of depreciation deductions allowed with respect to certain passenger automobiles (IRC Section 280F) in the first year by $7,650 (in lieu of the $4,600 provided under the JCWAA) for automobiles that qualify (and do not

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[18] A taxpayer is permitted to elect out of the 50% additional first-year depreciation deduction for any class of property for any taxable year.

[19] An extension of the placed in service date of one year (i.e., January 1, 2006) is provided for certain property with a recovery period of ten years or longer and certain transportation property as defined for purposes of the JCWAA.

[20] For purposes of determining the amount of eligible progress expenditures, it is intended that rules similar to IRC Section 46(d)(3) as in effect prior to the Tax Reform Act of 1986 shall apply.

elect out of the increased first year deduction). The $7,650 increase is not indexed for inflation.

For property eligible for the prior law 30% additional first year depreciation, the provision extends the date of the placed in service requirement to property placed in service prior to January 1, 2005. Thus, property otherwise qualifying for the 30% additional first-year depreciation deduction will now qualify if placed in service prior to January 1, 2005. The provision also extends the placed in service date requirement for certain property with a recovery period of ten years or longer and certain transportation property to property placed in service prior to January 1, 2006. In addition, progress expenditures eligible for the 30% additional first-year depreciation is extended to include costs incurred prior to January 1, 2005.

Effective Date

This provision is applicable to taxable years ending after May 5, 2003.

California Law (R&TC Section 17250)

Under the Personal Income Tax Law (PITL), California law, as it relates to MACRS and the IRC Section 179 deduction, is in full conformity with federal law as it read on January 1, 2001.

Under current California law, S corporations (and their shareholders) are allowed to use MACRS and an IRC Section 179 deduction under the PITL. For taxable years beginning on or after January 1, 2002, an S corporation may elect to expense up to $24,000 in the computation of the S corporation's measured tax (presently the S corporation tax rate for non-financial corporations is 1.5%).

Under the Corporation Tax Law (CTL), California does not conform to the federal law MACRS depreciation and the IRC Section 179 expensing provisions. The CTL permits an "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. Property qualifying for the "additional first-year depreciation" is similar to property qualifying under IRC Section 179. Prior to enactment of the present day IRC Section 179 deduction, "additional first-year depreciation" was the federal rule.

Impact on California Revenue

Estimated Revenue Impact for Increasing Special Depreciation Allowance for Certain Property Placed in Service After May 5, 2003 ($ Millions)			
Fiscal Year	2004-05	2005-06	2006-07
Revenue Impact*	-260	+73	-5

*California did not previously conform to the prior MACRS bonus depreciation allowance. However, there would be a "baseline" impact for taxpayers that claim their federal depreciation on state returns on a self-assessed basis. Projected baseline revenue effects are: $10 million loss for 2003-04, $245 million loss for 2004-05, $250 million loss for 2005-06, and $120 million gain for 2006-07.

Section	Section Title
202	Increased Expensing for Small Business

Background

Under current law, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment might elect to deduct up to $25,000 (for taxable years beginning in 2003 and thereafter) of qualifying property placed in service for the taxable year (IRC Section 179).[21]

In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. An election to expense these items generally is made on the taxpayer's original return for the taxable year to which the election relates, and may be revoked only with the consent of the Commissioner.[22]

In general, taxpayers may not elect to expense off-the-shelf computer software.[23]

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[21] Additional IRC Section 179 incentives are provided with respect to a qualified property used by a business in the New York Liberty Zone (IRC Section 1400(f)) or an empowerment zone (IRC Section 1397A).

[22] IRC Section 179(c)(2). A taxpayer may make the election on the original return (whether or not the return is timely), or on an amended return filed by the due date (including extensions) for filing the return for the tax year the property was placed in service. If the taxpayer timely filed an original return without making the election, the taxpayer may still make the election by filing an amended return within six months of the due date of the return (excluding extensions). Treasury Regulation Section 1.179-5.

[23] IRC Section 179(d)(1) requires that property be tangible to be eligible for expensing; in general, computer software is intangible property.

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a 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). No business credit under IRC Section 38 is allowed with respect to any amount for which a deduction is allowed under IRC Section 179.

New Federal Law (Section 179)

This provision provides that the maximum dollar amount that may be deducted under IRC Section 179 is increased to $100,000 for property placed in service in taxable years beginning in 2003, 2004, and 2005. In addition, the $200,000 amount is increased to $400,000 for property placed in service in taxable years beginning in 2003, 2004, and 2005. The dollar limitations are indexed annually for inflation for taxable years beginning after 2003 and before 2006. The provision also includes off-the-shelf computer software placed in service in a taxable year beginning in 2003, 2004, or 2005, as qualifying property. Also, the provision permits taxpayers to make or revoke expensing elections for taxable years beginning after 2002 and before 2006 on amended returns without the consent of the Commissioner.

Effective Date

This provision is effective for taxable years beginning after December 31, 2002.

California Law (R&TC Sections 17255 and 24356)

Under the PITL, California law, as it relates to MACRS and the IRC Section 179 deduction, is in full conformity with federal law as it read on January 1, 2001.

Under current California law, S corporations (and their shareholders) are allowed to use MACRS and the IRC Section 179 deduction under the PITL. For taxable years beginning on or after January 1, 2002, an S corporation may elect to expense up to $24,000 in the computation of the S corporation's measured tax (presently the S corporation tax rate for non-financial corporations is 1.5%).

Under the CTL, California does not conform to the federal law MACRS depreciation and the IRC Section 179 expensing provisions. The CTL permits an "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. Property qualifying for the "additional first-year depreciation" is similar to property qualifying under IRC Section 179. Prior to enactment of the present day IRC Section 179 deduction, "additional first-year depreciation" was the federal rule.

Impact on California Revenue

Estimated Revenue Impact for Increasing Section 179 Expense Deduction For Taxable Years Beginning After December 31, 2002* ($ Millions)			
Fiscal Year	2004-05	2005-06	2006-07
Revenue Loss	-125	-100	-30

*Applicable to taxpayers subject to the PIT law, including Subchapter S corporations.

Section 301

Section Title: Reduction in Capital Gains Rates for Individuals; Repeal of 5-year Holding Period Requirement

Background

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual is taxed at maximum rates lower than the rates applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain U.S. publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances that would have been available under the straight-line method of depreciation.

The maximum rate of tax on the adjusted net capital gain of an individual is 20%. In addition, any adjusted net capital gain which otherwise would be taxed at a 15% rate is taxed at a 10% rate. These rates apply for purposes of both the regular tax and AMT.

The “adjusted net capital gain” of an individual is the net capital gain reduced (but not below zero) by the sum of the 28% rate gain and the unrecaptured IRC Section 1250 gain. The net capital gain is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation under IRC Section 163(d).

The term “28% rate gain” means the amount of net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles (as defined in IRC Section 408(m) without regard to paragraph (3)), an amount of gain equal to the amount of gain excluded from gross income under IRC Section 1202 (relating to certain small business stock), the net short-term capital loss for the taxable year, and any long-term capital loss carryover to the taxable year.

“Unrecaptured IRC Section 1250 gain” means any long-term capital gain from the sale or exchange of IRC Section 1250 property (i.e., depreciable real estate) held more than one year to the extent of the gain that would have been treated as ordinary income if IRC Section 1250 applied to all depreciation, reduced by the net loss (if any) attributable to the items taken into account in computing 28% rate gain. The amount of unrecaptured IRC Section 1250 gain (before the reduction for the net loss) attributable to the disposition of property to which IRC Section 1231 applies shall not exceed the net IRC Section 1231 gain for the year.

The unrecaptured IRC Section 1250 gain is taxed at a maximum rate of 25%, and the 28% rate gain is taxed at a maximum rate of 28%. Any amount of unrecaptured IRC Section 1250 gain or 28% rate gain otherwise taxed at a 15% rate is taxed at the 15% rate.

Any gain from the sale or exchange of property held more than five years that would otherwise be taxed at the 10% rate is taxed at an 8% rate. Any gain from the sale or exchange of property held more than five years and the holding period for which begins after December 31, 2000, which would otherwise be taxed at a 20% rate is taxed at an 18% rate.

New Federal Law (IRC Section 1(h))

This provision reduces the 10% and 20% rates on capital gains to 5% (zero, in 2008) and 15%, respectively. These lower rates apply to assets held more than one year and are applicable to both regular tax and AMT.

Effective Date

This provision is applicable to sales and exchanges (and payments received) on or after May 6, 2003.

California Law (R&TC Sections 18151 and 24990)

California law has generally conformed to IRC Section 1201 through Section 1257, relating to the treatment of capital gains and losses. These sections provide rules for defining "capital assets," identifying holding periods, and determining the gain or loss from the sale or exchange of a capital asset. Federal law has complex rules allowing non-corporate taxpayers to use maximum capital gain rates from 8% to 28%. Corporate taxpayers pay the normal corporation tax rate on capital gains. California does not conform to the favorable federal treatment for capital gains and both corporate and individual taxpayers pay at their ordinary income tax rate.

Current federal law (IRC Section 1202) and state law (R&TC Section18152.5) allow non-corporate taxpayers to exclude 50% of the gain from certain small business stock originally issued after August 10, 1993, that is held for more than five years. The laws are similar but California law has certain limitations related to California payroll and assets. For federal AMT purposes 42% of the excluded income is a tax preference item. For California AMT purposes 50% of the excluded income is a tax preference item.

Federal and state laws allow an exclusion of the capital gain from the sale of a principal residence, subject to certain limitations. An individual may exclude up to $250,000 of gain, while a married couple filing a joint return may exclude up to $500,000.

A non-corporate taxpayer may deduct capital losses only to the extent of capital gains plus the lesser of $3,000 ($1,500 for married individuals filing separate returns) or the excess of losses over gains. Corporations may deduct capital losses only to the extent of capital gains. Federal law generally permits a three-year carry-back and a five-year carry-forward for excess capital losses. California law permits only a five-year carry-forward for excess losses.

Impact on California Revenue

Not applicable.

Section	Section Title
302	Dividends of Individuals Taxed at Capital Gains Rates

Background

Under current law, dividends received by an individual are included in gross income and taxed as ordinary income at rates up to 38.6%.[24]

The rate of tax on the net capital gain of an individual generally is 20% (10%[25] with respect to income which would otherwise be taxed at the 10% or 15% rate).[26]

Net capital gain means net gain from the sale or exchange of capital assets held for more than one year in excess of net loss from the sale or exchange of capital assets held not more than one year.

New Federal Law (IRC Section 1(h))

Pursuant to this provision, dividends received by an individual shareholder from domestic and qualified foreign corporations generally are taxed at the same rates that apply to net capital gains. This treatment applies for purposes of both the regular tax and AMT. Thus, under this provision, dividends are taxed at rates of 5% (zero, in 2008) and 15%.

Effective Date

This provision applies to dividends received in taxable years beginning after December 31, 2002.

California Law

California does not conform to the favorable federal tax rate for capital gains. Both corporate and individual taxpayers pay tax on net capital gains at their ordinary income tax rate. Dividends received by an individual are included in gross income and taxed as ordinary income.

Impact on California Revenue

Not applicable.

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[24] Section 105 of this act reduces the maximum rate to 35%.
[25] An 8% rate applies to property held more than five years.
[26] Section 301 of this act reduces the capital gain rates to 5% (zero, for taxable years beginning after 2007) and 15%, respectively.

Section	Section Title
303	Sunset of Sections 301 and 302

Background

Budget reconciliation is a procedure under the Budget Act by which Congress implements spending and tax policies contained in a budget resolution. The Budget Act contains numerous rules enforcing the scope of items permitted to be considered under the budget reconciliation process. One such rule, the Byrd rule, is contained in Section 313 of the Budget Act. The Byrd rule generally permits members to raise a point of order against extraneous provisions (those which are unrelated to the goals of the reconciliation process) from either a reconciliation bill or a conference report on such bill.

New Federal Law

This provision simply provides the sunset date for Sections 301 and 302. All provisions of, and amendments made by, Sections 301 and 302 of this act are not applicable to taxable years beginning after December 31, 2008. The IRC of 1986 is applicable to taxable years beginning on or after January 1, 2009, as if such provisions and amendments had never been enacted.

California Law

Not applicable.

Impact on California Revenue

Not applicable.

Section	Section Title
501	Corporate Estimated Tax Payments for 2003

Background

In general, corporations are required to make quarterly estimated tax payments of their income tax liability (IRC Section 6655). For a corporation whose taxable year is a calendar year, these estimated tax payments must be made by April 15, June 15, September 15, and December 15.

Jobs and Growth Tax Relief Reconciliation Act of 2003
(P.L. 108-27)

New Federal Law

With respect to corporate estimated tax payments due on September 15, 2003, 25% is required to be paid by October 1, 2003.

Effective Date

This provision is effective May 28, 2003.

California Law (R&TC Section 19025)

California law mirrors prior federal law as it relates to due dates of estimated tax payments. California law has not been changed to reflect the 2003 federal change in due dates of estimated tax.

Impact on California Revenue

Not applicable.

Section	Section Title
503	Conforming Amendment

Background

The IRC allows a corporation a deduction for making a "qualified computer contribution" to an eligible organization. This deduction expires for contributions made after December 31, 2003. A public library, as defined by the Library Services and Technology Act (LSTA), is an example of an eligible organization.

New Federal Law (IRC Section 170(e))

This act amends and redesignates some provisions of the LSTA, including extending the LSTA until 2009.

This act also updates a cross-reference in IRC Section 170 to conform to the redesignation of the paragraph defining "public library" made in the LSTA.

Effective Date

This act is effective September 25, 2003.

California Law (R&TC Section 24357.9)

California law, as it relates to corporate contributions made on or after January 1, 2002, through December 31, 2003, is in conformity with federal law as it read on January 1, 2001.

Impact on California Revenue

No Impact.

Section	Section Title
201	Disclosure of Return Information to Carry Out Income Contingent Repayment of Student Loans

Background

To carry out a federal direct student loan program that allows loans to be repaid on an income-contingent basis, the IRS may disclose to officers and employees of the Department of Education, on written request, return information about a taxpayer who has received an applicable student loan and whose loan repayments are based in whole or in part on his or her income. The information that may be disclosed includes the taxpayer's name, address, taxpayer identification number, filing status, and adjusted gross income.

New Federal Law (IRC Section 6301(l)(13))

This act extends the expiration date of this provision from September 30, 2003, until December 31, 2004.

Effective Date

This act applies to requests made after September 30, 2003.

California Law

California law does not conform to federal law relating to disclosure of tax return information to the Department of Education.

Impact on California Revenue

Not applicable.

Section	Section Title
202	Internal Revenue Service User Fees

Background

The IRS has statutory authority (as initially authorized by the Revenue Act of 1987) to impose user fees for determination letters, ruling letters, opinion letters, and other requests.

To Extend the Temporary Assistance for Needy Families Block Grant Program, and Certain Tax and Trade Programs, and For Other Purposes (P.L. 108-89)

New Federal Law (IRC Section 7528)

This act extends the expiration date of this provision from September 30, 2003, until December 31, 2004 and codifies the provision.

Effective Date

This act applies to requests made after October 1, 2003.

California Law

California law does not conform to federal law relating to user fees for certain requests.

Impact on California Revenue

Not applicable.

Military Family Tax Relief Act of 2003
(P.L. 108-121)

Section	Section Title
101	Exclusion of Gain on Sale of a Principal Residence by a Member of the Uniformed Services or the Foreign Service

Background

Under current law, an individual taxpayer may exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years ending on the date of sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or to the extent provided under regulations, unforeseen circumstances, is able to exclude an amount equal to $250,000 ($500,000 if married filing a joint return) multiplied by the fraction of the two years that the ownership and use requirements are met. There are no special rules relating to the members of the uniformed services or the Foreign Service of the United States.

New Federal Law (IRC Section 121)

Pursuant to this provision, an individual may elect to suspend for a maximum of ten years the five-year test period for ownership and use during certain absences due to service in the uniformed services or the Foreign Service of the United States. The uniformed services include: (1) the Armed Forces (the Army, Navy, Air Force, Marine Corps, and Coast Guard); (2) the commissioned corps of the National Oceanic and Atmospheric Administration; and (3) the commissioned corps of the Public Health Service. If the election is made, the five-year period ending on the date of the sale or exchange of a principal residence does not include any period up to ten years during which the taxpayer or the taxpayer's spouse is on qualified official extended duty as a member of the uniformed services or in the Foreign Service of the United States. For these purposes, qualified official extended duty is any period of extended duty while serving at a place of duty at least 50 miles away from the taxpayer's principal residence or under orders compelling residence in Government furnished quarters. Extended duty is defined as any period of duty pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period. The election may be made with respect to only one property for a suspension period.

Effective Date

This provision is effective for sales or exchanges made after May 6, 1997. The act provides a one-year period (beginning on November 11, 2003) for taxpayers to claim refunds as a result of this provision that are otherwise barred by the statute of limitations.

California Law (R&TC Section 17152)

California law, as it relates to the exclusion of gain from the sale of a principal residence, is generally in conformity with federal law as it read on January 1, 2001. California law reduces the required two-year occupancy period by up to six months for any time the taxpayer served in the Peace Corps.

Impact on California Revenue

Estimated Revenue Impact for Exclusion of Gain on Sale of Principal Residence by a Member of the Uniformed Services or the Foreign Service For Sales or Exchanges Made After May 6, 1997 ($ Millions)			
Fiscal Year	2004-05	2005-06	2006-07
Revenue Loss	-2	-0.5	-0.5

Revenue estimates were based on federal projections.

Section	Section Title
102	Exclusion from Gross Income of Certain Death Gratuity Payments

Background

Under current law, qualified military benefits are not included in gross income. Generally, a qualified military benefit is any allowance or in-kind benefit (other than personal use of a vehicle) which: (1) is received by any member or former member of the uniformed services of the United States or any dependent of such member by reason of such member's status or service as a member of such uniformed services; and (2) was excludable from gross income on September 9, 1986, under any provision of law, regulation, or administrative practice which was in effect on such date. Generally, other than certain cost of living adjustments, no modification or adjustment of any qualified military benefit after September 9, 1986, is taken into account for purposes of this exclusion from gross income. Qualified military benefits include certain death gratuities with the level of the death gratuity exclusion set at $3,000 since September 9, 1986. The amount of the military death gratuity benefit has been increased since September 9, 1986, to $6,000 pursuant to Chapter 75 of Title 10 of the United States Code, however the amount of the exclusion from gross income was not increased to take into account this change.

New Federal Law (IRC Section 134)

This provision increases the amount of the death gratuity payable under Chapter 75 of Title 10 of the United States Code to $12,000. Also, the provision extends the exclusion from gross income to any adjustment to the amount of the death gratuity payable under Chapter 75 of Title 10 of the United States Code that is pursuant to a provision of law enacted after September 9, 1986, with respect to the death of certain members of the Armed Services on active duty, inactive duty training, or engaged in authorized travel. Therefore, the amount of the exclusion is increased to $12,000.

Effective Date

The provision is effective with respect to deaths occurring after September 10, 2001.

California Law (R&TC Section 17131)

California law, as it relates to the exclusion from gross income of certain death gratuity payments, is in conformity with federal law as it read on January 1, 2001.

Impact on California Revenue

Conforming to the federal exclusion of certain death gratuity payments from gross income would have a negligible impact on state revenues.

Section	Section Title
103	Exclusion for Amounts Received Under Department of Defense Homeowners Assistance Program

Background

Homeowners Assistance Program Payment

The Department of Defense Homeowners Assistance Program (HAP) provides payments to certain employees and members of the Armed Forces to offset the adverse effects on housing values that result from a military base realignment or closure.[27]

In general, under HAP, eligible individuals receive either: (1) a cash payment as compensation for losses that may be or have been sustained in a private sale, in an amount

[27] The payments are authorized under the provisions of Title 42 U.S.C. Section 3374.

not to exceed the difference between (a) 95% of the fair market value of their property prior to public announcement of intention to close all or part of the military base or installation and (b) the fair market value of such property at the time of the sale; or (2) as the purchase price for their property, an amount not to exceed 90% of the prior fair market value as determined by the Secretary of Defense, or the amount of the outstanding mortgages.

Tax treatment

Unless specifically excluded, gross income for federal income tax purposes includes all income from whatever source derived. Amounts received under HAP are received in connection with the performance of services. These amounts are includible in gross income as compensation for services to the extent such payments exceed the fair market value of the property relinquished in exchange for such payments. Additionally, such payments are wages for Federal Insurance Contributions Act (FICA) tax purposes (including Medicare).

<u>New Federal Law</u> (IRC Section 132)

The provision generally exempts from gross income amounts received under the HAP (as in effect on November 11, 2003). Amounts received under the program also are not considered wages for FICA tax purposes (including Medicare). The excludable amount is limited to the reduction in the fair market value of property.

<u>Effective Date</u>

The provision is effective for payments made after November 11, 2003.

<u>California Law</u> (R&TC Section 17131)

California law, as it relates to amounts received under HAP, is in conformity with federal law as it read on January 1, 2001. The amounts are included in gross income.

<u>Impact on California Revenue</u>

Conforming to the federal exclusion of amounts received under HAP from gross income would have a negligible impact on state revenues.

Section	Section Title
104	Expansion of Combat Zone Filing Rules to Contingency Operations

Background

General time limits for filing tax returns

Individuals generally must file their federal income tax returns by April 15 of the year following the close of a taxable year. The Secretary may grant reasonable extensions of time for filing such returns. Treasury regulations provide an additional automatic two-month extension (until June 15 for calendar-year individuals) for United States citizens and residents in military or naval service on duty on April 15 of the following year (the otherwise applicable due date of the return) outside the United States. No action is necessary to apply for this extension, but taxpayers must indicate on their returns (when filed) that they are claiming this extension. Unlike most extensions of time to file, this extension applies to both filing returns and paying the tax due.

Treasury regulations also provide, upon application on the proper form, an automatic four-month extension (until August 15 for calendar-year individuals) for any individual timely filing that form and timely paying the amount of tax estimated to be due.

In general, individuals must make quarterly estimated tax payments by April 15, June 15, September 15, and January 15 of the following taxable year. Wage withholding is considered to be a payment of estimated taxes.

Suspension of time periods

In general, the period of time for performing various acts under the IRC, such as filing tax returns, paying taxes, or filing a claim for credit or refund of tax, is suspended for any individual serving in the Armed Forces of the United States in an area designated as a "combat zone" during the period of combatant activities. An individual who becomes a prisoner of war is considered to continue in active service and is therefore also eligible for these suspensions of time provisions. The suspension of time also applies to an individual serving in support of such Armed Forces in the combat zone, such as Red Cross personnel, accredited correspondents, and civilian personnel acting under the direction of the Armed Forces in support of those forces. The President in an Executive Order must make the designation of a combat zone. The President must also designate the period of combatant activities in the combat zone (the starting date and the termination date of combat).

The suspension of time encompasses the period of service in the combat zone during the period of combatant activities in the zone, as well as (1) any time of continuous qualified hospitalization resulting from injury received in the combat zone[28] or (2) time in missing-in-action status, plus the next 180 days.

The suspension of time applies to the following acts:

- Filing any return of income, estate, or gift tax (except employment and withholding taxes);
- Payment of any income, estate, or gift tax (except employment and withholding taxes);
- Filing a petition with the Tax Court for redetermination of a deficiency, or for review of a decision rendered by the Tax Court;
- Allowance of a credit or refund of any tax;
- Filing a claim for credit or refund of any tax;
- Bringing suit upon any such claim for credit or refund;
- Assessment of any tax;
- Giving or making any notice or demand for the payment of any tax, or with respect to any liability to the United States in respect of any tax;
- Collection of the amount of any liability in respect of any tax;
- Bringing suit by the United States in respect of any liability in respect of any tax; and
- Any other act required or permitted under the federal tax laws specified by the Secretary of the Treasury.

Individuals may, if they choose, perform any of these acts during the period of suspension. Spouses of qualifying individuals are entitled to the same suspension of time, except that the spouse is ineligible for this suspension for any taxable year beginning more than two years after the date of termination of combatant activities in the combat zone.

New Federal Law (IRC Section 7508)

This provision applies the special suspension of time period rules to persons deployed outside the United States away from the individual's permanent duty station while participating in an operation designated by the Secretary of Defense as a contingency operation or that becomes a contingency operation. A contingency operation is defined[29] as a military operation that is designated by the Secretary of Defense as an operation in which members of the Armed Forces are or may become involved in military actions, operations, or hostilities against an enemy of the United States or against an opposing military force, or results in the call or order to (or retention on) active duty of members of the uniformed services during a war or a national emergency declared by the President or Congress.

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[28] Two special rules apply to continuous hospitalization inside the United States. First, the suspension of time provisions based on continuous hospitalization inside the United states are applicable only to the hospitalized individual; they are not applicable to the spouse of such individual. Second, in no event do the suspension of time provisions based on continuous hospitalization inside the United States extend beyond five years from the date the individual returns to the United States. These two special rules do not apply to continuous hospitalization outside the United States.

[29] The definition is by cross-reference to 10 U.S.C. Section 101.

Effective Date

The provision applies to any period for performing an act that has not expired before November 11, 2003.

California Law (R&TC Section 18571)

California law, as it relates to combat zone filing rules, is in conformity with federal law as it read on January 1, 2001.

Impact on California Revenue

Conforming to the federal expansion of combat zone filing rules to contingency operations would have a negligible impact on state revenues.

Section	Section Title
105	Modification of Membership Requirements for Exemption from Tax for Certain Veterans' Organizations

Background

Under current law, a veteran's organization as described in IRC Section 501(c)(19) generally is exempt from taxation. The IRC defines such an organization as a post or organization of past or present members of the Armed Forces of the United States: (1) that is organized in the United States or any of its possessions; (2) no part of the net earnings of which inures to the benefit of any private shareholder or individual; and (3) that meets certain membership requirements. The membership requirements are that: (1) at least 75% of the organization's members are past or present members of the Armed Forces of the United States, and (2) substantially all of the remaining members are cadets or spouses, widows, or widowers of past or present members of the Armed Forces of the United States or of cadets. No more than 2.5% of an organization's total members may consist of individuals who are not veterans, cadets, or spouses, widows, or widowers of such individuals.

Contributions to an organization described in IRC Section 501(c)(19) may be deductible for federal income or gift tax purposes if the organization is a post or organization of war veterans.

New Federal Law (IRC Section 501(c))

The provision permits ancestors or lineal descendants of past or present members of the Armed Forces of the United States or of cadets to qualify as members for purposes of the "substantially all" test. The bill does not change the requirement that 75% of the organization's members must be past or present members of the Armed Forces of the United States.

Effective Date

The provision is effective for taxable years beginning after November 11, 2003.

California Law (R&TC Section 23701w)

California law, as it relates to veterans' organizations, is in conformity with federal law as it read on January 1, 2001.

Impact on California Revenue

Conforming to the federal modification of membership requirement for exemption from tax for certain veterans' organizations would have a negligible impact on state revenues.

Section	Section Title
106	Clarification of Treatment of Certain Dependent Care Assistance Programs Provided to Members of the Uniformed Services of the United States

Background

Current law provides that qualified military benefits are not included in gross income. Generally, a qualified military benefit is any allowance or in-kind benefit (other than personal use of a vehicle) which: (1) is received by any member or former member of the uniformed services of the United States or any dependent of such member by reason of such member's status or service as a member of such uniformed services; and (2) was excludable from gross income on September 9, 1986, under any provision of law, regulation, or administrative practice which was in effect on such date. Generally, other than certain cost of living adjustments, no modification or adjustment of any qualified military benefit after September 9, 1986, is taken into account for purposes of this exclusion from gross income.

New Federal Law (IRC Section 134)

The provision clarifies that dependent care assistance provided under a dependent care assistance program (as in effect on November 11, 2003) for a member of the uniformed services by reason of such member's status or service as a member of the uniformed services is excludable from gross income as a qualified military benefit subject to the present-law rules. The uniformed services include: (1) the Armed Forces (the Army, Navy, Air Force, Marine Corps, and Coast Guard); (2) the commissioned corps of the National Oceanic and Atmospheric Administration; and (3) the commissioned corps of the Public Health Service. Amounts received under the program also are not considered wages for FICA tax purposes (including Medicare).

Effective Date

The provision is effective for taxable years beginning after December 31, 2002. No inference is intended as to the tax treatment of such amounts for prior taxable years.

California Law (R&TC Section 17131)

California law, as it relates to the treatment of certain dependent care assistance programs provided to members of the uniformed services, is in conformity with federal law as it read on January 1, 2001.

Impact on California Revenue

Conforming to the federal clarification of treatment of certain dependent care assistance programs provided to members of the uniformed services would not impact state revenues.

Section	Section Title
107	Treatment of Service Academy Appointments as Scholarships for Purposes of Qualified Tuition Programs and Coverdell Education Savings Accounts

Background

The IRC provides tax-exempt status to qualified tuition programs, meaning programs established and maintained by a state or agency or instrumentality thereof or by one or more eligible educational institutions under which a person (1) may purchase tuition credits or certificates on behalf of a designated beneficiary which entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary, or (2) in the case of a program established by and maintained by a state or agency or instrumentality thereof, may make contributions to an account which is established for the purpose of meeting the qualified higher education expenses of the designated beneficiary of the account. Contributions to qualified tuition programs may be made only in cash. Qualified tuition programs must have adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of amounts necessary to provide for the qualified higher education expenses of the beneficiary.

The IRC provides tax-exempt status to Coverdell education savings accounts (ESAs), meaning certain trusts or custodial accounts that are created or organized in the United States exclusively for the purpose of paying the qualified education expenses of a designated beneficiary. Contributions to ESAs may be made only in cash. Annual contributions to ESAs may not exceed $2,000 per beneficiary (except in cases involving certain tax-free rollovers) and may not be made after the designated beneficiary reaches age 18.

Earnings on contributions to an ESA or a qualified tuition program generally are subject to tax when withdrawn. However, distributions from an ESA or qualified tuition program are excludable from the gross income of the distributee to the extent that the total distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made.

If the qualified education expenses of the beneficiary for the year are less than the total amount of the distribution from an ESA or qualified tuition program, then the qualified education expenses are deemed to be paid from a pro-rata share of both the principal and earnings components of the distribution. In such a case, only a portion of the earnings is excludable (i.e., the portion of the earnings based on the ratio that the qualified education expenses bear to the total amount of the distribution) and the remaining portion of the earnings is includible in the beneficiary's gross income.

The earnings portion of a distribution from an ESA or a qualified tuition program that is includible in income is generally subject to an additional 10% tax. The 10% additional tax does not apply if a distribution is made on account of the death or disability of the designated beneficiary, or on account of a scholarship received by the designated beneficiary (to the extent it does not exceed the amount of the scholarship).

Service obligations are required of recipients of appointments to the United States Military Academy, the United States Naval Academy, the United States Air Force Academy, the United States Coast Guard Academy, or the United States Merchant Marine Academy. Because of these service obligations, appointments to the Academies are not considered scholarships for purposes of IRC Section 117 (which provides that scholarships are excludable from gross income subject to tax). The Joint Committee on Taxation has concluded appointments to the Academies are not considered scholarships for purposes of the waiver of the additional 10% tax on withdrawals from ESAs and qualified tuition programs that are not used for qualified education purposes. However, the Office of Chief Counsel, Internal Revenue Service, has concluded that appointments to the Academies may be considered scholarships for purposes of the waiver of the additional 10% tax on withdrawals.

New Federal Law (IRC Sections 529 and 530)

Under the provision, the additional 10% tax does not apply to withdrawals from ESAs and qualified tuition programs made on account of the attendance of the beneficiary at the United States Military Academy, the United States Naval Academy, the United States Air Force Academy, the United States Coast Guard Academy, or the United States Merchant Marine Academy.

The amount of funds that can be withdrawn without payment of the 10% additional tax is limited to the costs of advanced education as defined in Title 10 U.S.C. Section 2005(e)(3) (as in effect on November 11, 2003) at such Academies.

Effective Date

The provision applies to taxable years beginning after December 31, 2002.

California Law (R&TC Sections 17140 and 17140.3)

California law, as it relates to qualified tuition programs and ESAs, generally conforms to federal law as it read on January 1, 2001. California law imposes a 2½% tax rather than a 10% tax on distributions that must be included in gross income.

Impact on California Revenue

Conforming to the federal treatment of qualified tuition programs and ESAs would have a negligible impact on state revenues.

Section	Section Title
108	Suspension of Tax-Exempt Status of Terrorist Organizations

Background

Under current law, the IRS generally issues a letter revoking recognition of an organization's tax-exempt status only after (1) conducting an examination of the organization, (2) issuing a letter to the organization proposing revocation, and (3) allowing the organization to exhaust the administrative appeal rights that follow the issuance of the proposed revocation letter. In the case of an organization described in IRC Section 501(c)(3), the revocation letter immediately is subject to judicial review under the declaratory judgment procedures of IRC Section 7428. To sustain a revocation of tax-exempt status under IRC Section 7428, the IRS must demonstrate that the organization is no longer entitled to exemption. There is no procedure under current law for the IRS to suspend the tax-exempt status of an organization.

To combat terrorism, the federal government has designated a number of organizations as terrorist organizations or supporters of terrorism under the Immigration and Nationality Act, the International Emergency Economic Powers Act, and the United Nations Participation Act of 1945.

<u>New Federal Law</u> (IRC Section 501(p))

The provision suspends the tax-exempt status of an organization that is exempt from tax under IRC Section 501(a) for any period during which the organization is designated or identified by U.S. federal authorities as a terrorist organization or supporter of terrorism. The act also makes such an organization ineligible to apply for tax exemption under IRC Section 501(a). The period of suspension runs from the date the organization is first designated or identified (or from November 11, 2003, whichever is later) to the date when all designations or identifications with respect to the organization have been rescinded pursuant to the law or Executive Order under which the designation or identification was made.

The provision describes a terrorist organization as an organization that has been designated or otherwise individually identified (1) as a terrorist organization or foreign terrorist organization under the authority of Section 212(a)(3)(B)(vi)(II) or Section 219 of the Immigration and Nationality Act; (2) in or pursuant to an Executive Order that is related to terrorism and issued under the authority of the International Emergency Economic Powers Act or Section 5 of the United Nations Participation Act for the purpose of imposing on such organization an economic or other sanction; or (3) in or pursuant to an Executive Order that refers to the provision and is issued under the authority of any federal law if the organization is designated or otherwise individually identified in or pursuant to such Executive Order as supporting or engaging in terrorist activity (as defined in Section 212(a)(3)(B) of the Immigration and Nationality Act) or supporting terrorism (as defined in Section 140(d)(2) of the Foreign Relations Authorization Act, Fiscal Years 1988 and 1989). During the period of suspension, no deduction for any contribution to a terrorist organization is allowed under the IRC, including under IRC Sections 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522.

No organization or other person may challenge, under IRC Section 7428 or any other provision of law, in any administrative or judicial proceeding relating to the federal tax liability of such organization or other person, the suspension of tax exemption, the ineligibility to apply for tax exemption, a designation or identification described above, the timing of the period of suspension, or a denial of deduction described above. The suspended organization may maintain other suits or administrative actions against the agency or agencies that designated or identified the organization, for the purpose of challenging such designation or identification (but not the suspension of tax-exempt status under this provision).

If the tax exemption of an organization is suspended and each designation and identification that has been made with respect to the organization is determined to be erroneous pursuant to the law or Executive Order making the designation or identification, and such erroneous designation results in an overpayment of income tax for any taxable year with respect to such organization, a credit or refund (with interest) with respect to such overpayment shall be made. If the operation of any law or rule of law (including res judicata) prevents the credit or refund at any time, the credit or refund may nevertheless be allowed or made if the claim for such credit or refund is filed before the close of the one-year period beginning on the date that the last remaining designation or identification with respect to the organization is determined to be erroneous.

The provision directs the IRS to update the listings of tax-exempt organizations to take account of organizations that have had their exemption suspended and to publish notice to taxpayers of the suspension of an organization's tax-exemption and the fact that contributions to such organization are not deductible during the period of suspension.

Effective Date

The provision is effective for designations made before, on, or after November 11, 2003.

California Law

California law conforms to federal law regarding exempt organizations with modifications and exceptions. California law does not contain statutes regarding the suspending or revoking of an organization’s tax-exemption due to terrorist activities.

Impact on California Revenue

Conforming to the federal suspension of tax-exempt status of terrorist organizations would have a negligible impact on state revenues.

Military Family Tax Relief Act of 2003
(P.L. 108-121)

Section	Section Title
109	Above-the-Line Deduction for Overnight Travel Expenses of National Guard and Reserve Members

Background

National Guard and Reserve members may claim itemized deductions for their nonreimbursable expenses for transportation, meals, and lodging when they must travel away from home (and stay overnight) to attend National Guard and Reserve meetings. These overnight travel expenses are combined with other miscellaneous itemized deductions on Schedule A of the individual's income tax return and are deductible only to the extent that the aggregate of these deductions exceeds two percent of the taxpayer's AGI. No deduction is generally permitted for commuting expenses to and from drill meetings.

New Federal Law (IRC Section 162(p))

The provision allows an above-the-line deduction for the overnight transportation, meals, and lodging expenses of National Guard and Reserve members who must travel away from home more than 100 miles (and stay overnight) to attend National Guard and Reserve meetings. Accordingly, these individuals incurring these expenses can deduct them from gross income regardless of whether they itemize their deductions. The amount of the expenses that may be deducted may not exceed the general federal government per diem rate applicable to that locale. Also, the amount of the expenses that may be deducted is only available for any period during which the individual is more than 100 miles from home in connection with such services.

Effective Date

The provision is effective with respect to amounts paid or incurred in taxable years beginning after December 31, 2002.

California Law (R&TC Sections 17076 and 17201)

California law, as it relates to the deduction of trade or business expenses and employee nonreimbursable expenses, is in conformity with federal law as it read on January 1, 2001.

Impact on California Revenue

Estimated Revenue Impact of Above-the-Line Deduction for Overnight Travel Expense of National Guard and Reserve Members For Amounts Paid Or Incurred After December 31, 2002 ($ Millions)			
Fiscal Year	2004-05	2005-06	2006-07
Revenue Loss	-2.5	-2.3	-2.3

Revenue estimates were based on federal projections.

Section	Section Title
110	Extension of Certain Tax Relief Provisions to Astronauts

Background

In general

The Victims of Terrorism Tax Relief Act of 2001 (the "Victims Act") provided certain income and estate tax relief to individuals who die from wounds or injury incurred as a result of the terrorist attacks against the United States on September 11, 2001, and April 19, 1995 (the bombing of the Alfred P. Murrah Federal Building in Oklahoma City) or as a result of illness incurred due to an attack involving anthrax that occurred on or after September 11, 2001, and before January 1, 2002.

Income tax relief

The Victims Act extended relief similar to the present-law treatment of military or civilian employees of the United States who die as a result of terrorist or military activity outside the United States to individuals who die as a result of wounds or injury which were incurred as a result of the terrorist attacks that occurred on September 11, 2001, or April 19, 1995, and individuals who die as a result of illness incurred due to an attack involving anthrax that occurred on or after September 11, 2001, and before January 1, 2002. Under the Victims Act, such individuals generally are exempt from income tax for the year of death and for prior taxable years beginning with the taxable year prior to the taxable year in which the wounds or injury occurred.[30] The exemption applies to these individuals whether killed in an attack (e.g., in the case of the September 11, 2001, attack in one of the four airplanes or on the ground) or in rescue or recovery operations.

[30] Present law does not provide relief from self-employment tax liability.

Current law provides tax relief of at least $10,000 to each eligible individual regardless of the income tax liability of the individual for the eligible tax years. If an eligible individual's income tax for years eligible for the exclusion under the provision is less than $10,000, the individual is treated as having made a tax payment for such individual's last taxable year in an amount equal to the excess of $10,000 over the amount of tax not imposed under the provision.

Subject to rules prescribed by the Secretary, the exemption from tax does not apply to the tax attributable to (1) deferred compensation which would have been payable after death if the individual had died other than as a specified terrorist victim, or (2) amounts payable in the taxable year which would not have been payable in such taxable year but for an action taken after September 11, 2001. Thus, for example, the exemption does not apply to amounts payable from a qualified plan or individual retirement arrangement to the beneficiary or estate of the individual. Similarly, amounts payable only as death or survivor's benefits pursuant to deferred compensation preexisting arrangements that would have been paid if the death had occurred for another reason are not covered by the exemption. In addition, if the individual's employer makes adjustments to a plan or arrangement to accelerate the vesting of restricted property or the payment of nonqualified deferred compensation after the date of the particular attack, the exemption does not apply to income received as a result of that action.[31] Also, if the individual's beneficiary cashed in savings bonds of the decedent, the exemption does not apply. On the other hand, the exemption does apply, for example, to a final paycheck of the individual or dividends on stock held by the individual when paid to another person or the individual's estate after the date of death but before the end of the taxable year of the decedent (determined without regard to the death). The exemption also applies to payments of an individual's accrued vacation and accrued sick leave.

The tax relief does not apply to any individual identified by the Attorney General to have been a participant or conspirator in any terrorist attack to which the provision applies, or a representative of such individual.

Exclusion of death benefits

The Victims Act generally provides an exclusion from gross income for amounts received if such amounts are paid by an employer (whether in a single sum or otherwise[32]) by reason of the death of an employee who dies as a result of wounds or injury which were incurred as a result of the terrorist attacks that occurred on September 11, 2001, or April 19, 1995, or as a result of illness incurred due to an attack involving anthrax that occurred on or after September 11, 2001, and before January 1, 2002. Subject to rules prescribed by the Secretary, the exclusion does not apply to amounts that would have been payable if the individual had died for a reason other than the attack. The exclusion does apply, however, to death benefits provided under a qualified plan that satisfy the incidental benefit rule.

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[31] Such amounts may, however, be excludible from gross income under the death benefit exclusion provided in Section 102 of the Victims Act.

[32] Thus, for example, payments made over a period of years could qualify for the exclusion.

For purposes of the exclusion, self-employed individuals are treated as employees. Thus, for example, payments by a partnership to the surviving spouse of a partner who died as a result of the September 11, 2001, attacks may be excludable under the provision.

The tax relief does not apply to any individual identified by the Attorney General to have been a participant or conspirator in any terrorist attack to which the provision applies, or a representative of such individual.

Estate tax relief

Current law provides a reduction in federal estate tax for taxable estates of U.S. citizens or residents who are active members of the U.S. Armed Forces and who are killed in action while serving in a combat zone (IRC Section 2201). This provision also applies to active service members who die as a result of wounds, disease, or injury suffered while serving in a combat zone by reason of a hazard to which the service member was subjected as an incident of such service.

In general, the effect of IRC Section 2201 is to replace the federal estate tax that would otherwise be imposed with a federal estate tax equal to 125% of the maximum state death tax credit determined under IRC Section 2011(b). Credits against the tax, including the unified credit of IRC Section 2010 and the state death tax credit of Section 2011, then apply to reduce (or eliminate) the amount of the estate tax payable.

Generally, the reduction in federal estate taxes under IRC Section 2201 is equal in amount to the "additional estate tax." The additional estate tax is the difference between the federal estate tax imposed by IRC Section 2001 and 125% of the maximum state death tax credit determined under IRC Section 2011(b) as in effect prior to its repeal by EGTRRA (P.L 107-16).

The Victims Act generally treats individuals who die from wounds or injury incurred as a result of the terrorist attacks that occurred on September 11, 2001, or April 19, 1995, or as a result of illness incurred due to an attack involving anthrax that occurred on or after September 11, 2001, and before January 1, 2002, in the same manner as if they were active members of the U.S. Armed Forces killed in action while serving in a combat zone or dying as a result of wounds or injury suffered while serving in a combat zone for purposes of IRC Section 2201. Consequently, the estates of these individuals are eligible for the reduction in federal estate tax provided by IRC Section 2201. The tax relief does not apply to any individual identified by the Attorney General to have been a participant or conspirator in any terrorist attack to which the provision applies, or a representative of such individual.

The Victims Act also changed the general operation of IRC Section 2201, as it applies to both the estates of service members who qualify for special estate tax treatment under present and prior law and to the estates of individuals who qualify for the special treatment only under the act. Under the Victims Act, the federal estate tax is determined in the same manner for all estates that are eligible for federal estate tax reduction under IRC Section 2201. In addition, the executor of an estate that is eligible for special estate tax treatment under IRC Section 2201 may elect not to have IRC Section 2201 apply to the estate. Thus, in the event that an estate may receive more favorable treatment without the application of IRC Section 2201 in the year of death than it would under IRC section 2201, the executor may elect not to apply the provisions of IRC Section 2201, and the estate tax owed (if any) would be determined pursuant to the generally applicable rules.

Under the Victims Act, IRC Section 2201 no longer reduces federal estate tax by the amount of the additional estate tax. Instead, the Victims Act provides that the federal estate tax liability of eligible estates is determined under IRC Section 2001 (or IRC Section 2101, in the case of decedents who were neither residents nor citizens of the United States), using a rate schedule that is equal to 125% of the pre-EGTRRA maximum state death tax credit amount. This rate schedule is used to compute the tax under IRC Section 2001(b) or Section 2101(b) (i.e., both the tentative tax under IRC Section 2001(b)(1) and Section 2101(b), and the hypothetical gift tax under IRC Section 2001(b)(2) are computed using this rate schedule). As a result of this provision, the estate tax is unified with the gift tax for purposes of IRC Section 2201 so that a single graduated (but reduced) rate schedule applies to transfers made by the individual at death, based upon the cumulative taxable transfers made both during lifetime and at death.

In addition, while the Victims Act provides an alternative reduced rate table for purposes of determining the tax under IRC Section 2001(b) or Section 2101(b), the amount of the unified credit nevertheless is determined as if IRC Section 2201 did not apply, based upon the unified credit as in effect on the date of death. For example, in the case of victims of the September 11, 2001, terrorist attack, the applicable unified credit amount under IRC Section 2010(c) would be determined by reference to the actual IRC Section 2001(c) rate table.

<u>New Federal Law</u> (IRC Sections 101(i) and 692(d))

The provision extends the exclusion from income tax, the exclusion for death benefits, and the estate tax relief available under the Victims Act, to astronauts who lose their lives on a space mission (including the individuals who lost their lives in the space shuttle Columbia disaster).

<u>Effective Date</u>

The provision is generally effective for qualified individuals whose lives are lost in the line of duty after December 31, 2002.

California Law (R&TC Section 17131)

California law is in conformity with the federal Victims Act as enacted on January 23, 2002.

Impact on California Revenue

Conforming to the federal extension of certain tax relief provisions to astronauts would have a negligible impact on state revenues.

Section	Section Title
105	Additional Provisions Relating to Medicare Prescription Drug Discount Card and Transitional Assistance Program

Background

IRC Section 6103(l) specifies the government agencies to which IRS may disclose return information for purposes other than tax administration and the conditions of disclosure.

Return information is confidential. Any person who has access to return information under specified provisions of IRC Section 6103 is prohibited from disclosing that information.

IRS may not disclose return information to certain specified agencies if the agency does not establish procedures satisfactory to IRS for safeguarding the information it receives, unless the return information is disclosed in the course of any judicial or administrative proceeding and made part of the public record of the proceeding.

IRC Section 7213 imposes penalties on any government employee who makes unauthorized disclosure of return information acquired by him under specified provisions of IRC Section 6103.

New Federal Law (IRC Section 6103(l))

This provision includes additional provisions relating to the implementation of the Medicare prescription drug discount card and transitional assistance program. It excludes program costs from the calculation of the Part B premium. It applies Medicaid confidentiality provisions to drug pricing data reported by manufacturers under the program.

The Secretary of the Treasury, upon written request from the Secretary of Health and Human Services (HHS), is required to disclose to officers and employees of HHS certain information with respect to a taxpayer for the most recent taxable year for which information is available in the IRS's taxpayer data information system, or if no return was filed for that year, the year before that. Required information would consist of whether the adjusted gross income (as modified by HHS regulations) of the taxpayer, and if applicable the taxpayer's spouse, exceeds amounts that are 100% and 135% of the official poverty line. Such information may only be used to determine eligibility for the transitional low-income assistance program.

Effective Date

This provision is effective December 8, 2003.

California Law

Not applicable.

Impact on California Revenue

Not applicable.

Section	Section Title
811	Income-Related Reduction in Part B Premium Subsidy

Background

The Medicare Part B premium is currently set each year to cover 25% of Medicare's benefits under Part B. When Medicare was created in 1965, the Part B premium was set to cover 50% of the costs of the Part B benefits. The share of Part B spending covered by the premium declined between 1975 and 1983 to less than 25% of spending, because during that time premium increases were limited by the cost-of-living adjustment for Social Security benefits. During the late 1980s and early 1990s, Congress routinely voted to set the Part B premium at 25% of Part B costs, and that percentage was codified in the Balanced Budget Act of 1997.

All seniors over age 65 who elect Part B during their initial enrollment period pay the same Part B premium, regardless of income.

New Federal Law (IRC Section 6103(l))

To begin to address the fiscal challenges facing the Medicare program, beginning in 2007, Medicare beneficiaries with incomes over $80,000 for an individual or $160,000 for a married couple will be asked to contribute more to the cost of their Medicare benefits through payment of a higher premium. Approximately 4% of Medicare beneficiaries have incomes above these levels. All beneficiaries will continue to receive some level of premium assistance, and all beneficiaries will continue to be eligible for the full range of Medicare benefits. This proposal will target taxpayer dollars at those who need it the most by reducing the government subsidy for those who have the resources to cover more of their own costs.

Beneficiaries with incomes under $80,000 for an individual and $160,000 for a married couple will continue to receive a government subsidy at 75% and pay premiums at the 25% rate. Those with incomes between $80,000 and $100,000 ($160,000 and $200,000 for a married couple) will receive a 65% subsidy and pay 35% as a premium. Those with incomes between $100,000 and $150,000 ($200,000 and $300,000 for a couple) will receive a 50% subsidy and pay 50% as a premium. Those with incomes between $150,000 and $200,000 ($300,000 and $400,000 for a married couple) will receive a 35% subsidy and pay a premium at a 65% rate. Those with incomes above $200,000 ($400,000 for a married couple) will receive a 20% subsidy and pay a premium at an 80% rate.

Beneficiaries who are affected will be notified of their premium levels at the start of the year. They may appeal their premium level based on major changes in life circumstances, such as divorce, marriage, or death of a spouse. Although this policy affects only a small number of beneficiaries, it will have a significant impact in controlling the growth of Medicare spending in the future.

To facilitate the income-related reduction in Part B premium subsidy, this provision authorizes the disclosure of certain return information to employees and contractors of the Social Security Administration. Upon written request from the Commissioner of Social Security, the IRS may disclose certain items of return information with respect to a taxpayer whose premium may be subject to adjustment. With respect to such taxpayers, the IRS may disclose (1) taxpayer identity information; (2) filing status; (3) adjusted gross income; (4) the amounts excluded from such taxpayer's gross income by IRC Sections 135 and 911 (relating to income from United States Savings bonds used to pay higher education tuition and fees, and foreign earned income); (5) tax-exempt interest received or accrued during the taxable year to the extent such information is available; (6) amounts excluded from such taxpayer's gross income by IRC Sections 931 and 933 (relating to income from sources within Guam, American Samoa, the Northern Mariana Islands, or Puerto Rico); (7) for nonfilers only, such other information relating to the liability of the taxpayer as the Secretary may prescribe by regulation, as might indicate that the amount of the premium of the taxpayer may be subject to adjustment (including estimated tax payments and income information derived from Form W-2, Form 1099, or similar information returns); and (8) the taxable year with respect to which the preceding information relates. Employees and contractors of the Social Security Administration only for purposes of, and to the extent necessary in, establishing the appropriate amount of any Part B premium adjustment, may use return information disclosed under this authority. Employees and contractors of the Social Security Administration are subject to the penalties for unauthorized disclosure and inspection, as well as the applicable safeguard requirements.

Effective Date

This provision is effective December 8, 2003.

California Law

Not applicable.

Impact on California Revenue

Not applicable.

<u>Section</u> <u>Section Title</u>
1201 Health Savings Accounts

<u>Background</u>

Overview

Present law contains a number of provisions dealing with the federal tax treatment of health expenses and health insurance coverage.

Employer-provided health coverage

In general, employer contributions to an accident or health plan are excludable from an employee's gross income (and wages for employment tax purposes).[33] This exclusion generally applies to coverage provided to employees (including former employees) and their spouses, dependents, and survivors. Benefits paid under employer-provided accident or health plans are also generally excludable from income to the extent they are reimbursements for medical care.[34] If certain requirements are satisfied, employer-provided accident or health coverage offered under a cafeteria plan is also excludable from an employee's gross income and wages.[35] Present law provides for two general employer-provided arrangements that can be used to pay for or reimburse medical expenses of employees on a tax-favored basis: flexible spending arrangements (FSAs) and health reimbursement arrangements (HRAs). While these arrangements provide similar tax benefits (i.e., the amounts paid under the arrangements for medical care are excludable from gross income and wages for employment tax purposes), they are subject to different rules. A main distinguishing feature between the two arrangements is that while FSAs are generally part of a cafeteria plan and contributions to FSAs are made on a salary reduction basis, HRAs cannot be part of a cafeteria plan and contributions cannot be made on a salary-reduction basis.[36]

Amounts paid or accrued by an employer within a taxable year for a sickness, accident, hospitalization, medical expense, or similar health plan for its employees are generally deductible as ordinary and necessary business expenses.[37]

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[33] IRC Sections 106, 3132(a)(2), and 3306(b)(2).

[34] IRC Section 105. In the case of a self-insured medical reimbursement arrangement, the exclusion applies to highly compensated employees only if certain nondiscrimination rules are satisfied. (IRC Section 105(h)). Medical care is defined as under IRC Section 213(d) and generally includes amounts paid for qualified long-term care insurance and services.

[35] IRC Sections 125, 3121(a)(5)(G), and 3306(b)(5)(G). Long-term care insurance and services may not be provided through a cafeteria plan.

[36] Notice 2002-45, 2002-28 I.R.B. 93 (July 15, 2002); Rev. Rul. 2002-41, 2002-28 I.R.B. 75 (July 15, 2002).

[37] IRC Section 162.

Self-employed individuals

The exclusion for employer-provided health coverage does not apply to self-employed individuals. However, under present law, self-employed individuals (i.e., sole proprietors or partners in a partnership)[38] are entitled to deduct 100% of the amount paid for health insurance for themselves and their spouse and dependents.[39]

Itemized deduction for medical expenses

Under present law, individuals who itemize deductions may deduct amounts paid during the taxable year (to the extent not reimbursed by insurance or otherwise) for medical care of the taxpayer, the taxpayer's spouse, and dependents, to the extent that the total of such expenses exceeds 7.5% of the taxpayer's AGI.[40]

Archer medical savings accounts

In general

In general, an Archer medical savings account (MSA) is a tax-exempt trust or custodial account created exclusively for the benefit of the account holder that is subject to rules similar to those applicable to individual retirement arrangements.[41]

Within limits, contributions to an MSA are deductible in determining adjusted gross income if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Earnings on amounts in an MSA are not includible in gross income in the year earned (i.e., inside buildup is not taxable). Distributions from an MSA for qualified medical expenses are not includible in gross income. Distributions not used for qualified medical expenses are includible in gross income and subject to an additional 15% tax unless the distribution is made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

Qualified medical expenses are generally defined as under IRC Section 213(d), except that qualified medical expenses do not include expenses for health insurance other than long-term care insurance, premiums for health coverage during any period of continuation coverage required by federal law, and premiums for health care coverage while an individual is receiving unemployment compensation under federal or state law. For purposes of determining the itemized deduction for medical expenses, distributions from an MSA for

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[38] Self-employed individuals include more than 2% shareholders of S corporations who are treated as partners for purposes of fringe benefit rules pursuant to IRC Section 1372.

[39] IRC Section 162(l).

[40] IRC Section 213. The adjusted gross income percentage is 10% for purposes of the alternative minimum tax. (IRC Section 56(b)(1)(B).

[41] IRC Section 220.

qualified medical expenses are not treated as expenses paid for medical care under IRC Section 213.

Eligible individuals

MSAs are available only to employees of a small employer who are covered under an employer-sponsored high deductible health plan and to self-employed individuals covered under a high deductible health plan.[42] An employer is a small employer if it employed, on average, no more than 50 employees on business days during either of the two preceding calendar years. An individual is not eligible for an MSA if he or she is covered under any other health plan that is not a high deductible health plan (other than a plan providing certain limited types of coverage). Individuals entitled to benefits under Medicare are not eligible individuals. Eligible individuals do not include individuals who may be claimed as a dependent on another person's tax return.

Treatment of contributions

Individual contributions to an MSA are deductible (within limits) in determining adjusted gross income (i.e., "above-the-line"). In addition, employer contributions are excludable from gross income and wages for employment tax purposes (within the same limits), except that this exclusion does not apply to contributions made through a cafeteria plan. In the case of an employee, contributions can be made to an MSA either by the individual or by the individual's employer, but not by both.

The maximum annual contribution that can be made to an MSA for a year is 65% of the annual deductible under the high deductible health plan in the case of self-only coverage and 75% of the annual deductible in the case of family coverage.

If an employer provides a high deductible health plan coupled with MSAs for employees and makes employer contributions to the MSAs, the employer must make available a comparable contribution on behalf of all employees with comparable coverage during the same period. Contributions are considered comparable if they are either of the same amount or the same percentage of the deductible under the high deductible health plan. If employer contributions do not satisfy the comparability rule during a period, then the employer is subject to an excise tax equal to 35% of the aggregate amount contributed by the employer to MSAs for that period.

Definition of high deductible health plan

A high deductible health plan is a health plan with an annual deductible of at least $1,700 and no more than $2,500 in the case of self-only coverage and at least $3,350 and no more than

[42] Self-employed individuals include more than 2% shareholders of S corporations who are treated as partners for purposes of fringe benefit rules pursuant to IRC Section 1372.

$5,050 in the case of family coverage.[43] In addition, the maximum out-of-pocket expenses with respect to allowed costs must be no more than $3,350 in the case of self-only coverage and no more than $6,150 in the case of family coverage. Out-of-pocket expenses include deductibles, co-payments, and other amounts (other than premiums) that the individual must pay for covered benefits under the plan. A plan does not fail to qualify as a high deductible health plan merely because it does not have a deductible for preventive care as required under state law. A plan does not qualify as a high deductible health plan if substantially all of the coverage under the plan is certain permitted insurance or is coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.

Treatment of death of account holder

Upon death, any balance remaining in the decedent's MSA is includible in his or her gross estate. If the account holder's surviving spouse is the named beneficiary of the MSA, then, after the death of the account holder, the MSA becomes the MSA of the surviving spouse and the amount of the MSA balance may be deducted in computing the decedent's taxable estate, pursuant to the estate tax marital deduction.[44] If, upon the account holder's death, the MSA passes to a named beneficiary other than the decedent's surviving spouse, the MSA ceases to be an MSA as of the date of the decedent's death, and the beneficiary is required to include the fair market value of the MSA assets as of the date of death in gross income for the taxable year that includes the date of death. The amount includible in gross income is reduced by the amount in the MSA used, within one year after death, to pay qualified medical expenses incurred prior to the death. If there is no named beneficiary for the decedent's MSA, the MSA ceases to be an MSA as of the date of death, and the fair market value of the assets in the MSA as of such date is includible in the decedent's gross income for the year of the death.

Limit on number of MSAs; termination of MSA availability

The number of taxpayers benefiting annually from an MSA contribution is limited to a threshold level (generally 750,000 taxpayers). The number of MSAs established has not exceeded the threshold level.

After 2003, no new contributions can be made to MSAs except by or on behalf of individuals who previously had MSA contributions and employees who are employed by a participating employer.

[43] The deductible and out-of-pocket expenses dollar amounts are for 2003. These amounts are indexed for inflation in $50 increments.
[44] IRC Section 2056.

New Federal Law (IRC Section 223)

In general

This provision creates health savings accounts (HSAs), which provides tax-favored treatment for current medical expenses as well as the ability to save on a tax-favored basis for future medical expenses. In general, HSAs are tax-exempt trusts or custodial accounts created exclusively to pay for the qualified medical expenses of the account holder and his or her spouse and dependents that are subject to rules similar to those applicable to individual retirement arrangements.[45]

Within limits, contributions to HSAs are deductible if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Contributions in excess of the maximum contribution amount are generally subject to a 6% excise tax.[46] Distributions from HSAs for qualified medical expenses are not includible in gross income. Distributions that are not for qualified medical expenses are includible in gross income and subject to an additional 10% tax. The additional 10% tax does not apply after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

Eligible individuals

Eligible individuals are individuals who are covered by a high deductible health plan and no other health plan that is not a high deductible health plan. Individuals entitled to benefits under Medicare are not eligible to make contributions to an HSA. Eligible individuals do not include individuals who may be claimed as a dependent on another person's tax return.

An individual with other coverage in addition to a high deductible health plan is still eligible for an HSA if such coverage is certain permitted insurance or permitted coverage. Permitted insurance is: (1) insurance if substantially all of the coverage provided under such insurance relates to (a) liabilities incurred under worker's compensation law, (b) tort liabilities, (c) liabilities relating to ownership or use of property (e.g., auto insurance), or (d) such other similar liabilities as the Secretary may prescribe by regulations; (2) insurance for a specified disease or illness; and (3) insurance that provides a fixed payment for hospitalization. Permitted coverage is coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.

A high deductible health plan is a health plan that has a deductible that is at least $1,000 for self-only coverage or $2,000 for family coverage and that has an out-of-pocket expense limit that is no more than $5,000 in the case of self-only coverage and $10,000 in the case of

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[45] As under MSAs, this provision provides that the present-law requirement applicable to insurance companies that certain policy acquisition expenses must be capitalized and amortized (IRC Section 848) does not apply in the case of any contract that is a health account.

[46] Ordering rules apply to determine the nature of any distributed excess contributions.

family coverage.[47] Out-of-pocket expenses include deductibles, co-payments, and other amounts (other than premiums) that the individual must pay for covered benefits under the plan. The annual deductible maximum and minimum and out-of-pocket expense amounts are indexed for inflation. A plan is not a high deductible health plan if substantially all of the coverage is for permitted coverage or coverage that may be provided by permitted insurance, as described above.

Tax treatment of and limits on contributions

Contributions made by or on behalf of an eligible individual are deductible by the individual. Thus, for example, contributions made by an eligible individual's family members are deductible by the eligible individual to the extent the contribution would be deductible if made by the individual. In addition, employer contributions to an HSA (including salary reduction contributions made through a cafeteria plan) are excludable from gross income and wages for employment tax purposes to the extent the contribution would be deductible if made by the employee.[48] All contributions by or on behalf of an eligible individual are aggregated for purposes of the maximum annual contribution limit. Contributions to MSAs reduce the annual contribution limit for HSAs.

The maximum aggregate annual contribution that can be made to an HSA is the lesser of (1) 100% of the annual deductible under the high deductible health plan, or (2) the maximum deductible permitted under an MSA, as adjusted for inflation.[49] For 2004, the amount of the maximum high deductible is estimated to be $2,600 in the case of self-only coverage and $5,150 in the case of family coverage.

This provision increases the annual contribution limits for individuals who have attained age 55 by the end of the taxable year. In the case of policyholders and covered spouses who are 55 or older, the HSA annual contribution limit is greater than the otherwise applicable limit by $500 in 2004, $600 in 2005, $700 in 2006, $800 in 2007, $900 in 2008, and $1,000 in 2009 and thereafter. Contributions, including catch-up contributions cannot be made once an individual is eligible for Medicare. Qualified medical expenses are expanded to include health insurance premiums for individuals eligible for Medicare, other than premiums for Medigap policies. Qualified health insurance premiums include, for example, Medicare Part A and Part B premiums, Medicare HMO premiums, and the employee share of premiums for employer-sponsored health insurance, including employer-sponsored retiree health insurance.

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[47] Special rules apply for determining whether a health plan that is a preferred provider organization plan meets the requirements of a high deductible plan.

[48] Employer contributions to an HSA are excludable from wages for employment tax purposes if, at the time of payment, it is reasonable to believe that the employee will be able to exclude such payment from income.

[49] The annual contribution limit for an HSA is the sum of the limits determined separately for each month, based on the individual's status and health plan coverage as of the first day of the month.

Amounts can be rolled over into an HSA from another HSA or from an MSA

If an employer makes contributions to employees' HSAs, the employer must make available comparable contributions on behalf of all employees with comparable coverage during the same period. Contributions are considered comparable if they are either of the same amount or the same percentage of the deductible under the plan. The comparability rule is applied separately to part-time employees (i.e., employees who are customarily employed for fewer than 30 hours per week). The comparability rule does not apply to amounts transferred from an employee's HSA, health FSA, or MSA or to contributions made through a cafeteria plan.

If employer contributions do not satisfy the comparability rule during a period, then the employer is subject to an excise tax equal to 35% of the aggregate amount contributed by the employer to HSAs for that period. The excise tax is designed as a proxy for the denial of the deduction for employer contributions. In the case of a failure to comply with the comparability rule that is due to reasonable cause and not willful neglect, the Secretary may waive part or all of the tax imposed to the extent that the payment of the tax would be excessive relative to the failure involved. For purposes of the comparability rule, employers under common control are aggregated.

Taxation of distributions

Distributions from a HSA for qualified medical expenses of the individual and his or her spouse or dependents generally are excludable from gross income. In general, amounts in a HSA can be used for qualified medical expenses even if the individual is not currently eligible for contributions to the HSA. [50]

Qualified medical expenses generally are defined as under IRC Section 213(d) and include expenses for diagnosis, cure, mitigation, treatment, or prevention of disease, including prescription drugs, transportation primarily for and essential to such care, and qualified long-term care expenses. Qualified medical expenses do not include expenses for insurance other than for (1) long-term care insurance, (2) premiums for health coverage during any period of continuation coverage required by federal law, and (3) premiums for health care coverage while an individual is receiving unemployment compensation under federal or state law. For purposes of determining the itemized deduction for medical expenses, distributions from a HSA for qualified medical expenses are not treated as expenses paid for medical care under IRC Section 213.

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[50] However, in any year for which a contribution is made to an HSA, withdrawals from the HSA maintained by that individual generally are excludable from income only if the individual for whom the expenses were incurred was covered under a high deductible plan for the month in which the expenses were incurred. The rule does not apply for continuation coverage or coverage while the individual is receiving unemployment compensation even if for an individual who is not an eligible individual.

Distributions from a HSA that are not for qualified medical expenses are includible in gross income.[51] Distributions includible in gross income are also subject to an additional 10% tax unless made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

Ordering rules apply to determine the extent to which distributions are attributable to nondeductible contributions.

Tax treatment of HSAs after death

Upon death, any balance remaining in the decedent's HSA is includible in his or her gross estate.

If the HSA holder's surviving spouse is the named beneficiary of the HSA, then, after the death of the HSA holder, the HSA becomes the HSA of the surviving spouse and the amount of the HSA balance may be deducted in computing the decedent's taxable estate, pursuant to the estate tax marital deduction. The surviving spouse is not required to include any amount in gross income as a result of the death; the general rules applicable to the HSA apply to the surviving spouse's HSA (e.g., the surviving spouse is subject to income tax only on distributions from the HSA for nonqualified expenses). The surviving spouse can exclude from gross income amounts withdrawn from the HSA for expenses incurred by the decedent prior to death, to the extent they otherwise are qualified medical expenses.

If, upon death, the HSA passes to a named beneficiary other than the decedent's surviving spouse, the HSA ceases to be a HSA as of the date of the decedent's death, and the beneficiary is required to include the fair market value of HSA assets as of the date of death in gross income for the taxable year that includes the date of death. The amount includible in income is reduced by the amount in the HSA used, within one year after death, to pay qualified medical expenses incurred by the decedent prior to the death. As is the case with other HSA distributions, whether the expenses are qualified medical expenses is determined as of the time the expenses were incurred. In computing taxable income, the beneficiary may claim a deduction for that portion of the federal estate tax on the decedent's estate that was attributable to the amount of the HSA balance.

If there is no named beneficiary of the decedent's HSA, the HSA ceases to be a HSA as of the date of death, and the fair market value of the assets in the HSA as of such date is includible in the decedent's gross income for the year of the death.

This rule applies in all cases in which there is no named beneficiary, even if the surviving spouse ultimately obtains the right to the HSA assets (e.g., if the surviving spouse is the sole beneficiary of the decedent's estate).

[51] Ordering rules apply to determine the extent to which distributions are attributable to nondeductible contributions.

Reporting requirements

Employer contributions are required to be reported on the employee's Form W-2. Trustees of HSAs may be required to report to the Secretary of the Treasury amounts with respect to contributions, distributions, and other matters as determined appropriate by the Secretary. In addition, providers of health insurance are required to report information as may be prescribed by the Secretary.

Effective Date

This provision is effective for taxable years beginning after December 31, 2003.

California Law (R&TC Section 17215)

California law allows a deduction equal to the amount deducted on the federal return for an MSA.

Impact on California Revenue

Estimated Revenue Impact for Health Savings Accounts For Taxable Years Beginning After December 31, 2003 ($ Millions)			
Fiscal Year	2004-05	2005-06	2006-07
Revenue Loss	-25	-21	-23

Revenue estimates were based on federal projections.

Section	Section Title
1202	Exclusion from Gross Income of Certain Federal Subsidies for Prescription Drug Plans

Background

Gross income includes all income from whatever source derived unless a specific exclusion applies.

New Federal Law (IRC Sections 61, 56, and 139A)

This provision provides that gross income does not include any special subsidy payment received under Section 1860D-22 of the Social Security Act. The exclusion applies for purposes of both regular tax and AMT.

The exclusion is not taken into account in determining whether a deduction is allowable with respect to costs taken into account in determining the subsidy payment. Accordingly, a taxpayer could claim a deduction for prescription drug expenses incurred even though the taxpayer also received an excludible subsidy related to the same expenses.

Effective Date

This provision is effective for taxable years ending after December 8, 2003.

California Law (R&TC Section 17071 and 24271)

California law, as it relates to gross income, is in conformity with federal law, as it read on January 1, 2001.

Impact on California Revenue

Estimated Revenue Impact for Tax Exclusion for Certain Subsidies to Employers For Taxable Years Beginning After December 8, 2003 ($ Millions)			
Fiscal Year	2004-05	2005-06	2006-07
Revenue Loss	-0	-40	-58

Revenue estimates were based on federal projections.

Section 1203 — Section Title: Exception to Information Reporting Requirements Related to Certain Health Arrangements

Background

Any person in a trade or business who, in the course of that trade or business, makes specified payments to another person totaling $600 or more in a year, must provide an information report to the IRS (as well as a copy to the recipient) on the payments. Reporting is required to be done on Form 1099. In general, these information reports remind taxpayers of amounts of income that should be reflected on their tax returns and assist the IRS in verifying that taxpayers have correctly reported these amounts.

Treasury regulations specify that fees for professional services, including the services of physicians, must be reported. Treasury regulations also provide a general exception from these information reporting requirements for payments made to corporations, except that this exception is inapplicable if the corporation is "engaged in providing medical and health care services." Earlier this year, the IRS issued a revenue ruling describing whether employer-provided expense reimbursements made through debit or credit cards or other electronic media are excludible from gross income. The ruling states that "payments made to medical service providers through the use of debit, credit, and stored value cards are reportable by the employer on Form 1099-MISC under IRC Section 6041."

New Federal Law (IRC Section 6041)

This provision adds an exception from the generally applicable information reporting provisions for payments for medical care made under either: (1) a flexible spending arrangement, or (2) a health reimbursement arrangement that is treated as employer-provided coverage.

Effective Date

This provision applies to payments made after December 31, 2002.

California Law (R&TC Section 18631)

California law, as it relates to information reporting requirements, is in conformity with federal law as it read on January 1, 2001.

Impact on California Revenue

Not applicable. However, there is a potential baseline impact for the 1099 exception projected to be a loss of $1 million annually beginning in 2004-05.

Servicemembers Civil Relief Act
P.L. 108-189

Section	Section Title
510-511	Income Taxes; Residence for Tax Purposes

Background

Congress has long recognized that the men and women of our military services should have civil legal protections so they can “devote their entire energy to the defense of the Nation.” The Soldiers’ and Sailors’ Civil Relief Act (SSCRA) has provided these protections. The SSCRA contains a general relief provision that authorizes a servicemember, at any time during military service or within six months thereafter, to apply to a court for relief of (1) any obligation or liability incurred by the servicemember before active duty, or (2) any tax assessment that falls due before or during active military service. The SSCRA provides additional protections with respect to litigation, eviction, taxes, and insurance. The SSCRA also provides limits on state taxation of servicemembers, their personal property, and their compensation for military service.

Under the SSCRA, servicemembers may only be taxed on their military income by the tax jurisdiction of which they are a resident. Service members may not be taxed on their military pay by the state in which they are stationed if it is not their state of legal residence. However, if a servicemember or spouse earns additional non-military pay, the nonresident state may tax that non-military income.

In certain states with graduated income tax rates, the income tax rate that is applied to the non-military income may be based on the servicemember’s total income, including the military pay. This can result in the non-military income being taxed at a higher rate. This method of calculating state income tax is sometimes called the “California Method,” although as many as 18 or more other states also use the method.

The U.S. Constitution’s war power authority permits Congress to enact this type of legislation.

New Federal Law (Title 50, Appendix, USC, Sections 501-593)

This act restates prior law and replaces the current term “materially impaired” with the term “materially affected” for consistent usage throughout the act.

This act adds a provision preventing the use of a nonresident servicemember’s military compensation to increase the state tax liability for other income of the servicemember or spouse. In other words, this act prevents (or preempts) states from applying the “California method” to nonresident members of the armed forces.

Also, this act codifies case law holding that servicemembers that are Indians possessing a Federal Indian Reservation residence or domicile are not subject to state taxation of their military compensation.

Effective Date

This provision applies to any case that is not final before December 19, 2003.

California Law (R&TC Sections 17041, 17140.5, and 17951)

California law, as it relates to military compensation, is in conformity with federal law as it read on January 1, 2001. California does include the military pay when determining the income tax rate that is applied to the non-military income (the "California Method").

Impact on California Revenue

Not applicable. However, this act will reduce personal income tax baseline revenue on the order of $1 million annually since it preempts the "California Method." In 2002 there were 126,832 nonresident military personnel stationed in California, of which 66,107 were single and 60,725 were married. The $1 million baseline revenue loss is based primarily on single military personnel since married couples can file separate tax returns in California under current law and significantly reduce or eliminate any tax liability in California.

EXHIBIT A
EXPIRING TAX PROVISIONS

California Sunset*	California Section	Federal Section	Federal Sunset	Description and Comments
05/31/04[1]	17053.46 23646	N/A	N/A	Credit: Hiring in the Local Agency Military Base Recovery Area
05/31/04[1]	17268 24356.8	N/A	N/A	Deduction: Expensing Business Property in Local Agency Military Base Recovery Areas
05/31/04[1]	17276.2 24416.2	N/A	N/A	Deduction: Net Operating Losses in Local Agency Military Base Recovery Areas
12/31/04	17053.80	N/A	N/A	Credit: Caregiver
12/31/04	18766	N/A	N/A	Voluntary Contribution: Alzheimer’s Disease & Related Disorders Research Fund
12/31/05	17053.30 23630	N/A	N/A	Credit: Natural Heritage Preservation
12/31/05	17053.36 17053.37 23636 23637	N/A	N/A	Credit: Joint Strike Fighters Wage & Property
12/31/05	17053.84 23684	N/A	N/A	Credit: Solar Energy
12/31/05	18804	N/A	N/A	Voluntary Contribution: California Firefighter Memorial Fund
12/31/05	18808	N/A	N/A	Voluntary Contribution: California Peach Officer Memorial Fund
12/31/05	19283	N/A	N/A	Administration: Court Imposed Amounts Collection Study
12/31/05	21028	Title 31	Perm	Taxpayer's Bill of Rights: Attorney Client Privilege
12/31/06	17052.17 23617	45F	Perm	Credit: Employer Child Care Facility
12/31/06	17052.18 23617.5	N/A	N/A	Credit: Employer Dependent Care Plan

EXHIBIT A
EXPIRING TAX PROVISIONS

California Sunset*	California Section	Federal Section	Federal Sunset	Description and Comments
12/31/06	17053.57 23657	N/A	N/A	Credit: Community Development Financial Institution Deposits
12/31/06	18835	N/A	N/A	Voluntary Contribution: Asthma & Lung Disease Research Fund
12/31/07	17052.10 23610	N/A	N/A	Credit: Rice Straw
12/31/07	18716	N/A	N/A	Voluntary Contribution: State Children Trust Fund
12/31/07	18744	N/A	N/A	Voluntary Contribution: Fish & Game Preservation Fund
12/31/07	18796	N/A	N/A	Voluntary Contribution: California Breast Cancer Research Fund
12/31/07	18844	N/A	N/A	Voluntary Contribution: California Missions Foundation Fund
12/31/07	18855	N/A	N/A	Voluntary Contribution: Emergency Food Assistance Program
12/31/08	19551.1	N/A	N/A	Disclosure: Tax Information Furnished to Cities
12/31/09	18724	N/A	N/A	Voluntary Contribution: California Fund for Senior Citizens

Footnotes

This table only extends out eight years.

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

1. The LAMBRA provisions expire eight years after one of two events occur. The expiration date listed for LAMBRAs is the earliest date the tax preferences or incentives can expire.

EXHIBIT B
REVENUE TABLES

TABLE 1 Conformity Revenue Estimates for H.R. 2 The Jobs and Growth Tax Relief Reconciliation Act of 2003 Assumed Enactment after June 30, 2004					
			State Revenue Impact (in million)		
Act Section	**Provisions**	**Effective Date**	**2004-05**	**2005-06**	**2006-07**
101	Acceleration of the Increase in the Child Tax Credit	tyba 12/31/02	n/a	n/a	n/a
102 & 103	Accelerate the Expansion of the 15% Rate Bracket and Standard Deduction Marriage Penalty Relief	tyba 12/31/02	n/a	n/a	n/a
104	Accelerate the Expansion of the 10% Rate Bracket	tyba 12/31/02	n/a	n/a	n/a
105	Accelerate Reductions in Individual Income Tax Rates	tyba 12/31/02	n/a	n/a	n/a
106	Minimum Tax Relief to Individuals	tyba 12/31/02	n/a	n/a	n/a
201	Special Depreciation Allowance for Certain Property [1]	ppisa 5/5/03	-$260	+$73	-$5
202	Increased Expensing for Small Business[2]	tyba 12/31-02	-$125	-$100	-$30
301	Reduction in Capital Gains Rates for Individuals; Repeal of 5-year Holding Period Requirement	so/a 5-6-03	n/a	n/a	n/a
302	Dividends of Individuals Taxed at Capital Gains Rates	dri tyba 12/31/02	n/a	n/a	n/a
Total			**-$385**	**-$27**	**-$35**

n/a = not applicable
[1] California did not previously conform to the prior MACRS bonus depreciation allowance. However, there would be a "baseline" impact for taxpayers that claim their federal depreciation on state returns on a self-assessed basis. Projected baseline revenue effects are: $10 million loss for 2003-04, $245 million loss for 2004-05, $250 million loss for 2005-06, and $120 million gain for 2006-07.
[2] Applicable to taxpayers subject to the PIT law, including Subchapter S corporations.

Legend for Effective Date:
dri = dividends received in
ppisa = property placed in service after
so/a = sales on or after
tyba = taxable years beginning after

EXHIBIT B
REVENUE TABLES

TABLE 2 Conformity Revenue Estimates for H.R. 3365 The Military Family Tax Relief Act of 2003 Assumed Enactment after June 30, 2004					
			State Revenue Impact (in million)		
Act Section	**Provisions**	**Effective Date**	**2004-05**	**2005-06**	**2006-07**
101	Exclusion of Gain on Sale of a Principal Residence by a Member of the Uniformed Services or the Foreign Service	soea 5/6/97	-$2	-$0.5	-$0.5
102	Exclusion from Gross Income of Certain Death Gratuity Payments	doa 9/10/01	negligible	negligible	negligible
103	Exclusion for Amounts Received Under Department of Defense Homeowners Assistance Program	pma 11/11/03	negligible	negligible	negligible
104	Expansion of Combat Zone Filing Rules to Contingency Operations	[1]	negligible	negligible	negligible
105	Modification of Membership Requirements for Exemption from Tax for Certain Veterans' Organizations	tyba 11/11/03	negligible	negligible	negligible
106	Clarification of Treatment of Certain Dependent Care Assistance Programs Provided to Members of the Uniformed Services of the United States	tyba 12/31/02	no impact	no impact	no impact
107	Treatment of Service Academy Appointments as Scholarships for Purposes of Qualified Tuition Programs and Coverdell Education Savings Accounts	tyba 12/31/02	negligible	negligible	negligible
108	Suspension of Tax-Exempt Status of Terrorist Organizations	dmbo/a 11/11/03	negligible	negligible	negligible
109	Above-the-Line Deduction for Overnight Travel Expenses of National Guard and Reserve Members	apoia 12/31/02	-$2.5	-$2.3	-$2.3
110	Extension of Certain Tax Relief Provisions to Astronauts	[2]	negligible	negligible	negligible
Total			**-$4.5**	**-$2.8**	**-$2.8**

Negligible = loss not exceeding $50,000.
[1] The provision applies to any period for performing an act which has not expired before 11/11/2003.
[2] Generally effective for qualified individuals whose lives are lost in the line of duty after 12/31/2002.

<u>Legend for Effective Date:</u>
apoia = amounts paid or incurred after
dbmo/a = designations made before, on, or after
doa = deaths occurring after
pma = payments made after
soea = sales or exchanges after
tyba = taxable years beginning after

EXHIBIT B
REVENUE TABLES

TABLE 3 Conformity Revenue Estimates for H.R. 1 The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 Assumed Enactment after June 30, 2004					
			State Revenue Impact (in million)		
Act Section	**Provisions**	**Effective Date**	**2004-05**	**2005-06**	**2006-07**
---	Indirect Tax Effect of Reduction in Employer Costs for Prescription Drug Insurance and Medicare Subsidies to Employers [1]		n/a	n/a	n/a
1201	Health savings Accounts	tyba 12/31/03	-$25	-$21	-$23
1202	Exclusion from Gross Income of Certain Federal Subsidies for Prescription Drug Plans	tyba 12/08/03	$0	-$40	-$58
1203	Exception to Information Reporting Requirements Related to Certain Health Arrangements [2]	pma 12/31/02	n/a	n/a	n/a
Total			**-$25**	**-$61**	**-$81**

n/a = not applicable
[1] This is not an item that can be conformed to but rather an indirect revenue effect due to a reduction of certain employer expenses (i.e. deductions) that would otherwise occur without the federal legislation. Projected baseline state revenue gains are: 2003-04 = minor gain; 2004-05 = minor gain, 2005-06 = $55 million gain; and for 2006-07 = $80 million gain. Minor gain = gain not exceeding $500,000.
[2] Potential baseline impact for the 1099 exception projected to be a loss of $1 million annually beginning in 2004-05.

Legend for Effective Date:
pma = payments made after
tyba = taxable years beginning after

EXHIBIT B
REVENUE TABLES

TABLE 4 Conformity Revenue Estimates for H.R. 100 Servicemembers Civil Relief Act					
			State Revenue Impact (in million)		
Act Section	**Provisions**	**Effective Date**	**2004-05**	**2005-06**	**2006-07**
510-511	Income Taxes; Residence for Tax Purposes [1]	[2]	$0	$0	$0
Total			**$0**	**$0**	**$0**

[1] This act will reduce personal income tax baseline revenue on the order of $1 million annually since it preempts the "California Method." Conforming to the federal law will have no incremental impact. In 2002 there were 126,832 nonresident military personnel stationed in California, of which 66,107 were single and 60,725 were married. The $1 million baseline revenue loss is based primarily on single military personnel since married couples can file separate tax returns in California under current law and significantly reduce or eliminate any tax liability in California.
[2] This act applies to any case that is not final before 12/19/2003.

EXHIBIT C
GLOSSARY OF ABBREVIATIONS

AGI	Adjusted Gross Income
AMT	Alternative Minimum Tax
AMTI	Alternative Minimum Taxable Income
CTL	Corporation Tax Law
EGTRRA	Economic Growth and Tax Relief Reconciliation Act of 2001
ESA	Education Savings Account
FICA	Federal Insurance Contributions Act
FSA	Flexible Spending Arrangement
HAP	Homeowners Assistance Program
HHS	Health and Human Services
HRA	Health Reimbursement Arrangement
HSA	Health Savings Account
IRC	Internal Revenue Code
IRS	Internal Revenue Service
JCWAA	The Job Creation and Worker Assistance Act of 2002
LSTA	Library Services and Technology Act
MACRS	Modified Accelerated Cost Recovery System
MSA	Medical Savings Account
PITL	Personal Income Tax Law
SSCRA	The Soldiers' and Sailors' Civil Relief Act

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