California
Franchise
Tax
Board

SUMMARY OF FEDERAL INCOME TAX CHANGES ---- 1998

Laws Affected:

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

SUMMARY OF

FEDERAL INCOME TAX CHANGES

1998

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 - 1998
Prepared by the Staff of the
FRANCHISE TAX BOARD
State of California

Executive Summary

During 1998, the Internal Revenue Code was changed by:

PUBLIC LAW	TITLE
105-206	INTERNAL REVENUE SERVICE REFORM & RESTRUCTURING ACT OF 1998
105-277	TAX AND TRADE RELIEF EXTENSION ACT OF 1998

This report examines the changes made by these Acts by explaining the new federal law along with its effective date, 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 change in federal law. The explanations also contain citations to the section numbers of the Public Law as well as the Internal Revenue Code and California Revenue and Taxation Code sections impacted by the change.

Following is a list of California tax provisions that expire in either 1998 or 1999.

Calif. Sunset	Calif. Section	Federal Section	Fed. Sect.	Description and Comments
12/31/98	18152.5	Permanent	1202	Exclusion: Capital Gain on Sale of Small Business Stock
01/01/99	19290.1	N/A	N/A	Collections for the Department of Industrial Relations under Sect. 62.9 of the Labor Code
01/01/99	19432	N/A	N/A	Cancellation of Tax, Penalties & Interest for Inactive Corporations
12/31/99	17053.66 23666	N/A	N/A	Credit: Restoration of Habitat for Salmon and Steelhead Trout

Calif. Sunset	Calif. Section	Federal Section	Fed. Sect.	Description and Comments
12/31/99	17091 24272.3	Permanent	865	Sourcing Rules: Unprocessed Timber
12/31/99	25135	N/A	N/A	Apportionment Formula: Sales of Unprocessed Timber
12/31/99	18724	N/A	N/A	Voluntary Contribution: California Fund for Senior Citizens
12/31/99	18766	N/A	N/A	Voluntary Contribution: Alzheimer's Disease and Related Disorders Research Fund
12/31/99	18844	N/A	N/A	Voluntary Contribution: California Military Museum Fund

Exhibit A contains a complete listing of expiring provisions in California law.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
1001 - 1205	Internal Revenue Service Restructuring.

Background

Through the Department of Treasury, the Internal Revenue Service (IRS) has the responsibility for determining, assessing, collecting taxes and enforcing the Internal Revenue Code (IRC). The IRS consists of the national office in Washington D.C. and four regional offices. Each regional office is headed up by a regional commissioner and a regional counsel. The four regions have 33 district offices, 10 service centers and two computing centers. The IRS is organized by six functions: customer service, forms processing, examination, collection, criminal investigation, and employee plans and exempt organizations. Each of the four regions maintain these functions separately. Additionally, each district maintains separate customer service, examination, collection and criminal investigation units, frequently with different policies and procedures on how the function or unit is administered.

New Federal Law

The Internal Revenue Service Restructuring and Reform Act of 1998 (IRS Reform Act) makes numerous changes to how the IRS is organized and operated. The IRS Reform Act requires the six functions listed above to be revamped to service four groups of taxpayers: individuals, small businesses, large corporations, and exempt organizations. These functions will be administered nationwide, therefore eliminating any differences due to the geographical location of the taxpayer.

The IRS Reform Act requires the IRS to review and revise their mission statement, which presently emphasizes tax collection, to place a greater emphasis on "serving the public."

The IRS Reform Act also codifies and expands the IRS Commissioner's duties and powers. The IRS Commissioner is appointed by the president, with consent of the Senate, and under the IRS Reform Act is appointed for a renewable five year term.

The IRS Reform Act also made changes to the IRS's chief counsel and the Taxpayers' Advocate's Office and creates an IRS Oversight Board. Additionally, a new Office of Treasury Inspector General for Tax Administration under the Treasury Department is created to replace the IRS Office of Chief Inspector.

Finally, the IRS Reform Act makes numerous amendments to the United States Code regarding IRS personnel. Modifications and additions were made effecting recruitment, retention, relocation incentives, performance awards, separation and other employee items.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Current California Law

Not applicable.

Effective Date

The majority of the provisions affecting the restructuring of the IRS are effective July 22, 1998, the date of enactment of the IRS Reform Act.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
2001	Electronic Filing of Tax and Information Returns.

Background

Treasury Regulations section 1.6012-5 provides that the Commissioner may authorize a taxpayer to elect to file a composite return in lieu of a paper return. An electronically filed return is a composite return consisting of electronically transmitted data and certain paper documents that cannot be electronically transmitted. The IRS periodically publishes a list of the forms and schedules that may be electronically transmitted, as well as a list of forms, schedules, and other information that cannot be electronically filed.

During the 1997 tax filing season, the IRS received approximately 20 million individual income tax returns electronically.

New Federal Law (Sec. 6011(f) & (g))

The IRS Reform Act states that the policy of Congress is to promote paperless filing, with a long-range goal of providing for the filing of at least 80% of all tax returns in electronic form by the year 2007. The provision requires the Secretary of the Treasury to establish a strategic plan to eliminate barriers, provide incentives, and use competitive market forces to increase taxpayer use of electronic filing. The provision requires all returns prepared in electronic form but filed in paper form to be filed electronically, to the extent feasible, by the year 2002.

The provision also requires the Secretary to promote electronic filing and to create an electronic commerce advisory group and to report annually to the Congress on electronic filing implementation issues. Additionally, the provision requires that the annual report discuss the effects on small businesses and the self-employed of electronically filing tax and information returns. For taxable years beginning after December 31, 1998, the IRS Reform Act also requires the posting of all tax forms and instructions for the most recent five-year period on the Internet in a searchable database.

Current California Law (R&TC Sec. 18621)

California law provides that the FTB shall prescribe the manner, on paper, magnetic media or other form, that returns, declarations, statements and other documents shall be filed. The FTB permits certain returns and statements to be filed electronically that follow a format approved by the FTB.

For the 1997 tax year, the FTB received 1.1 million individual tax returns electronically. This was a 120% increase over the 1996 tax year. Of the electronically file returns, 66,000 were filed through the Internet.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

The FTB is presently working closely with private sector software companies promoting the use of the Internet to file tax returns. This will enable individuals who purchase certain tax preparation software to file their return from their home computer.

The FTB posts 1994 through present tax return forms on its Internet site. FTB publications on a variety of topics are also posted on the web site. Additional pages are dedicated to frequently ask questions on a variety of subjects, FTB legal rulings and notices, legislative change notices and other information.

Effective Date

This provision is effective July 22, 1998.

Impact on California Revenue

No revenue impact.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
2002	Due Date for Certain Information Returns.

Background

Information such as the amount of dividends, partnership distributions, and interest paid during the calendar year must be supplied to taxpayers by the payers by January 31st of the following calendar year. The payers must file an information return with the IRS with the information by February 28th of the year following the calendar year for which the return must be filed. Under prior law, the due date for filing information returns with the IRS is the same whether such returns are filed on paper, on magnetic media, or electronically. Most information returns are filed on magnetic media (such as computer tapes), which are physically shipped to the IRS.

New Federal Law (Sec. 6071)

The IRS Reform Act provides an incentive to filers of information returns to use electronic filing by extending the due date for filing such returns with the IRS from February 28th (under present law) to March 31st of the year following the calendar year to which the return relates. The IRS Reform Act also requires the Treasury to issue a study evaluating the merits and disadvantages, if any, of extending the deadline for providing taxpayers with copies of information returns (other than Forms W-2) from January 31st to February 15th.

Current California Law

California law requires the information returns to be filed by February 28th of the year following the calendar year to which the return relates.

A payer may file an election with the IRS to participate in a combined filing program. Under this program the IRS automatically provides information to the FTB electronically. The payer does not file a separate information return with the FTB. Only certain types (the most common) of information returns qualify for this program.

Effective Date

The extension of the due date for filing returns applies to information returns required to be filed after December 31, 1999. The Treasury study is due by June 30, 1999.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
2003	Paperless Electronic Filing.

Background

Federal law requires that tax forms be signed as required by the Secretary. The IRS will not accept an electronically filed return unless it has also received a Form 8453, which is a paper form that contains signature information of the filer.

A return generally is considered timely filed when it is received by the IRS on or before the due date of the return. If the requirements of Code section 7502 are met, timely mailing is treated as timely filing. If the return is mailed by registered mail, the dated registration statement is prima facie evidence of delivery.

The IRS periodically publishes a list of the forms and schedules that may be electronically transmitted, as well as a list of forms, schedules, and other information that cannot be electronically filed.

New Federal Law (Sec. 6061, 7502(c))

This provision requires the Secretary to develop procedures that would eliminate the need to file a paper form relating to signature information. Until the procedures are in place, the provision authorizes the Secretary to provide for alternative methods of signing all returns, declarations, statements, or other documents or to waive the signature requirement. Only returns signed or subscribed under alternative methods prescribed by the Secretary (not including waiver) are entitled to be treated as though signed or subscribed. An alternative method of signature would be treated identically, for both civil and criminal purposes, as a signature on a paper form.

The provision also provides rules for determining when electronic returns are deemed filed and for authorization for return preparers to communicate with the IRS on matters included on electronically filed returns.

The provision requires the Secretary to establish procedures, to the extent practicable, to receive all forms electronically for taxable periods beginning after December 31, 1999.

Additionally, the Secretary of the Treasury must establish procedures for all tax forms, instructions, and publications created in the most recent five-year period to be made available electronically on the Internet in a searchable database not later than the date such records are available to the public in printed form. The Secretary of the Treasury also must, to the extent practicable, establish procedures for other taxpayer guidance to be made available electronically on the Internet in a searchable database not later than the date such guidance is available to the public in printed form.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Current California Law

California law requires that all returns must contain a written statement stating that the return is made under penalties of perjury. However, for returns filed electronically, as prescribed by the FTB, the taxpayer or tax preparer may retain the statement.

Effective Date

the provision is generally effective on July 22, 1998. The provision which relates to Internet access to IRS forms, instructions, publications, and guidance is effective for taxable periods beginning after December 31, 1998. The provision that requires the Secretary, to the extent practicable, to receive all forms electronically applies to taxable periods after December 31, 1999.

Impact on California Revenue

No revenue impact.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
2004	Return-Free Tax System.

Background

Taxpayers generally have been required to calculate their own tax liabilities and submit returns showing their calculations.

New Federal Law

The provision requires the Secretary or his delegate to study the feasibility of, and develop procedures for, the implementation of a return-free tax system for appropriate individuals for taxable years beginning after 2007. The Secretary is required annually to report to the tax-writing committees on the progress of the development of such system. The Secretary is required to make the first report on the development of the return-free tax system to the tax-writing committees by June 30, 2000.

Current California Law

California law follows federal law and generally requires the taxpayer to calculate their own tax liabilities and submit returns showing their calculations.

Effective Date

This provision is effective July 22, 1998.

Impact on California Revenue

No revenue impact.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
2005	Access to Account Information.

Background

Taxpayers who file their returns electronically cannot review their accounts electronically.

New Federal Law

The provision requires the Secretary to develop procedures not later than December 31, 2006, under which a taxpayer filing returns electronically (or the taxpayer's designee under section 6103(c)) could review the taxpayer's own account electronically, but only if all necessary privacy safeguards are in place by that date. The Secretary is also required to issue an interim progress report to the tax-writing committees by December 31, 2003.

Current California Law

A taxpayer may not review their accounts electronically. Taxpayers may request a detailed recap of their account from the FTB.

Taxpayers who file their returns electronically may request a paper copy of the return that resembles traditional returns originally filed on paper.

Effective Date

This provision is effective July 22, 1998.

Impact on California Revenue

No revenue impact.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3001	Burden of Proof.

Background

Under present law, a rebuttable presumption exists that the Commissioner of the IRS (Commissioner) determination of tax liability is correct. In Danville Plywood Corp. v. U.S., U.S. Cl. Ct., 63 AFTR 2d 89-1036, 1043 (1989), the court stated, “This presumption in favor of the Commissioner is a procedural device that requires the plaintiff to go forward with prima facie evidence to support a finding contrary to the Commissioner's determination. Once this procedural burden is satisfied, the taxpayer must still carry the ultimate burden of proof or persuasion on the merits. Thus, the plaintiff not only has the burden of proof of establishing that the Commissioner's determination was incorrect, but also of establishing the merit of its claims by a preponderance of the evidence”.

The general rebuttable presumption that the Commissioner's determination of tax liability is correct is a fundamental element of the structure of the IRC. Although this presumption is judicially based, rather than legislatively based, there is considerable evidence that the presumption has been repeatedly considered and approved by the Congress. This is the case because the Internal Revenue Code contains a number of civil provisions that explicitly place the burden of proof on the Commissioner in specifically designated circumstances.

New Federal Law (Sec. 7491)

The provision provides that the Secretary of the Treasury shall have the burden of proof in any court proceeding with respect to a factual issue if the taxpayer introduces credible evidence with respect to the factual issue relevant to ascertaining the taxpayer's income tax liability.

Four conditions apply:

1. The taxpayer must comply with the requirements of the IRC and the regulations issued thereunder to substantiate any item (as under present law).

2. The taxpayer must maintain records required by the Code and regulations (as under present law).

3. The taxpayer must cooperate with reasonable requests by the Secretary for meetings, interviews, witnesses, information, and documents (including providing, within a reasonable period of time, access to and inspection of witnesses, information, and documents within the control of the taxpayer, as reasonably requested by the Secretary). Cooperation also includes providing reasonable assistance to the Secretary in obtaining access to and inspection

of witnesses, information, or documents not within the control of the taxpayer (including any witnesses, information, or documents located in foreign countries). Cooperation also includes providing English translations, as reasonably requested by the Secretary.

A necessary element of cooperating with the Secretary is that the taxpayer must exhaust administrative remedies (including any appeal rights provided by the IRS). The taxpayer is not required to agree to extend the statute of limitations to be considered to have cooperated with the Secretary. Cooperating also means that the taxpayer must establish the applicability of any privilege.

4. Taxpayers other than individuals must meet the net worth limitations that apply for awarding attorney's fees (accordingly, no net worth limitation would be applicable to individuals). Corporations, trusts, and partnerships whose net worth exceeds $7 million are not eligible for the benefits of the provision.

The taxpayer has the burden of proving that it meets each of these conditions, because they are necessary prerequisites to establishing that the burden of proof is on the Secretary.

The burden will shift to the Secretary under this provision only if the taxpayer first introduces credible evidence with respect to a factual issue relevant to ascertaining the taxpayer's income tax liability. Credible evidence is the quality of evidence which, after critical analysis, the court would find sufficient upon which to base a decision on the issue if no contrary evidence were submitted (without regard to the judicial presumption of IRS correctness). A taxpayer has not produced credible evidence for these purposes if the taxpayer merely makes implausible factual assertions, frivolous claims, or tax protestor-type arguments. The introduction of evidence will not meet this standard if the court is not convinced that it is worthy of belief. If after evidence from both sides, the court believes that the evidence is equally balanced, the court shall find that the Secretary has not sustained his burden of proof.

Nothing in the provision is to be construed to override any requirement under the IRC or regulations to substantiate any item. Accordingly, taxpayers must meet applicable substantiation requirements, whether generally imposed or imposed with respect to specific items, such as charitable contributions or meals, entertainment, travel, and certain other expenses. Substantiation requirements include any requirement of the Code or regulations that the taxpayer establish an item to the satisfaction of the Secretary. Taxpayers who fail to substantiate any item in accordance with the legal requirement of substantiation will not have satisfied the legal conditions that are prerequisite to claiming the item on the taxpayer's tax return and will accordingly be unable to avail themselves of this provision regarding the burden of proof. Thus, if a taxpayer required to substantiate an item fails to do so in the manner required (or destroys the substantiation), this burden of proof provision is inapplicable.

If, however, the taxpayer can demonstrate that he had maintained the required substantiation but that it was destroyed or lost through no fault of the taxpayer, such as by fire or flood, existing tax rules regarding reconstruction of those records would continue to apply. In the case of an individual taxpayer, the Secretary shall have the burden of proof in any court proceeding with respect to any item of income which was reconstructed by the Secretary solely through the use of statistical information on unrelated taxpayers.

Further, the provision provides that, in any court proceeding, the Secretary must initially come forward with evidence that it is appropriate to apply a particular penalty to the taxpayer before the court can impose the penalty. This provision is not intended to require the Secretary to introduce evidence of elements such as reasonable cause or substantial authority. Rather, the Secretary must come forward initially with evidence regarding the appropriateness of applying a particular penalty to the taxpayer; if the taxpayer believes that, because of reasonable cause, substantial authority, or a similar provision, it is inappropriate to impose the penalty, it is the taxpayer's responsibility (and not the Secretary's obligation) to raise those issues.

For this purpose, self-employment taxes are treated as income taxes.

Act section 4002(b) of the Tax and Trade Relief Extension Act of 1998 made technical corrections to this IRS Reform Act provision. The Tax and Trade Relief Extension Act of 1998 provision removes the net worth limitation (as discussed in item 4 above) from certain revocable trusts for the same period of time that the trust would have been treated as part of the estate had the trust made the election under section 645 to be treated as part of the estate.

Current California Law

Under current state law, all taxpayers may be requested by FTB to furnish substantiation of the items reflected on their income tax returns and certain taxpayers may be required to keep certain records. California does not have a counterpart to the general federal provision which requires every person liable for any tax to keep records as prescribed by the Secretary. California does, however, conform by reference to the information reporting requirements in IRC Section 6038, 6038A, 6038B and 6038C (R&TC. Secs. 19141.2 and 19141.5). In addition, R&TC Section 19141.6 contains specific recordkeeping requirements with respect to taxpayers determining income under the world wide combined report method or making a water’s-edge election.

The FTB may issue a proposed deficiency assessment based on: taxpayer’s inability to substantiate an item shown on the tax return, third party information returns (W-2, 1099, etc.), or information FTB receives from the IRS.

If the taxpayer disputes an assessment, the taxpayer may (1) protest the proposed deficiency assessment by filing a written “protest” with the FTB, or

(2) pay the assessment and file a claim for refund. If the claim is denied or no action is taken on the claim within six months the taxpayer may proceed to the Board of Equalization (BOE) or Superior Court.

The taxpayer's administrative forum for appealing an adverse FTB action is the Board of Equalization (BOE). The BOE is the first independent administrative level of review of an FTB action. During the appeal process, the BOE makes an independent determination of the action. The BOE accepts evidence submitted by the taxpayer and, if requested by the taxpayer, grants an oral hearing on the matter. In the independent review by BOE, there is a rebuttable presumption that the FTB action is correct. Hence, taxpayers have the burden of producing evidence to show that the FTB's action was incorrect and establishing the merits of the position by a preponderance of the evidence.

In the event of a final adverse BOE decision, the taxpayer's recourse is to pay the amount due and bring action for refund against the state in Superior Court. With residency matters payment is not required. In litigation, as with appeals, there is a rebuttable presumption that the FTB action is correct. In addition, a taxpayer in a suit for refund is the plaintiff. Consequently, taxpayers (like plaintiffs in other civil actions) have the burden of proving that the FTB's action was incorrect and establishing the merits of their claims by a preponderance of the evidence.

Case law and BOE decisions have placed the burden of proof, applying the clear and convincing standard, on the taxing agency for civil penalty cases.

In criminal proceedings, the burden of proof is on the prosecution and the standard of proof is beyond a reasonable doubt.

Effective Date

This provision applies to court proceedings arising in connection with examinations commencing July 22, 1998 (If there is no examination, this provision applies to court proceedings arising in connection with taxable periods or events beginning or occurring after July 22, 1998).

Impact on California Revenue

Revenue losses in any given year are unknown. It appears that the IRS anticipates a negative revenue impact from self-assessed reporting, which could have an effect self-assessed state taxes and on departmental audit programs. It is not possible to determine the number of taxpayers that would cooperate with the FTB and have the burden of proof shift to the FTB to substantiate assessments in court.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3101	Expand Authority to Award Costs and Fees.

Background

Any person who substantially prevails in any action by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative costs incurred before the IRS and reasonable litigation costs incurred in connection with any court proceeding.

Reasonable administrative costs are defined as (1) any administrative fees or similar charges imposed by the IRS and (2) expenses, costs and fees related to attorneys, expert witnesses, and studies or analyses necessary for preparation of the case, to the extent that such costs are incurred before the earlier of the date of the notice of decision by IRS Appeals or the notice of deficiency. Net worth limitations apply.

Reasonable litigation costs include reasonable fees paid or incurred for the services of attorneys, except that the attorney's fees will not be reimbursed at a rate in excess of $110 per hour (indexed for inflation) unless the court determines that a special factor, such as the limited availability of qualified attorneys for the proceeding, justifies a higher rate. Attorneys fees include fees for services of an individual authorized to practice before the Tax Court or the IRS.

Rule 68 of the Federal Rules of Civil Procedure (FRCP) provides a procedure under which a party may recover costs if the party's offer for judgment was rejected and the subsequent court judgment was less favorable to the opposing party than the offer. The offering party's costs are limited to the costs (excluding attorney's fees) incurred after the offer was made. The FRCP generally apply to tax litigation in the district courts and the United States Court of Federal Claims.

Code section 7431 permits the award of civil damages for unauthorized inspection or disclosure of return information. The federal appellate courts are split over whether a party who substantially prevails over the United States in an action under Code section 7431 is eligible for an award of fees and reasonable costs.

New Federal Law (Secs. 7430(c), 7431)

The provision makes the following changes:

(1) Moves the point in time after which reasonable administrative costs can be awarded to the date of the first letter of proposed deficiency that allows the taxpayer an opportunity for administrative review with a hearing officer.

(2) Raises the hourly rate on attorney’s fees to $125 and provides that the difficulty of issues and unavailability of local tax experts may justify

a higher rate. In addition, the cap will continue to be indexed for inflation.

(3) Permits reasonable attorneys fees to persons who represent for no more than a nominal fee a taxpayer who is a prevailing party.

(4) When determining whether a U.S. position is substantially justified, the court should take into account whether the U.S. has lost in other courts of appeal on substantially similar issues.

(5) Provides that if a taxpayer makes a "qualified offer" (as specified) after the taxpayer has a right to administrative review in the IRS Office of Appeals, the IRS rejects the offer, and later the IRS obtains a judgment (other than a judgement pursuant to a stipulation or settlement) against the taxpayer in an amount that is equal to or less than the taxpayer's qualified offer for the amount of the tax liability (excluding interest), reasonable costs and attorney's fees from the date of the offer would be awarded.

(6) The award of attorney's fees is permitted in actions for civil damages for unauthorized inspection or disclosure of taxpayer returns and return information.

With respect to the award of attorney's fees in unauthorized inspection and disclosure cases, Congress clarified that fees are payable by the United States only when the United States is the defendant and the plaintiff is a prevailing party. Also, individual defendants (such as State employees or contractors) may be liable for attorneys' fees and costs in cases where the United States is not a party, whenever they are found to have made a wrongful disclosure.

<u>Current California Law (R&TC Sec. 19717, 21013)</u>

Current state law allows taxpayers to appeal adverse FTB actions on protests of proposed deficiency assessments to the BOE. In the event of an adverse BOE decision, the taxpayer can pay the amount due, file a claim for refund and bring an action against FTB in Superior Court.

California law provides that taxpayers may be reimbursed for costs/fees and expenses, including attorneys fees, relating to a tax matter before the BOE or court. For litigation the award may be made to a prevailing party; however, for matters before the BOE, awards may be made if the BOE finds that the FTB has been unreasonable.

For both litigation and tax matters before the BOE, fees for representation are limited to attorneys fees. For litigation, the allowable amount for attorney’s fees is $110 per hour (adjusted for inflation); there is no statutory limit on attorney’s fees for BOE hearings. To be entitled to attorney fees for litigation, the taxpayer must exhaust all administrative remedies and prevail before the BOE or in court. At issue in awarding fees for litigation and for BOE hearings is whether FTB can establish that it was substantially justified in its position. FTB’s position is presumed <u>not</u> to be substantially justified if the FTB did not follow its applicable published guidance (e.g. regulation, legal ruling, notice, information release, announcement, or any chief counsel ruling or determination letter). Attorney fees awarded in court proceedings are appealable; however, there is no right to appeal matters relating to attorney fees awarded in BOE hearings. Additionally, the taxpayer’s ability to receive an award for fees is unaffected by net worth (federal law contains net worth limitations). For litigation, state law (CCP Sec. 998) permits a party to receive costs and fees if the party makes a pre-trail settlement offer and the party obtains an equal or more favorable amount at trial.

Effective Date

The provision is effective for costs incurred and services performed after January 22, 2000.

Impact on California Revenue

This provision would not impact state tax revenues unless budget Redirection impacted the department’s audit or collection program.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3102	Civil Damages for Collection Actions.

Background

A taxpayer may sue the United States for up to $1 million of civil damages caused by an officer or employee of the IRS who recklessly or intentionally disregards provisions of the IRC or Treasury regulations in connection with the collection of federal tax with respect to the taxpayer.

New Federal Law (Secs. 7426(h)&(i), 7433)

The provision permits:
(1) up to $100,000 in civil damages caused by an officer or employee of the IRS who negligently disregards provisions of the Internal Revenue Code or Treasury regulations in connection with the collection of federal tax with respect to the taxpayer.
(2) up to $1 million in civil damages caused by an officer or employee of the IRS who willfully violates provisions of the Bankruptcy Code relating to automatic stays or discharges.

The provision also provides that persons other than the taxpayer may sue for civil damages for unauthorized collection actions. No person is entitled to civil damages in court without first exhausting administrative remedies.

Courts have concluded that federal law (including the United States Constitution) exempts the State of California from the imposition of monetary sanctions for violations of the proceedings required under the Bankruptcy Code.

Current California Law (R&TC Sec. 21022)

A taxpayer may bring action against the State of California in Superior Court, if any officer or employee of the FTB recklessly disregards board published procedures.

Upon a finding of liability, the state is liable for actual and direct monetary damages sustained as a result of the actions or omissions and reasonable litigation costs. There is no limit on the award or requirement to exhaust administrative remedies.

Effective Date

The provision is effective for actions of officers or employees of the IRS occurring after July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3103	Increase in Size of Cases Permitted on Tax Court Small Case Calendar

Background

Taxpayers may choose to contest many tax disputes in the Tax Court. Special small case procedures apply to disputes involving $10,000 or less, if the taxpayer chooses to utilize these procedures (and the Tax Court concurs). The IRS cannot require the taxpayer to use the small case procedures. The Tax Court generally concurs with the taxpayer's request to use the small case procedures, unless it decides that the case involves an issue that should be heard under the normal procedures. After the case has commenced, the Tax Court may order that the small case procedures should be discontinued only if (1) there is reason to believe that the amount in controversy will exceed $10,000 or (2) justice would require the change in procedure.

Small tax cases are conducted as informally as possible. Neither briefs nor oral arguments are required and strict rules of evidence are not applied. Most taxpayers represent themselves in small tax cases. Decisions in a case conducted under small case procedures are neither precedent for future cases nor reviewable upon appeal by either the government or the taxpayer.

New Federal Law (Secs. 7436(c), 7443A(b), 7463)

The provision increases the cap for small case treatment from $10,000 to $50,000.

Congress recognizes that an increase of this size may encompass a small number of cases of significant precedential value. Accordingly, Congress anticipates that the Tax Court will carefully consider (1) IRS objections to small case treatment, such as objections based upon the potential precedential value of the case, as well as (2) the financial impact on the taxpayer, including additional legal fees and costs, of not utilizing small case treatment.

Current California Law

California does not have small case procedures under current BOE practices.

Effective Date

This provision is effective for proceedings commenced after July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3104	Refunds When Estate Elects Installment Method of Payment.

Background

In general, the U.S. Court of Federal Claims and the U.S. district courts have jurisdiction over suits for the refund of taxes, as long as full payment of the assessed tax liability has been made. Under Code section 6166, if certain conditions are met, the executor of a decedent's estate may elect to pay the estate tax attributable to certain closely-held businesses over a 14-year period. Courts have held that U.S. district courts and the U.S. Court of Federal Claims do not have jurisdiction over claims for refunds by taxpayers deferring estate tax payments pursuant to section 6166 unless the entire estate tax liability has been paid. Under section 7479, the U.S. Tax Court has limited authority to provide declaratory judgments regarding initial or continuing eligibility for deferral under section 6166.

New Federal Law (Secs. 7422(j)&(k), 7479(c))

The provision grants the U.S. Court of Federal Claims and the U.S. district courts jurisdiction to determine the correct amount of estate tax liability (or refund) in actions brought by taxpayers deferring estate tax payments under section 6166, as long as certain conditions are met. In order to qualify for the provision: (1) the estate must have made an election pursuant to section 6166; (2) the estate must have fully paid each installment of principal and/or interest due (and all non-6166-related estate taxes due) before the date the suit is filed; (3) no portion of the payments due may have been accelerated; (4) there must be no suits for declaratory judgment pursuant to section 7479 pending; and (5) there must be no outstanding deficiency notices against the estate. In general, to the extent that a taxpayer has previously litigated its estate tax liability, the taxpayer would not be able to take advantage of this procedure under principles of res judicata. Taxpayers are not relieved of the liability to make any installment payments that become due during the pendency of the suit (i.e., failure to make such payments would subject the taxpayer to the existing provisions of section 6166(g)(3)).

The provision further provides that once a final judgment has been entered by a district court or the U.S. Court of Federal Claims, the IRS is not permitted to collect any amount disallowed by the court, and any amounts paid by the taxpayer in excess of the amount the court finds to be currently due and payable are refunded to the taxpayer, with interest. Lastly, the provision provides that the two-year statute of limitations for filing a refund action is suspended during the pendency of any action brought by a taxpayer pursuant to section 7479 for a declaratory judgment as to an estate's eligibility for section 6166.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Current California Law

California law imposes an estate tax equal to the credit available under the federal estate tax for state death taxes. Such estate taxes are referred to as "pick-up" taxes because the tax burden on the estate is not increased. The California estate or pick-up tax is administered by the State Controller's Office.

Effective Date

This provision is effective for claims for refunds filed after July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3105	Bond Issue Tax-Exempt Status.

Background

Interest on debt incurred by state or local governments generally is excluded from gross income if the proceeds of the borrowings are used to carry out governmental functions of those entities and the debt is repaid with governmental funds.

A state or local government that seeks to issue bonds, the interest on which is intended to be excludable from gross income, can request a ruling from the IRS regarding the eligibility of such bonds for tax-exemption. The prospective issuer can challenge the IRS's determination (or failure to make a timely determination) in a declaratory judgment proceeding in the Tax Court. Because bondholders, not issuers, are the parties whose tax liability is affected, issuers are not allowed to litigate the tax-exempt status of the bonds directly after the bonds are issued.

New Federal Law

The provision directs the IRS to modify its administrative procedures to allow tax-exempt bond issuers examined by the IRS to appeal adverse examination determinations to the Appeals Division of the IRS as a matter of right. Because of the complexity of the issues involved, the IRS is directed to provide that these appeals would be heard by senior appeals officers having experience in resolving complex cases.

Congress will evaluate judicial remedies in future legislation once the IRS's tax-exempt bond examination program has developed more fully and the Congress is better able to ensure that any such future measure protects all parties in interest to these determinations (i.e., issuers, bondholders, conduit borrowers, and the federal government).

Current California Law (R&TC Sec. 17133)

The Personal Income Tax Law conforms to the exclusion of income of interest on debt incurred by state or local governments. Additionally, interest on federal obligations are exempt from income. The California Constitution provides an exemption from income taxation for all interest from bonds issued by this state or a local government of this state. Federal law, other than the IRC, prohibits state taxation of interest on federal bonds, if the interest on state obligations is exempt from tax. Taxpayers subject to the corporate franchise tax must report as income all interest received. Interest received from federal obligations and California obligations or its political subdivision generally is excluded from income subject to the corporation and personal income tax.

The FTB is precluded from using the (a) source of payment of the bond or security for the bond, public or private and (b) whether or not public improvements are financed in its determination of whether the interest on a bond by this state or local government in this state qualifies as exempt interest.

Effective Date

The direction to the IRS is effective on July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3106	Civil Action for Release of Erroneous Liens.

Background

Prior to 1995, the provisions governing jurisdiction over refund suits had generally been interpreted to apply only if an action was brought by the taxpayer against which tax was assessed. Remedies for third parties from whom tax was collected (rather than assessed) were found in other provisions of the Internal Revenue Code. The Supreme Court has held that a third party who paid another person's tax under protest to remove a lien on the third party's property could bring a refund suit, because he/she had no other adequate administrative or judicial remedy. The Supreme Court held that parties who are forced to pay another's tax under duress could bring a refund suit, because no other judicial remedy was adequate.

New Federal Law (Secs. 6325(b), 6503(f), 7426)

The provision creates an administrative procedure permitting a record owner of property against which a federal tax lien has been filed to obtain a certificate of discharge of property from the lien as a matter of right. The third party is required to apply to the Secretary of the Treasury for such a certificate and either to deposit cash or to furnish a bond sufficient to protect the lien interest of the United States. However, the Secretary has no discretion to refuse to issue a certificate of discharge if this procedure is followed. the provision also authorizes the refund of all or part of the amounts deposited, plus interest, if the tax liability is reduced or eliminated.

In addition, the Act establishes a judicial cause of action for third parties challenging a lien. The period within which such an action must be commenced is 120 days after the date the certificate of discharge is issued to ensure an early resolution of the parties' interests. Actions to quiet title under Title 28, United States Code would still be available.

Current California Law (R&TC Sec. 19207)

Under California law, other than in connection with an action to quiet title, a third party generally cannot obtain a release of property until the tax debt is satisfied. To claim a refund of amounts paid, the third party could file a claim against the state. However, no expedited administrative process is available for third parties to obtain a lien release.

Administrative law judges through formal proceedings must conduct many administrative hearings, requiring strict rules of evidence (Administrative Procedures Act). Expressly excepted from the APA are FTB’s protest hearings and hearings related to jeopardy assessments. Additionally, FTB’s informal hearings for collection activities have not been subject to the APA.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Effective Date

This provision is effective the July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3201	Relief from Joint and Several Liability on Joint Return.

Background

Spouses who file a joint return are each responsible for the accuracy of the return and for the full tax liability. This is true even through only one spouse may have earned all the income which is shown on the return. This is "joint and several" liability. A spouse who wishes to avoid joint liability may file as a "married person filing separately."

Prior to the IRS Reform Act, relief from liability for tax, interest and penalties is available for "innocent spouses" in certain circumstances. To qualify for such relief, the innocent spouse must establish that: (1) a joint return was made; (2) an understatement of tax, which exceeds the greater of $500 or a specified percentage of the innocent spouse's adjusted gross income for the preadjustment (most recent) year, was attributable to a grossly erroneous item of the other spouse; (3) in signing the return, the innocent spouse did not know, and had no reason to know, that there was an understatement of tax; and (4) taking into account all the facts and circumstances, it was inequitable to hold the innocent spouse liable for the deficiency in tax. The specified percentage of adjusted gross income was 10% if adjusted gross income was $20,000 or less. Otherwise, the specified percentage was 25%.

The proper forum for contesting the Secretary's denial of innocent spouse relief is determined by whether an underpayment is asserted or the taxpayer is seeking a refund of overpaid taxes. Accordingly, the Tax Court may not have jurisdiction to review all denials of innocent spouse relief.

New Federal Law (Secs. 66(c), 6013(e), 6015, 6230(c), 7421)

The provision generally makes innocent spouse status easier to obtain by eliminating all of the understatement thresholds and requiring only that the understatement of tax be attributable to an erroneous (and not just a grossly erroneous) item of the other spouse.

The provision provides that innocent spouse relief may be provided on an apportioned basis. A spouse may be relieved of liability for portion of an understatement of tax even if the spouse knew or had reason to know of other understatements of tax on the same return. The provision specifically provides that the Tax Court has jurisdiction to review any denial of innocent spouse relief. Except for termination and jeopardy assessments, the Secretary may not levy or proceed in court to collect any tax from a taxpayer claiming innocent spouse status with regard to such tax until the expiration of the 90-day period in which such taxpayer may petition the Tax Court or, if the Tax Court considers such petition, before the decision of the Tax Court has become final. The running of the statute of limitations is suspended in such situations with respect to the spouse claiming innocent spouse status.

The provision permits a spouses to elect to limit his or her liability for unpaid taxes on a joint return to the spouse's separate liability amount. In the case of a deficiency arising from a joint return, a spouse could elect to be liable only to the extent that items giving rise to the deficiency are allocable to the spouse. The separate liability election also applies in situations where the tax shown on a joint return is not paid with the return. In this case, the amount determined under the separate liability election equals the amount that would have been reported by the electing spouse on a separate return. However, if any item of credit or deduction would be disallowed solely because a separate return is filed, the item of credit or deduction will be computed without regard to such prohibition. Special rules apply to prevent the inappropriate use of the election. The separate liability election may not be used to create a refund, or to direct a refund to a particular spouse.

Items are generally allocated between spouses in the same manner as they would have been allocated had the spouses filed separate returns. The Secretary may prescribe other methods of allocation by regulation. The allocation of items is to be accomplished without regard to community property laws.

To qualify for the separate liability election, the taxpayer must be no longer married to, be legally separated from, or for at least 12 months have been living apart from the person with whom the taxpayer originally filed the joint return.

The election applies to all unpaid taxes under subtitle A of the IRC, including the income tax and the self-employment tax. The election may be made at any time not later than two years after collection activities begin with respect to the electing spouse. It is intended that the two-year period not begin until collection activities have been undertaken against the electing spouse that have the effect of giving the spouse notice of the IRS' intention to collect the joint liability from such spouse. For example, garnishment of wages or a notice of intent to levy against the property of the electing spouse would constitute collection activity against the electing spouse. The mailing of a notice of deficiency and demand for payment to the last known address of the electing spouse, addressed to both spouses, would not.

Congress further indicated that the taxpayer, regardless of whether is eligible to make the separate liability election, may be granted equitable relief in appropriate situations. For example, Congress intends that equitable relief be available to a spouse who does not know, and has no reason to know, that funds intended for payment of tax were instead taken by the other spouse for such other spouse’s benefit.

Congress does not intend to limit the use of the Secretary’s authority to provide equitable relief to situations where tax is shown on a return but not paid. Congress intends that such authority be used where, taking into account all the facts and circumstances, it is inequitable to hold an individual liable for all or part of any unpaid tax or deficiency arising from a joint return.

Congress intends that relief be available where there is both an understatement and an underpayment of tax.

The provision establishes jurisdiction in the Tax Court over disputes arising from the separate liability election. For example, a spouse who makes the separate liability election may petition the Tax Court to determine the limits on liability applicable under this provision. The Tax Court is authorized to establish rules that would allow the Secretary and the electing spouse to require, with adequate notice, the other spouse to become a party to any proceeding before the Tax Court. The Secretary is required to develop a separate form with instructions for taxpayers to use in electing to limit liability.

The IRS is required to notify all taxpayers who have filed joint returns of their rights to elect to limit their joint and several liability under this provision. It is expected that notice will appear in appropriate IRS publications, including IRS Publication 1, and in collection related notices sent to taxpayers. In addition, the IRS should, whenever practicable, send appropriate notifications separately to each spouses.

For the purpose of the separate liability election, the provision indicates that a taxpayer is no longer married if he or she is widowed. For example, a deficiency is assessed after IRS audit of a joint return. The deficiency relates to income earned by the husband that was not reported on the return. If the spouses who joined in the return are no longer married, are legally separated, or have lived apart for at least 12 months, either may elect limited liability under this provision. If the wife elects, she would owe none of the deficiency. The deficiency would be the sole responsibility of the husband whose income gave rise to the deficiency.

If the deficiency relates to the items of both spouses, the separate liability for the deficiency is allocated between the spouses in the same proportion as the net items taken into account in determining the deficiency. For example, a deficiency is assessed that is attributable to $70,000 of unreported income allocable to the husband and the disallowance of a $30,000 miscellaneous itemized deduction allocable to the wife. If the spouses who joined in the return are no longer married, are legally separated, or have lived apart for at least 12 months, either may elect limited liability under this provision. If either the husband and wife elect, the husband's liability would be limited to 70% of the deficiency (if he elects) and the wife's liability limited to 30% (if she elects). This would be the case even if a portion of the miscellaneous itemized deductions had been disallowed under section 67(a). The election is required in order to limit liability. If either spouse fails to elect, that spouse would be liable for the full amount of the deficiency, unless reduced by innocent spouse relief or pursuant to the grant of authority to the Secretary to provide equitable relief.

If the deficiency arises as a result of the denial of an item of deduction or credit, the amount of the deficiency allocated to the spouse to whom the item of deduction or credit is allocated is limited to the amount of income or tax allocated to such spouse that was offset by the deduction or credit. The remainder of the liability is allocated to the other spouse to reflect the fact that income or tax allocated to that spouse was originally offset by a portion of the disallowed deduction or credit.

For example, a married couple files a joint return with wage income of $100,000 allocable to the wife and $30,000 of self-employment income allocable to the husband. On examination, a $20,000 deduction allocated to the husband is disallowed, resulting in a deficiency of $5,600. Under the provision, the liability is allocated in proportion to the items giving rise to the deficiency. Since the only item giving rise to the deficiency is allocable to the husband, and because he reported sufficient income to offset the item of deduction, the entire deficiency is allocated to the husband and the wife has no liability with regard to the deficiency, regardless of the ability of the IRS to collect the deficiency from the husband.

If the joint return had shown only $15,000 (instead of $30,000) of self-employment income for the husband, the income offset limitation rule discussed above would apply. In this case, the disallowed $20,000 deduction entirely offsets the $15,000 of income of the husband, and $5,000 remains. This remaining $5,000 of the disallowed deduction offsets income of the wife. The liability for the deficiency is therefore divided in proportion to the amount of income offset for each spouse. In this example, the husband is liable for 3/4 of the deficiency ($4,200), and the wife is liable for the remaining 1/4 ($1,400).

Where a deficiency is attributable to the disallowance of a credit, or to any tax other than regular or alternative minimum income tax, the portion of the deficiency attributable to such credit or other tax is considered first. For example, on examination a deficiency of $10,000 ($2,800 of self-employment tax and $7,200 of income tax) is determined to be attributable to $20,000 of unreported self-employment income of the husband and a disallowed itemized deduction of $5,000 allocable to the wife. The $2,800 of deficient self-employment taxes is first allocated to the husband, and the remaining $7,200 of income tax deficiency is allocated 80% to the husband and 20% to the wife.

The provision includes special rules to prevent the inappropriate use of the election.

1. If the IRS demonstrates that assets were transferred between the spouses in a fraudulent scheme joined in by both spouses, neither spouse is eligible to make the election under the provision (and consequently joint and several liability applies to both spouses).

2. If the IRS proves that the electing spouse had actual knowledge that an item on a return is incorrect, the election will not apply to the extent any deficiency is attributable to such item. Such actual knowledge must be established by the evidence and shall not be inferred based on indications that the electing spouse had a reason to know.

The rule that the election will not apply to the extent any deficiency is attributable to an item the electing spouse had actual knowledge of is expected to be applied by treating the item as fully allocable to both spouses. For example a married couple files a joint return with wage income of $150,000 allocable to the wife and $30,000 of self employment income allocable to the husband. On examination, an additional $20,000 of the husband's self-employment income is discovered, resulting in a deficiency of $9,000. The IRS proves that the wife had actual knowledge that $5,000 of this additional self-employment income, but had no knowledge of the remaining $15,000. In this case, the husband would be liable for the full amount of the deficiency, since the item giving rise to the deficiency is fully allocable to him. In addition, the wife would be liable for the amount that would have been calculated as the deficiency based on the $5,000 of unreported income of which she had actual knowledge. The IRS would be allowed to collect that amount from either spouse, while the remainder of the deficiency could be collected from only the husband.

3. The portion of the deficiency for which the electing spouse is liable is increased by the value of any disqualified assets received from the other spouse. Disqualified assets include any property or right to property that was transferred to an electing spouse if the principle purpose of the transfer is the avoidance of tax (including the avoidance of payment of tax). A rebuttable presumption exists that a transfer is made for tax avoidance purposes if the transfer was made less than one year before the earlier of the payment due date or the date of the notice of proposed deficiency. The rebuttable presumption does not apply to transfers pursuant to a decree of divorce or separate maintenance. The presumption may be rebutted by a showing that the principal purpose of the transfer was not the avoidance of tax or the payment of tax.

The provision also provides that taxpayers who do not make the separate liability election may be eligible for innocent spouse relief. For example, a taxpayer may be ineligible to make the separate liability election for a deficiency because he or she is not widowed, divorced, legally separated, or living apart (for at least 12 months) from the person with whom the taxpayer originally joined in filing the joint return. Such a taxpayer may apply for relief of any deficiency that is attributable to an erroneous item of the other spouse, provided he or she did not know or have reason to know of the understatement of tax and it would be inequitable to hold the taxpayer responsible for the deficiency. The election is required to be made no later than the date that is two years after the Secretary has begun collection actions with respect to the individual.

Current California Law (R&TC Secs. 18533, 18534 and 19006)

Under current state law, as with prior federal law, spouses who file a joint tax return are each fully responsible for the accuracy of the return and for the full tax liability (joint and several liability).

Current state law also provides relief from liability for tax, interest and penalties for “innocent spouses” if it is inequitable to hold that spouse liable for the understatement. To qualify for innocent spouse relief, the innocent spouse must have filed a joint tax return and did not know, or had no reason to know, of the understatement. The spouse must be innocent with respect to the entire understatement.

Current state law, as with prior federal law, also provides relief for innocent spouses with respect to community property income not included on the separate return of a married person.

Current state law, in the case where the self-assessed tax has not been fully paid, requires FTB to provide the other spouse with 30 days notice of any determination to provide relief to the innocent spouse so that the other spouse may appeal the determination.

Effective Date

The separate liability election, expanded innocent spouse relief and authority to provide equitable relief all apply to liabilities for tax arising after July 22, 1998, as well as any liability for tax arising on or before July 22, 1998, that remains unpaid on July 22, 1998. The applicable two-year election periods do not expire before the date that is two years after the first collection activity taken by the IRS after July 22, 1998. The Secretary is required to develop a separate form for electing innocent spouse relief by January 22, 1999.

Impact on California Revenue

Current law already provides innocent spouse relief under certain circumstances. The incremental impact of conforming to proportionate liability would result in minor revenue losses, on the order of $500,000 annually.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3202	Suspension of Statute of Limitations on Filing Refund Claims.

Background

In general, a taxpayer must file a refund claim within three years of the filing of the return or within two years of the payment of the tax, whichever period expires later (if no return is filed, the two-year limit applies). A refund claim that is not filed within these time periods is rejected as untimely.

No explicit statutory rule provides for equitable tolling of the statute of limitations. The U.S. Supreme Court has held that Congress did not intend the equitable tolling doctrine to apply to the statutory limitations of section 6511 on the filing of tax refund claims.

New Federal Law (Secs. 6511(h)-(l))

The provision permits equitable tolling of the statute of limitations for refund claims of an individual taxpayer during any period of the individual's life in which he or she is unable to manage his or her financial affairs by reason of a medically determinable physical or mental impairment that can be expected to result in death or to last for a continuous period of not less than 12 months. Tolling does not apply during periods in which the taxpayer's spouse or another person is authorized to act on the taxpayer's behalf in financial matters.

Current California Law (R&TC Secs. 19306, 19308, 19309 and 19311-19313)

Current state law requires a taxpayer to file a claim for refund within four years from the due date (without regard to extensions) or one year from the date of payment of tax, whichever is later. In the case of a California waiver of the SOL, the period for filing a claim for refund is the period of the waiver or one year from the date of overpayment, whichever is later. In the case of a federal waiver, the period for filing a claim for refund is six months from the expiration of the federal waiver.

Current state law requires the taxpayer to notify FTB if the amount of gross income or deductions reported to the IRS for any year is changed, either by the taxpayer or federal authorities. The taxpayer has six months from the final federal determination date to report the change to FTB. Claims for refund must be filed within two years from the date of the final federal determination.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Current state law allows taxpayers to file a claim for refund up to seven years after the due date of the return in the case of bad debts, worthless securities or erroneous inclusion of recoveries.

Effective Date

The provision applies to periods of disability before, on, or after the July 22, 1998, but does not apply to any claim for refund or credit that (without regard to the provision) is barred by the operation of any law (including the statute of limitations) or rule of law (including res judicata) as of July 22,1998.

Impact on California Revenue

Revenue losses from additional refunds issued would be on the order of $1 million annually based on federal projections.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3301	Elimination of Interest Differential.

Background

A taxpayer that underpays its taxes is required to pay interest on the underpayment at a rate equal to the federal short-term interest rate plus three percentage points. A special "hot interest" rate equal to the federal short-term interest rate plus five percentage points applies in the case of certain large corporate underpayments.

A taxpayer that overpays its taxes receives interest on the overpayment at a rate equal to the federal short-term interest rate plus two percentage points. In the case of corporate overpayments in excess of $10,000, this is reduced to the federal short-term interest rate plus one-half of a percentage point.

If a taxpayer has an underpayment of tax from one year and an overpayment of tax from a different year that are outstanding at the same time, the IRS will typically offset the overpayment against the underpayment and apply the appropriate interest to the resulting net underpayment or overpayment. However, if either the underpayment or overpayment has been satisfied, the IRS will not typically offset the two amounts, but rather will assess or credit interest on the full underpayment or overpayment at the underpayment or overpayment rate. This has the effect of assessing the underpayment at the higher underpayment rate and crediting the overpayment at the lower overpayment rate. This results in the taxpayer being assessed a net interest charge, even if the amounts of the overpayment and underpayment are the same.

The Secretary has the authority to credit the amount of any overpayment against any liability under the Code. Congress has previously directed the IRS to consider procedures for "netting" overpayments and underpayments and, to the extent a portion of tax due is satisfied by a credit of an overpayment, not impose interest.

New Federal Law (Secs. 6601(f) & 6621(d))

The provision establishes a net interest rate of zero where interest is payable and allowable on equivalent amounts of overpayment and underpayment for a period of any tax that is imposed by the IRC. Each overpayment and underpayment is considered only once in determining whether equivalent amounts of overpayment and underpayment exist. The special rules that increase the interest rate paid on large corporate overpayments and decrease the interest rate received on corporate underpayments in excess of $10,000 do not prevent the application of the net zero rate. This provision applies to income and self-employment taxes.

It is anticipated that the Secretary will take into account interest paid on previously determined deficiencies or refunds for the purpose of determining the rate of interest under this provision without regard to whether the underpayments or overpayments are currently outstanding. It is also anticipated that where interest is both payable from and allowable to an individual taxpayer for the same period, the Secretary will take all reasonable efforts to offset the liabilities, rather than process them separately using the net interest rate of zero. Where interest is payable and allowable on an equivalent amount of underpayment and overpayment that is attributable to a taxpayer's interest in a pass-through entity (e.g., a partnership), Congress intends that the benefits of the provision apply.

Current California Law (R&TC Secs. 19101–19103, 19106, 19111, 19113-19115, & 19521)

The adjusted annual interest rate for overpayments and underpayments is equal to the federal underpayment rate (applicable federal rate (AFR) plus three percentage points).

As under federal law, “hot interest” is charged on underpayments in excess of $100,000 at AFR plus five percentage points.

Effective Date

Interest for calendar quarters beginning after July 22, 1998. In addition, the provision applies to interest for periods beginning before July 22, 1998 if: (1) the statute of limitations has not expired with respect to either the underpayment or overpayment; (2) the taxpayer reasonably identifies and establishes the periods of underpayment and overpayment for which the zero rate applies; and (3) not later than December 31, 1999, the taxpayer asks the Secretary to apply the zero rate.

Impact on California Revenue

This provision would establish a net interest rate of zero when interest is payable and allowable on equivalent amounts of overpayment and underpayment of income taxes.

Based on limited data and assumptions discussed below, any forgone interest as a result of this proposal is estimated to be on the order of $1.5 million annually.

- It is projected that approximately 65% of PIT audit assessments would be impacted and 80% of B&C.
- The average period of time for overlapping overpayment and underpayment interest is estimated to be one month under PIT and two and one half months under B&C.
- Assumes that on average overpayments represent approximately 50% of underpayments.
- The average interest rate is estimated to be 9%.
- Adjustments were made under B&CTL to allow for the differential in interest for overpayments and underpayment interest regarding “hot interest.”

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3302	Increase Overpayment Interest Rate.

Background

A taxpayer that underpays its taxes is required to pay interest on the underpayment at a rate equal to the AFR plus three percentage points. A taxpayer that overpays its taxes receives interest on the overpayment at a rate equal to the AFR plus two percentage points.

New Federal Law (Sec. 6621(a))

The provision provides that the overpayment interest rate will be AFR plus three percentage points except that for corporations, the rate remains at AFR plus two percentage points.

Current California Law (R&TC Sec. 19521)

Under state law, the overpayment rate and the underpayment rate are both equal to the federal underpayment rate (AFR plus three percentage points).

Effective Date

Interest for the second and succeeding calendar quarters beginning after July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3303	Penalty for Failure to Pay During Installment Agreement.

Background

Taxpayers who fail to pay their taxes are subject to a penalty of one-half percent per month on the unpaid amount, up to a maximum of 25%. If the liability is shown on the return, the penalty begins to accrue on the date prescribed for payment of the tax (with regard to extensions). If the liability should have been shown on the return but was not, the penalty generally begins to accrue after the date that is 21 days from the date of the IRS notice and demand for payment with respect to such liability. Taxpayers who make installment payments pursuant to an agreement with the IRS are also subject to this penalty.

New Federal Law (Sec. 6651(h))

The provision provides that the penalty for failure to pay taxes is one-half of the usual rate (.25% instead of .5%) for any month in which an installment payment agreement with the IRS is in effect, provided that the individual filed the tax return in a timely manner (including extensions).

Current California Law (R&TC Sec. 19132)

The penalty for failure to pay tax is 5% of the total unpaid tax plus 0.5% per month of the “remaining tax” for each additional month or fraction thereof not to exceed 40 months. The maximum penalty is limited to 25% of the unpaid tax.

State law does not specifically addressing the application of the failure to pay penalty to installment payment arrangements.

Effective Date

This provision is effective for installment agreement payments made after December 31, 1999.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Impact on California Revenue

This provision would reduce the penalty for failure to pay taxes for any month in which an installment agreement is in effect. Conform to federal with modifications. This provision would make the penalty for failure to pay equal to 5% of the unpaid amount plus 0.25% per month for any month in which an installment payment agreement with FTB is in effect. The taxpayer must timely file the return relating to the liability that is subject to the installment agreement.

Based on the discussion below, the revenue loss for a reduction in the amount of penalty assessed for installment agreements is as follows:

Estimated Revenue Impact Penalty for Failure to Pay During Installment Agreement (In Millions)		
1999-0	2000-1	2001-2
No Impact	($3)	($6)

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

This estimate was prepared in the following steps: Departmental data were analyzed that suggested that approximately 75,000 individuals annually are participating in installment agreements, with an estimated $12 million in penalties assessed annually for the .5% penalty for each month tax is unpaid. The average period of time for payment of an installment agreement is estimated to be two years for an overall penalty of 12%. Therefore, reducing the monthly penalty from .5% to .25% per month results in a penalty reduction of 50% ($6 million annually). A comparative analysis was also done based on federal estimates for these provisions in H.R. 2676 which, when prorated to California, produced similar results.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3304	Penalty for Failure to Deposit Payroll Taxes.

Background

Deposits of payroll taxes are allocated to the earliest period for which such a deposit is due. If a taxpayer misses or makes an insufficient deposit, later deposits will first be applied to satisfy the shortfall for the earlier period; the remainder is then applied to satisfy the obligation for the current period. Cascading penalties may result as payments that would otherwise be sufficient to satisfy current liabilities are applied to satisfy earlier shortfalls. The Secretary may waive the failure to make deposit penalty for inadvertent failures by first-time depositors of employment taxes.

New Federal Law (Sec. 6656(c) & (e))

The provision allows the taxpayer to designate the period to which each deposit is applied. The designation must be made during the 90 days immediately following the sending of the related IRS penalty notice. The provision also extends the authorization to waive the failure to deposit penalty to the first deposit a taxpayer is required to make after the taxpayer is required to change the frequency of the taxpayer's deposits.

In addition, for deposits required to be made after December 31, 2001, any deposit is to be applied to the most recent period to which the deposit relates, unless the taxpayer explicitly designates otherwise.

Current California Law

Defer to the Employment Development Department (EDD).

Effective Date

This provision is effective for deposits required to be made after January 18, 1999.

Impact on California Revenue

Defer to EDD.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3305	Suspension of Interest if IRS Fails to Notify Taxpayer.

Background

In general, interest and penalties accrue during periods for which taxes are unpaid without regard to whether the taxpayer is aware that there is tax due.

New Federal Law (Sec. 6404(g)&(h))

The provision suspends the accrual of penalties and interest after one year if the IRS has not sent the taxpayer a notice of deficiency within one year following the date which is the later of (1) the original due date of the return or (2) the date on which the individual taxpayer timely filed the return. The suspension only applies to taxpayers who file a timely tax return. With respect to taxable years beginning before January 1, 2004, the 1-year period is increased to 18 months. Interest and penalties are suspended if the IRS fails to send a notice specifically stating the taxpayer's liability and the basis for the liability within the specified period. Interest and penalties resume 21 days after the IRS sends that notice to the taxpayer.

The provision is applied separately with respect to each item or adjustment. The provision does not apply where a taxpayer has self-assessed the tax. For example, if the IRS sends a math error notice to a taxpayer two months after the return is filed and also sends a notice of deficiency related to a different item two years later, the provision applies to the item reflected on the second notice (notwithstanding that the first notice was sent within the applicable time period).

The provision applies only to individuals and does not apply to the failure to pay penalty, in the case of fraud, or with respect to criminal penalties. Interest and penalties resume 21 days after the IRS sends a notice and demand for payment to the taxpayer.

Current California Law (R&TC Sec. 19104)

In general, interest accrues on any unpaid amount from the due date of the tax or, if paid in installments, from the date prescribed for payment of the first installment, until the date the tax is paid.

The FTB may abate the assessment of all or part of the interest attributable to any unreasonable error or delay by an FTB employee in performing a ministerial or managerial act or any delay in payment attributable to an FTB employee being dilatory in performing a ministerial or managerial act.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Effective Date

This provision is applicable for taxable years ending after July 22, 1998.

Impact on California Revenue

Based on the discussion below, the amount of forgone interest and penalty collections as a result of this proposal is estimated as follows:

Suspension Period for Interest & Penalties (In Millions)					
2001-2	2002-3	2003-4	2004-5	2005-6	2006-7
($5)	($10)	($15)	($20)	($30)	($35)

These estimates are based on the results of FTB's current audit programs. The following assumptions were applied:

- The average period of time to complete FTB audits is estimated to be 2.5 years for desk audits, 3.5 years for field audits, and 2 years for clerical audits from the due date of the return.
- On average the department issues notices, as a result of a final federal determination, within three months from the date the taxpayer or the IRS notifies the department of the final federal determination.
- The average interest rate is estimated to be 9%.
- Assumed effective for taxable years ending after 1999 enactment date.
- Based on departmental data, 18.5% of IRS audits are for California taxpayers. This yields a higher than normal (i.e. 6%) federal proration factor for RAR purposes and is consistent with information from IRS that more audits are conducted for West Coast residents.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3306	Procedures for Imposing Penalties .

Background

Present law does not require the IRS to show how penalties are computed on the notice of penalty. In some cases, penalties may be imposed without supervisory approval.

New Federal Law (Sec. 6751)

The provision requires that each notice imposing a penalty include the name of the penalty, the code section imposing the penalty, and a computation of the penalty. The provision also requires the specific approval of IRS management to assess all non-computer generated penalties unless excepted. This provision does not apply to failure to file penalties, failure to pay penalties, or to penalties for failure to pay estimated tax.

Current California Law (R&TC Sec. 19034)

Current law requires the notice of proposed deficiency to set forth the reasons for the proposed deficiency assessment and the computation of the assessment. Under current practice, notices imposing a penalty include the name of the penalty and an insert, Form FTB 1140 (Interest and Penalty Explanation and Rates). Form FTB 1140 includes a description of various penalties, how interest is assessed and the interest rate, collection costs, Taxpayer Bill of Rights information and how to contact the Taxpayer's Advocate. For penalties not described on the enclosure, current practice is to include a standardized paragraph that describes the penalty, including a brief explanation of how the penalty is computed in general terms. Some standardized paragraphs include the IRC or R&TC Section number.

Effective Date

This provision is effective for notices issued, and penalties assessed after December 31, 2000.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3307	Procedures for Section 6672 Penalty.

Background

Any person who is required to collect, truthfully account for, and pay over any tax imposed by the IRC who willfully fails to do so is liable for a penalty equal to the amount of the tax. Before the IRS may assess any such "100% penalty," it must mail a written preliminary notice informing the person of the proposed penalty to that person's last known address. The mailing of such notice must precede any notice and demand for payment of the penalty by at least 60 days. The statute of limitations on assessments shall not expire before the date 90 days after the date on which the notice was mailed. These restrictions do not apply if the Secretary finds the collection of the penalty is in jeopardy.

New Federal Law (Sec. 6672(b))

The provision permits in person delivery, as an alternative to delivery by mail, of a preliminary notice that the IRS intends to assess a 100% penalty.

Current California Law

Defer to EDD.

Effective Date

The provision is effective as of July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3308	Notice of Interest Charges.

Background

Taxpayers generally must pay interest on amounts due to the IRS.

New Federal Law (Sec. 6631)

The provision requires every IRS notice that includes an amount of interest required to be paid by the taxpayer that is sent to an individual taxpayer to include a detailed computation of the interest charged and a citation to the Code section under which such interest is imposed.

Current California Law (R&TC Sec. 19104)

In general, interest is assessed on any deficiency from the due date of the return (without regard to extension) until paid. Under current practice, Form FTB 1140 (Interest and Penalty Explanation and Rates) is included with notices. Form FTB 1140 includes a description of eight penalties, how interest is assessed and the interest rate, collection costs, Taxpayer Bill of Rights information and how to contact the Taxpayer's Advocate.

Effective Date

This provision is effective for notices issued after December 31, 2000.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3309	Abatement of Interest on Underpayments in Disaster Areas.

Background

In the case of a presidentially declared disaster, the Secretary of the Treasury has the authority to postpone some tax-related deadlines, but has no authority to abate interest.

Under a provision of the Taxpayer Relief Act of 1997, if the Secretary of the Treasury extends the filing date of an individual tax return for individuals living in a Presidentially declared disaster during 1997, no interest is charged as a result of the failure of the individual taxpayer to file an individual tax return, or to pay the taxes shown on such return, during the extension.

New Federal Law (Sec. 6404(h)-(l))

The provision provides that taxpayers located in a Presidentially declared disaster area do not have to pay interest on taxes due for the length of any extension for filing their tax returns granted by the Secretary of the Treasury.

Current California Law (R&TC Secs. 17207, 19132.5 and 24348)

Special disaster loss treatment is provided to taxpayers who suffer losses in a presidentially declared disaster area. In general, taxpayers may carry forward the loss to each of the five taxable or income years following the taxable or income year for which the loss is claimed. Fifty percent of any remaining disaster loss (after the five-year period) may be carried forward to each of the next ten years.

For taxpayers in a disaster area, FTB delays billing notices, provides copies of lost or damaged returns (free of charge) and expedites return processing. Current law provides for the waiver of the late payment penalty for victims of the Northridge Earthquake of 1994, any related aftershock, or any related casualty.

California law conforms with the provisions of the Taxpayer Relief Act of 1997 related to disaster losses. Thus, FTB abates interest for individual taxpayers located in a Presidentially-declared disaster area for the period the FTB extended the time to file a return and pay the tax (and waive any penalty) for disaster declared during 1997.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Effective Date

This provision is effective for disasters declared after December 31, 1997, with respect to taxable years beginning after December 31, 1997.

Impact on California Revenue

Any forgone interest would depend on the extent to which interest would not have otherwise been abated under current law. To the extent FTB abates additional interest as a result of this provision, there would be a reduction in the amount of interest assessed. However, due to the deductibility of disaster losses, it is estimated that the majority of taxpayers located in disaster areas would not have a balance due return. Therefore, any forgone interest would be negligible.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3401	Due Process in IRS Collection Actions.

Background

Levy is the IRS's administrative authority to seize a taxpayer's property to pay the taxpayer's tax liability. The IRS is entitled to seize a taxpayer's property by levy if the federal tax lien has attached to such property. The federal tax lien arises automatically where (1) a tax assessment has been made, (2) the taxpayer has been given notice of the assessment stating the amount and demanding payment, and (3) the taxpayer has failed to pay the amount assessed within 10 days after the notice and demand.

The IRS may collect taxes by levy upon a taxpayer's property or rights to property (including accrued salary and wages) if the taxpayer neglects or refuses to pay the tax within 10 days after notice and demand that the tax be paid. Notice of the IRS's intent to collect taxes by levy must be given no less than 30 days (90 days in the case of a life insurance contract) before the day of the levy. The notice of levy must describe the procedures that will be used, the administrative appeals available to the taxpayer and the procedures relating to such appeals, the alternatives available to the taxpayer that could prevent levy, and the procedures for redemption of property and release of liens.

The effect of a levy on salary or wages payable to or received by a taxpayer is continuous from the date the levy is first made until it is released. If the IRS district director finds that the collection of any tax is in jeopardy, collection by levy may be made without regard to either notice period. A similar rule applies in the case of termination assessments.

New Federal Law (Secs. 6320, 6330 and 7443)

The provision establishes formal procedures designed to ensure due process where the IRS seeks to collect taxes by levy (including by seizure). The due process procedures also apply after the federal tax lien attaches, but before the notice of the federal tax lien has been given to the taxpayer.

Liens.

Taxpayers would have a right to a hearing after the Notice of Lien is filed. The IRS would be required to notify the taxpayer that a Notice of Lien had been filed within five days after filing. During the 30-day period beginning with the mailing or delivery of such notification, the taxpayer may demand a hearing before an appeals officer who has had no prior involvement with the taxpayer's case. In general, any issue relevant to the appropriateness of the proposed collection against the taxpayer can be raised at this hearing. For example, the taxpayer can request innocent spouse status, make an offer-in-compromise, request an installment agreement or suggest which assets should be used to satisfy the tax liability. However, the validity of the tax liability can be challenged only if the taxpayer did not actually receive the statutory notice of deficiency or has not otherwise had an opportunity to dispute the liability. This hearing right applies only after the first Notice of Lien with regard to each tax liability is filed. To the extent practicable, a hearing under this section shall be held in conjunction with a hearing under section 6330 (Notice of Hearing Before Levy)

Levies.

The IRS would be required to provide the taxpayer with a Notice of Intent to Levy, formally stating its intention to collect a tax liability by levy against the taxpayer's property or rights to property. Congress intends that the Secretary have the discretion to provide the Notice of Intent to Levy in combination with the notice required by present law under section 6331(d). Service by registered or certified mail, return receipt requested would be required. The Notice of Intent to Levy would not be required to itemize the property the Secretary seeks to levy on.

Subject to the exceptions noted below, no levy could occur within the 30-day period beginning with the mailing of the Notice of Intent to Levy. During that 30-day period, the taxpayer may demand a hearing before an appeals officer who has had no prior involvement with the taxpayer's case, other than in connection with a hearing after the filing of a notice of tax lien. If a hearing is requested within the 30-day period, no levy could occur until a determination by the appeals officer is rendered. In general, any issue that is relevant to the appropriateness of the proposed collection against the taxpayer can be raised at the pre-levy hearing. For example, the taxpayer can request innocent spouse status, make an offer-in-compromise, request an installment agreement or suggest which assets should be used to satisfy the tax liability. However, the validity of the tax liability can be challenged only if the taxpayer did not actually receive the statutory notice of deficiency or has not otherwise had an opportunity to dispute the liability.

If a return receipt is not returned, the Secretary may proceed to levy on the taxpayer's property or rights to property 30 days after the Notice of Intent to Levy was mailed. The Secretary must provide a hearing equivalent to the pre-levy hearing if later requested by the taxpayer. However, the Secretary is not required to suspend the levy process pending the completion of a hearing that is not requested within 30 days of the mailing of the Notice. If the taxpayer did not receive the required notice and requests a hearing after collection activity has begun, then collection shall be suspended and a hearing provided to the taxpayer.

During the hearing, the IRS is required to verify that all statutory, regulatory, and administrative requirements for the proposed collection action have been met. IRS verifications are expected to include (but not be limited to) showings that: (1) the revenue officer recommending the collection action has verified the taxpayer's liability; (2) the estimated expenses of levy and sale will not exceed the value of the property to be seized; (3) the revenue officer has determined that there is sufficient equity in the property to be seized to yield net proceeds from sale to apply to the unpaid tax liabilities;

and (4) with respect to the seizure of the assets of a going business, the revenue officer recommending the collection action has thoroughly considered the facts of the case, including the availability of alternative collection methods, before recommending the collection action.

The taxpayer (or affected third party) is allowed to raise any relevant issue at the hearing. Issues eligible to be raised include (but are not limited to): (1) challenges to the underlying liability as to existence or amount; (2) appropriate spousal defenses; (3) challenges to the appropriateness of collection actions; and (4) collection alternatives, which could include the posting of a bond, substitution of other assets, an installment agreement or an offer-in-compromise.

No further hearings are provided under this provision as a matter of right. It is the responsibility of the taxpayer to raise all relevant issues at the time of the pre-levy hearing. A taxpayer could apply for consideration of new information, make an offer-in-compromise, request an installment agreement, or raise other considerations at any time before, during, or after the Notice of Intent to Levy hearing. However, after the 30 day period had expired, the IRS is not required to provide a hearing or delay any levy or sale of levied property. Nothing in this provision is intended to limit any remedy that is otherwise available under present law.

An exception to the general rule prohibiting levies during the 30-day period would apply in the case of state tax offset procedures, and in the case of jeopardy or termination assessments.

Congress anticipates that the IRS will combine Notice of Intent to Levy and Notice of Lien hearings whenever possible. If multiple hearings are held, it is expected that, to the extent practicable, the same appellate officer will hear the taxpayer with regard to both lien and levy issues. If the taxpayer requests a hearing following receipt of a Notice of Lien or Notice of Intent to Levy and, prior to the date of the hearing, receives the other notice, the scheduled hearing will serve for both purposes and the taxpayer is obligated to raise all relevant issues at such hearing.

Judicial review.

Congress expects the appeals officer will prepare a written determination addressing the issues presented by the taxpayer and considered at the hearing. The determination of the appeals officer may be appealed to Tax Court or, where appropriate, the Federal district court. Where the validity of the tax liability was properly at issue in the hearing, and where the determination with regard to the tax liability is a part of the appeal, no levy may take place during the pendency of the appeal. The amount of the tax liability will in such cases be reviewed by the appropriate court on a de novo basis. Where the validity of the tax liability is not properly part of the appeal, the taxpayer may challenge the determination of the appeals officer for abuse of discretion. In such cases, the appeals officer's determination as to the appropriateness of collection activity will be reviewed using an abuse of discretion standard of review. Levies will not be suspended during the appeal if the Secretary shows good cause why the levy should be allowed to proceed.

No seizure of a dwelling that is the principal residence of the taxpayer or the taxpayer's spouse, former spouse, or minor child would be allowed without prior judicial approval. Notice of the judicial hearing must be provided to the taxpayer and family members residing in the property. At the judicial hearing, the Secretary would be required to demonstrate (1) that the requirements of any applicable law or administrative procedure relevant to the levy have been met, (2) that the liability is owed, and (3) that no reasonable alternative for the collection of the taxpayer's debt exists.

Current California Law (R&TC Sec. 21019)

Current law requires notice to be sent to taxpayers at least 30 days prior to the filing of a lien. The notice includes the statutory authority for filing or recording the lien, the earliest date the lien may be filed or recorded, and the remedies available to prevent the filing or recording. The taxpayer may provide evidence that the filing or recording would be in error; however, no formal hearing is provided in law. Pursuant to the Civil Code, a notice of state tax lien must be mailed to the tax debtor unless mail to that address was previously returned undeliverable with no forwarding address.

During 1996, FTB filed through its automated system approximately 300,000 liens on tax debts in excess of $250. However, recently FTB has increased from $250 to $1000 the amount of tax debt that would be subjected to a lien filed through its automated system. This increased tax amount is expected to decrease the filing of liens by approximately 35%.

Under current practice FTB typically provides at a minimum a 15-day notice before levy, which includes the proposed actions that may be taken. Upon receipt of the notice, the taxpayer can provide evidence as to why a levy should not be issued. However, no formal hearing is provided in law. After the levy is received, the taxpayer is given notice by the person receiving the levy that the taxpayer has ten days to resolve collection issues with FTB before withholding is remitted to FTB.

While tax debtors have no formal process for appealing collection actions, they may contact the FTB's Taxpayer's Advocate if staff cannot resolve the collection issue.

The above provisions do not apply to jeopardy assessments.

Effective Date

The provision is effective for collection actions initiated after January 18, 1999.

Impact on California Revenue

Collection losses from this proposal would result in negligible revenue losses, less than $250,000 annually based on federal projections.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3411	Confidentiality Privileges Relating to Taxpayer Communication.

Background

A common law privilege of confidentiality exists for communications between an attorney and client with respect to the legal advice the attorney gives the client. Communications protected by the attorney-client privilege must be based on facts of which the attorney is informed by the taxpayer, for the purpose of securing the advice of the attorney. The privilege may not be claimed where the purpose of the communication is the commission of a crime or tort. The taxpayer must either be a client of the attorney or be seeking to become a client of the attorney.

The privilege of confidentiality applies only where the attorney is advising the client on legal matters. It does not apply in situations where the attorney is acting in other capacities. Thus, a taxpayer may not claim the benefits of the attorney-client privilege simply by hiring an attorney to perform some other function. For example, if an attorney is retained to prepare a tax return, the attorney-client privilege will not automatically apply to communications and documents generated in the course of preparing the return. The privilege of confidentiality also does not apply where the communication is made for further communication to third parties. For example, information that is communicated to an attorney for inclusion in a tax return is not privileged because it is communicated for the purpose of disclosure. The privilege of confidentiality does not apply where an attorney is acting in another capacity, or where an attorney who is licensed to practice another profession is performing such other profession.

The attorney-client privilege is considered waived if the communication is voluntarily disclosed to anyone other than the attorney, the client or the agents of the client or the attorney. The attorney-client privilege is limited to communications between taxpayers and attorneys. No equivalent privilege is provided for communications between taxpayers and other professionals authorized to practice before the IRS, such as accountants or enrolled agents.

New Federal Law (Sec. 7525)

The provision extends the present law attorney-client privilege of confidentiality to tax advice that is furnished to a client-taxpayer (or potential client-taxpayer) by any individual who is authorized under federal law to practice before the IRS if such practice is subject to regulation under section 330 of Title 31, United States Code (USC). Individuals subject to regulation under section 330 of Title 31, USC include attorneys, certified public accountants, enrolled agents and enrolled actuaries. Tax advice means advice that is within the scope of authority for such individual's practice with respect to matters under Title 26 (the IRC). The privilege of confidentiality may be asserted in any noncriminal tax proceeding before the IRS, as well as in noncriminal tax proceedings in the federal courts where the IRS is a party to the proceeding.

The provision allows taxpayers to consult with other qualified tax advisors in the same manner they currently may consult with tax advisors who are licensed to practice law. The provision does not modify the attorney-client privilege of confidentiality, other than to extend it to other authorized practitioners. The privilege established by the Act applies only to the extent that communications would be privileged if they were between a taxpayer and an attorney. Accordingly, the privilege does not apply to any communication between a certified public accountant, enrolled agent, or enrolled actuary and such individual's client (or prospective client) if the communication would not have been privileged between an attorney and the attorney's client or prospective client. For example, information disclosed to an attorney for the purpose of preparing a tax return is not privileged under present law. Such information would not be privileged under the provision whether it was disclosed to an attorney, certified public accountant, enrolled agent or enrolled actuary.

The privilege granted by the provision may only be asserted in noncriminal tax proceedings before the IRS and in the federal courts with regard to such noncriminal tax matters in proceedings where the IRS is a party. The privilege may not be asserted to prevent the disclosure of information to any regulatory body other than the IRS. The ability of any other regulatory body, including the Securities and Exchange Commission (SEC), to gain or compel information is unchanged by the provision. No privilege may be asserted under this provision by a taxpayer in dealings with such other regulatory bodies in an administrative or court proceeding.

The privilege of confidentiality created by this provision will not apply to any written communication between a federally authorized tax practitioner and any director, shareholder, officer, employee, agent, or representative of a corporation in connection with the promotion of the direct or indirect participation of such corporation in any tax shelter (as defined in section 6662(d)(2)(C)(iii)).

A tax shelter for this purpose is any partnership, entity, plan, or arrangement a significant purpose of which is the avoidance or evasion of income tax. Tax shelters for which no privilege of confidentiality will apply include, but are not limited to, those required to be registered as confidential corporate tax shelter arrangements under section 6111(d). Congress does not understand the promotion of tax shelters to be part of the routine relationship between a tax practitioner and a client. Accordingly, Congress does not anticipate that the tax shelter limitation will adversely affect such routine relationships.

The privilege created by this provision may be waived in the same manner as the attorney-client privilege. For example, if a taxpayer or federally authorized tax practitioner discloses to a third party the substance of a communication protected by the privilege, the privilege for that communication and any related communications is considered to be waived to the same extent and in the same manner as the privilege would be waived if the disclosure related to an attorney-client communication.

The provision also clarifies that the privilege created by this provision may be asserted in noncriminal tax proceedings before the IRS and in the Federal courts with regard to a noncriminal tax proceeding where the United States is a party.

This provision relates only to matters of privileged communications. No inference is intended as to whether aspects of federal tax practice covered by the new privilege constitute the authorized or unauthorized practice of law under various State laws.

Current California Law (Evidence Code Sections 950-962)

The Evidence Code establishes the attorney client privilege. However, the attorney client privilege does not extend to communication with an individual other than an attorney.

Effective date

The provision is effective with regard to communications made on or after July 22, 1998.

Impact on California Revenue

Revenue losses from this proposal would be negligible, if any.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3412	Financial Status Audits.

Background

The Secretary is authorized and required to make the inquiries and determinations necessary to insure the assessment of federal income taxes. For this purpose, any reasonable method may be used to determine the amount of federal income tax owed. The courts have upheld the use of financial status and economic reality examination techniques to determine the existence of unreported income in appropriate circumstances.

New Federal Law (Sec. 7602(d))

The provision prohibits the IRS from using financial status or economic reality examination techniques to determine the existence of unreported income of any taxpayer unless the IRS has a reasonable indication that there is a likelihood of unreported income.

Current California Law (R&TC Sec. 19504)

FTB has the power to require by demand that employers, persons or financial institutions provide information or make available for examination or copying at a specified time or place, any books, papers, or other data which may be relevant.

Current audit procedures do not include financial status or economic reality examination techniques unless there is a reasonable indication of unreported income. However, such techniques may be used in investigation cases where there is a reasonable indication of unreported income. Current law prohibits investigations for non-tax purposes.

The filing enforcement program estimates income based upon third-party information to evaluate whether a taxpayer has an unsatisfied filing requirement. If the taxpayer does not respond, an assessment is made based upon information available. If, at any point, the taxpayer files a return, provides information that he or she has no filing requirement or provides proof that they already filed, the filing enforcement activity is stopped.

Effective Date

This provision is effective July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3413	Software Trade Secrets Protection.

Background

The Secretary of the Treasury is authorized to examine any books, papers, records, or other data that may be relevant or material to an inquiry into the correctness of any federal tax return. The Secretary may issue and serve summonses necessary to obtain such data, including summonses on certain third-party recordkeepers.

The Secretary is considered to have made a prima facie case for the enforcement of a summons if the so-called "Powell standards" are met. The Powell standards require: (1) that the examination to which the summons relates is being conducted pursuant to a legitimate purpose; (2) that the summons seek information that may be relevant to such examination; (3) that the IRS not already be in possession of the information; and (4) that the administrative steps required by the Code have been followed. However, a summons will not be enforced if the burden it places on the summonsed party is out of proportion to the end sought.

Where the summons is issued against a third-party, particularly one that is a stranger to the taxpayer's affairs, the IRS has been required to show that the circumstances of the investigation indicate a realistic expectation, and not merely an idle hope, that something relevant to the investigation may be discovered in order to have the summons enforced. (See Powell v. U.S., 379 U.S. 48 (1964). Harrington v. U.S., 388 F. 2d 520 (2nd Cir, 1968).

There are no specific statutory restrictions on the ability of the Secretary to demand the production of computer records, programs, source code or similar materials, whether held by the taxpayer or by a third party.

New Federal Law (Secs. 7213(d)&(e), 7603(b) & 7612)

The provision prohibits the Secretary from issuing (or beginning an action to enforce) a summons in a civil action for any portion of any third-party tax-related computer source code.

Under the Act, no summons may be issued for tax-related computer software source code unless (1) the Secretary is unable otherwise to ascertain the correctness of any item on a return from the taxpayer's books and records or the computer software program and associated data, (2) the Secretary identifies with reasonable specificity the portion of the computer source code needed to verify the correctness of the item, and (3) the Secretary determines that the need for the source code outweighs the risk of unauthorized disclosure of trade secrets. The Secretary is considered to have satisfied the first two of these requirements if the Secretary makes a formal request for such materials to both the taxpayer and the owner of the software that is not satisfied within 180 days.

This limitation on the summons of tax-related computer software source code does not apply if the summons is issued in connection with an inquiry into any offense connected with the administration or enforcement of the internal revenue laws. The limitation also does not apply to a summons of computer software source code that was acquired or developed by the taxpayer or a related person primarily for internal use by the taxpayer or such person rather than for commercial distribution. A finding that computer software source code was developed for internal use, and thus not eligible for the limitation in summons authority in this provision, is not intended to be dispositive of whether such software was intended for internal use for any other purpose of Title 26 of the United States Code.

Communications between the owner of the tax-related computer software source code and the taxpayer are not protected from summons by this provision. Communications between the owner of the tax-related source code and persons not related to the taxpayer that are related to the functioning and operation of the software may be treated as a part of the computer software source code.

The provision does not change or eliminate any other requirement of the Code. A summons for third-party tax-related computer source code that meets the standards established by the provision will not be enforced if it would not be enforced under present law. For example, if the Secretary's purpose in issuing the summons is shown to be improper, the summons would not be enforced, even if the Secretary otherwise met the standards for the summons of computer source code established by the provision. The limitations on the summons of tax-related computer software source code apply only with respect to computer software that is used for accounting tax return preparation, tax compliance or tax planning purposes. No inference is intended with respect to computer software used for all other purposes. In such cases, current law will continue to apply, subject to the protections against the disclosure and improper use of trade secrets and other confidential information added by this provision.

Software or source code that is required to be provided under present law must be provided without regard to this provision. For example, computer software or source code that is required to be provided in connection with the registration of a confidential corporate tax shelter arrangements under section 6111 would continue to be required to be provided without regard to this provision. Thus, the registration requirement of section 6111 cannot be avoided where the tax benefits of the shelter are discernible only from the operation of a computer program.

In addition to authorizing any court enforcing a subpoena to issue any order necessary to prevent the disclosure of confidential information, the Act establishes a number of specific protections against the disclosure and improper use of trade secrets and confidential information incident to the examination by the Secretary of any computer software program or source code that comes into the possession or control of the Secretary in the course of any examination with respect to any taxpayer.

These protections include the following: (1) Such software or source code may be examined only in connection with the examination of the taxpayer's return with regard to which it was received. (2) Such software or source code must be maintained in a secure area. (3) Such source code may not be removed from the owner's place of business without the owner's consent unless such removal is pursuant to a court order. (4) Such software or source code may not be decompiled or disassembled. (5) Such software or source code may only be copied as necessary to perform the specific examination. The owner of the software must be informed of any copies that are made, such copies must be numbered, and at the conclusion of the examination and any related court proceedings, all such copies must be accounted for and returned to the owner, permanently deleted, or destroyed. The Secretary must provide the owner of such software or source code with the names of any individuals who will have access to such software or source code. (6) If an individual who is not an officer or employee of the U.S. Government will examine the software or source code, such individual must enter into a written agreement with the Secretary that such individual will not disclose such software or source code to any person other than authorized employees or agents of the Secretary at any time, and that such individual will not participate in the development of software that is intended for a similar purpose as the summoned software for a period of two years.

Criminal penalties are provided where any person willfully divulges or makes known software that was obtained (regardless of whether by summons) for the purpose of examining a taxpayer's return in violation of this provision.

The provision specifically provides that computer software or source code that is obtained by the IRS in the course of the examination of a taxpayer's return will be treated as return information for the purposes of section 6103.

Current California Law (R&TC Sec. 19054)

Under current state law, FTB is authorized to examine books, papers, records or other data that may be relevant to an inquiry into the correctness of a state tax return. In addition, the FTB may issue subpoenas on certain third party recordkeepers. Current law does not, however, contain any specific guidelines for computer source codes.

Effective Date

This provision is effective for summons issued and software acquired after July 22, 1998. In addition, 90 days after the date of enactment, the protections against the disclosure and improper use of trade secrets and confidential information added by the provision (except for the requirement that the Secretary provide a written agreement from non-U.S. government officers and employees) apply to software and source code acquired on or before July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3414	Threat of Audit To Coerce Tip Reporting Alternative Commitment.

Background

Restaurants may enter into Tip Reporting Alternative Commitment (TRAC) agreements. A restaurant entering into a TRAC agreement is obligated to educate its employees on their tip reporting obligations, to institute formal tip reporting procedures, to fulfill all filing and record keeping requirements, and to pay and deposit taxes. In return, the IRS agrees to base the restaurant's liability for employment taxes solely on reported tips and any unreported tips discovered during an IRS audit of an employee.

New Federal Law

The provision requires the IRS to instruct its employees that they may not threaten to audit any taxpayer in an attempt to coerce the taxpayer to enter into a TRAC agreement.

Current California Law

Defer to EDD as EDD is responsible for tip reporting.

Effective Date

This provision is effective July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3415	Taxpayers Allowed Motion to Quash All Third-Party Summonses.

Background

When the IRS issues a summons to a "third-party recordkeeper" relating to the business transactions or affairs of a taxpayer, notice of the summons must be given to the taxpayer within three days by certified or registered mail. The taxpayer is thereafter given up to 23 days to begin a court proceeding to quash the summons. If the taxpayer does so, third-party recordkeepers are prohibited from complying with the summons until the court rules on the taxpayer's petition or motion to quash, but the statute of limitations for assessment and collection with respect to the taxpayer is stayed during the pendency of such a proceeding. Third-party recordkeepers are generally persons who hold financial information about the taxpayer, such as banks, brokers, attorneys, and accountants.

New Federal Law (Sec. 7609)

The provision generally expands the current "third-party recordkeeper" procedures to apply to summonses issued to persons other than the taxpayer. Thus, the taxpayer whose liability is being investigated receives notice of the summons and is entitled to bring an action in the appropriate U.S. District Court to quash the summons. As under the current third-party recordkeeper provision, the statute of limitations on assessment and collection is stayed during the litigation, and certain kinds of summonses specified under present law are not subject to these requirements.

The provision clarifies that nothing in section 7609 of the Code (relating to special procedures for third-party summonses) shall be construed to limit the ability of the IRS to obtain information (other than by summons) through formal or informal procedures authorized by the Code.

Current California Law (R&TC Sec. 19064)

FTB issues subpoenas, including subpoena deces tecum, instead of summonses. For FTB issue subpoenas, the Code of Civil Procedure is followed, which allows taxpayers to quash any third-party subpoenas.

California previously conformed to federal law (Taxpayer Bill of Rights 2) that suspended the statute of limitations (SOL) pending the resolution of the enforcement of the subpoena.

Effective Date

This provision is effective for summonses served after July 22, 1998.

Impact on California Revenue

Based on the negligible revenue losses projected for the federal provision relating to motion to quash, revenue losses from conforming to the federal provision would be negligible.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3416	Services of Summonses to Third-Party Recordkeepers Permitted by Mail

Background

A summons must be served "by an attested copy delivered in hand to the person to whom it is directed or left at his last and usual place of abode." If a third-party recordkeeper summons is served, the IRS may give the taxpayer notice of the summons via certified or registered mail. The Federal Rules of Civil Procedure permits service of process by mail even in summons enforcement proceedings.

New Federal Law (Sec. 7603(b))

The provision allows the IRS the option of serving any summons either in person or by certified or registered mail.

Current California Law (Code of Civil Procedure Sec. 415.30)

The Code of Civil Procedure is followed for service of a subpoena, including a subpoena duces tecum. Service may be accomplished in state by mail with the use of an acknowledgement and out-of-state mail with return receipt requested.

Effective Date

This provision is effective for summonses served after July 22, 1998

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3417	Notice of IRS Contact of Third Parties.

Background

Third-parties may be contacted by the IRS in connection with the examination of a taxpayer or the collection of the tax liability of the taxpayer. The IRS has the right to summon third-party recordkeepers. In general, the taxpayer must be notified of the service of summons on a third party within three days of the date of service. The IRS also has the right to seize property of the taxpayer that is held in the hands of third parties. Except in jeopardy situations, the Internal Revenue Manual provides that IRS will personally contact the taxpayer and inform the taxpayer that seizure of the asset is planned.

New Federal Law (Sec. 7602(c)– (e))

The provision provides that the IRS may not contact any person other than the taxpayer with respect to the determination or collection of the tax liability of the taxpayer without providing reasonable notice in advance to the taxpayer that the IRS may contact persons other than the taxpayer. It is intended that in general this notice will be provided as part of an existing IRS notice provided to taxpayers.

In addition, the Act also requires the IRS to provide periodically to the taxpayer a record of persons previously contacted during that period by the IRS with respect to the determination or collection of that taxpayer's tax liability. This record shall also be provided upon request of the taxpayer. The provision does not apply to criminal tax matters, if the collection of the tax liability is in jeopardy, if the Secretary determines for good cause shown that disclosure may involve reprisal against any person, or if the taxpayer authorized the contact.

Current California Law

Under current practice, during an audit, FTB issues notice to taxpayers prior to contacting third parties, unless notice would result in confidentiality issues or during criminal investigations. In FTB’s filing enforcement process (where a tax return has not been filed for that year, and FTB determines whether there is a requirement for a person to file a tax return for a particular year and what tax amount FTB would propose to be assessed for that year), FTB typically uses information provided via information returns or other information sources. However, when FTB is determining whether to open an audit or on occasion during the filing enforcement process, FTB contacts third parties to obtain or clarify information, in which case notice prior to the contact currently is not given to the tax debtor. In addition, in making a determination whether an individual is a resident subject to California tax and as to what tax amount FTB would propose to be assessed (residency audits), FTB may contact governmental agencies and businesses in and out of state without giving the taxpayer prior notice. Also, in the process of collecting tax debts, FTB does not notify tax debtors that third parties may be contacted.

Once a tax amount is final, whether assessed by FTB or self-assessed, and unpaid, a statement of tax due (STD) is mailed as a first notice. If the debt continues to remain unpaid, FTB generally will mail a notice that unless payment is made collection action may be taken (involuntary collection billing cycle) and provides a general statement as to the type of collection actions that FTB may take. Notice will not be mailed, if prior notice mailed to the address of record is returned undeliverable with no forwarding address. When a debt posts to an account on which there is an existing debt that has entered the involuntary collection billing cycle, an STD is the only notice mailed on the new debt. The debts are then consolidated and the involuntary collection billing cycle continues, which may include levies. In no event, does FTB disclose the identity of third parties to taxpayers or send taxpayers a record of persons contacted.

Effective Date

This provision is effective for contacts made after 180 days after July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3421	Approval Process for Liens, Levies and Seizures.

Background

Supervisory approval of liens, levies or seizures is only required under certain circumstances. For example, a levy on a taxpayer's principal residence is only permitted upon the written approval of the District Director or Assistant District Director.

New Federal Law

The provision requires the IRS to implement an approval process under which any lien, levy or seizure would, where appropriate, be approved by a supervisor, who would review the taxpayer's information, verify that a balance is due, and affirm that a lien, levy or seizure is appropriate under the circumstances. Circumstances to be considered include the amount due and the value of the asset. Failure to follow such procedures could result in disciplinary action against the supervisor and/or revenue officer.

Congress intends that the Commissioner have discretion in promulgating the procedures required by this provision to determine the circumstances under which supervisory review of liens or levies issued by the automated collection system is or is not appropriate.

Current California Law (R&TC Sec. 19262, 19263 and 19264)

FTB currently uses an automated collection account processing system to generate collection actions. The actions may be generated manually if the account has been assigned for manual resolution or directly through the system without direct manual-intervention if asset information is readily available on the system. Through FTB’s automated collection program, liens and levies are issued automatically based on certain criteria and without specific case-by-case approval. Once assigned for manual collection, liens and levies are issued and/or seizures are made on a case-by-case basis with prior supervisory approval, as appropriate, and as provided in procedures.

Effective Date

This provision is effective for collection actions commenced after July 22, 1998, except for any action under the automated collection system; the provision applies to actions initiated after December 31, 2000.

Impact on California Revenue

Based on the negligible revenue losses projected for the federal provision relating to the approval process for liens, levies and seizures, revenue losses from conforming to the federal provision would be negligible.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3431	Levy Exemption Amounts.

Background

The IRS may levy on all non-exempt property of the taxpayer. Property exempt from levy includes up to $2,500 in value of fuel, provisions, furniture, and personal effects in the taxpayer's household and up to $1,250 in value of books and tools necessary for the trade, business or profession of the taxpayer.

New Federal Law (Sec. 6334(a)&(g))

The provision increases the value of personal effects exempt from levy to $6,250 and the value of books and tools exempt from levy to $3,125. These amounts are indexed for inflation.

Current California Law (R&TC Sec. 21017)

California law provides that personal effects are 100% exempt from levy if ordinarily and reasonably necessary to the family, as determined by the court. In addition, $5,000 of the value of books and tools of trade/business are exempt. The value is increased to $10,000 if both spouses are in a trade or business. All exemption amounts are indexed for inflation whenever the change in the California Consumer Price Index is more than 5% higher than any previous adjustment.

Effective Date

This provision is effective for levies issued after July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3432	Release of Levy on Uncollectible Amounts.

Background

Some taxpayers have contended that the IRS does not release a wage levy immediately upon receipt of proof that the taxpayer is unable to pay the tax. Instead, they claim, the IRS levies on one period's wage payment before releasing the levy.

New Federal Law (Sec. 6343(e))

The provision requires the IRS to release, as soon as practicable, a wage levy upon the IRS receipt of proof or agreement with the taxpayer that the tax is not collectible.

Current California Law (R&TC Sections 21016)

Under California law, FTB is required to release any levy in the event of circumstances deemed appropriate by the FTB including, but not limited to, the following:

- Levy was not issued in accordance with administrative procedures;
- The taxpayer has entered into an installment agreement to satisfy the tax liability for which the levy was made;
- The sale proceeds would not result in a reasonable reduction of the debt; and
- The levy threatens the health or welfare of the taxpayer.

This provision does not apply to the seizure of property as a result of a jeopardy assessment.

Effective Date

This provision is effective for levies imposed after December 31, 1999.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3433	Levy Prohibited during Pending Refund Proceedings.

Background

The IRS is prohibited from making a tax assessment (and thus prohibited from collecting payment) with respect to a tax liability while it is being contested in Tax Court. However, the IRS is permitted to assess and collect tax liabilities during the pendency of a refund suit relating to such tax liabilities, under the circumstances described below.

Generally, full payment of the tax at issue is a prerequisite to a refund suit. However, if the tax is divisible (such as employment taxes or the trust fund penalty under Code section 6672), the taxpayer need only pay the tax for the applicable period before filing a refund claim.

New Federal Law (Sec. 6331(i)-(j))

The provision requires the IRS to withhold collection of liabilities that are the subject of a refund suit during the pendency of the litigation. This will only apply when refund suits can be brought without the full payment of the tax, i.e., in the case of divisible taxes. Collection by levy would be withheld unless jeopardy exists or the taxpayer waives the suspension of collection in writing (because collection will stop the running of interest and penalties on the tax liability). The Secretary could not commence a civil action to collect a liability except in a proceeding related to the initial refund proceeding. The statute of limitations on collection is stayed for the period during which the IRS is prohibited from collecting by levy or otherwise.

Proceedings related to a proceeding under this provision include, but are not limited to, civil actions or third-party complaints initiated by the United States or another person with respect to the same kind of tax (or related taxes or penalties) for the same (or overlapping) tax periods. For example, if a taxpayer brings a suit for refund of a portion of a penalty that the taxpayer has paid under section 6672, the United States could, consistent with this provision, counterclaim against the taxpayer for the balance of the penalty or initiate related claims against other persons assessed penalties under section 6672 for the same employment taxes.

Current California Law

Defer to EDD as the provision relates to employer payroll taxes for which EDD is responsible.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Effective Date

This provision is effective for unpaid tax attributable to taxable periods beginning after December 31, 1998.

Impact on California Revenue

Defer to EDD.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3434	Approval of Jeopardy/Termination Assessments and Levies.

Background

In general, a 30-day waiting period is imposed after assessment of all types of taxes. In certain circumstances, the waiting period puts the collection of taxes at risk. The Code provides special procedures that allow the IRS to make jeopardy assessments or termination assessments in certain extraordinary circumstances, such as if the taxpayer is leaving or removing property from the United States, or if assessment or collection would be jeopardized by delay. In jeopardy or termination situations, a levy may be made without the 30-days' notice of intent to levy that is ordinarily required.

New Federal Law (Sec. 7429(a))

The provision requires IRS Counsel review and approval before the IRS can make a jeopardy assessment, a termination assessment, or a jeopardy levy. If Counsel's approval is not obtained, the taxpayer is entitled to obtain abatement of the assessment or release of the levy, and, if the IRS fails to offer such relief, to appeal first to IRS Appeals under the new due process procedure for IRS collections and then to court. Under prior law, there was no statutory requirement of IRS Counsel Review and approval.

Current California Law (R&TC Sec. 19081 and 19082)

California law provides that FTB may issue jeopardy or termination assessments, if the FTB determines the collection of tax will be jeopardized by delay. Jeopardy or termination assessments allow for immediate levies approved by field office managers or section managers.

Effective Date

This provision is effective for taxes assessed and levies made after July 22, 1998.

Impact on California Revenue

Revenue losses from this provision would be negligible, based on the negligible revenue impact projected for the federal law change.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3435	Increase in Property Amount on which Lien is not Valid.

Background

A federal tax lien attaches to all property and rights in property of the taxpayer, if the taxpayer fails to pay the assessed tax liability after notice and demand. However, the federal tax lien is not valid as to certain "superpriority" interests.

Two of these interests are limited by a specific dollar amount. Purchasers of personal property at a casual sale are presently protected against a federal tax lien attached to such property to the extent the sale is for less than $250. In addition, present law provides protection to mechanic's lienors with respect to the repairs or improvements made to owner-occupied personal residences, but only to the extent that the contract for repair or improvement is for not more than $1,000.

In addition, a superpriority is granted to banks and building and loan associations which make passbook loans to their customers, provided that those institutions retain the passbooks in their possession until the loan is completely paid off.

New Federal Law (Sec. 6323(b)&(l))

The provision increases the dollar limit for purchasers at a casual sale from $250 to $1,000, and further increases the dollar limit from $1,000 to $5,000 for mechanics lienors providing home improvement work for owner-occupied personal residences. The provision indexes these amounts for inflation. The provision also clarifies the superpriority rules to reflect present banking practices, where a passbook-type loan may be made even though an actual passbook is not used.

Current California Law (Government Code Sec. 7170)

California law provides for state tax lien priority based on time of recording and/or the type of debt, without regard to dollar amount.

Effective Date

This provision is effective July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3436	Waiver of Early Withdrawal Penalties for IRS Levies on Retirement.

Background

Under present law, a distribution of benefits from a employer-sponsored retirement plan or an Individual Retirement Arrangement (IRA) generally is includable in gross income in the year it is paid or distributed, except to the extent the amount distributed represents the employee's after-tax contributions or investment in the contract (i.e., basis). Special rules apply to lump-sum distributions from qualified retirement plans, distributions rolled over to an IRA or employer-sponsored retirement plan, and distributions of employer securities.

Distributions from qualified plans and IRAs prior to attainment of age 59½ that are includable in income generally are subject to a 10% early withdrawal tax, unless an exception to the tax applies. Includable amounts withdrawn prior to attainment of age 59½ are subject to the additional 10% early withdrawal tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, is used to pay medical expenses in excess of 7.5% of adjusted gross income (AGI), or is used to purchase health insurance of an unemployed individual. Certain additional exceptions to the tax apply separately to withdrawals from IRAs and qualified plans. Distributions from IRAs for education expenses and for up to $10,000 of first-time homebuyer expenses, or to unemployed individuals to purchase health insurance are not subject to the 10% early withdrawal tax. A distribution from a qualified plan made by an employee after separation from service after attainment of age 55 is not subject to the 10% early withdrawal tax.

Under present law, the IRS is authorized to levy on all non-exempt property of the taxpayer. Benefits under employer-sponsored retirement plans (including 403(b) and 457 plans) and IRAs are not exempt from levy by the IRS. Distributions from employer-sponsored retirement plans or IRAs made on account of an IRS levy would be includable in the gross income of the individual, except to the extent the amount distributed represents after-tax contributions. In addition, the amount includable in income would be subject to the 10% early withdrawal tax, unless an exception described above applies.

New Federal Law (Sec. 72(t))

The provision provides an exception from the 10% early withdrawal tax for amounts withdrawn from an employer-sponsored retirement plan or an IRA that are subject to a levy by the IRS. The exception applies only if the plan or IRA is levied; it does not apply, for example, if the taxpayer withdraws funds to pay taxes in the absence of a levy, in order to release a levy on other interests.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Current California Law (R&TC Sec. 17085.8)

California is generally conformed with modifications to the prior federal law regarding early withdrawal penalties. California law imposes a penalty of 2.5%, rather than 10%, even if the amounts withdrawn were subject to levy by FTB.

Effective Date

The provision is effective for distributions made after December 31, 1999.

Impact on California Revenue

Revenue losses from the exception to the 2.5% early withdrawal penalty would result in negligible revenue losses, less than $250,000 annually, based on federal projections.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3441	Sales of Seized Property/Minimum Bid.

Background

Federal law requires that a minimum bid price be established for seized property offered for sale. To conserve the taxpayer's equity, the minimum bid price should normally be computed at 80% or more of the forced sale value of the property less encumbrances having priority over the federal tax lien. If the group manager concurs, the minimum sales price may be set at less than 80%. The taxpayer is to receive notice of the minimum bid price within 10 days of the sale. The taxpayer has the opportunity to challenge the minimum bid price, which cannot be more than the tax liability plus the expenses of sale. Present law does not contemplate a sale of the seized property at less than the minimum bid price. Rather, if no person offers the minimum bid price, the IRS may buy the property at the minimum bid price or the property may be released to the owner. Code section 7433 provides civil damages for certain unauthorized collection action.

New Federal Law (Sec. 6335(e)&(w))

The provision prohibits the IRS from selling seized property for less than the minimum bid price. The provision provides that the sale of property for less than the minimum bid price would constitute an unauthorized collection action, which would permit an affected person to sue for civil damages.

Current California Law

The levying officer (e.g., sheriff, California Highway Patrol (CHP)) establishes a minimum bid, in accordance with the Code of Civil Procedure. The minimum bid takes into consideration the value of the asset, the amount exempt from levy and any security interests. However, under FTB policy, a reserved price is computed, which is higher than the minimum bid (giving more protection to the taxpayer and value of the property). This price takes into consideration the above items and also the amount of tax debt. If the reserved price is not bid, the sale is cancelled and rescheduled. The property is released only if a new sale will not bring the reserved price.

Effective Date

This provision is effective for sales occurring after July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3442	Sales of Seized Property/Accounting.

Background

The IRS is authorized to seize and sell a taxpayer's property to satisfy an unpaid tax liability. The IRS is required to give written notice to the taxpayer before seizure of the property. The IRS must also give written notice to the taxpayer at least 10 days before the sale of the seized property. The IRS is required to keep records of all sales of real property. The records must set forth all proceeds and expenses of the sale. The IRS is required to apply the proceeds first against the expenses of the sale, then against a specific tax liability on the seized property, if any, and finally against any unpaid tax liability of the taxpayer. Any surplus proceeds are credited to the taxpayer or persons legally entitled to the proceeds.

New Federal Law (Sec. 6343(e))

The provision requires the IRS to provide a written accounting of all sales of seized property, whether real or personal, to the taxpayer. The accounting must include a receipt for the amount credited to the taxpayer's account.

Current California Law (California Code of Civil Procedure Sec. 701.510)

California law provides that the levying officer (sheriff or CHP) is responsible for the sale, collection and accounting of all property sold.

Effective Date

This provision is effective for seizures occurring after July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3443	Uniform Asset Disposal Mechanism.

Background

The IRS must sell property seized by levy either by public auction or by public sale under sealed bids. These are often conducted by the revenue officer charged with collecting the tax liability.

New Federal Law (Sec. 6331(i)-(j))

The provision requires the IRS to implement a uniform asset disposal mechanism for sales of seized property. The disposal mechanism should be designed to remove any participation in the sale of seized assets by revenue officers. The provision authorizes the consideration of outsourcing of the disposal mechanism.

Current California Law (R&TC Secs. 19262 and 19263)

California law authorizes FTB or its duly authorized agent to seize and sell property to collect any delinquent amounts. Current FTB policy requires seizure and sale of all personal and real property to be done by levying officers (sheriff or CHP). Under California law, the levying officer may not be a purchaser or have an interest in any purchase at a sale.

Effective Date

This provision requires a uniform asset disposal system to be implemented by July 22, 2000.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3444	IRS Procedures for Seizure of Property.

Background

The Internal Revenue Manual provides general guidelines for seizure actions. Prior to the levy action, the revenue officer must determine that there is sufficient equity in the property to be seized to yield net proceeds from the sale to apply to unpaid tax liabilities. If it is determined after seizure that the taxpayer's equity is insufficient to yield net proceeds from sale to apply to the unpaid tax, the revenue officer will immediately release the seized property.

New Federal Law (Sec. 7429(a))

The provision codifies the IRS administrative procedures which require the IRS to investigate the status of property prior to levy.

The provision clarifies that the investigation requirement only applies to property to be sold pursuant to section 6335.

Current California Law

Current FTB administrative procedures are similar in concept to IRS procedures. To levy on property of a tax debtor, FTB has authority to issue orders to withhold and seize property and use warrants to have the property sold and seized. Current procedures require the investigation of the status of property prior to levy.

Effective Date

This provision is effective July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3445	Procedures for Seizure of Residences and Businesses.

Background

Subject to certain procedural rules and limitations, the Secretary may seize the property of the taxpayer who neglects or refuses to pay any tax within 10 days after notice and demand. The IRS may not levy on the personal residence of the taxpayer unless the District Director (or the assistant District Director) personally approves in writing or in cases of jeopardy. There are no special rules for property that is used as a residence by parties other than the taxpayer. IRS Policy Statement P-5-34 states that the facts of a case and alternative collection methods must be thoroughly considered before deciding to seize the assets of a going business.

New Federal Law (Sec. 6334(a)&(e))

The provision generally prohibits the IRS from seizing real property that is used as a residence to satisfy an unpaid liability of $5,000 or less, including penalties and interest. This prohibition applies to any real property used as a residence by the taxpayer or any nonrental real property of the taxpayer used by any other individual as a residence.

The provision requires the IRS to exhaust all other payment options before seizing the taxpayer's business assets or principal residence. For this purpose, future income that may be derived by a taxpayer from the commercial sale of fish or wildlife under a specified state permit must be considered in evaluating other payment options before seizing the taxpayer's business assets. The prohibition does not apply in cases of jeopardy. A levy is permitted on a principal residence only if a judge or magistrate of a United States district court approves (in writing) of the levy. Congress clarified that the definition of business assets applies to tangible personal property or real property used in the trade or business of an individual taxpayer (other than real property that is rented).

Current California Law (R&TC Sec. 19236(b) &(c))

Current FTB administrative procedures are similar in concept to IRS procedures. To levy on property of a tax debtor, FTB has authority to issue orders to withhold and seize property and use warrants to have the property sold and seized.

Current procedures prohibit the sale and seizure of principal residences. Moreover, under the California Code of Civil Procedure sales, of any dwellings requires a court order.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Current collection procedures, seizures and sales of most property require approval by a collection supervisor. Current collection policy requires that all collection options be exhausted before real property or business property is seized and sold.

Effective Date

This provision is effective July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3461	Extension of Statute of Limitations by Agreement.

Background

The statute of limitations within which the IRS may assess additional taxes is generally three years from the date a return is filed. Prior to the expiration of the statute of limitations, both the taxpayer and the IRS may agree in writing to extend the statute. An extension may be for either a specified period or an indefinite period. The statute of limitations within which a tax may be collected after assessment is 10 years after assessment. Prior to the expiration of the statute of limitations on collection, both the taxpayer and the IRS may agree in writing to extend the statute.

New Federal Law (Secs. 6501(c) & (4)

The IRS Reform Act eliminates the provision of present law that allows the statute of limitations on collections to be extended by agreement between the taxpayer and the IRS, except that extensions may be made in connection with an installment agreement. The extension is applicable for the period for which the waiver of the statute of limitations entered in connection with the original written terms of the installment agreement extends beyond the end of the otherwise applicable 10-year period, plus 90 days.

The provision also requires that, on each occasion on which the taxpayer is requested by the IRS to extend the statute of limitations on assessment, the IRS must notify the taxpayer of the taxpayer's right to refuse to extend the statute of limitations or to limit the extension to particular issues.

Current California Law (R&TC Secs. 19067 and 21007)

Under current California law, FTB generally has four years from the due date of a return to assess additional tax. The SOL on deficiency assessments may be extended by the taxpayer signing a waiver.

Current law does not limit the collection period; thus, waivers extending the statute of limitations (SOL) on collection are not necessary.

Effective Date

This provision is generally effective for requests to extend the statute of limitations made after December 31, 1999. If the taxpayer agreed to extend the statute of limitations on collections beyond the 10-year statute, that extension expires on the latest of the last day of such 10-year period, December 31, 2002, or, in the case of an extension in connection with an installment agreement, the 90th day after the end of the period of such extension.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3462	Offers-in-Compromise.

Background

The Code permits the IRS to compromise a taxpayer's tax liability. An offer-in-compromise is an offer by the taxpayer to settle unpaid tax accounts for less than the full amount of the assessed balance due. An offer-in-compromise may be submitted for all types of taxes, as well as interest and penalties, arising under the IRC.

There are two bases on which an offer can be made: doubt as to liability for the amount owed and doubt as to the taxpayer's ability to fully pay the amount owed.

A compromise agreement based on doubt as to ability to pay requires the taxpayer to file returns and pay taxes for five years from the date the IRS accepts the offer. Failure to do so permits the IRS to begin immediate collection actions for the original amount of the liability. The Internal Revenue Manual provides guidelines for revenue officers to determine whether an offer-in-compromise is adequate. An offer is adequate if it reasonably reflects collection potential. Although the revenue officer is instructed to consider the taxpayer's assets and future and present income, the Internal Revenue Manual advises that rejection of an offer solely based on narrow asset and income evaluations should be avoided. Pursuant to the Internal Revenue Manual, collection normally is withheld during the period an offer-in-compromise is pending, unless it is determined that the offer is a delaying tactic and collection is in jeopardy.

New Federal Law (Secs. 6159(d), 6331(k)-(l) & 7122(c)&(d))

Rights of taxpayers entering into offers-in-compromise. The provision requires the IRS to develop and publish schedules of national and local allowances that will provide taxpayers entering into an offer-in-compromise with adequate means to provide for basic living expenses. The IRS also is required to consider the facts and circumstances of a particular taxpayer's case in determining whether the national and local schedules are adequate for that particular taxpayer. If the facts indicate that use of scheduled allowances would be inadequate under the circumstances, the taxpayer is not limited by the national or local allowances.

The provision prohibits the IRS from rejecting an offer-in-compromise from a low-income taxpayer solely on the basis of the amount of the offer. The Act provides that, in the case of an offer-in-compromise submitted solely on the basis of doubt as to liability, the IRS may not reject the offer merely because the IRS cannot locate the taxpayer's file. The provision prohibits the IRS from requesting a financial statement if the taxpayer makes an offer-in-compromise based solely on doubt as to liability.

Publication of taxpayer's rights with respect to offers-in-compromise. The provision requires the IRS to publish guidance on the rights and obligations of taxpayers and the IRS relating to offers in compromise, including a compliant spouse's right to apply to reinstate an agreement that would otherwise be revoked due to the nonfiling or nonpayment of the other spouse, providing all payments required under the compromise agreement are current.

Suspend collection by levy while offer-in-compromise is pending. The provision prohibits the IRS from collecting a tax liability by levy (1) during any period that a taxpayer's offer-in-compromise for that liability is being processed, (2) during the 30 days following rejection of an offer, (3) during any period in which an appeal of the rejection of an offer is being considered, and (4) while an installment agreement is pending. Taxpayers whose offers are rejected and who made good faith revisions of their offers and resubmitted them within 30 days of the rejection or return would be eligible for a continuous period of relief from collection by levy. This prohibition on collection by levy would not apply if the IRS determines that collection is in jeopardy or that the offer was submitted solely to delay collection. The provision provides that the statute of limitations on collection would be tolled for the period during which collection by levy is barred.

Procedures for reviews of rejections of offers-in-compromise and installment agreements. The provision requires that the IRS implement procedures to review all proposed IRS rejections of taxpayer offers-in-compromise and requests for installment agreements prior to the rejection being communicated to the taxpayer. The provision requires the IRS to allow the taxpayer to appeal any rejection of such offer or agreement to the IRS Office of Appeals. The IRS must notify taxpayers of their right to have an appeals officer review a rejected offer-in-compromise on the application form for an offer-in-compromise.

Guidelines to determine whether an offer-in-compromise should be accepted. The Act authorizes the Secretary to prescribe guidelines for the IRS to determine whether an offer-in-compromise is adequate and should be accepted to resolve a dispute. Accordingly, it is expected that the present regulations will be expanded so as to permit the IRS, in certain circumstances, to consider additional factors (i.e., factors other than doubt as to liability or collectibility) in determining whether to compromise the income tax liabilities of individual taxpayers. For example, Congress anticipates that the IRS will take into account factors such as equity, hardship, and public policy where a compromise of an individual taxpayer's income tax liability would promote effective tax administration. Congress anticipates that, among other situations, the IRS may utilize this new authority to resolve longstanding cases by forgoing penalties and interest, which have accumulated as a result of delay in determining the taxpayer's liability.

Current California Law (R&TC Sec. 19008)

In California, an offer in compromise for income and franchise tax purposes may be based only on doubt as to collectibility and requires a judicial process (stipulated summary judgement). As part of the judicial offer-in-compromise process, FTB staff must prepare the legal documents, and keep track of the court’s calendar for filing civil action. The FTB is responsible for paying court costs, however, as a condition of compromise, the tax debtor must agree to pay the court costs from the amount offered in compromise. FTB is in the process of seeking legislation to grant administrative authority for offers-in-compromise, which would eliminate the required payment of the court costs.

Effective Date

This provision is generally effective for proposed offers-in-compromise and installment agreements submitted after July 22, 1998. The provision suspending levy is effective with respect to offers-in-compromise pending on or made after December 31, 1999.

Impact on California Revenue

Revenue enhancements associated with this provision would be negligible.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3463	Notice of Deficiency/Deadlines for Filing Tax Court Petition.

Background

Taxpayers must file a petition with the Tax Court within 90 days after the deficiency notice is mailed (150 days if the person is outside the United States) (sec. 6213). If the petition is not filed within that time period, the Tax Court does not have jurisdiction to consider the petition.

New Federal Law (Sec. 6213(a))

The provision requires the IRS to include on each deficiency notice the date determined by the IRS as the last day on which the taxpayer may file a petition with the Tax Court. The provision provides that a petition filed with the Tax Court by this date is treated as timely filed.

Current California Law (R&TC Secs. 19034, 19041 & 19045)

California law requires each notice to set forth the reasons for the proposed deficiency assessment and the computation. The taxpayer may file a written protest against the assessment within 60 days of the date of the notice of proposed deficiency assessment. The FTB's action on the protest is final 30 days after the date the notice of action is mailed to the taxpayer, unless within that 30-day period the taxpayer appeals in writing to the BOE. Under current FTB practice the back of the notice of the proposed assessment and the notice of action provide information on the timeframes and the rules for making protests and appeals.

Effective Date

This provision is effective for notices mailed after December 31, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3464	Refund/Credit of Overpayments Before Final Determination.

Background

Generally, the IRS may not take action to collect a deficiency during the period a taxpayer may petition the Tax Court, or if the taxpayer petitions the Tax Court, until the decision of the Tax Court becomes final. Actions to collect a deficiency attempted during this period may be enjoined, but there is no authority under prior law for ordering the refund of any amount collected by the IRS during the prohibited period.

If a taxpayer contests a deficiency in the Tax Court, no credit or refund of income tax for the contested taxable year generally may be made, except in accordance with a decision of the Tax Court that has become final. Where the Tax Court determines that an overpayment has been made and a refund is due the taxpayer, and a party appeals a portion of the decision of the Tax Court, no provision exists for the refund of any portion of any overpayment that is not contested in the appeal.

New Federal Law (Secs. 6213(a) and 6512(a) & (b))

The provision provides that a proper court (including the Tax Court) may order a refund of any amount that was collected within the period during which the Secretary is prohibited from collecting the deficiency by levy or other proceeding.

The provision also allows the refund of that portion of any overpayment determined by the Tax Court to the extent the overpayment is not contested on appeal.

Current California Law

California law provides no specific authority to allow the refund of amounts involuntarily collected prior to the date a deficiency becomes final. Generally, collection action does not begin until assessments are final.

Effective Date

This provision is effective July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3465	Codifies IRS Procedures for Referrals to Appeals and Collections Appeals Process and Alternative Dispute Resolution Process.

Background

IRS Appeals operates through regional Appeals offices which are independent of the local District Director and Regional Commissioner's offices. In general, IRS Appeals offices have jurisdiction over both pre-assessment and post-assessment cases. The taxpayer generally has an opportunity to seek appeals jurisdiction after failing to reach agreement with the examination function and before filing a petition in Tax Court, after filing a petition in Tax Court (but before litigation), after assessment of certain penalties, after a claim for refund has been rejected by the District Director's Office, and after a proposed rejection of an offer-in-compromise in a collection case.

In certain cases under Coordinated Examination Program procedures, the taxpayer has an opportunity to seek early Appeals jurisdiction over some issues while an examination is still pending on other issues. The early referral procedures also apply to employment tax issues on a limited basis.

A mediation or "alternative dispute resolution" (ADR) process is also available in certain cases. ADR is used at the end of the administrative process as a final attempt to resolve a dispute before litigation. ADR is currently only available for cases with more than $10 million in dispute. ADR processes are also available in bankruptcy cases and cases involving a competent authority determination.

In April 1996, the IRS implemented a Collections Appeals Program within the Appeals function, which allows taxpayers to appeal lien, levy, or seizure actions proposed by the IRS. In January 1997, appeals for installment agreements proposed for termination were added to the program.

New Federal Law (Secs. 7123 – 7124)

The provision codifies existing IRS procedures with respect to early referrals to Appeals and the Collections Appeals Process. The provision also codifies the existing ADR procedures, as modified by eliminating the dollar threshold. In addition, the IRS is required to establish a pilot program of binding arbitration for disputes of all sizes. Under the pilot program, both the taxpayer and the IRS must agree to binding arbitration.

The IRS is required to make Appeals officers available on a regular basis in each state, and consider videoconferencing of Appeals conferences for taxpayers seeking appeals in rural or remote areas.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Current California Law (R&TC Secs. 21004, 21010 and 21016)

California law, pursuant to the Taxpayers' Bill of Rights, established the Taxpayer Rights Advocate. The advocate coordinates the resolution of taxpayer complaints and problems, including staying action where taxpayers have suffered or will suffer irreparable loss as the result of FTB action. Further, FTB was required in cooperation with BOE and other interested parties, to develop a plan to reduce the time required to resolve claims for refund, protests and appeals.

In addition, FTB has the authority to settle unpaid assessments (protests and appeals) based on a reasonable evaluation of the costs and risks associated with litigation of these cases.

FTB's executive officer and chief counsel upon notification of the board may approve settlements reducing tax by $5,000 or less. Reduction of tax in excess of $5,000 must first be reviewed by the Attorney General and then go the board.

Effective Date

This provision is effective July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3466	Certain Fair Debt Collection Practices Applicable to IRS.

Background

The Fair Debt Collection Practices Act provides a number of rules relating to debt collection practices. Among these are restrictions on communication with the consumer, such as a general prohibition on telephone calls outside the hours of 8 a.m. to 9 p.m. local time, and prohibitions on harassing or abusing the consumer. In general, these provisions do not apply to the Federal Government.

New Federal Law (Sec. 6304)

The provision applies the restrictions relating to communication with the taxpayer/debtor and the prohibitions on harassing or abusing the debtor to the IRS. The restrictions relating to communication with the taxpayer/debtor are not intended to hinder the ability of the IRS to respond to taxpayer inquiries (such as answering telephone calls from taxpayers).

Current California Law

FTB’s current collection procedures for taxpayer communications follow the federal Fair Debt Collection Practices Act and the state Robbins-Rosenthal Fair Debt Collection Practices Act for private collections.

Effective Date

This provision is effective July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3467	Guaranteed Availability of Installment Payments.

Background

The Code authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer is allowed to pay taxes owed, as well as interest and penalties, in installment payments if the IRS determines that doing so will facilitate collection of the amounts owed. An installment agreement does not reduce the amount of taxes, interest, or penalties owed, but does provide for a longer period during which payments may be made during which other IRS enforcement actions (such as levies or seizures) are held in abeyance. The IRS in most instances readily approves these requests if the amounts involved are not large (in general, below $10,000) and if the taxpayer has filed tax returns on time in the past. Some taxpayers are required to submit background information to the IRS substantiating their application.

New Federal Law (Sec. 6159(c)-(d))

The provision requires the Secretary to enter an installment agreement, at the taxpayer's option, if: (1) the liability is $10,000, or less (excluding penalties and interest); (2) within the previous five years, the taxpayer has not failed to file or to pay, nor entered an installment agreement under this provision; (3) if requested by the Secretary, the taxpayer submits financial statements, and the Secretary determines that the taxpayer is unable to pay the tax due in full; (4) the installment agreement provides for full payment of the liability within three years; and (5) the taxpayer agrees to continue to comply with the tax laws and the terms of the agreement for the period (up to three years) that the agreement is in place.

Current California Law (R&TC Sec. 19008)

California law authorizes the FTB to enter into installment payment agreements in cases of financial hardship. Under current practice, taxpayers that meet specified criteria are able to make installment payments without completing a financial statement. To qualify, taxpayers must owe no more that $10,000, agree to pay their liabilities by electronic funds transfer within three years, and have filed all required tax returns.

The agreements may be deemed null and void if the individual or fiduciary fails to comply with the terms of the agreement. To terminate the agreement, the FTB must provide notice to the taxpayer or fiduciary 30 days before termination. The notice includes an explanation of why FTB intends to terminate the agreement.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Under California law, the FTB's Taxpayer's advocate must establish procedures for an independent departmental administrative review for installment payment agreements that are terminated for individuals or fiduciaries that request that review. The administrative review does not stay collection.

Effective Date

This provision is effective July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3468	Prohibition of Requests to Waive Rights to Bring Action.

Background

There is no restriction on the circumstances under which the government may request a taxpayer to waive the taxpayer's right to sue the United States or one of its employees for any action taken in connection with the tax laws.

New Federal Law

The provision provides that the government may not request a taxpayer to waive the taxpayer's right to sue the United States or one of its employees for any action taken in connection with the tax laws, unless (1) the taxpayer knowingly and voluntarily waives that right, or (2) the request is made to the taxpayer's attorney or other representative.

It is not intended that this provision apply to the waiver of claims for attorneys' fees or costs or to the waiver of one or more claims brought in the same administrative or judicial proceeding with other claims that are being settled.

Current California Law

Current procedures prohibit requesting a taxpayer to waive their right to sue the state or one of its employees.

Effective Date

This provision is effective July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3501	Explanation of Joint and Several Liability.

Background

In general, spouses who file a joint tax return are each fully responsible for the accuracy of the tax return and for the full liability. Spouses who wish to avoid such joint and several liability may file as married persons filing separately. Special rules apply in the case of innocent spouses.

New Federal Law

The provision requires that the IRS establish procedures clearly to alert married taxpayers of their joint and several liability on all appropriate tax publications and instructions. Congress anticipates that the IRS will make an appropriate cross reference to these statements near the signature line on appropriate tax forms. In addition, the Act requires notification of the availability of electing separate liability under new section 6015 of the Code.

Current California Law (R&TC Secs. 18533, 18534 and 19006)

Under current state law, like federal law, married taxpayers who file a joint tax return are fully responsible for the accuracy of the return and are fully liable for any tax payable under the return. However, current California law does not contain a provision requiring instructions and forms to alert taxpayers of joint and several liability.

Effective Date

This provision requires that the procedures be established as soon as practicable, but no later than January 18, 1999.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3502	Explanation of Taxpayer’s Rights in Interviews with the IRS.

Background

Prior to or at initial in-person audit interviews, the IRS must explain to taxpayers the audit process and taxpayers' rights under that process. In addition, prior to an initial in-person collection interview, the IRS must explain the collection process and taxpayers' rights under that process. If a taxpayer clearly states during an interview with the IRS that the taxpayer wishes to consult with the taxpayer's representative, the interview must be suspended to afford the taxpayer a reasonable opportunity to consult with the representative.

New Federal Law

The provision requires that the IRS rewrite Publication 1 (“Your Rights as a Taxpayer”) to inform taxpayers more clearly of their rights (1) to be represented by a representative and (2) if the taxpayer is so represented, that the interview may not proceed without the presence of the representative unless the taxpayer consents.

Current California Law

California law is not conformed to the underlying federal law regarding a taxpayer’s rights during an interview. However, California law does provide specified rights during a protest hearing.

Publication 4058 states that throughout the examination the taxpayer has the right to have someone represent them. In addition, FTB 1015 that is sent with the initial audit letter states that the taxpayer has the right to have someone represent them.

Effective Date

The addition to Publication 1 must be made not later than January 18, 1999.

Impact on California Revenue

No identifiable revenue impact.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3503	Disclosure of Criteria for Examination Selection.

Background

The IRS examines federal tax returns to determine the correct liability of taxpayers. The IRS selects returns to be audited in a number of ways, such as through a computerized classification system (the discriminant function ("DIF") system).

New Federal Law

The provision requires that IRS add to Publication 1 (Your Rights as a Taxpayer) a statement which sets forth in simple and nontechnical terms the criteria and procedures for selecting taxpayers for examination. The statement must not include any information the disclosure of which would be detrimental to law enforcement. The statement must specify the general procedures used by the IRS, including whether taxpayers are selected for examination on the basis of information in the media or from informants.

Current California Law (R&TC Sec. 19544)

California law provides that if the disclosure of a requested audit criterion would seriously impair tax assessment, collection or enforcement, the law can not be construed to require disclosure of the standard used for audit.

Effective Date

The addition to Publication 1 must be made not later than January 22, 2000.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3504	Explanation of Appeals and Collection Process.

Background

There is no statutory requirement that specific notices be given to taxpayers with the first letter of proposed deficiency that allows the taxpayer an opportunity for administrative review in the IRS Office of Appeals.

New Federal Law

The provision requires that an explanation of the entire process from examination through collections, including the assistance available to taxpayers from the Taxpayer Advocate at various points in the process, be provided with the first letter of proposed deficiency that allows the taxpayer an opportunity for administrative review in the IRS Office of Appeals.

Current California Law (R&TC. 21007)

California law requires FTB to provide an explanation of the taxpayer's rights and obligations with initial notice of audit, the notice of proposed assessment (NPA) and any subsequent notices.

Form FTB 1015 (sent with initial audit letters) explains what the taxpayer can expect during the audit and their rights and obligations. Form FTB 1140 (included with the NPA) discloses how interest and penalties are assessed and the Taxpayer's Bill Rights. The backs of the NPA and the notice of action (NOA) disclose the protest and appeal process. Form FTB 1013 (sent with initial billing) explains rights during collection, and Publication 4058 outlines all rights and obligations.

Effective Date

Requires that the explanation be included as soon as practicable, but no later than January 18, 1999.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3505	Explanation of Refund Disallowance.

Background

The Examination Division of the IRS examines claims for refund submitted by taxpayers. The Internal Revenue Manual requires examination or other audit action on refund claims within 30 days after receipt of the claims. The refund claim is preliminarily examined to determine if it should be disallowed because it (1) was untimely filed, (2) was based solely on alleged unconstitutionality of the Revenue Acts, (3) was already waived by the taxpayer as consideration for a settlement, (4) covers a taxable year and issues which were the subject of a final closing agreement or an offer-in-compromise, or (5) relates to a return closed on the basis of a final order of the Tax Court. In those cases, the taxpayer will receive a form from the IRS stating that the claim for refund cannot be considered. Other cases will be examined as quickly as possible and the disposition of the case, including the reasons for the disallowance or partial disallowance of the refund claim, must be stated in the portion of the revenue agent's report that is sent to the taxpayer.

New Federal Law (Sec. 6402(j))

The provision requires the IRS to notify the taxpayer of the specific reasons for the disallowance (or partial disallowance) of the refund claim.

Current California Law (R&TC Sec. 19323)

California law requires FTB to notify the taxpayer if the FTB disallows any claim for refund. Currently, the reasons for disallowing the claim are included on the notice.

Effective Date

This provision is effective January 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3506	Statements Regarding Annual Installment Agreements.

Background

A taxpayer entering into an installment agreement to pay tax liabilities due to the IRS must complete a Form 433-D, which sets forth the installment amounts to be paid monthly and the total amount of tax due. The IRS does not provide the taxpayer with an annual statement reflecting the amounts paid and the amount due remaining.

New Federal Law

The provision requires the IRS to send every taxpayer in an installment agreement an annual statement of the initial balance owed, the payments made during the year, and the remaining balance.

Current California Law (Sec. 21026)

Current law requires the FTB to mail to taxpayers with delinquent accounts an annual statement showing amounts owed as of the date of the notice. Current law does not require an annual statement to taxpayers with installment agreements.

Effective Date

This provision is effective on July 1, 2000.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3507	Notification of Change in Tax Matters Partner.

Background

In general, the tax treatment of items of partnership income, loss, deductions and credits are determined at the partnership level in a unified partnership proceeding rather than in separate proceedings with each partner. In providing notice to taxpayers with respect to partnership proceedings, the IRS relies on information furnished by a party designated as the tax matters partner (TMP) of the partnership. The TMP is required to keep each partner informed of all administrative and judicial proceedings with respect to the partnership. Under certain circumstances, the IRS may require the resignation of the incumbent TMP and designate another partner as the TMP of a partnership.

New Federal Law (Sec. 6231(a))

The provision requires the IRS to notify all partners of any resignation of the tax matters partner that is required by the IRS, and to notify the partners of any successor TMP.

Current California Law

Not applicable as current California law does not conform to the federal unified partnership proceedings.

Effective Date

This provision is effective for selections of TMP made by the Secretary after July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3508	Disclosure to Taxpayers.

Background

There is no requirement that the general tax forms instruction booklets include a description of conditions under which tax return information may be disclosed outside the IRS (including to states).

New Federal Law (Sec. 6103(f)(5))

The provision requires that general tax forms instruction booklets include a description of conditions under which tax return information may be disclosed outside the IRS (including to States). Congress considers the statement currently contained in the general tax forms instruction booklets to be sufficient to fulfill the requirements of this provision.

Current California Law (Civil Code Sec. 1798.17)

California law, under the Civil Code, requires any agency whenever it collects personal information to provide notice of how and when the information may be disclosed. California income tax booklets currently include a description of conditions under which tax return information may be disclosed to those external to FTB.

Effective Date

This provision is effective July 22, 1998.

Impact on California Revenue

Not applicable.

Section	Section Title
3509	Disclosure of Chief Counsel Advice.

Background

Section 6110 of the Code provides for the public inspection of written determinations, i.e., rulings, determination letters, and technical advice memoranda. The IRS issues annual revenue procedures setting forth the procedures for requests for these various forms of written determinations and participation in the formulation of such determinations.

Under section 6110 and the regulations promulgated thereunder, the taxpayer who is the subject of a written determination can participate in the redaction of the documents to ensure that the taxpayer's privacy is protected and that sensitive private information is removed before the determination is publicly disclosed. In the event there is disagreement as to the information to be deleted, the section provides for litigation in the courts to resolve such disagreements (See e.g., Rev. Procs. 98-1 and 98-2).

One of the Office of Chief Counsel's major roles is to advise IRS personnel on legal matters at all stages of case development. The Office of Chief Counsel thus issues various forms of written legal advice to field agents of the IRS and to its own field attorneys that do not fall within the current definition of "written determination" under section 6110. Traditionally, field Counsel offices provided most of the assistance to the IRS, usually at IRS field offices, but since 1988, the National Office of Chief Counsel has been rendering more assistance to field Counsel and IRS offices. National Office of Chief Counsel assistance in taxpayer-specific cases is generally called “field service advice.” The taxpayers who are the subject of field service advice generally do not participate in the process, leading some tax commentators to express concern that the field service advice process was displacing the technical advice process.

There has been controversy as to whether the Office of Chief Counsel must release forms of advice other than written determinations pursuant to the Freedom of Information Act (FOIA). In Tax Analysts v. IRS, 22117 F.3d 607 (D.C. Cir. 1997), the D.C. Circuit held that the legal analysis portions of field service advice created in the context of specific taxpayers' cases are not "return information," as defined by section 6103(b)(2), and must be released under FOIA. The court also found that portions of field service advice issued in docketed cases may be withheld as privileged attorney work product. However, some issues remain outstanding. Although the extent to which such materials must be released is still in dispute, it is clear that they are not expressly covered by section 6110. As a consequence, there exists no mechanism by which taxpayers may participate in the administrative process of redacting their private information from such documents or to resolve disagreements in court.

New Federal Law (Secs. 6110(b), (f), (l)-(m))

In general, it is intended that written documents issued by the National Office of Chief Counsel to its field components and field agents of the IRS should be subject to public release in a manner similar to technical advice memoranda or other written determinations. In this way, all taxpayers can be assured of access to the considered view of the Chief Counsel's national office on significant tax issues. Creating a structured mechanism by which these types of legal memoranda are open to public inspection will increase the public's confidence that the tax system operates fairly and in an even-handed manner with respect to all taxpayers.

As part of making these documents public, however, the privacy of the taxpayer who is the subject of the advice must be protected. Any procedure for making such advice public must therefore include adequate safeguards for taxpayers whose privacy interests are implicated. There should be a mechanism for taxpayer participation in the deletion of any private information. There should also be a process whereby appropriate governmental privileges may be asserted by the IRS and contested by the public or the taxpayer.

The provision amends section 6110 of the Code, establishing a structured process by which the IRS will make certain work products, designated as “Chief Counsel Advice,” open to public inspection on an ongoing basis. It is designed to protect taxpayer privacy while allowing the public inspection of these documents in a manner generally consistent with the mechanism of section 6110 for the public inspection of written determinations. In general, the provision operates by establishing that Chief Counsel Advice are written determinations subject to the public inspection provisions of section 6110.

Definition of Chief Counsel Advice.

For purposes of this provision, Chief Counsel Advice is written advice or instruction prepared and issued by any national office component of the Office of Chief Counsel to field employees of the IRS or the Office of Chief Counsel that convey certain legal interpretations or positions of the IRS or the Office of Chief Counsel concerning existing or former revenue provisions. For these purposes, the term "revenue provisions" includes, without limitation: the IRC itself; regulations, revenue rulings, revenue procedures, or other administrative interpretations or guidance, whether published or unpublished (including, for example, other Chief Counsel Advice); tax treaties; and court decisions and opinions. Chief Counsel Advice also includes legal interpretations of state law, foreign law, or other federal law relating to the assessment or collection of liabilities under revenue provisions.

Chief Counsel Advice may interpret or set forth policies concerning the internal revenue laws either in general or as applied to specific taxpayers or groups of specific taxpayers. The definition is, however, not meant to include advice written with respect to nontax matters, including but not limited to employment law, conflicts of interest, or procurement matters.

The new statutory category of written determination encompasses certain existing categories of advisory memoranda or instructions written by the National Office of Chief Counsel to field personnel of either the IRS or the Office of Chief Counsel. Specifically, Chief Counsel Advice includes field service advice, technical assistance to the field, service center advice, litigation guideline memoranda, tax litigation bulletins, general litigation bulletins, and criminal tax bulletins. The definition applies not only to the case-specific field service advice issued from the offices of the Associate Chief Counsel (International), Associate Chief Counsel (Employee Benefits and Exempt Organizations), and the Assistant Chief Counsel (Field Service), which were at issue in the Tax Analysts decision, but any case-specific or noncase-specific written advice or instructions issued by the National Office of Chief Counsel to field personnel of either the IRS or the Office of Chief Counsel.

Moreover, Chief Counsel Advice includes any documents created subsequent to the enactment of this provision that satisfy the general statutory definition, regardless of their name or designation. Chief Counsel Advice also includes any such advice or instruction even if the organizations currently issuing them are reorganized or reconstituted as part of any IRS restructuring.

The new subsection covers written advice "issued" to field personnel of either the IRS or the Office of Chief Counsel in its final form. With respect to Chief Counsel Advice, issuance occurs when the Chief Counsel Advice has been approved within the national office component of the office of Chief Counsel in which the Chief Counsel Advice was proposed, signed by the person authorized to do so (usually the Assistant Chief Counsel or a Branch Chief), and sent to the field. Chief Counsel Advice does not include written recordations of informal telephonic advice by the National Office of Chief Counsel to field personnel of either the IRS or the Office of Chief Counsel. Drafts of Chief Counsel Advice sent to the field for review, criticism, or comment prior to approval within the National Office also need not be made public. However, Chief Counsel Advice may be treated as issued even if supplemental advice is contemplated. The Secretary is expected to issue regulations to clarify the distinction between issuance as it applies to Chief Counsel Advice and as it applies to other documents disclosed under section 6110.

The provision also allows the Secretary to promulgate regulations providing that additional types of advice or instruction issued by the Office of Chief Counsel (or components of the Office of Chief Counsel, such as regional or local Counsel offices) will be treated as Chief Counsel Advice and subject to public inspection pursuant to this provision. No inference shall be drawn from the failure of the Secretary to treat additional types of advice or instruction as Chief Counsel Advice in determining whether such advice or instruction is to be disclosed under FOIA.

As with other written determinations, Chief Counsel Advice may not be used or cited as precedent, except as the Secretary otherwise establishes by regulation.

Redaction process.

Under this provision, Chief Counsel Advice will be redacted prior to their public release in a manner similar to that provided for private letter rulings, technical advice memoranda, and determination letters. Specific taxpayers or groups of specific taxpayers who are the subject of Chief Counsel Advice will be afforded the opportunity to participate in the process of redacting the Chief Counsel Advice prior to their public release.

In addition, the new provision affords additional protection for certain governmental interests implicated by Chief Counsel Advice. Information may be redacted from Chief Counsel Advice under subsections (b) and (c) of the Freedom of Information Act, 5 U.S.C. sec. 552 (except, with respect to 5 U.S.C. sec. 552(b)(3), only material required to be withheld under a Federal statute, other than title 26, may be redacted), as those provisions have been, or shall be, interpreted by the courts of the United States. For those deletions that are discretionary, such as those under FOIA section 552(b)(5), it is expected that the Office of Chief Counsel and the IRS will apply any discretionary standards applicable to federal agencies in general or the Chief Counsel or the IRS in particular. The current standards for the exercise of such discretion are set forth in the Internal Revenue Manual (part 1230, section 293(2)) and the Attorney General's October 4, 1993, Memorandum for Heads of Departments and Agencies.

Under new section 6110(i), as with current section 6110(c)(1), identifying details consisting of names, addresses, and any other information that the Secretary determines could identify any person, including the taxpayer's representative, will be redacted, after the participation of the taxpayer in the redaction process. In some situations, information included in a Chief Counsel Advice (other than a name or address) may not identify a person as of the time the advice is made open to public inspection, but that information, together with information that is expected to be disclosed by another source at a later date, will serve to identify a person. Consequently, in deciding whether a Chief Counsel Advice contains identifying information, the Secretary is to take into account information that is available to the public at the time that the advice is made open to public inspection as well as information that is expected to be publicly available from other sources within a reasonable time after the Chief Counsel Advice is made open to public inspection. Generally, it is intended that the standard the IRS is to use in determining whether information will identify a person is a standard of a reasonable person generally knowledgeable with respect to the appropriate community. The standard is not, however, to be one of a person with inside knowledge of the particular taxpayer.

As under current section 6110, taxpayers who are the subject of Chief Counsel Advice, as well as members of the public, will be afforded the opportunity to challenge judicially the redaction determinations by the Secretary.

Relation to present law.

The public inspection of Chief Counsel Advice is to be accomplished only pursuant to the rules and procedures set forth in section 6110, as amended, and not under those of any other provision of law, such as FOIA. This provision is not intended to affect the disclosure under FOIA, or under any other provision of law, of any documents not included within the definition of Chief Counsel Advice in new sections 6110(i)(1) and (i)(2). The only FOIA exemption affected by this provision is 5 U.S.C. section 552(b)(3), to the extent that it incorporates section 6103 of the Code. The timetable and the manner in which existing Chief Counsel Advice may ultimately be open to public inspection shall be governed by this provision, except that the provision is inapplicable to Chief Counsel Advice that any federal district court has, prior to the date of enactment, ordered be disclosed. Disclosure of any documents that are subject to such a court order is to proceed pursuant to the order rather than this provision. Finally, no inference is intended with respect to the disclosure, under FOIA or any other provision of law, of any other documents produced by the Office of Chief Counsel that are not included in the definition of Chief Counsel Advice.

Current California Law

California is not conformed to section 6110. California law does not require the disclosure of written determinations. In some circumstances, the text of Information Letters, Chief Counsel Rulings and Opinion Letters that respond to questions of general applicability may be released as FTB Notices (the name and any identifying characteristics of the requesting taxpayer are deleted).

Effective date

The provision applies to Chief Counsel Advice issued after October 22, 1998. In addition, the provision contains certain rules governing disclosure of any document fitting the definition of Chief Counsel Advice issued after 1985 and before 90 days after the date of enactment by the offices of the associate chief counsel for domestic, employee benefits and exempt organizations, and international. It sets forth a schedule for the IRS to release such Chief Counsel Advice over a six year period after the date of enactment. Finally, additional advice or instruction that the Secretary determines by regulations to treat as Chief Counsel Advice shall be made public pursuant to this provision in accordance with the effective dates set forth in such regulations.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3601	Low-Income Taxpayer Clinics.

Background

There are no provisions in present law providing for assistance to clinics that assist low-income taxpayers.

New Federal Law

The provision provides that the Secretary is authorized to provide up to $6 million per year in matching grants to certain low-income taxpayer clinics. No clinic can receive more than $100,000 per year. Eligible clinics would be those that charge no more than a nominal fee to either represent low-income taxpayers in controversies with the IRS or provide tax information to individuals for whom English is a second language.

A "clinic" includes (1) a clinical program at an accredited law school, an accredited business school or an accounting school that would be eligible for grants, in which students represent low-income taxpayers, or (2) an organization exempt from tax under Code section 501(c) which either represents low-income taxpayers or provides referral to qualified representatives.

Current California Law (R&TC Secs. 21005 & 21006)

California law requires the board, in consultation with the Taxpayers’ Rights Advocate, to develop and implement a taxpayer education and information program directed at areas such as: identifying forms, procedures, regulations, or laws which are confusing and lead to taxpayer errors; the most common errors made by specified taxpayers and how these errors may be avoided or corrected; participating in small business seminars and similar programs organized by state and local agencies; and implementation of continuing education program for audit personnel to include the application of new legislation.

FTB partners with the IRS for Volunteers in Tax Assistance (VITA) program and Tax Counseling for the Elderly (TCE). FTB also administers the Homeowners and Renters Assistance Program (HRA) for the State Controller’s Office,

Effective Date

This provision is effective July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3701	Cataloging Complaints.

Background

The IRS is required to make an annual report to the Congress, beginning in 1997, on all categories of instances involving allegations of misconduct by IRS employees, arising either from internally identified cases or from taxpayer or third-party initiated complaints. The report must identify the nature of the misconduct or complaint, the number of instances received by category, and the disposition of the complaints.

New Federal Law

The provision requires that, in collecting data for this report, records of taxpayer complaints of misconduct by IRS employees must be maintained on an individual employee basis. These individual records are not to be listed in the report.

Current California Law (R&TC Sec. 21009)

FTB does not report to the Legislature regarding employee misconduct. Employees are evaluated annually, including the employee’s contact with taxpayers. Adverse action may be taken against an employee for misconduct with taxpayers. Notices of adverse action are filed with the State Personnel Board (SPB) and, through SPB, are public.

Effective Date

This provision is effective on January 1, 2000.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3702	Internal Revenue Service Archive Records.

Background

The IRS is obligated to transfer agency records to the National Archives and Records Administration ('NARA') for retention or disposal. The IRS is also obligated to protect confidential taxpayer records from disclosure. These two obligations have created conflict between NARA and the IRS. Under prior law, the IRS determined whether records contain taxpayer information. Once the IRS had made that determination, NARA was not permitted to examine those records. NARA had expressed concern that the IRS may be using the disclosure prohibition to improperly conceal agency records with historical significance.

The IRC prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the Internal Revenue Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431). Section 6103 does not authorize the disclosure of confidential return information to NARA.

New Federal Law

The provision provides an exception to the disclosure rules to require IRS to disclose IRS records to officers or employees of NARA, upon written request from the U.S. Archivist, for purposes of the appraisal of such records for destruction or retention in the National Archives. The present-law prohibitions on and penalties for disclosure of tax information would generally apply to NARA.

Current California Law (Civil Code Sec. 1798.24(j))

California law, under the Civil Code, allows an agency to disclose information to the State Archives. Under current procedures (agreement with State Archivist), information requested by State Archives is sanitized to remove any information that would identify the specific taxpayer. The FTB Disclosure Officer reviews material and removes any confidential information before it is sent to Archives.

In addition, the Civil Code requires each agency to maintain an accounting of information disclosed to the State Archives. No record may be destroyed or disposed of unless the director has determined the record has no further value and the SOS has determined it is inappropriate for preservation in the State Archives.

Effective Date

This provision is effective for requests made by the Archivist after July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3703	Payment of Taxes.

Background

The Code provides that it is lawful for the Secretary to accept checks or money orders as payment for taxes, to the extent and under the conditions provided in regulations prescribed by the Secretary (sec. 6311). Those regulations state that checks or money orders should be made payable to the IRS.

New Federal Law

The provision requires the Secretary or his delegate to establish such rules, regulations, and procedures as are necessary to allow payment of taxes by check or money order to be made payable to the United States Treasury.

Current California Law (R&TC Sec. 19005)

California law requires remittances in the form of a check to be payable to the "Franchise Tax Board." Current procedures allow the processing of checks made payable to the State of California, the IRS or other state agency if the amount is the same as the tax reported on the return.

Effective Date

This provision is effective July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3704	Authority of Secretary Regarding Elections.

Background

Except as otherwise provided, elections provided by the Code are to be made in such manner as the Secretary shall by regulations or forms prescribe.

New Federal Law (Sec. 7805(d))

The provision clarifies that, except as otherwise provided; the Secretary may prescribe the manner of making of any election by any reasonable means.

Current California Law (R&TC Secs. 17024.5 and 23051.5)

Where California law conforms to federal law, a proper election filed with the IRS shall be deemed to be a proper election for California purposes, unless otherwise expressly provided. To obtain treatment other than that elected for federal purposes, the taxpayer must file a separate election with FTB at the time and manner required by FTB.

Effective Date

This provision is effective July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3705	Internal Revenue Service Employee Contacts

Background

The IRS sends many different notices to taxpayers. Some (but not all) of these notices contain a name and telephone number of an IRS employee whom the taxpayer may call if the taxpayer has any questions.

New Federal Law

The provision requires any manually generated correspondence received by a taxpayer from the IRS must include in a prominent manner the name, telephone number, and unique identifying number of an IRS employee the taxpayer may contact with respect to the correspondence. Any other correspondence or notice received by a taxpayer from the IRS must include in a prominent manner a telephone number that the taxpayer may contact. An IRS employee must give a taxpayer during a telephone or personal contact the employee's name and unique identifying number. In addition, to the extent practicable and advantageous to the taxpayer, the IRS should assign one employee to handle a matter with respect to a taxpayer until that matter is resolved.

The provision also requires that, in appropriate circumstances, IRS telephone help lines provide an option for any taxpayer questions to be answered in Spanish.

Further, the Act requires that, in appropriate circumstances, IRS telephone help lines provide an option for any taxpayer to talk to a live person in addition to hearing a recorded message. That person can then direct the taxpayer to other IRS personnel who can provide understandable information to the taxpayer.

Current California Law

California law, under the Government Code, requires the phone number, the address, and the name of the writer or a contact person familiar with the subject area. For computer generated correspondence, a phone number and address where a person familiar with the subject area may be contacted must be provided.

Current procedures require employees to identify themselves and provide business cards or identification during in-person contact. Current procedures for the Taxpayer Service Center require employees to provide a station number and phone number.

To the extent possible, current procedure is to have one employee handle a taxpayer’s case for that stage of the process (i.e., one auditor, one collector, etc.).

Some interactive voice response (IRV) applications are available in both English and Spanish. The department maintains a list of bilingual employees; calls may be referred to those employees where appropriate. Voice mail provides an option of talking to a person. Some of the IRV applications have the ability to transfer the taxpayer to an employee.

Effective Date

The notice provisions are effective 60 days after the date of enactment (after September 20, 1998). The requirements pertaining to a unique identifying number are effective six months after the date of enactment (after January 22, 1999). The telephone helpline provisions are effective January 1, 2000.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3706	Use of Pseudonyms by Internal Revenue Service Employees.

Background

The Federal Service Impasses Panel has ruled that if an employee believes that use of the employee's last name only will identify the employee due to the unique nature of the employee's last name, and/or nature of the office locale, then the employee may "register" a pseudonym with the employee's supervisor.

New Federal Law

The provision provides that an IRS employee may use a pseudonym only if (1) adequate justification, such as protecting personal safety, for using the pseudonym was provided by the employee as part of the employee's request, and (2) management has approved the request to use the pseudonym prior to its use.

Current California Law

Neither current law nor current policy pertains to the use of pseudonyms. Generally, current procedures require employees to provide at least their first name, station number and phone number.

Effective Date

This provision is effective for requests made after July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3707	Illegal Tax Protester Designations.

Background

The IRS designates individuals who meet certain criteria as “illegal tax protesters" in the IRS master file.

New Federal Law

The provision prohibits the use by the IRS of the "illegal tax protester" designation. Any extant designation in the individual master file (the main computer file) must be removed and any other extant designation (such as on paper records that have been archived) must be disregarded. The IRS is, however, permitted to designate appropriate taxpayers as nonfilers. The IRS must remove the nonfiler designation once the taxpayer has filed valid tax returns for two consecutive years and paid all taxes shown on those returns.

While this provision prohibits the use by the IRS of the "illegal tax protester" designation, it does allow the IRS to continue its current practice of tracking "potentially dangerous taxpayers." It is recognized the potential hazards connected with the assessment and collection of taxes, and this provision is not intended to jeopardize the safety of IRS employees. Accordingly, if the IRS needs to implement additional procedures, such as the maintenance of appropriate records, in connection with this provision so as to ensure IRS employees' safety, it has the authority to do so.

Current California Law

FTB, like the courts, uses a “protester” designation when taxpayers protest the filing of a valid return and/or paying state taxes due to “protester arguments” based upon moral, religious or constitutional grounds. FTB uses the term “nonfiler” to designate taxpayers who have not used “protester arguments” to justify their failure to file. The “protester” status is deleted when all delinquent returns are filed and/or no taxes are pending from “protester type” arguments. Only specified FTB staff may place a “protester” designation on a file.

Effective Date

This provision is effective July 22, 1998, except that the removal of any designation from the master file, is not required to begin before January 1, 1999.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3708	Confidential Information to Congress by Whistleblowers.

Background

Tax return information generally may not be disclosed, except as specifically provided by statute. The Secretary of the Treasury may furnish tax return information to the Senate Committee on Finance, the House Committee on Ways and Means, and the Joint Committee on Taxation upon a written request from the chairmen of such committees. If the information can be associated with, or otherwise identify, directly or indirectly, a particular taxpayer, the information may be furnished to the committee only while sitting in closed executive session unless such taxpayer otherwise consents in writing to such disclosure.

New Federal Law (Sec. 6103(f)(5))

The provision provides that any person (i.e., a whistleblower) who otherwise has or had access to any return or return information under section 6103 may disclose such return or return information to the House Ways and Means Committee, the Senate Finance Committee, or the Joint Committee on Taxation or to any individual authorized by one of those committees to receive or inspect any return or return information if such person (the whistleblower) believes such return or return information may relate to evidence of possible misconduct, maladministration, or taxpayer abuse. Disclosure to one of these committees could be made either to the Chairman or to the full committee (sitting in closed executive session), but would not be permitted to be made to an individual Member of Congress (unless explicitly authorized as an agent). No inference is intended that such whistleblower disclosures are not permitted under present law.

Current California Law (R&TC Sec. 19546)

California law allows the disclosure of confidential information to an Assembly or Senate legislative committee upon request of the committee. However, it is a misdemeanor for the committee or any member, clerk, or other officer or employee of the Legislature to disclose in any manner any details of the information furnished, except for purposes of facilitating the detection or prosecution of tax crimes.

Effective Date

This provision is effective July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3709	Listing of Local IRS Phone Numbers and Addresses.

Background

The IRS is not statutorily required to publish the local telephone number or address of its local offices.

New Federal Law

The provision requires the IRS, as soon as is practicable but no later than 180 days after July 22, 1998, to publish addresses and local telephone numbers of local IRS offices in appropriate local telephone directories. It is intended that (1) the IRS not be required to publish in more than one directory in any local area and (2) publication in alternate language directories is permissible.

Current California Law

Addresses of district offices and the FTB toll free phone numbers are listed in the local phone directory where the office is located. In addition, the FTB toll free number is included in the state government pages of the phone book.

Effective Date

This provision is effective July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3710	Identification of Return Preparer.

Background

Any return or claim for refund prepared by an income tax return preparer must bear the social security number of the return preparer, if such preparer is an individual.

New Federal Law (Sec. 6109(a))

The provision authorizes the IRS to approve alternatives to social security numbers to identify tax return preparers.

Current California Law (R&TC Sec. 18624)

California law is conformed with modification to the federal law requiring the Social Security numbers as identification of individuals who prepare tax returns.

Effective Date

This provision is effective July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3711	Offset of Past Due Legally Enforceable State Income Tax Obligations.

Background

Overpayments of federal tax may be used to pay past-due child support and debts owed to federal agencies, without the consent of the taxpayer. Such amount for past-due child support may be paid directly to a state. Present law provides that offsets are made in the following priority: (1) child support and (2) other federal debts, in the order in which such debts accrued.

New Federal Law (Sec. 6103(l)(10) and 6402)

The provision permits states to participate in the IRS refund offset program for specified past-due, legally enforceable state income tax debts, providing the person making the federal tax overpayment has shown on the federal return for the taxable year of the overpayment an address that is within the state seeking the tax offset. The offset applies after the offsets provided in present law for internal revenue tax liabilities, past-due support, and past due, legally enforceable obligations owed a federal agency. The offset occurs before the designation of any refund toward future federal tax liability.

The provision permits the Secretary to prescribe additional conditions (pursuant to new section 6402(e)(4)(D)) to ensure that the determination is valid that the state or local income tax liability is past due and legally enforceable. It is intended that this include consideration of questions that may arise as a result of the taxpayer being a Native American.

Current California Law

Not applicable as the Government Code provides for state refund offsets to federal agencies.

Effective Date

This provision is effective for Federal income tax refunds payable after December 31, 1999.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3712	Reporting Requirements for Education Tax Credits.

Background

Individual taxpayers are allowed to claim a nonrefundable HOPE credit against federal income taxes up to $1,500 per student per year for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree program. A Lifetime Learning credit against federal income taxes equal to 20% of qualified expenses (up to a maximum credit of $1,000 per taxpayer return for 1998 through 2002 and $2,000 per taxpayer return after 2002) is also available. Qualified tuition and related expenses do not include expenses covered by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the credit (e.g., scholarship or fellowship grants).

Code section 6050S requires information reporting by eligible educational institutions which receive payments for qualified tuition and related expenses, and certain other persons who make reimbursement or refunds of qualified tuition and related expenses, in order to assist students, their parents, and the IRS in calculating the amount of the HOPE and Lifetime Learning credits potentially available. Section 6050S(b) provides that the annual information report to the Secretary must be in the form prescribed by the Secretary and must contain the following: (1) the name, address, and taxpayer identification number (TIN) of the individual which respect to whom the qualified tuition and related expenses were received or the reimbursement or refund was paid; (2) the name, address, and TIN of any individual certified by the student as the taxpayer who will claim that student as a dependent for purposes of the deduction under section 151 for any taxable years ending with or within the year for which the information return is filed; (3) the aggregate amount of payments of qualified tuition and related expenses received by the eligible educational institution and the aggregate amount of reimbursements or refunds (or similar amounts) paid during the calendar year with respect to the student; and (4) such other information as the Secretary may prescribe. Under section 6050S(d), an educational institution also must provide to each person identified on the information return submitted to the Secretary (e.g., the student and his or her parent(s)) a written statement showing the name, address, and phone number of the reporting person's information contact, and the amounts set forth in (3) above.

On December 22, 1997, the Department of Treasury issued Notice 97-73 setting forth the information reporting requirements under section 6050S for 1998. Notice 97-73 describes who must report information and the nature of the information that must be reported for 1998. In general, the required reporting under Notice 97-73 is more limited than that which ultimately will be required under section 6050S upon the issuance of final regulations. Accordingly, for 1998, educational institutions must report the following information: (1) the name, address, and TIN of the educational institution; (2) the name, address, and TIN of the student with respect to whom payments of qualified tuition and related expenses were received during 1998; (3) an indication as to whether the student was enrolled for at least half the full-time academic workload during any academic period commencing in 1998; and (4) an indication as to whether the student was enrolled exclusively in a program or programs leading to a graduate-level degree, graduate-level certificate, or other recognized graduate-level educational credential.

Educational institutions must provide to students the information listed above, as well as the phone number of the information contact at the school. Information returns must be provided to students by February 1, 1999 and filed with the IRS by March 1, 1999.

Notice 97-73 states that until final regulations are adopted, no penalties will be imposed under sections 6721 and 6722 for failure to file correct information returns or to furnish correct statements to the individuals with respect to whom information reporting is required under section 6050S. In addition, Notice 97-73 states that, even after final regulations are adopted, no penalties will be imposed under sections 6721 and 6722 for 1998 if the institution made a good faith effort to file information returns and furnish statements in accordance with Notice 97-73.

<u>New Federal Law (Sec. 6050S(b), (d) & (e))</u>

The provision modifies the information reporting requirements under section 6050S. In addition to reporting the aggregate amount of payments for qualified tuition and related expenses received by the educational institution with respect to a student, the institution must report any grant amount received by the student and processed through the institution during the applicable calendar year. The institution is not required to report on grant aid that is paid directly to the student and is not processed through the institution. In addition, an educational institution is required to report only the aggregate amount of reimbursements or refunds paid to a student by the institution (and not by any other party).

The provision includes certain additional clarifications intended to minimize the reporting burdens imposed on educational institutions while preserving the ability of the IRS to monitor compliance with respect to the HOPE Scholarship and Lifetime Learning credits. In particular, the Act clarifies that the definition of the term "qualified tuition and related expenses" shall be as set forth in section 25A, determined without regard to section 25A(g)(2) (which requires adjustments for certain scholarships). Eligible educational institutions that receive payments of qualified tuition and related expenses (or reimburse or refund such payments) are required separately to report the following items with respect to each student under section 6050S(b)(2)(C): (1) the aggregate amount of qualified tuition and related expenses (not including certain expenses relating to sports, games, or hobbies, or nonacademic fees); (2) any grant amount (whether or not excludable from income) received by such individual for payment of costs of attendance and processed through the institution during the applicable calendar year; and (3) the aggregate amount of reimbursements or refunds (or similar amounts) paid to such individual during the calendar year by the institution.

It is understood that the Department of Treasury is in the process of issuing regulatory guidance with respect to the education credit reporting requirements. In developing such guidance, Congress urges Treasury to minimize the reporting burdens imposed on educational institutions in connection with the HOPE Scholarship and Lifetime Learning credits. For example, section 472(1) of the Higher Education Act contains a definition of tuition and fees that is used in calculating a student's total "cost of attendance." Congress urges Treasury to conform the definition of "qualified tuition and related expenses" for purposes of the HOPE Scholarship and Lifetime Learning credits to the definition set forth in section 472(1) to the extent possible, so as to minimize the additional reporting burden on educational institutions.

In general, Congress expects that the regulatory guidance regarding the education credit reporting requirements will have an effective date that will provide educational institutions with sufficient time, after any notice and comment period, to implement additional required reporting. In addition, although the provision generally applies to taxable years beginning after December 31, 1998, Congress intends that no reporting beyond the reporting currently required in Notice 97-73 would be required of educational institutions until such final regulatory guidance is available.

In furtherance of the objective of minimizing the reporting burden on educational institutions, it is noted that, pursuant to the regulatory authority granted in section 25A(i), Treasury may exempt educational institutions from the reporting requirements with respect to certain categories of students, such as non-degree students enrolled in a course for which academic credit is not granted by the institution, provided that such exemptions do not undermine the overall compliance objectives of the provision. Congress further expects that Treasury will provide clarification regarding the reasonable cause exception contained in section 6724(a) as it may apply to the education information reporting requirements. Finally, Congress urges that any update and modernization of IRS computer systems incorporate the capacity to match a dependent's TIN with the return filed by the person claiming the individual as a dependent.

Current California Law (R&TC Sec. 18645)

AB 2797 (Chpt.322, Stats. 1998) amended California law for returns related to higher education tuition and related expenses.

Effective Date

The provision applies to returns required to be filed with respect to taxable years beginning after December 31, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3801	Administration of Penalties and Interest.

Background

The last major comprehensive revision of the overall penalty structure in the IRC was the "Improved Penalty Administration and Compliance Tax Act," enacted as part of the Omnibus Budget Reconciliation Act of 1989.

New Federal Law

The provision requires the Joint Committee on Taxation (JCT) and the Treasury to each conduct a separate study reviewing the interest and penalty provisions of the Code and making any legislative and administrative recommendations it deems appropriate to simplify penalty administration and reduce taxpayer burden.

It is expected that the JCT and the Treasury Department studies will examine whether the current penalty and interest provisions encourage voluntary compliance. The studies also should consider whether the provisions operate fairly, whether they are effective deterrents to undesired behavior, and whether they are designed in a manner that promotes efficient and effective administration of the provisions by the IRS. It is expected that the JCT and the Treasury Department will consider comments from taxpayers and practitioners on issues relevant to the studies.

Current California Law

Although California law establishes certain Legislative reporting requirements for the FTB, such as the Annual Report and the Annual Federal Conformity report, there is no provision requiring an interest and penalty study.

Effective Date

The reports must be provided not later than July 22, 1999.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3802	Confidentiality of Return Information.

Background

The IRC prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the IRC.

Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both. An action for civil damages also may be brought for unauthorized disclosure. The IRS may not furnish tax information to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information the agency receives.

New Federal Law

The provision requires the JCT and Treasury to each conduct a separate study on provisions regarding taxpayer confidentiality. The studies are to examine: (1) Present-law protections of taxpayer privacy; (2) the need, if any, for third parties to use tax return information; (3) whether greater levels of voluntary compliance can be achieved by allowing the public to know who is legally required to file tax returns but does not do so; (4) the interrelationship of the taxpayer confidentiality provisions in the IRC with those elsewhere in the United States Code (such as the Freedom of Information Act); (5) the impact on taxpayer privacy of sharing tax information for the purposes of enforcing State and local tax laws (other than income tax laws); and (6) whether the public interest would be served by greater disclosure of information relating to tax-exempt organizations (described in section 501 of the Code).

Current California Law (R&TC Secs. 19542-19568 and 19191 –19194)

Current law prohibits FTB from disclosing confidential tax information, unless expressly authorized. Current law does not contain a provision requiring a study of the above-enumerated items related to confidentiality.

Effective Date

The findings of the study, along with any recommendations, are required to be reported to the Congress no later than January 22, 2000.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3803	Study of Noncompliance by Taxpayers.

New Federal Law

Not later than one year after July 22, 1998, the Secretary of the Treasury and the Commissioner of Internal Revenue shall conduct jointly a study, in consultation with the JCT, of the noncompliance with internal revenue laws by taxpayers (including willful noncompliance and noncompliance due to tax law complexity or other factors) and report the findings of such study to Congress.

The provision clarifies that the study is to examine noncompliance with the internal revenue laws by taxpayers (including willful noncompliance and noncompliance due to tax law complexity or other factors). Treasury and IRS are to conduct the study, in consultation with the Joint Committee on Taxation.

Current California Law (R&TC Sec. 21006)

Current law, under the Taxpayers' Bill of Rights, requires the FTB to annually identify and report to the Legislature areas of recurrent taxpayer noncompliance. Additionally, the FTB annually convenes a Taxpayers' Bill of Rights meeting providing taxpayers a forum to present their ideas for changes to the income tax laws.

Effective Date

The findings of the study, along with the report to Congress are due July 22, 1999.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
3804	Study of Payments Made for Detection of Underpayments/Fraud.

Background

Under present law, rewards may be paid for information relating to civil violations, as well as criminal violations. Present law also provides that the rewards are paid out of the proceeds of amounts (other than interest) collected by reason of the information provided. An annual report on the rewards program is required.

New Federal Law

The provision requires a study and report by Treasury to the Congress (within one year of the date of enactment, July 22, 1998) of the present-law reward program (including results) and any legislative or administrative recommendations regarding the program and its application.

Current California Law (R&TC Sec. 19525)

Current law authorizes the FTB to establish a reward program. However, the program has not been established. There is no current statutory provision requiring a study of the reward program.

Effective Date

The provision is effective July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
4001	Review of Requests for GAO Investigations of the IRS.

Background

Prior to the passage of the IRS Reform Act there was no specific statutory requirement that requests for investigations by the General Accounting Office (GAO) relating to the IRS be reviewed by the Joint Committee on Taxation (the Joint Committee). However, some of the studies that GAO conducts relating to taxation and oversight of the IRS require access under section 6103 of the Code to confidential tax returns and return information. Under section 6103, the GAO may inform the Joint Committee of its initiation of an audit of the IRS and obtain access to confidential taxpayer information unless, within 30 days, 60% of the members of the Joint Committee disapprove of the audit. This provision has not been utilized; the GAO generally seeks advance access to confidential taxpayer return information from the Joint Committee.

New Federal Law (Sec. 8021)

The provision requires the Joint Committee to review all requests (other than requests by the chair or ranking member of a Committee or Subcommittee of the Congress, investigations required by statute, and work initiated by GAO under its basic statutory authorities) for investigations of the IRS by the GAO and approves such requests when appropriate. In reviewing such requests, the Joint Committee is to eliminate overlapping investigations, ensure that the GAO has the capacity to handle the investigation, and ensure that investigations focus on areas of primary importance to tax administration.

The provision does not change the present-law rules under section 6103.

Current California Law

California law has no comparable provisions.

Effective Date

This provision is effective July 22, 1998.

Impact on California Revenue

No impact.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
4002	Joint Congressional Hearings and Oversight Reports.

Background

Prior to the passage of the IRS Reform Act, a number of committees had jurisdiction with respect to IRS oversight. The committees most responsible for IRS oversight are the House Committees on Ways and Means, Appropriations, Government Reform and Oversight, the corresponding Senate Committees on Finance, Appropriations, and Governmental Affairs, and the Joint Committee on Taxation. While these Committees have a shared interest in IRS matters, they typically act independently, and have separate hearings and make separate investigations into IRS matters. Each committee also has jurisdiction over certain issues. For example, the House Ways and Means Committee and the Senate Finance Committee have exclusive jurisdiction over changes to the tax laws. Similarly, the House and Senate Appropriations Committees have exclusive jurisdiction over IRS annual appropriations. The Joint Committee does not have legislative jurisdiction, but has significant responsibilities with respect to tax matters and IRS oversight.

New Federal Law (Sec. 8022)

The provision provides that there will be an annual joint hearing of two majority and one minority members of each of the Senate Committees on Finance, Appropriations, and Governmental Affairs and the House Committees on Ways and Means, Appropriations, and Government Reform and Oversight. The annual joint hearing is to review: (1) the progress of the IRS in meeting its objectives under the strategic and business plans; (2) the progress of the IRS in improving taxpayer service and compliance; (3) the progress of the IRS on technology modernization; and (4) the annual filing season. The joint review will be held at the call of the Chairman of the Joint Committee on Taxation, and is to take place before June 1 of each calendar year.

The provision provides that the Joint Committee is to make annual reports to the Committee on Finance and the Committee on Ways and Means on the overall state of the federal tax system, together with recommendations with respect to possible simplification proposals and other matters relating to the administration of the federal tax system as it may deem advisable. The Joint Committee also is to report annually to the Senate Committees on Finance, Appropriations, and Governmental Affairs and the House Committees on Ways and Means, Appropriations, and Government Reform and Oversight with respect to the matters that are the subject of the annual joint hearings of members of such Committees.

The provision did not modify the existing jurisdiction of the Committees involved in the joint hearings.

In addition, the provision requires the Joint Committee on Taxation to report on the overall state of the federal tax system to provide that such report shall be prepared once in each Congress, but only if amounts necessary to carry out this requirement are specifically appropriated to the Joint Committee on Taxation.

Current California Law

California law currently has no statutory provision relating to legislative oversight. The FTB is made up of three members: the State Controller, Chairman of the Board of Equalization and the Executive Officer of the Department of Finance. Funding for the department is included in the Governor's annual budget and subject to legislative approval.

Effective Date

Generally, this provision is effective July 22, 1998. The requirement for an annual joint review, and report by the Joint Committee on Taxation, shall apply only for calendar years 1999-2003.

Impact on California Revenue

No impact.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
4011	Funding for Century Date Change.

New Federal Law

The century date change issue (referred to as Y2K) relating to most computer systems also impacts the IRS's computer system. The IRS has diverted resources originally slated for other modernization projects to the Y2K problem. Due to testing and implementation concerns, it is uncertain whether the IRS will succeed in fixing the Y2K glitch before January 1, 2000.

New Federal Law

The IRS Reform Act states that IRS's Y2K problem should be fully funded to ensure the resolution of the problem.

Current California Law

The FTB has planned for the Y2K problem and the work to correct the problem is on schedule to be completed and tested before the December 31, 1999, deadline.

Effective Date

This provision is effective July 22, 1998.

Impact on California Revenue

No impact.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
4022	Tax Law Complexity Analysis.

New Federal Law

Role of the IRS. The IRS is to report to the House Ways and Means Committee and the Senate Finance Committee annually regarding sources of complexity in the administration of the Federal tax laws. Factors the IRS may take into account include: (1) frequently asked questions by taxpayers; (2) common errors made by taxpayers in filling out returns; (3) areas of the law that frequently result in disagreements between taxpayers and the IRS; (4) major areas in which there is no or incomplete published guidance or in which the law is uncertain; (5) areas in which revenue agents make frequent errors in interpreting or applying the law; (6) impact of recent legislation on complexity; (7) information regarding forms, including a listing of IRS forms, the time it takes for taxpayers to complete and review forms, the number of taxpayers who use each form, and how the time required changed as a result of recently enacted legislation; and (8) recommendations for reducing complexity in the administration of the federal tax system.

Complexity analysis with respect to current legislation. The provision requires the Joint Committee on Taxation (in consultation with the IRS and Treasury) to provide an analysis of complexity or administrability concerns raised by tax provisions of widespread applicability to individuals or small businesses. The analysis is to be included in any Committee Report of the House Ways and Means Committee or Senate Finance Committee or Conference Report containing tax provisions, or provided to the Members of the relevant Committee or Committees as soon as practicable after the report is filed. The analysis is to include: (1) an estimate of the number and type of taxpayers affected; and (2) if applicable, the income level of affected individual taxpayers. In addition, such analysis should include, if determinable, the following: (1) the extent to which existing tax forms would require revision and whether a new form or forms would be required; (2) whether and to what extent taxpayers would be required to keep additional records; (3) the estimated cost to taxpayers to comply with the provision; (4) the extent to which enactment of the provision would require the IRS to develop or modify regulatory guidance; (5) whether and to what extent the provision can be expected to lead to disputes between taxpayers and the IRS; and (6) how the IRS can be expected to respond to the provision (including the impact on internal training, whether the Internal Revenue Manual would require revision, whether the change would require reprogramming of computers, and the extent to which the IRS would be required to divert or redirect resources in response to the provision).

A point of order arises with respect to the floor consideration of a bill or conference report that does not contain the required Complexity Analysis. The point of order may be waived by a majority vote. The point of order is subject to the Constitutional right of each House of the Congress to establish its own rules and procedures; thus, such point of order may be changed at any time pursuant to the procedures of the House of Representatives.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Current California Law

Under the Taxpayer Bills of Rights, the FTB is required annually to identify areas of recurrent taxpayer noncompliance and report its findings to the Legislature. The include shall include recommendations for improving taxpayer compliance and uniform administration.

The FTB prepares and distributes bill analysis reports on all California legislation introduced that affects the income tax provisions of the Revenue and Taxation Code. The bill analysis identifies any administrative or implementation problems the Franchise Tax Board may have implementing the bill if enacted into law. The analysis are provided to various interested parties, including the bill's author and legislative tax committees.

Effective Date

The provisions are effective for calendar years after 1998.

Impact on California Revenue

No impact.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
5001	Elimination of 18-Month Holding Period for Capital Gains.

Background

The TRA of 1997 provided lower capital gains rates for individuals. Generally, the TRA of 1997 reduced the maximum rate on the adjusted net capital gain of an individual from 28% to 20% and provided a 10% rate for the adjusted net capital gain otherwise taxed at a 15% rate. The "adjusted net capital gain" is the net capital gain determined without regard to certain gains for which the TRA of 1997 provided a higher maximum rate of tax. The TRA of 1997 retained the prior-law 28% maximum rate for net long-term capital gains attributable to the sale or exchange of collectibles, certain small business stock to the extent the gain is included in income, and property held more than one year but not more than 18 months. In addition, the TRA of 1997 provided a maximum rate of 25% for the long-term capital gain attributable to depreciation from real estate held more than 18 months. Beginning in 2001, lower rates of 8 and 18% will apply to the gain from certain property held more than five years.

New Federal Law (Sec. 1223 & 1235(a))

Under the IRS Reform Act property held more than one year (rather than more than 18 months) is eligible for the 10%, 20%, and 25% capital gain rates provided by the TRA of 1997.

Current California Law (R&TC Sec. 17041)

While California generally conforms to federal law on the definition of a capital asset and how gain or loss is calculated, the tax rates on net capital gains and ordinary income are the same.

Effective Date

The provision is effective for amounts properly taken into account on or after January 1, 1998.

Impact on California Revenue

No impact.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
5002	Deductibility of Meals Provided for the Convenience of the Employer.

Background

In general, subject to several exceptions, only 50% of business meals and entertainment expenses are allowed as a deduction (sec. 274(n)). Under the Tax Relief and Reform Act of 1997 (TRA of 1997) exception, meals that are excludable from employees' incomes as a de minimis fringe benefit (sec. 132) are fully deductible by the employer. In addition, the courts that have considered the issue have held that if substantially all of the meals are provided for the convenience of the employer pursuant to section 119, the cost of such meals is fully deductible because the employer is treated as operating a de minimis eating facility within the meaning of section 132(e)(2).

New Federal Law (Sec. 119(b))

The IRS Reform Act provides that all meals furnished to employees at a place of business for the convenience of the employer are treated as provided for the convenience of the employer under section 119 if more than one-half of employees to whom such meals are furnished on the premises are furnished such meals for the convenience of the employer under section 119. If these conditions are satisfied, the value of all such meals would be excludable from the employee's income and fully deductible to the employer. No inference is intended as to whether such meals are fully deductible under prior law.

Current California Law (R&TC Sec. 17131)

California law is in full conformity with federal law as it read on January 1, 1998, as it relates to the deduction of meals provided to employees.

Effective Date

The provision is effective for taxable years beginning before, on, or after July 22, 1998.

Impact on California Revenue

Based on projections for the federal law, conforming to this change would result in a revenue loss of $1 million annually.

Section	Section Title
5003	Normal Trade Relations.

Background

In the context of U.S. tariff legislation, section 251 of the Trade Expansion Act of 1962 states the principle of "most-favored-nation" (MFN) treatment, requiring tariff treatment to be applied to all countries equally. Specifically, the products of a country given MFN treatment are subject to rates of duty found in column 1 of the Harmonized Tariff Schedule (HTS) of the United States. Products from countries not eligible for MFN treatment under U.S. law are subject to higher rates of duty. Only six countries are subject to higher rates of duty: Afghanistan, Cuba, Laos, North Korea, Serbia, and Vietnam. The remaining U.S. trading partners are subject to either conditional or unconditional MFN treatment, or to even more preferential rates than MFN under free trade agreements (Israel, Canada, and Mexico) and unilateral grants of tariff preference.

New Federal Law

The provision changes the terminology used in U.S. trade statutes from "most-favored-nation" to "normal trade relations" (NTR) in order to reflect more accurately the nature of the trade relationship in question. The legislation does not change the tariff treatment received by any country. The terminology implies that a country receiving MFN is somehow receiving treatment that is special or better than what a country would normally receive. In reality, however, a country receiving MFN receives nothing more than ordinary or normal treatment. Only six countries receive treatment that is less favorable than this normal treatment. In addition, three countries actually receive tariff treatment that is better than MFN because they participate in a free trade agreement with the United States and numerous others receive treatment more favorable than MFN under unilateral grants of trade preference signifying that the "most" favored terminology is misleading. The Conference Committee states that the change in terminology from MFN to NTR does not have any effect whatsoever on the meaning of any existing U.S. law or practice. It does not change any procedures under existing law for granting or removing MFN status. Rather, the new term has the same meaning as MFN as is currently defined in domestic legislation and international agreements and does not change the tariff treatment granted by the United States to any of its trading partners.

Current California Law

Under federal law, individual states are not permitted to impose tariffs.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6003	Technical Corrections to Child Credit.

Background

Present federal law provides a $500 ($400 for taxable year 1998) tax credit for each qualifying child under the age of 17. A qualifying child is defined as an individual for whom the taxpayer can claim a dependency exemption and who is a son or daughter of the taxpayer (or a descendent of either), a stepson or stepdaughter of the taxpayer or an eligible foster child of the taxpayer. For taxpayers with modified adjusted gross income in excess of certain thresholds, the allowable child credit is phased out. The length of the phase-out range is affected by the number of the taxpayer's qualifying children.

Generally, the maximum amount of a taxpayer's child credit for each taxable year is limited to the excess of the taxpayer's regular tax liability over the taxpayer's tentative minimum tax liability (determined without regard to the alternative minimum foreign tax credit). In the case of a taxpayer with three or more qualifying children, the maximum amount of the taxpayer's child credit for each taxable year is limited to the greater of: (1) the amount computed under the rule described above, or (2) an amount equal to the excess of the sum of the taxpayer's regular income tax liability and the employee share of FICA taxes (and one-half of the taxpayer's SECA tax liability, if applicable) reduced by the earned income credit. In the case of a taxpayer with three or more qualifying children, the excess of the amount allowed in (2) over the amount computed in (1) is a refundable credit.

Nonrefundable credits may not be used to reduce tax liability below a taxpayer's tentative minimum tax. Certain credits not used as a result of this rule may be carried over to other taxable years, while others may not. Special ordering rules apply in determining which nonrefundable credits are used in the current year. Generally, the ordering rules require that nonrefundable personal credits be considered first, followed by other credits, business credits, and the investment tax credit. It is understood that there also is a ordering rule under which the income tax liability limitation applies between the nonrefundable personal credits, including the nonrefundable portion of the child credit. Generally, the nonrefundable portion of the child credit and the other nonrefundable personal credits which do not provide a carryforward are grouped together and stacked first, followed by the nonrefundable personal credits which provide a carryforward for purposes of applying the income tax liability limitation.

Refundable credits, which are not limited by the minimum tax, are not stacked until after the nonrefundable credits.

A portion of the child credit may be treated as a supplemental child credit. The amount of the supplemental child credit, if any, equals the excess of (1) $500 times the number of qualifying children up to the excess of the taxpayer's income tax liability (net of applicable credits other than the earned income credit) over the taxpayer's alternative minimum tax liability (determined without regard to the alternative minimum foreign tax credit) over (2) the sum of the taxpayer's regular income tax liability (net of applicable credits other than the earned income credit) and the employee share of FICA taxes reduced by any earned income credit amount. The supplemental child credit is treated as provided under the earned income credit, and the child credit amount is reduced by the amount of the supplemental child credit.

New Federal Law (Sec. 24(d) & 32)

The IRS Reform Act clarifies the application of the income tax liability limitation to the refundable portion of the child credit by treating the refundable portion of the child credit in the same way as the other refundable credits. Specifically, after all other credits are applied according to the ordering rules of the income tax limitation, then the refundable credits are applied first to reduce the taxpayer's tax liability for the year and then to provide a credit in excess of income tax liability for the year.

The IRS Reform Act also clarifies that the treatment of a portion of the child credit as a supplemental child credit under the earned income credit (sec. 32) and the offsetting reduction of the child credit (sec. 24) do not affect any other credit available to the taxpayer. It also clarifies that the earned income credit rules (e.g., the phaseout of the earned income credit) generally do not apply to the supplemental child credit.

Current California Law (R&TC Sec. 17054)

California law does not generally conform to federal credits. California law does provide for personal and dependent exemption credits. The dependent credit is $253 and $227 for the 1998 and 1999 taxable years, respectively. The dependent credit is allowed to taxpayers with qualifying dependents as defined under IRC section 151(c), and unlike the federal credit is available for (but not limited to) parents of the taxpayer and children over 17 years of age. The nonrefundable, noncarryover dependent credit is applied before all other credits. California law does not have a refundable provision for taxpayers with three or more dependents.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6004(a)	Clarification of Reporting Requirements for the HOPE and Lifetime Learning Credits.

Background

Section 6050S provides that certain educational institutions and other taxpayers engaged in a trade or business must file information returns with the IRS and certain individual taxpayers, as required by regulations prescribed by the Secretary of the Treasury, containing information on individuals who made payments for qualified tuition and related expenses or to whom reimbursements or refunds were made of such expenses.

New Federal Law (Sec. 25A and 6050S)

The IRS Reform Act clarifies that, under section 6050S, information returns containing information with respect to qualified tuition and fees must be filed by a person that is not an eligible educational institution only if such person is engaged in a trade or business of making payments to any individual under an insurance arrangement as reimbursements or refunds (or similar payments) of qualified tuition and related expenses. As under present law, section 6050S also will require the filing of information returns by persons engaged in a trade or business if, in the course of such trade or business, the person receives from any individual interest aggregating $600 or more for any calendar year on one or more qualified education loans.

Current California Law

California has no comparable credit.

Effective Date

The provision is effective as if included in the TRA of 1997, i.e., for expenses paid after December 31, 1997, for education furnished in academic periods beginning after such date.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6004(b)	Clarification of the Deduction for Student Loan Interest.

Background

Certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, up to a maximum deduction of $2,500 per year. The deduction is allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. In this regard, required payments of interest do not include nonmandatory payments, such as interest payments made during a period of loan forbearance. Months during which the qualified education loan is in deferral or forbearance do not count against the 60-month period. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year. A qualified education loan generally is defined as any indebtedness incurred to pay for the qualified higher education expenses of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending (1) post-secondary educational institutions and certain vocational schools defined by reference to section 481 of the Higher Education Act of 1965, or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.

New Federal Law (Sec. 221)

The provision clarifies that the student loan interest deduction may be claimed only by a taxpayer who is legally obligated to make the interest payments pursuant to the terms of the loan.

Current California Law (R&TC Sec. 17024.5)

California law is in full conformity with federal law as it read on January 1, 1998, as it relates to the deduction of education loan interest (AB 2797, Stat. 1998, Ch. 322). California law has not conformed to the changes made to the IRC by the IRS Reform Act.

Effective Date

The provision is effective for interest payments due and paid after December 31, 1997, on any qualified education loan.

Impact on California Revenue

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be insignificant.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6004(c)	Clarification of Qualified State Tuition Programs.

Background

Section 529 provides tax-exempt status to “qualified state tuition programs,” meaning certain programs established and maintained by a state (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account. The term “qualified higher education expenses” means expenses for tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible postsecondary educational institution, as well as room and board expenses (meaning the minimum room and board allowance applicable to the student as determined by the institution in calculating costs of attendance for federal financial aid programs under sec. 472 of the Higher Education Act of 1965) for any period during which the student is at least a half-time student.

Section 529 also provides that no amount shall be included in the gross income of a contributor to, or beneficiary of, a qualified state tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary (e.g., when the beneficiary attends college) will be included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor or another distributee (e.g., when a parent receives a refund) will be included in the contributor's/distributee's gross income to the extent such amounts exceed contributions made on behalf of the beneficiary.

Earnings on an account may be refunded to a contributor or beneficiary, but the state or instrumentality must impose a more than de minimis monetary penalty unless the refund is (1) used for qualified higher education expenses of the beneficiary, (2) made on account of the death or disability of the beneficiary, or (3) made on account of a scholarship received by the designated beneficiary to the extent the amount refunded does not exceed the amount of the scholarship used for higher education expenses. A transfer of credits (or other amounts) from one account benefiting one designated beneficiary to another account benefiting a different beneficiary will be considered a distribution (as will a change in the designated beneficiary of an interest in a qualified state tuition program), unless the beneficiaries are members of the same family. For this purpose, the term "member of the family" means persons described in paragraphs (1) through (8) of section 152(a), e.g., sons, daughters, brothers, sisters, nephews and nieces, certain in-laws, etc., and any spouse of such persons.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

New Federal Law (Sec. 529)

The provision clarifies that, under annuity rules contained in present-law section 72, distributions from qualified state tuition programs are treated as representing a pro-rata share of the principal (i.e., contributions) and accumulated earnings in the account.

In addition, the provision modifies section 529(e)(2) to clarify that for purposes of tax-free rollovers and changes of designated beneficiaries, a “member of the family” includes the spouse of the original beneficiary.

Current California Law (R&TC Sec. 23711)

California law is in conformity with federal law as it read on January 1, 1998, as it relates to qualified state tuition programs (AB 2797, Stat. 1998, Ch. 322). California law has not conformed to the changes made to the IRC by the IRS Reform Act.

Additionally, AB 530 (Stat. 1997, Ch. 851), under the Education Code, created the Golden State Scholarshare Trust, effective for taxable years beginning on or after January 1, 1998. (The Golden State Scholarshare was designed to meet the requirements of section 529 as a state-sponsored qualified tuition program.) The Revenue and Taxation Code was modified to make the Scholarshare trust tax-exempt and earnings on the deposits to the trust non-taxable to the participant or beneficiary until the earnings are distributed.

Effective Date

The provisions are effective for distributions made after December 31, 1997.

Impact on California Revenue

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be insignificant.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6004(d)	Clarification of Education IRAs

Background

Section 530 provides that taxpayers may establish "education IRAs," meaning certain trusts or custodial accounts created exclusively for the purpose of paying qualified higher education expenses of a named beneficiary. Annual contributions to education IRAs may not exceed $500 per designated beneficiary, and may not be made after the designated beneficiary reaches age 18. Contributions to an education IRA may not be made by certain high-income taxpayers, i.e., the contribution limit is phased out for taxpayers with modified adjusted gross income between $95,000 and $110,000 ($150,000 and $160,000 for taxpayers filing joint returns). No contribution may be made to an education IRA during any year in which any contributions are made by anyone to a qualified state tuition program on behalf of the same beneficiary.

Until a distribution is made from an education IRA, earnings on contributions to the account generally are not subject to tax. However, education IRAs are subject to the unrelated business income tax (UBIT) imposed by section 511. In addition, distributions from an education IRA are excludable from gross income to the extent that the distribution does not exceed qualified higher education expenses incurred by the beneficiary during the year the distribution is made (provided that a HOPE credit or Lifetime Learning credit is not claimed with respect to the beneficiary for the same taxable year). The earnings portion of an education IRA distribution not used to pay qualified higher education expenses is includible in the gross income of the distributee and generally is subject to an additional 10% tax. This 10% additional tax does not apply if a distribution from an education IRA is made on account of the death, disability, or scholarship received by the designated beneficiary. However, the additional 10% tax does not apply if a distribution is made of excess contributions above the $500 limit (and any earnings attributable to such excess contributions) if the distribution is made on or before the date that a return is required to be filed (including extensions of time) by the contributor for the year in which the excess contribution was made. In addition, section 530 allows tax-free rollovers of account balances from an education IRA benefiting one family member to an education IRA benefiting another family member. Section 530 is effective for taxable years beginning after December 31, 1997.

New Federal Law (Sec. 530)

Consistent with the legislative history to the TRA of 1997, the provision provides that any balance remaining in an education IRA will be deemed to be distributed within 30 days after the date that the designated beneficiary reaches age 30 (or, if earlier, within 30 days of the date that the beneficiary dies). The provision further clarifies that, in the event of the death of the designated beneficiary, the balance remaining in an education IRA may be distributed (without imposition of the additional 10% tax) to any other (i.e., contingent) beneficiary under the age of 30 or to the estate of the deceased designated beneficiary. If any member of the family of the deceased beneficiary becomes the new designated beneficiary of an education IRA, then no tax will be imposed on such redesignation and the account will continue to be treated as an education IRA.

The provision also clarifies that for purposes of the special rules regarding tax-free rollovers and changes of designated beneficiaries, the new beneficiary must be under the age of 30.

Under the provision, the additional 10% tax provided for by section 530(d)(4) will not apply to a distribution from an education IRA, which (although used to pay for qualified higher education expenses) is includible in the beneficiary's gross income solely because the taxpayer elects to claim a HOPE or Lifetime Learning credit with respect to the beneficiary. The provision further provides that the additional 10% tax will not apply to the distribution of any contribution to an education IRA made during a taxable year if such distribution is made on or before the date that a return is required to be filed (including extensions of time) by the beneficiary for the taxable year during which the contribution was made (or, if the beneficiary is not required to file such a return, April 15th of the year following the taxable year during which the contribution was made). In addition, the provision amends section 4973(e) to provide that the excise tax penalty applies under that section for each year that an excess contribution remains in an education IRA (and not merely the year that the excess contribution is made).

The provision clarifies that, in order for taxpayers to establish an education IRA, the designated beneficiary must be a life-in-being. The provision also clarifies that, under annuity rules contained in present-law section 72, distributions from education IRAs are treated as representing a pro-rata share of the principal (i.e., contributions) and accumulated earnings in the account.

In addition, because the TRA of 1997 allows taxpayers to redeem U.S. Savings Bonds and be eligible for the exclusion under present-law section 135 (as if the proceeds were used to pay qualified higher education expenses) provided the proceeds from the redemption are contributed to an education IRA (or to a qualified state tuition program defined under section 529) on behalf of the taxpayer, the taxpayer's spouse, or a dependent, the provision conforms the definition of “eligible educational institution” under section 135 to the broader definition of that term under present-law section 530 (and section 529). Thus, for purposes of section 135, as under present-law sections 529 and 530, the term “eligible educational institution” is defined as an institution which (1) is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) and (2) is eligible to participate in Department of Education student aid programs.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Current California Law (R&TC Sec. 23712(b)(1))

California law is in conformity with federal law as it read on January 1, 1998, as it relates to education IRAs (SB 1233, Stat. 1997, Ch. 612). California law has not conformed to the changes made to the IRC by the IRS Reform Act. In the original education IRA enactment, California required the distribution to that beneficiary within 30 days after the date the beneficiary becomes 30 years of age (SB 1233, Ch. 612, Laws 1997).

Effective Date

The provisions are effective for taxable years beginning after December 31, 1997, as if included in the TRA of 1997.

Impact on California Revenue

The proposed changes to educational IRA rules include both minor gains (deemed distributions would increase slightly) and minor losses (certain penalties would be waived). These gains and losses would tend to offset one another and would be insignificant in the near term.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6004(e)	Clarification of the Enhanced Deduction for Corporate Contributions of Computer Technology and Equipment.

Background

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the fair market value of property contributed to a charitable organization. However, in the case of a charitable contribution of inventory or other ordinary-income property, short-term capital gain property, or certain gifts to private foundations, the amount of the deduction is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, a taxpayer's deduction is limited to the adjusted basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose.

The TRA of 1997 provided that certain corporate contributions of computer and other equipment to eligible donees to be used for the benefit of elementary and secondary school children qualify for an augmented deduction. Under this special rule, the amount of the augmented deduction available to a corporation making a qualified contribution generally is equal to its basis in the donated property plus one-half of the amount of ordinary income that would have been realized if the property had been sold. However, the augmented deduction cannot exceed twice the basis of the donated property. To qualify for the augmented deduction, the contribution must satisfy various requirements.

The legislative history of the provision states that the special tax treatment for contributions of computer and other equipment was to be effective for contributions made during a three-year period in taxable years beginning after December 31, 1997, and before January 1, 2001. However, as a result of a drafting error, the statutory provision does not apply to contributions made during taxable years beginning after December 31, 1999.

New Federal Law (Sec. 170(e))

The provision corrects the termination date of the provision to provide that the special rule applies to contributions made during taxable years beginning after December 31, 1997, and before December 31, 2000.

In addition, the provision clarifies that the requirements set forth in section 170(e)(6)(B)(ii)-(vii) apply regardless of whether the donee is an educational organization or a tax-exempt charitable entity. Similarly, the rule in section 170(e)(6)(ii)(I) regarding subsequent contributions by private foundations is clarified to permit contributions to either educational organizations or tax-exempt charitable entities described in section 170(e)(6)(B)(i).

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Current California Law (R&TC Sec. 24357.9)

California law is in conformity with federal law as it read on January 1, 1998, as it relates to corporate contributions of computer technology (AB 2797, Stat. 1998, Ch. 322). California law additionally requires the donee school to be located in California. California law has not conformed to the changes made to the IRC by the IRS Reform Act.

Effective Date

The provision is effective as of August 5, 1997, the date of enactment of the TRA of 1997.

Impact on California Revenue

If California conforms to the federal termination date, revenue loses for the one year extension would be $4 million, $1 million for 1999-0 and $3 million for 2000-1, and minor loss for 2001-2.

Note: AB 2797 (Stat. 1998, Ch. 322) included the revenue losses as if the enhanced deduction for the computer technology and equipment were available to corporations for income years beginning after December 31, 1997, and before January 1, 2001. The $4 million loss was attributed to that bill.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6004(f)	Clarification of the Cancellation of Certain Student Loans.

Background

Under present law, an individual's gross income does not include forgiveness of loans made by tax-exempt educational organizations if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance outstanding student loans and the student is not employed by the lender organization. The exclusion applies only if the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers. In addition, the student's work must fulfill a public service requirement.

New Federal Law (Sec. 108(f))

The provision clarifies that gross income does not include amounts from the forgiveness of loans made by educational organizations and certain tax-exempt organizations to refinance any existing student loan (and not just loans made by educational organizations). In addition, the provision clarifies that refinancing loans made by educational organizations and certain tax-exempt organizations must be made pursuant to a program of the refinancing organization (e.g., school or private foundation) that requires the student to fulfill a public service work requirement.

Current California Law (R&TC Sec. 17201, 17144)

California law is in conformity with federal law as it read on January 1, 1998, as it relates to qualified state tuition programs (AB 2797, Stat. 1998, Ch. 322). California law has not conformed to the changes made to the IRC by the IRS Reform Act.

In addition, California law provides that any loan made pursuant to the Forgivable Loan Program of the California State University would be a “student loan” for purposes of the exclusion from gross income of income resulting from discharges of student loan indebtedness.

Effective Date

The provision is effective as of August 5, 1997, the date of enactment of the TRA of 1997.

Impact on California Revenue

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be insignificant.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6004(g)	Clarification of Qualified Zone Academy Bonds.

Background

Certain financial institutions (i.e., banks, insurance companies, and corporations actively engaged in the business of lending money) that hold "qualified zone academy bonds" are entitled to a nonrefundable tax credit in an amount equal to a credit rate (set monthly by the Treasury Department) multiplied by the face amount of the bond (sec. 1397E). The credit rate applies to all such bonds issued in each month. A taxpayer holding a qualified zone academy bond on the credit allowance date (i.e., each one-year anniversary of the issuance of the bond) is entitled to a credit. The credit is includible in gross income, and may be claimed against regular income tax and AMT liability.

"Qualified zone academy bonds" (QZAB) are defined as any bond issued by a state or local government, provided that (1) at least 95% of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a "qualified zone academy", meaning certain public schools located in empowerment zones or enterprise communities or with a certain percentage of students from low-income families and (2) private entities have promised to make contributions to the qualified zone academy with a value equal to at least 10% of the bond proceeds.

A total of $400 million of QZAB may be issued in each of 1998 and 1999. The $400 million aggregate bond cap will be allocated each year to the states according to their respective populations of individuals below the poverty line. Each state will allocate the credit to qualified zone academies within such state. A state may carry over any unused allocation into subsequent years.

New Federal Law (Sec. 42, 49, 50, 1397E)

The provision clarifies that, for purposes of section 6655(g)(1)(B), the credit for certain holders of qualified zone academy bonds may be claimed for estimated tax purposes. Similarly, the provision clarifies for purposes of section 6401(b)(1) the manner in which the credit is taken into account when determining whether a taxpayer has made an overpayment of tax.

Current California Law

California has no comparable credit.

Effective Date

The provisions are effective for obligations issued after December 31, 1997.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6005(a)	Clarification of Limitations for Active Participation in an IRA.

Background

Under present law, if a married individual (filing a joint return) is an active participant in an employer-sponsored retirement plan, the $2,000 IRA deduction limit is phased out over the following levels of adjusted gross income (AGI):

Taxable years beginning in:	In dollars:
1997	$ 40,000 - 50,000
1998	50,000 - 60,000
1999	51,000 - 61,000
2000	52,000 - 62,000
2001	53,000 - 63,000
2002	54,000 - 64,000
2003	60,000 - 70,000
2004	65,000 - 75,000
2005	70,000 - 80,000
2006	75,000 - 85,000
2007	80,000 - 100,000

An individual is not considered an active participant in an employer-sponsored retirement plan merely because the individual's spouse is an active participant. The $2,000 maximum deductible IRA contribution for an individual who is not an active participant, but whose spouse is, is phased out for taxpayers with AGI between $150,000 and $160,000.

New Federal Law (Sec. 219)

The provision clarifies the intent of the TRA of 1997 relating to the AGI phase-out ranges for married individuals who are active participants in employer-sponsored plans and the AGI phase-out range for spouses of such active participants as described above.

Current California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to limitations for active participation in an IRA (AB 2797, Stat. 1998, Ch. 322). California law has not conformed to the changes made to the IRC by the IRS Reform Act.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Effective Date

The provision is effective as if included in the TRA of 1997, i.e., for taxable years beginning after December 31, 1997.

Impact on California Revenue

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be insignificant.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6005(b)	Changes to Roth IRAs.

Background

Beginning in 1998, federal and California law provide for a new type of IRA, called a Roth IRA. A Roth IRA differs from other IRAs in that the tax advantages are “backloaded.” Contributions to a Roth IRA are not tax deductible. Instead, the IRA earnings (e.g., interest and dividends) are distributed tax free (provided that certain requirements are met). To be treated as a Roth IRA, the account must be designated as such when it is established. Unlike other IRAs, an individual may make contributions to a Roth IRA beyond the individual’s age of 70½.

Distributions from a Roth IRA are not included in gross income and are not subject to the 10% early withdrawal tax if certain requirements are met. In addition to other requirements, the individual must have held the Roth IRA for a five-year period beginning with the first year in which a contribution was made to the Roth IRA and ending with the end of the fifth year after the contribution.

Additionally, holders of a Roth IRA do not need to start receiving distributions by the age of 70½, as do holders of other types of IRAs.

The law also permits the “rollover” of a non-Roth IRA into a Roth IRA if the taxpayer’s AGI for the year does not exceed $100,000 (computed without regard to the rollover distribution) and the taxpayer is not a married individual filing a separate return. The $2,000 annual contribution limit does not apply to rollovers. The rollover of an ordinary IRA into a Roth IRA requires the taxpayer to report the ordinary IRA distribution in gross income. However, if the ordinary IRA is contributed to the new Roth IRA within 60 days of the distribution, the 10% early withdrawal tax will not apply. If an ordinary IRA is rolled into a Roth IRA before January 1, 1999, the amount that is includible in gross income is included ratably over a four-year period. The law permits a rollover into or between Roth IRAs more than one time a year.

New Federal Law (Sec. 408A)

Changes in the following seven areas of the Roth IRA provisions were made:

1. Early Withdrawals of Amounts Converted From Regular IRAs to Roth IRAs. Under the law before the IRS Reform Act (1) the four-year income spread was mandatory, not elective and (2) the 10% tax on early withdrawals did not apply to conversions of regular IRAs into Roth IRAs. Thus, under federal law before this change, taxpayers under age 59½ could escape the 10% early withdrawal penalty tax by rolling over funds from a regular IRA to a Roth IRA and then immediately thereafter taking a distribution from the Roth IRA.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

The provision modifies the rules relating to conversions of regular IRAs into Roth IRAs in order to prevent taxpayers from receiving premature distributions from a Roth Conversion IRA while retaining the benefits of the four-year income spread as follows:

- Acceleration of income inclusion. Where amounts are converted in 1998, and are thus subject to the four-year income spread, income inclusion is accelerated for any amounts withdrawn before 2001, the fourth year of the spread. This is done by adding the amount withdrawn in that year to the amount required to be included in income in that year under the four-year income spread rule. However, a limitation to the inclusion rule is provided to prevent more than the total amount required to be included in income over the four-year period from being included in income.

- Election. The IRS Reform Act makes the four-year income spread elective. The election or non-election cannot be later changed.

- Application of early withdrawal tax to converted amounts. If converted amounts are withdrawn within the five-year period beginning with the year of the conversion, then, only to the extent attributable to amounts that were includible in income due to the conversion, the amount withdrawn will be subject to the 10% early withdrawal tax.

2. Determination of Five-Year Holding Period. Under the law before the IRS Reform Act change, the five-year holding period with respect to conversion of Roth IRAs began with the tax year of the conversion.

- Applying the five-year holding period for Roth IRAs. The provision eliminates the special rule under which a separate five-year holding period begins for purposes of determining whether a distribution of amounts attributable to a conversion is a qualified distribution. Thus, the five-year holding period rule for Roth IRAs will begin with the year for which a contribution is first made to a Roth IRA. A subsequent conversion will not start the running of a new five-year period.

- Return of excess contributions. Distributions of excess contributions and earnings allocable to the contributions are not considered qualified distributions.

- Ordering rules. Ordering rules are provided to determine what amounts are withdrawn in the event a Roth IRA contains both conversion amounts (possibly from different years) and other contributions. Under these rules, regular Roth IRA contributions will be deemed to be withdrawn first, then converted amounts (starting with the amounts first converted). Withdrawals of converted amounts will be treated as coming first from converted amounts that were includible in income. Earnings will continue to be treated as withdrawn after contributions. For purposes of these rules, all Roth IRAs (whether or not maintained in separate accounts) are considered a single Roth IRA.

3. Corrections of Erroneous Conversions. Under the law before the IRS Reform Act change, no mechanism allowed a taxpayer to correct or “undo” an erroneous conversion, such as when a taxpayer makes a conversion early in a tax year and then discovers by the end of the year that the AGI limit of $100,000 has been exceeded and, thus, the taxpayer is ineligible to make the conversion.

The provision provides that contributions to an IRA and earnings on those contributions may be transferred in a trustee-to-trustee transfer from any IRA to another IRA by the due date for the taxpayer’s return for the year of the contribution (including extensions). Any transferred contributions will be treated as if contributed to the transferee IRA and not to the transferor IRA. Any transfer of contributions must be accompanied by any net income allocable to the contributions. Also, these transfers are permitted only if no deduction was allowed with respect to the contribution to the transferor plan. These provisions are effective for tax years beginning after December 31, 1997.

4. Effect of Account Holder’s Death During Four-Year Spread Period. The provision provides that any amounts remaining to be included in income as a result of a 1998 conversion (the four-year spread) will be includible in income on the final return of the deceased taxpayer. If the surviving spouse is the sole beneficiary of the Roth IRA, the spouse may elect to continue the deferral by including the remaining amounts in his or her income over the remainder of the four-year period. However, that election may not be made or changed after the due date for the spouse’s tax year that includes the date of death.

5. Determination of AGI Limit for Conversions. The provision provides that AGI, for purposes of applying the $100,000 threshold, is determined in the same manner as for regular IRAs. For regular IRAs, AGI includes taxable social security and railroad retirement benefits and the application of the passive activity loss rules. However, the exclusions for interest on U.S. savings bonds used to pay higher education expenses, for employer-provided adoption assistance programs, and for foreign earned income are not taken into account in determining AGI. In addition, the deduction for a contribution to a regular IRA is not taken into account.

The provision also makes it clear that the applicable AGI is the AGI for the year of the distribution to which the conversion relates. It also clarifies that, for purposes of computing taxable income, the conversion amount (to the extent otherwise includible in AGI) is to be taken into account in computing the AGI-based phaseout amounts.

6. Clarification of Phaseout Range. The $2,000 Roth IRA maximum contribution limit is phased out for individual taxpayers with AGI between $95,000 and $110,000 and for married taxpayers filing a joint return with AGI between $150,000 and $160,000. The provision clarifies that the phase-out range for the Roth IRA maximum contribution limit for a married individual filing a separate return is $0 to $10,000 of AGI.

7. Clarification of Contribution Limit. The provision clarifies that the maximum amount of contributions an individual may make to all of his or her IRAs is limited to a cumulative total of $2,000 per year.

The provision also provides that a simplified employee pension (SEP) or a SIMPLE IRA may not be designated as a Roth IRA and contributions to a SEP or SIMPLE IRA cannot be taken into account for purposes of the $2,000 contribution limit. Thus, contributions to a SEP or SIMPLE IRA will not affect the amount that an individual can contribute to a Roth IRA.

Current California Law (R&TC Sec. 17507.5)

SB 1233 (Stat. 1997, Ch. 612) conformed California law to federal law as it relates to Roth IRAs with one exception. SB 1233 corrected one of the original federal drafting errors by requiring a regular IRA rollover to be held in a Roth IRA for five years to avoid a premature withdrawal penalty and to use the ratable income inclusion rules. Additionally, FTB Legal Ruling 98-4 permits the recharacterization of or "undo" an ordinary IRA rollover into a Roth IRA for the 1998 tax year. California law has not conformed to the other changes made by the IRS Reform Act to Roth IRAs.

Effective Date

The provisions are effective for income years beginning after December 31, 1997.

Impact on California Revenue

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be minor losses.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6005(c)	Clarification of the Penalty-Free Distributions for Education Expenses and of First Homes.

Background

The 10% early withdrawal tax does not apply to distributions from an IRA if the distribution is for first-time homebuyer expenses, subject to a $10,000 life-time cap, or for higher education expenses. These exceptions do not apply to distributions from employer-sponsored retirement plans. A distribution from an employer-sponsored retirement plan that is an “eligible rollover distribution” may be rolled over to an IRA. The term “eligible rollover distribution” means any distribution to an employee of all or a portion or the balance to the credit of the employee in a qualified trust, except the term does not include certain periodic distributions, distributions based on life or joint life expectancies and distributions required under the minimum distribution rules. Generally, distributions from cash or deferred arrangements made on account of hardship are eligible rollover distributions. An eligible rollover distribution that is not transferred directly to another retirement plan or an IRA is subject to 20% withholding on the distribution.

Prior to the IRS Reform Act, participants in employer-sponsored retirement plans can avoid the early withdrawal tax applicable to such plans by rolling over hardship distributions to an IRA and withdrawing the funds from the IRA.

New Federal Law (Sec. 72(t), 402, 403)

The provision modifies the rules relating to the ability to roll over hardship distributions from employer-sponsored retirement plans (including section 403(b) plans) in order to prevent such avoidance of the 10% early withdrawal tax. The provision provides that distributions from cash or deferred arrangements and similar arrangements made on account of hardship of the employee are not eligible rollover distributions. Such distributions will not be subject to the 20% withholding applicable to eligible rollover distributions.

Current California Law (R&TC Sec. 17085.8(b))

California law is in conformity with federal law as it read on January 1, 1998, as it relates to penalty-free distributions for education expenses and of first-time home buyers (AB 1233, Stat. 1997, Ch. 612). California law has not conformed to the changes made to the IRC by the IRS Reform Act.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Effective Date

The provision is effective for distributions after December 31, 1998.

Impact on California Revenue

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be insignificant.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6005(d)	Individual Capital Gains Rate Reductions.

Background

The TRA of 1997 provided lower capital gains rates for individuals. Generally, the TRA of 1997 reduced the maximum rate on the adjusted net capital gain of an individual from 28% to 20% and provided a 10% rate for the adjusted net capital gain otherwise taxed at a 15% rate. The "adjusted net capital gain" means the net capital gain determined without regard to certain gain for which the TRA of 1997 provided a higher maximum rate of tax. The TRA of 1997 generally retained a 28% maximum rate for the long-term capital gain from collectibles, certain long-term capital gain included in income from the sale of small business stock, and the net capital gain determined by including all capital gains and losses properly taken into account after July 28, 1997, from property held more than one year but not more than 18 months and all capital gains and losses properly taken into account for the portion of the taxable year before May 7, 1997. In addition, the TRA of 1997 provided a maximum rate of 25% for the long-term capital gain attributable to real estate depreciation ("unrecaptured section 1250 gain").
Beginning in 2001 and 2006, lower rates of 8 and 18% will apply to certain property held more than five years.

The amounts taxed at the 28 and 25% rates may not exceed the individual's net capital gain and also are reduced by amounts otherwise taxed at a 15% rate.

Under the provisions of the TRA of 1997, net short-term capital losses and long-term capital loss carryovers reduce the amount of adjusted net capital gain before reducing amounts taxed at the maximum 25 and 28% rates.

The TRA of 1997 failed to coordinate the new multiple holding periods with certain provisions of the Code.

New Federal Law (Sec. 1(h), 55(b), 57(a), 1235)

Under the provision, 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 section 1250 gain. "28% rate gain" means the amount of net gain attributable to collectibles gains and losses, an amount of gain equal to the gain excluded from gross income on the sale of certain small business stock under section 1202, long-term capital gains and losses properly taken into account after July 28, 1997, from property held more than one year but not more than 18 months, the net short-term capital loss for the taxable year and the long-term capital loss carryover to the taxable year. Long-term capital gains and losses properly taken into account before May 7, 1997, also are included in computing 28% rate gain.

"Unrecaptured section 1250 gain" means the amount of long-term capital gain (not otherwise treated as ordinary income) which would be treated as ordinary income if section 1250 recapture applied to all depreciation (rather than only to depreciation in excess of straight-line depreciation) from property held more than 18 months (one year for amounts properly taken into account after May 6, 1997, and before July 29, 1997). (In the case of a disposition of a partnership interest held more than 18 months, the amount of the individual's long-term capital gain which would be treated as ordinary income under section 751(a) if section 1250 applied to all depreciation will be taken into account in computing unrecaptured section 1250 gain). The unrecaptured section 1250 depreciation is reduced (but not below zero) by the excess (if any) of the amount of losses taken into account in computing 28% gain over the amount of gains taken into account in computing 28% rate gain.

The provision contains several conforming amendments to coordinate the multiple holding periods with other provisions of the Code. Inherited property (sec. 1223 (11) and (12)) and certain patents (sec. 1235) are deemed to have a holding period of more than 18 months, allowing the 10 and 20% rates to apply. Amounts treated as ordinary income by reason of section 1231(c) will be allocated among categories of net section 1231 gain in accordance with IRS forms or regulations. The provision clarifies that the amount treated as long-term capital gain or loss on a section 1256 contract is treated as attributable to property held for more than 18 months.

Under the provision, in applying section 1233(b) where the substantially identical property has been held more than one year but not more than 18 months, any gain on the closing of the short sale will be considered gain from property held not more than 18 months, and the substantially identical property will be treated as held for one year on the day before the earlier of the date of the closing of the short sale or the date the property is disposed of. In applying section 1233(d) where, on the date of the short sale, the substantially identical property has been held more than 18 months, any loss on the closing of the short sale will be treated as a loss from the sale or exchange of a capital asset held more than 18 months. Finally, in applying section 1092(f), any loss with respect to the option shall be treated as a loss from the sale or exchange of a capital asset held more than 18 months, if at the time the loss is realized, gain on the sale or exchange of the stock would be treated as gain from the sale or exchange of a capital asset held more than 18 months. Any loss treated as a long-term capital loss by reason of section 1233(d) or 1092(f) will be taken into account in computing 28% rate gain where the property causing such loss to be treated as a long-term capital loss was held not more than 18 months on the applicable date.

The provision reorders the rate structure under sections 1(h)(1) and 55(b)(3) without any substantive change.

The provision makes minor technical changes, including a provision to reduce the minimum tax preference on certain small business stock to 28%, beginning in 2006. Thus, the maximum rate under the minimum tax will be 17.92% (.64 times 28%).

Current California Law (R&TC Sec. 17041, 17062.5)

California generally conforms to federal law on the definition of a capital gain or loss and how such gains or losses are calculated, the tax rates on ordinary income and net capital gains are the same.

Effective Date

The provision applies to taxable years ending after May 6, 1997.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6005(e)	Modifications to the Exclusion of Gain from the Sale of a Principal Residence.

Background

A taxpayer generally is able to 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. The exclusion is allowed each time a taxpayer selling a principal residence meets certain eligibility requirements, but generally no more frequently than once every two years (sales occurring before May 7, 1997, are not considered for the two-year rule). To be eligible for the exclusion, a taxpayer must have owned the residence and used it as a principal residence for a period of at least two years during the five years prior to the sale or exchange.

In the case of joint filers not sharing a principal residence, an exclusion of $250,000 is available on a qualifying sale of the principal residence of one of the spouses. Similarly, if a single taxpayer who is otherwise eligible for an exclusion marries someone who has used the exclusion within the two years prior to the marriage, the couple would be allowed a maximum exclusion of $250,000. Once both spouses satisfy the eligibility rules and two years have passed since the last exclusion was allowed to either, the taxpayers may exclude $500,000 of gain on their joint return. Special rules apply regarding: the sale of a remainder interest, cooperative housing corporations (e.g., co-ops and condominiums), involuntary conversions, and taxpayers residing in nursing homes.

An additional special rule applies to a taxpayer who fails to meet the requirements (use for two out of the last five years and no sale within two years of another sale) by reason of a change of place of employment, health, or other unforeseen circumstances. The taxpayer is able to exclude part of the gain recognized. The law as enacted could be interpreted to limit the exclusion to the fraction of the taxpayer’s realized gain on the sale equal to the fraction of two years that the requirements are met. Congress has indicated in committee reports that it was intended to exclude the fraction of the $250,000 ($500,000 for joint filers) equal to the portion of the two-year period that the requirements were met.

New Federal Law (Sec. 121)

The provision made technical changes to the law regarding the exclusion of gain from the sale of a personal residence. The technical changes are:

- Proration Exclusion of Gain. The Act corrected the provision relating to the proration of the exclusion in the case where the taxpayer does not meet the two-year ownership and use requirements if the sale is due to a change in place of employment, health, or unforeseen circumstances. The technical correction provides that the $250,000 or $500,000 exclusion, not the realized gain, is prorated for a taxpayer who does not meet the two-year ownership and use requirements and the sale is due to a change in place of employment, health, or unforeseen circumstances. This provision is effective for sales and exchanges after May 6, 1997.

- Exclusion Joint Returns. The Act corrects the provision relating to the computation of the exclusion to clarify that the limit on the amount of excludable gain is computed separately for each spouse in the case of married individuals filing a joint return who fail to qualify for the $500,000 exclusion for gain on a residence because they do not satisfy the two-year ownership test, two-year use test, and the prohibition on any other sale or exchange within the last two years. Thus, the maximum exclusion for such a couple is equal to the sum of the exclusions to which each spouse would otherwise be entitled if they were not married. Each spouse is treated as owning the property during the period that either spouse owned the property. This provision is effective for sales and exchanges after May 6, 1997.

- Election of Prior Law. Sales or Exchanges on Enactment Date. The Act corrects the provision relating to the ability of a taxpayer to elect to apply prior law to a sale or exchange occurring on August 5, 1997, as well as to sales and exchanges occurring before August 5, 1997. Thus, taxpayers who sold or exchanged a home on or before August 5, 1997, could choose to use the $125,000 once-in-a-lifetime exclusion for taxpayers age 55 or over or the rollover-of-gain rule for homes that are replaced within the replacement period.

The IRS anticipated the above technical corrections and interpreted the law as Congress intended it. The 1997 federal form 2119 (Sale of Your Home) was drafted with the above three changes incorporated, therefore; taxpayers will not be required to file amended returns.

<u>Current California Law (R&TC Sec. 17152, 18037.6)</u>

California law is in conformity with federal law as it read on January 1, 1998, as it relates to the exclusion of gain from the sale of a personal residence (SB 5, Stat. 1997, Ch. 610). California does not have a separate form but uses the federal form 2119. California law has not conformed to the three technical changes made to the IRC by the IRS Reform Act.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Effective Date

The provision is effective as if it was included in the TRA of 1997 (May 6, 1997).

Impact on California Revenue

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be insignificant.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6005(f)	Rollover of Gain from Sale of Qualified Stock.

Background

The TRA of 1997 provided that gain from the sale of qualified small business stock held by an individual for more than six months can be "rolled over" tax-free to other qualified small business stock.

New Federal Law (Sec. 1045)

Under the provision, a partnership or an S corporation can roll over gain from qualified small business stock held more than six months only if at all times during the taxable year all the interests in the partnership or S corporation are held by individuals, estates, and trusts with no corporate beneficiaries. The term "estate" is intended to include both the estate of a decedent and the estate of an individual in bankruptcy. The above was accomplished by changing the word "individual" in section 1045(a) to "taxpayer other than a corporation," making it clear that the rollover provisions apply to certain partnerships and S corporations.

The provision also provides that rules similar to the rules contained in subsections (f) through (k) of section 1202 will apply for purposes of the rollover provision (sec. 1045). Under these rules, for example, the benefit of a tax-free rollover with respect to the sale of small business stock by a partnership will flow through to a partner who is not a corporation if the partner held its partnership interest at all times the partnership held the small business stock. A similar rule applies to S corporations.

Current California Law (R&TC Sec. 18038.4, 18038.5, 18152.5, 18155.5)

California law conforms to the federal exclusion of 50% of the gain from the sale of small business stock and to the rollover of gain from the sale of qualified stock with modifications. In addition to the federal requirements, for California purposes the corporation must be doing business in California throughout the five-year period and 80% of its payroll must be attributable to employment located in California.

California law has not conformed to the changes made to the IRC by the IRS Reform Act.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Effective Date

The provision applies to sales on or after August 5, 1997, the date of enactment of the TRA of 1997.

Impact on California Revenue

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be insignificant.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6006(a)	Clarification of the Small Business Exemption.

Background

The corporate alternative minimum tax is repealed for small corporations for taxable years beginning after December 31, 1997. A small corporation is one that had average gross receipts of $5 million or less for a prior three-year period. A corporation that meets the $5 million gross receipts test will continue to be treated as a small corporation exempt from the alternative minimum tax so long as its average gross receipts do not exceed $7.5 million.

New Federal Law (Sec. 55)

The provision clarifies the application of the $5 million and $7.5 million gross receipts tests that a corporation must meet to be a small corporation exempt from the AMT. Under the provision, in order for a corporation to qualify as a small corporation exempt from the AMT for a taxable year, the corporation's average gross receipts for all three-taxable-year periods beginning after December 31, 1993, and ending before such taxable year must be $7.5 million or less. The $7.5 million amount is reduced to $5 million for the corporation's first three-taxable-year period (or portion thereof) beginning after December 31, 1993, and ending before the taxable year for which the exemption is claimed.

If a corporation's first taxable year beginning after December 31, 1997 (the first year the exemption is available) is its first taxable year (and the corporation does not lose its status as a small corporation because it is aggregated with one or more corporations under section 448(c)(2) or treated as having a predecessor corporation under section 448(c)(3)(D)), the corporation will be treated as an exempt small corporation for such year regardless of its gross receipts for such year.

The operation of the gross receipts tests for the small corporation AMT exemption is demonstrated by the following examples.

Example 1. Assume a calendar-year corporation was in existence on January 1, 1994. In order to qualify as a small corporation for 1998 (the first year the exemption is available), (1) the corporation's average gross receipts for the three-taxable-year period 1994 through 1996 must be $5 million or less and (2) the corporation's average gross receipts for the 1995 through 1997 period must be $7.5 million or less. If the corporation qualifies for 1998, the corporation will qualify for 1999 if its average gross receipts for the three-taxable-year period 1996 through 1998 also is $7.5 million or less. If the corporation does not qualify for 1998, the corporation cannot qualify for 1999 or any subsequent year.

Example 2. Assume a calendar-year corporation is first incorporated in 1999 and is neither aggregated with a related, existing corporation under section 448(c)(2) nor treated as having a predecessor corporation under section

448(c)(3)(D). The corporation will qualify as a small corporation for 1999 regardless of its gross receipts for such year. In order to qualify as a small corporation for 2000, the corporation's gross receipts for 1999 must be $5 million or less. The gross receipts for 1999 must be annualized under section 448(c)(3)(B) if the 1999 taxable year is less than 12 months.

If the corporation qualifies for 2000, the corporation also will qualify for 2001 if its average gross receipts for the two-taxable-year period 1999 through 2000 is $7.5 million or less. If the corporation does not qualify for 2000, the corporation cannot qualify for 2001 or any subsequent year. If the corporation qualifies for 2001, the corporation will qualify for 2002 if its average gross receipts for the three-taxable-year period 1999 through 2001 is $7.5 million or less.

Current California Law (R&TC Sec. 23400)

California law is conformed to federal law as it relates to corporate alternative minimum tax with modifications. California assesses an alternative minimum tax at a rate of 6.65% on AMTI in excess of $40,000 (the exemption is gradually phased-out when AMTI reaches $150,000). California law does not contain an exemption from alternative minimum tax for “small corporations.” However, California “S” corporations are exempt from the alternative minimum tax. In addition, California law provides that an individual’s AMTI does not include adjustments or items of tax preference attributable to any “qualified business” of the individual taxpayer. A qualified business is defined as any trade or business in which the individual taxpayer has an ownership interest in and has aggregate gross receipts of less than $1 million from all trade or businesses. In the case of an individual taxpayer owning less than 100% of the trade or business, the individual taxpayer’s proportionate share of the trade or business gross income is counted.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6006(b)	Election to Use AMT Depreciation for Regular Tax Purposes

Background

For regular tax purposes, depreciation deductions for certain shorter-lived tangible property may be determined using the 200% declining balance method over 3-, 5-, 7-, or 10-year recovery periods (depending on the type of property). For alternative minimum tax (AMT) purposes, depreciation on such property placed in service after 1986 and before 1999 is computed by using the 150% declining balance method over the longer class lives prescribed by the alternative depreciation system of section 168(g). A taxpayer may elect to use the methods and lives applicable to AMT depreciation for regular tax purposes.

The TRA of 1997 conformed the recovery periods (but not the methods) used for purposes of the AMT depreciation to the recovery periods used for purposes of the regular tax, for property placed in service after 1998. The TRA of 1997 did not make a conforming change to the election to use the pre-1998 AMT recovery methods and recovery periods for regular tax purposes.

New Federal Law (Sec. 168)

For property placed in service after 1998, a taxpayer would be allowed to elect, for regular tax purposes, to compute depreciation on tangible personal property otherwise qualified for the 200% declining balance method by using the 150% declining balance method over the recovery periods applicable to the regular tax (rather than the longer class lives of the alternative depreciation system of sec. 168(g)).

Current California Law (R&TC Sec. 17062, 23400, 23456)

California law is in conformity with federal law as it read on January 1, 1998, as it relates to the election to use AMT depreciation for regular tax purposes (AB 2797, Stat. 1998, Ch. 322). California law has not conformed to the changes made to the IRC by the IRS Reform Act.

Effective Date

The provision is effective for property placed in service after December 31, 1998.

Impact on California Revenue

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be insignificant.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6007	Clarification of Items Effecting Estates and Trusts.

Background

Prior to the TRA of 1997, a 5% surtax was imposed upon cumulative taxable transfers between $10 million and $21,040,000 to phase out the benefits of the graduated rates and the unified credit. The TRA of 1997 increased the unified credit beginning in 1998, from an effective exemption of $600,000 to an effective exemption of $1 million in 2006. A conforming amendment was made to the 5% surtax provision in section 2001(c)(2) that was intended to reflect the increased unified credit. However, the conforming amendment was drafted in a manner that had the effect of phasing out the benefits of the graduated rates but not the unified credit.

The TRA of 1997 provided for the indexation of the $1 million exemption from generation-skipping transfers effective for decedents dying after December 31, 1998.

The qualified family-owned business provision in the TRA of 1997 provides an exclusion from estate taxes for certain qualified family-owned business interests. It is unclear whether the provision provides an exclusion of value or an exclusion of property from the estate, and thus it is unclear how the new provision interacts with other provisions in the IRC (e.g., secs. 1014, 2032A, 2056, 2612, and 6166).

The TRA of 1997 effectively increased the amount of lifetime gifts and transfers at death that are exempt from unified estate and gift tax from $600,000 to $1 million over the period 1997 to 2006, through increases in an individual's unified credit. In addition, the TRA of 1997 provided a limited exclusion for certain family-owned business interests. The exclusion for family-owned business interests may be taken only to the extent that the exclusion for family-owned business interests, plus the amount effectively exempted by the unified credit, does not exceed $1.3 million. As a result, for years after 1998, the maximum amount of exclusion for family-owned business interests is reduced by increases in the dollar amount of transfers effectively exempted through the unified credit.

Because the structure of the TRA of 1997 increases the unified credit over time (until 2006) while decreasing over the same period the benefit of the closely-held business exclusion, the estate tax on estates with family-owned businesses increases over time until 2006. This increase in estate tax results from the fact that increases in the unified credit provide a benefit at the decedent's lowest estate tax brackets, while the exclusion for family-owned businesses provides a benefit at the decedent's highest estate tax brackets.

In order to be eligible to exclude from the gross estate a portion of the value of a family-owned business, the sum of (1) the adjusted value of family-owned business interests includible in the decedent's estate, and (2) the amount of gifts of family-owned business interests to family members of the decedent that are not included in the decedent's gross estate, must exceed 50% of the decedent's adjusted gross estate.

A qualified family-owned business interest is defined as any interest in a trade or business that meets certain requirements e.g., the decedent and members of his family must own certain percentages of the trade or business have materially participated in the trade or business for five of the eight years preceding the decedent's death, and the qualified heir or members of his family must materially participate in the trade or business for at least five years of any eight-year period within 10 years following the decedent's death.

The TRA of 1997 provided a new exclusion for qualified family-owned business interests. One of the requirements for the exclusion is that such interests must pass to a ”qualified heir," which includes members of the decedent's family and any individual who has been actively employed by the trade or business for at least 10 years prior to the date of the decedent's death.

The qualified family-owned business provision incorporates by cross-reference several other provisions of the Code, including a number of provisions in section 2032A and the personal holding company rules of section 543(a).

If certain conditions are met, a decedent's estate may elect to pay the estate tax attributable to certain closely-held businesses over a 14-year period. The TRA of 1997 provided for a 2% interest rate on the estate tax on the first $1 million in value of interests in qualified closely-held businesses, and a rate equal to 45% of the regular deficiency rate on the amount in excess of the portion eligible for the 2% rate, but also provided that none of the interest on the deferred payment of estate taxes is deductible for income or estate tax purposes. Interests in holding companies and non-readily-tradeable business interests are not eligible for the 2% rate.

<u>New Federal Law (Sec. 2001, 2031(c), 2057, 6166(b),6501, 7479(a))</u>

Clarification of Phaseout Range for 5-Percent Surtax to Phaseout the Benefits of the Unified Credit and Graduated Rates Election to Use AMT Depreciation for Regular Tax Purposes. The provision clarifies section 2001(c)(2) to properly phase out the benefits of both the graduated rates and the unified credit. This provision is effective for decedents dying, and gifts made, after December 31, 1997.

Effective Date for Indexing of Generation-Skipping Exemption. The provision clarifies that the indexing of the exemption from generation-skipping transfers is effective with respect to all generation-skipping transfers (i.e., direct skips, taxable terminations, and taxable distributions) made after 1998.

With respect to existing trusts, transferors are permitted to make a late allocation of any additional GST exemption amount attributable to indexing adjustments in accordance with the present-law rules applicable to late allocations as set forth in sections 2632 and 2642, and the regulations promulgated thereunder. For example, assume an individual transferred $2 million to a trust in 1995 and allocated his entire $1 million GST exemption to the trust at that time (resulting in an inclusion ratio of .50). Assume further that in 2001, the GST exemption has increased to $1.1 million as the result of indexing, and that the value of the trust assets is now $3 million. If the individual is still alive in 2001, he is permitted to make a late allocation of $100,000 of GST exemption to the trust, resulting in a new inclusion ratio of 1-(($1,500,000+100,000)/$3,000,000), or .467. The provision is effective for generation-skipping transfers (i.e., direct skips, taxable terminations, and taxable distributions) made after December 31, 1998.

Conversion of Qualified Family-Owned Business Exclusion into a Deduction. The provision converts the qualified family-owned business exclusion into a deduction, and redesignates section 2033A as section 2057. Except as provided below, the requirements of the qualified family-owned business provision otherwise remain unchanged. The qualified family-owned business deduction is not available for generation-skipping transfer tax purposes. The provision is effective with respect to estates of decedents dying after December 31, 1997.

Coordination Between Unified Credit and Family-Owned Business Provision. Under the provision, if an executor elects to utilize the qualified family-owned business deduction, the estate tax liability is calculated as if the estate were allowed a maximum qualified family-owned business deduction of $675,000 and an applicable exclusion amount under section 2010 (i.e., the amount exempted by the unified credit) of $625,000, regardless of the year in which the decedent dies. If the estate includes less than $675,000 of qualified family-owned business interests, the applicable exclusion amount is increased on a dollar-for-dollar basis, but only up to the applicable exclusion amount generally available for the year of death.

For example, assume a decedent dies in 2005, when the applicable exclusion amount under section 2010 is $800,000. If the estate includes qualified family-owned business interests valued at $675,000 or more, the estate tax liability is calculated as if the estate were allowed a qualified family-owned business deduction of $675,000, and the applicable exclusion amount under section 2010 is limited to $625,000. If the estate includes qualified family-owned business interests of $500,000 or less, all of the qualified family-owned business interests could be deducted from the estate, and the applicable exclusion amount under section 2010 is $800,000. If the estate includes qualified family-owned business interests valued between $500,000 and $675,000, all of the qualified family-owned business interests could be deducted from the estate, and the applicable exclusion amount under section 2010 is calculated as the excess of $1.3 million over the amount of qualified family-owned business interests. (For example, if the qualified family-owned business interests were valued at $600,000, the applicable exclusion amount under section 2010 is $700,000.)

If a recapture event occurs with respect to any qualified family-owned business interest, the total amount of estate taxes potentially subject to recapture is calculated as the difference between the actual amount of estate tax liability for the estate, and the amount of estate taxes that would have been owed had the qualified family-owned business election not been made.

The provision is effective for decedents dying after December 31, 1997.

Clarification of Businesses Eligible for Family-Owned Business Provision. The provision clarifies the formula for determining the amount of gifts of family-owned business interests made to members of the decedent's family that are not otherwise includible in the decedent's gross estate. The provision is effective with respect to decedents dying after December 31, 1997.

Clarification of "Trade or Business" Requirement for Family-Owned Business. The provision clarifies that an individual's interest in property used in a trade or business may qualify for the qualified family-owned business provision as long as such property is used in a trade or business by the individual or a member of the individual's family. Thus, for example, if a brother and sister inherit farmland upon their father's death, and the sister cash-leases her portion to her brother, who is engaged in the trade or business of farming, the "trade or business" requirement is satisfied with respect to both the brother and the sister. Similarly, if a father cash-leases farmland to his son, and the son materially participates in the trade or business of farming the land for at least five of the eight years preceding his father's death, the pre-death material participation and "trade or business" requirements are satisfied with respect to the father's interest in the farm. The provision is effective with respect to estates of decedents dying after December 31, 1997.

Clarification that Interests Eligible for Family-Owned Business Provision Must be Passed to a Qualified Heir. The provision clarifies that qualified family-owned business interests must pass to a qualified heir in order to qualify for the deduction. For this purpose, if all beneficiaries of a trust are qualified heirs (and in such other circumstances as the Secretary of the Treasury may provide), property passing to the trust may be treated as having passed to a qualified heir. The provision is effective with respect to estates of decedents dying after December 31, 1997.

Other Modifications to the Qualified Family-Owned Business. The provision modifies section 2033A(g) (relating to the security requirements for noncitizen qualified heirs) by deleting the cross-reference to section 2033A(i)(3)(M), which does not appear to be appropriate. The provision also makes rules similar to those set forth in section 2032A(h) and (i) (relating to conversions and exchanges of property under sections 1031 and 1033) applicable for purposes of section 2033A. Finally, the provision clarifies that, in identifying assets that produce (or are held for the production of) income of a type described in section 543(a), section 543(a) is applied without regard to section 543(a)(2) (the dividend requirement for corporate entities). The provision is effective with respect to estates of decedents dying after December 31, 1997.

Clarification of Interest on Installment Payment of Estate Tax on Holding Companies. The provision clarifies that deferred payments of estate tax on holding companies and non-readily-tradable business interests do not qualify for the 2% interest rate, but instead are subject to a rate of 45% of the regular deficiency rate. Such interest payments are not deductible for income or estate tax purposes. The provision generally is effective for decedents dying after December 31, 1997.

Current California Law

California does not impose an estate or gift tax; the California estate tax is a "pick-up" tax, that is, the state tax is equal to the maximum credit for a state death tax on the federal estate tax return for that particular decedent's estate. This "pick-up" tax is administered by the State Controller's Office.

Effective Date

The effective date for the above provisions is the same as that specified in the TRA of 1997, which is generally for taxable years starting after December 31, 1997.

Impact on California Revenue

Not applicable.

Section	Section Title
6008	Clarification of Incentives for the District of Columbia Zone.

Designation of D.C. Enterprise Zone. Certain economically depressed census tracts within the District of Columbia are designated as the "D.C. Enterprise Zone," within which businesses and individual residents are eligible for special tax incentives. The census tracts that compose the D.C. Enterprise Zone for purposes of the wage credit, expensing, and tax-exempt financing incentives include all census tracts that presently are part of the D.C. enterprise community and census tracts within the District of Columbia where the poverty rate is not less than 20%. The D.C. Enterprise Zone designation generally will remain in effect for five years for the period from January 1, 1998, through December 31, 2002.

Empowerment Zone Wage Credit, Expensing, and Tax-Exempt Financing. The following tax incentives generally are available in the D.C. Enterprise Zone: (1) a 20% wage credit for the first $15,000 of wages paid to D.C. residents who work in the D.C. Enterprise Zone; (2) an additional $20,000 of expensing under Code section 179 for qualified zone property placed in service by a "qualified D.C. zone business"; and (3) special tax-exempt financing for certain zone facilities.

Zero-Percent Capital Gains Rate. A zero percent capital gains rate applies to capital gains from the sale of certain qualified D.C. Zone assets held for more than five years. For purposes of the zero percent capital gains rate, the D.C. Enterprise Zone is defined to include all census tracts within the District of Columbia where the poverty rate is not less than 10%. Only capital gain that is attributable to the 10-year period beginning January 1, 1998, and ending December 31, 2007, is eligible for the zero percent rate.

First-Time Homebuyer Tax Credit. First-time homebuyers of a principal residence in the District are eligible for a tax credit of up to $5,000 of the amount of the purchase price, except that the credit phases out for individual taxpayers with adjusted gross income (AGI) between $70,000 and $90,000 ($110,000 and $130,000 for joint filers). The credit is available with respect to property purchased after the date of enactment and before January 1, 2001. Any excess credit may be carried forward indefinitely to succeeding taxable years.

New Federal Law (Sec. 1400, 1400A, 1400B, 1400C)

Eligible Census Tracts. The provision clarifies that the determination of whether a census tract in the District of Columbia satisfies the applicable poverty criteria for inclusion in the D.C. Enterprise Zone for purposes of the wage credit, expensing, and special tax-exempt financing incentives (poverty rate of not less than 20%) or for purposes of the zero percent capital gains rate (poverty rate of not less than 10%) is based on 1990 decennial census data. Thus, data from the 2000 decennial census would not result in the expansion or other reconfiguration of the D.C. Enterprise Zone.

Qualified D.C. Zone Business. The provision modifies section 1400B(c) to clarify that a proprietorship can constitute a D.C. Zone business for purposes of the zero percent capital gains rate. The provision also clarifies that qualified D.C. Zone businesses that take advantage of the special tax-exempt financing incentives do not become subject to a 35% zone resident requirement after the close of the testing period.

Zero-Percent Capital Gains Rate. The provision clarifies that there is no requirement that D.C. Zone business property be acquired by a subsequent purchaser prior to January 1, 2003, to be eligible for the special rule applicable to subsequent purchasers.

In addition, the provision clarifies that the termination of the D.C. Enterprise Zone designation at the end of 2002 will not, by itself, result in property failing to be treated as a qualified D.C. Zone asset for purposes of the zero percent capital gains rate, provided that the property otherwise continues to qualify were the D.C. Zone designation in effect.

First-Time Homebuyer Credit. The provision clarifies that, for purposes of the first-time homebuyer credit, a "first-time homebuyer" means any individual if such individual (and, if married, such individual's spouse) did not have a present ownership interest in a principal residence in the District of Columbia during the one-year period ending on the date of the purchase of the principal residence to which the credit applies.

The provision also clarifies that the phaseout of the credit for individual taxpayers with adjusted gross income between $70,000 and $90,000 ($110,000 $130,000 for joint filers) applies only in the year the credit is generated, and does not apply in subsequent years to which the credit may be carried over.

In addition, the provision clarifies that the term "purchase price" means the adjusted basis of the principal residence on the date the residence is purchased. Newly constructed residences are treated as purchased by the taxpayer on the date the taxpayer first occupies such residence.

The provision clarifies that the first-time homebuyer credit is a nonrefundable personal credit and would provide that the first-time homebuyer credit is claimed after the credits described in Code sections 25 (credit for interest on certain home mortgages) and 23 (adoption credit).

Finally, the provision clarifies that the first-time homebuyer credit would be available only for property purchased after August 4, 1997, and before January 1, 2001. Thus, the credit is available to first-time home purchasers who acquire title to a qualifying principal residence on or after August 5, 1997, and on or before December 31, 2000, irrespective of the date the purchase contract was entered into.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Current California Law

Existing state law does not conform to the federal economic development area provisions. Instead, California provides for the designation of the following economic development areas: 39 enterprise zones, five local agency military base recovery areas, one targeted tax area, and two manufacturing enhancement areas. California allows the following tax incentives to qualifying businesses operating in economic development areas:

Types of Incentives	EZ	LAMBRA	TTA	MEA
Sales or Use Tax Credit	X	X	X	
Hiring Credit	X	X	X	X
Employee Wage Credit	X			
Business Expense Deduction	X	X	X	
Net Interest Deduction	X			
Net Operating Loss	X	X	X	

Effective Date

The provisions are effective as of January 1, 1998, the date the provision are effective under the TRA of 1997.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6009(a)	Clarification of Qualification for Reduced Rate of Excise Tax on Certain Hard Ciders.

Background

Distilled spirits are taxed at a rate of $13.50 per proof gallon; beer is taxed at a rate of $18 per barrel (approximately 58 cents per gallon); and still wines of 14% alcohol or less are taxed at a rate of $1.07 per wine gallon. The Code defines still wines as wines containing not more than 0.392 gram of carbon dioxide per hundred milliliters of wine. Higher rates of tax are applied to wines with greater alcohol content, to sparkling wines, and to artificially carbonated wines.

Certain small wineries may claim a credit against the excise tax on wine of 90 cents per wine gallon on the first 100,000 gallons of still wine produced annually (i.e., net tax rate of 17 cents per wine gallon on wines with an alcohol content of 14% or less). No credit is allowed on sparkling wines. Certain small breweries pay a reduced tax of $7.00 per barrel (approximately 22.6 cents per gallon) on the first 50,000 barrels of beer produced annually.

Hard cider is a wine fermented solely from apples or apple concentrate and water, containing no other fruit product and containing at least one-half of one percent and less than 7 percent alcohol by volume. Once fermented, eligible hard cider may not be altered by the addition of other fruit juices, flavor, or other ingredients that alter the flavor that results from the fermentation process.

The TRA of 1997 provided a lower excise tax rate of 22.6 cents per gallon on hard cider. Qualifying small producers that produce 250,000 gallons or less of hard cider and other wines in a calendar year may claim a credit of 5.6 cents per wine gallon on the first 100,000 gallons of hard cider produced. This credit produces an effective tax rate of 17 cents per gallon, the same effective rate as that applied to small producers of still wines having an alcohol content of 14% or less. This credit is phased out for production in excess of 100,000 gallons but less than 250,000 gallons annually.

New Federal Law (Sec. 5041)

The provision clarifies that the 22.6-cents-per-gallon tax rate applies only to apple cider that otherwise would be a still wine subject to a tax rate of $1.07 per wine gallon, i.e., still wines having an alcohol content of 14% or less.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Current California Law

No comparable provisions are contained in the parts of the Revenue and Taxation Code administered by the FTB. Excise taxes are normally administered by the BOE.

Effective Date

The provision is effective as if included in the TRA of 1997.

Impact on California Revenue

Defer to BOE.

Section	Section Title
6009(b)	Election for 1987 Partnerships to Continue Exception from Treatment of Publicly Traded Partnerships as Corporations.

Background

In general, in the case of an "electing 1987 partnership" that elects to be subject to a 3.5% tax on gross income from the active conduct of a trade or business, the general rule treating a publicly traded partnership as a corporation does not apply. The 3.5% tax was intended to approximate the corporate tax the partnership would pay if it were treated as a corporation for federal tax purposes.

Tax on Partnership. The 3.5% tax is imposed on the electing 1987 partnership under the provision (sec. 7704(g)(3)). The provision does not specifically make inapplicable, however, the general rule that a partnership as such is not subject to income tax, but rather, the partners are liable for the tax in their separate or individual capacities (sec. 701).

Estimated Tax Payments. The provision does not specifically make applicable the requirements for payment of estimated tax that apply generally to payments of corporate tax.

New Federal Law (Sec. 7704)

Tax on Partnership. The technical correction clarifies that the 3.5% tax is paid by the partnership. The general rule of section 701(a) that a partnership as such is not subject to income tax, rather the partners are liable for the tax in their separate or individual capacities, does not apply to the payment of the 3.5% tax by the partnership.

Estimated Tax Payments. The technical correction provides that the corporate estimated tax payment rules of section 6655 are applied to the 3.5% tax payable by an electing 1987 partnership in the same manner as if the partnership were a corporation and the tax were imposed under section 11 (relating to corporate tax rates). References in section 11 to taxable income are to be applied for this purpose as if they were references to gross income of the partnership for the taxable year from the active conduct of trades and businesses by the partnership.

Current California Law (R&TC Sec. 17008.5, 23038.53)

SB 455 (Stat. 1997, Ch 611) conformed California law to federal law changes made by the Taxpayer Relief Act of 1997 as it relates to electing 1987 partnerships. California law conformed with one exception; in lieu of the 3.5% federal tax rate on gross income, a 1% tax on trade or business gross income will be imposed. California law also requires that the federal treatment of a publicly traded partnership (corporation or partnership) be binding for California purposes, so that no separate state election is permitted.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

California law has not conformed to the changes made to the IRC by the IRS Reform Act.

Effective Date

Tax on Partnership. The provision is effective for taxable years beginning after December 31, 1997.

Estimated Tax Payments. The provision is effective for taxable years beginning after July 22, 1998.

Impact on California Revenue

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be insignificant.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6009(c)	Depreciation Limitations for Electric Vehicles.

Background

Annual depreciation deductions with respect to passenger automobiles are limited to specified dollar amounts, indexed for inflation. Any cost not recovered during the six-year recovery period of such vehicles may be recovered during the years succeeding the recovery period, subject to similar limitations. The recovery-period limitations are trebled for vehicles that are propelled primarily by electricity.

New Federal Law (Sec. 280F)

The depreciation limitations applicable to post-recovery periods under section 280F are trebled for vehicles that are propelled primarily by electricity.

Current California Law (R&TC Sec. 17201)

California law is in conformity with federal law as it read on January 1, 1998, as it relates to the modified limits on depreciation of luxury automobiles for clean burning and electric vehicles (AB 2797, Stat. 1998, Ch. 322). California law has not conformed to the federal changes made by the IRS Reform Act.

Effective Date

The provision is effective for property placed in service after August 5, 1997, and before January 1, 2005.

Impact on California Revenue

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be insignificant.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6009(d)	Combined Employment Tax Reporting Demonstration Project.

Background

Traditionally, federal tax forms are filed with the federal government, and state tax forms are filed with individual states. This necessitates duplication of items common to both returns. Some states have recently been working with the IRS to implement combined state and federal reporting of certain types of items on one form as a way of reducing the burdens on taxpayers. The State of Montana and the IRS have cooperatively developed a system to combine state and federal employment tax reporting on one form.

The IRC prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the IRC (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431).

Implementation of the combined Montana-federal employment tax reporting project had been hindered because the IRS interprets section 6103 to apply that provision's restrictions on disclosure to information common to both the state and federal portions of the combined form, although these restrictions would not apply to the state with respect to the state's use of state-requested information if that information were supplied separately to both the state and the IRS.

The TRA of 1997 permits implementation of a demonstration project to assess the feasibility and desirability of expanding combined reporting in the future. There are several limitations on the demonstration project.

New Federal Law (Sec. 6103)

The provision permits Montana to use this information as if it had collected it separately by eliminating federal penalties for disclosure of this information. The provision also corrects a cross-reference to the provision.

Current California Law

No comparable provisions are contained in the parts of the Revenue and Taxation Code administered by the FTB.

Effective Date

The provision is effective August 5, 1997.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6009(e)	Modification of Operation of Elective Carryback of Existing Net Operating Losses of the National Railroad Passenger Corporation.

The TRA of 1997 provides elective procedures that allow National Railroad Passenger Corp. (Amtrak) to consider the tax attributes of its predecessors (i.e., those railroads that were relieved of their responsibility to provide intercity rail passenger service as a result of the Rail Passenger Service Act of 1970) in the use of Amtrak's net operating losses. The benefit allowable under these procedures is limited to the lesser of: (1) 35% of Amtrak's existing qualified carryovers, (2) the net tax liability for the carryback period, or (3) $2,323,000,000. One-half of the amount so calculated will be treated as a payment of the tax imposed by chapter 1 of the IRC of 1986 for Amtrak's taxable year ending December 31, 1997, and a similar amount for Amtrak's taxable year ending December 31, 1998.

The availability of the elective procedures is conditioned on Amtrak (1) agreeing to make payments of 1% of the amount it receives to each of the non-Amtrak states to offset certain transportation related expenditures and (2) using the balance for certain qualified expenses. Non-Amtrak states are those States that are not receiving Amtrak service at any time during the period beginning on the date of enactment and ending on the date of payment.

New Federal Law

The provision provides that the term "non-Amtrak state" means any state that is not receiving intercity passenger rail service from Amtrak as of the date of enactment of the TRA of 1997 (August 5, 1997). Thus, a state will not lose its status as a non-Amtrak state with respect to any payment by reason of acquiring Amtrak service with any payment from Amtrak under the TRA of 1997 provision.

Current California Law (R&TC Sec. 24416)

Existing state law generally conforms to the computation of federal NOLs. California does not allow NOL carrybacks. The type of taxpayer and how the NOL is generated determines the amount of the NOL that is eligible to be carried forward and the number of years it can be carried forward:

Type of NOL	NOL % Allowed to be Carried Over	Carryover Period
General NOL	50%	5 Years
New Business Year 1 Year 2 Year 3	100% 100% 100%	8 Years 7 Years 6 Years
Eligible Small Business	100%	5 Years
Specified Disaster Loss	100% 50%	5 Years 10 Years
LARZ, LAMBRA & EZ	100%	15 Years

Current California law does not contain any provisions specially related to tax attributes of Amtrak predecessors.

Effective Date

The provision is effective as if included in section 977 of the TRA of 1997.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6010(a)	Clarification of Constructive Sales Rules.

Background

Exception from Constructive Sales Rules for certain Debt Positions. A taxpayer is required to recognize gain (but not loss) upon entering into a constructive sale of an "appreciated financial position," which generally includes an appreciated position with respect to any stock, debt instrument or partnership interest. An exception is provided for positions with respect to debt instruments that have an unconditionally payable principal amount, that are not convertible into the stock of the issuer or a related person, and the interest on which is either fixed, payable at certain variable rates or based on certain interest payments on a pool of mortgages.

Definition of Forward Contract under Constructive Sales Rules. A constructive sale of an appreciated financial position generally results when the taxpayer enters into a forward contact to deliver the same or substantially identical property. A forward contract for this purpose is defined as a contract that provides for delivery of a substantially fixed amount of property at a substantially fixed price.

Special Effective Date for Constructive Sales Rules. The constructive sales rules contain a special effective date provision for decedents dying after June 8, 1997, if (1) a constructive sale of an appreciated financial position occurred before such date, (2) the transaction remains open for not less than two years, (3) the transaction remains open at any time during the three years prior to the decedent's death, and (4) the transaction is not closed within the 30-day period beginning on the date of enactment of the TRA of 1997. If the requirements of the special effective date provision are met, both the appreciated financial position and the transaction resulting in the constructive sale are generally treated as property constituting rights to receive income in respect of a decedent under section 691. However, gain with respect to a position in a constructive sale transaction that accrues after the transaction is closed is not included in income in respect of a decedent.

New Federal Law (Sec. 1259(b) & (d), 6010(a))

Exception from Constructive Sales Rules for certain Debt Positions. The provision clarifies that, to qualify for the exception for positions with respect to debt instruments, the position would either have to meet the requirements as to unconditional principal amount, non-convertibility and interest terms or, alternatively, be a hedge of a position meeting these requirements. A hedge for purposes of the provision includes any position that reduces the taxpayer's risk of interest rate or price changes or currency fluctuations with respect to another position.

Definition of Forward Contract under Constructive Sales Rules. The provision clarifies that the definition of a forward contract includes a contract that provides for cash settlement with respect to a substantially fixed amount of property at a substantially fixed price.

Special Effective Date for Constructive Sales Rules. The provision clarifies the special effective date rule to provide that the rule does not apply if the constructive sale transaction is closed at any time prior to the end of the 30th day after the date of enactment of the TRA of 1997.

<u>Current California Law (R&TC Sec. 18151, 24990)</u>

California law is in conformity with federal law as it read on January 1, 1998, as it relates to the constructive sales rules (AB 2797, Stat. 1998, Ch. 322). California law has not conformed to the federal changes made by the IRS Reform Act.

<u>Effective Date</u>

The provision is generally effective for constructive sales entered into after June 8, 1997 (the effective date contained in the TRA of 1997).

<u>Impact on California Revenue</u>

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be insignificant.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6010(a)	Treatment of Mark-to-Market Gains of Electing Traders.

Background

Securities and commodities traders may elect application of the mark-to-market accounting rules. Gain or loss recognized by an electing taxpayer under these rules is treated as ordinary gain or loss.

Under the self-employment Contributions Act (SECA), a tax is imposed on an individual's net earnings from self-employment (NESE). Gain or loss from the sale or exchange of a capital asset is excluded from NESE.

A publicly-traded partnership generally is treated as a corporation for federal tax purposes. An exception to this rule applies if 90% or more of the partnership's gross income consists of passive-type income, which includes gain from the sale or disposition of a capital asset.

New Federal Law (Sec. 475(f)(1))

The provision clarifies that gain or loss of a securities or commodities trader that is treated as ordinary solely by reason of election of mark-to-market treatment is not treated as other than gain or loss from a capital asset for purposes of determining NESE for SECA tax purposes, determining whether the passive-type income exception to the publicly-traded partnership rules is met, or for purposes of any other Code provision specified by the Treasury Department in regulations.

Current California Law (R&TC Secs. 17551, 17571, 24710)

California law is in conformity with federal law as it read on January 1, 1998, as it relates to mark-to-market method of accounting (AB 2797, Stat. 1998, Ch. 322). California law has not conformed to the federal changes made by the IRS Reform Act.

Effective Date

The provision applies to taxable years of electing securities and commodities traders ending after August 5, 1997, the date of enactment of the TRA of 1997.

Impact on California Revenue

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be insignificant.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6010(b)	Gain Recognition for Certain Extraordinary Dividends.

Background

A corporate shareholder generally can deduct at least 70% of a dividend received from another corporation. This dividends received deduction is 80% if the corporate shareholder owns at least 20% of the distributing corporation and generally 100% if the shareholder owns at least 80% of the distributing corporation.

Section 1059 of the Code requires a corporate shareholder that receives an "extraordinary dividend" to reduce the basis of the stock with respect to which the dividend was received by the nontaxed portion of the dividend. Whether a dividend is "extraordinary" is determined, among other things, by reference to the size of the dividend in relation to the adjusted basis of the shareholder's stock. In addition, dividends resulting from non pro rata redemptions, partial liquidations, and certain other redemptions are extraordinary dividends. Pursuant to a provision of the TRA of 1997, gain is recognized to the extent the reduction in basis of stock exceeds the basis in the stock with respect to which an extraordinary dividend is received. Prior to the TRA of 1997, the recognition of such gain generally was deferred until the stock to which the adjustment related was sold or disposed of.

The consolidated return regulations provide basis adjustment rules with respect to dividends paid within a consolidated group of corporations. These rules provide that a dividend paid from one member of a group to its parent reduces the parent's basis in the stock of the payor and if such reduction exceeds the parent's basis, an "excess loss account" is created or increased. Excess loss accounts generally are not restored to income until the occurrence of certain specified events (e.g., when the corporation to which the excess loss account relates leaves the consolidated group). Legislative history indicates that, except as provided in regulations, the extraordinary dividend provisions do not apply to result in a double reduction in basis in the case of distributions between members of an affiliated group filing consolidated returns or in double inclusion of earnings and profits.

New Federal Law (Sec. 1059)

The provision provides the Treasury Department specific regulatory authority to coordinate the basis adjustment rules of section 1059 and the consolidated return regulations. Except as provided in regulations to be issued, section 1059 will not cause current gain recognition to the extent that the consolidated return regulations require the creation or increase of an excess loss account with respect to a distribution.

Current Treas. Reg. sec. 1.1059(e)-1(a) will not result in gain recognition with respect to distributions within a consolidated group to the extent such distribution results in the creation or increase of an excess loss account under the consolidated return regulations.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Current California Law (R&TC Sec. 24966)

California law provides for deduction of a portion of the dividends received during the year declared from income which has been included in the measure of tax for California franchise, corporate income or alternative minimum tax purposes. Special rules apply for dividends received from insurance company subsidiaries and dividends received by taxpayers with a water's-edge election in effect.

California law is in conformity with federal law as it read on January 1, 1998, as it relates to the treatment of extraordinary dividends and the basis of the subsidiary's stock (AB 2797, Stat. 1998, Ch. 322). California law has not conformed to the federal changes made by the IRS Reform Act.

Effective Date

The provision generally is effective for distributions after May 3, 1995.

Impact on California Revenue

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be insignificant.

Section	Section Title
6010(c)	Treatment of Certain Corporate Distributions.

Background

The TRA of 1997 (sec. 1012(a)) requires a distributing corporation ("distributing") to recognize corporate level gain on the distribution of stock of a controlled corporation ("controlled") under section 355 of the Code if, pursuant to a plan or series of related transactions, one or more persons acquire a 50% or greater interest (defined as 50% or more of the voting power or value of the stock) of either the distributing or controlled corporation (Code sec. 355(e)). Certain transactions are excepted from the definition of acquisition for this purpose, including, under section 355(e)(3)(A)(iv), the acquisition by a person of stock in a corporation if shareholders owning directly or indirectly stock possessing more than 50% of the voting power and more than 50% of the value of the stock in distributing or any controlled corporation before such acquisition own directly or indirectly stock possessing such vote and value in such distributing or controlled corporation after such acquisition. This exception (as certain other exceptions) does not apply if the stock held before the acquisition was acquired pursuant to a plan (or series of related transactions) to acquire a 50% or greater interest in distributing or a controlled corporation.

In the case of a 50% or more acquisition of either the distributing corporation or the controlled corporation, the amount of gain recognized is the amount that the distributing corporation would have recognized had the stock of the controlled corporation been sold for fair market value on the date of the distribution. The Conference Report to the TRA of 1997 states that no adjustment to the basis of the stock or assets of either corporation is allowed by reason of recognition of the gain. The TRA of 1997 does not limit the otherwise applicable Treasury regulatory authority under section 336(e) of the Code. Nor does it limit the otherwise applicable provisions of section 1367 with respect to the effect on shareholder stock basis of gain recognized by an S corporation under this provision.

The TRA of 1997 (sec. 1012(b)(1)) also provides that, except as provided in regulations, section 355 shall not apply to the distribution of stock from one member of an affiliated group of corporations (as defined in section 1504(a)) to another member of such group (an intragroup spin-off) if such distribution is part of such a plan or series of related transactions pursuant to which one or more persons acquire stock representing a 50% or greater interest in a distributing or controlled corporation, determined after the application of the rules of section 355(e).

In addition, the TRA of 1997 (sec. 1012(b)(2)) provides that in the case of any distribution of stock of one member of an affiliated group of corporations to another member under section 355, the Treasury Department has regulatory authority under section 358(g) to provide adjustments to the basis of any stock in a corporation which is a member of such group, to reflect appropriately the proper treatment of such distribution.

The TRA of 1997 (sec. 1012(c)) also modified certain rules for determining control immediately after a distribution in the case of certain divisive transactions in which the stock of a controlled corporation is distributed and the transaction meets the requirements of section 355. In such cases, under section 351 and modified section 368(a)(2)(H) with respect to reorganizations under section 368(a)(1)(D), those shareholders receiving stock in the distributed corporation are treated as in control of the distributed corporation immediately after the distribution if they hold stock representing a greater than 50% interest in the vote and value of stock of the distributed corporation.

The effective date (Act section 1012(d)(1)) states that the forgoing provisions of the TRA of 1997 apply to distributions after April 16, 1997, pursuant to a plan (or series of related transactions) which involves an acquisition occurring after such date (unless certain transition provisions apply).

<u>New Federal Law (Sec. 351(c), 355(e), 368(a)(2))</u>

Acquisition of a 50% or Greater Interest. The provision clarifies that the acquisitions described in Code section 355(e)(3)(A) are disregarded in determining whether there has been an acquisition of a 50% or greater interest in a corporation. However, other transactions that are part of a plan or series of related transactions could result in an acquisition of a 50% or greater interest.

In the case of acquisitions under section 355(e)(3)(A)(iv), the provision clarifies that the acquisition of stock in the distributing corporation or any controlled corporation is disregarded to the extent that the percentage of stock owned directly or indirectly in such corporation by each person owning stock in such corporation immediately before the acquisition does not decrease.

Example: Geoff owns 10% of the vote and value of the stock of Distrib, Inc. (which owns all of Sub, Inc.). There are nine other equal shareholders of Distrib, Inc. Geoff also owns 100% of the vote and value of the stock of unrelated corporation Acq, Inc. Distrib, Inc. distributes Sub, Inc to the 10 shareholders of Distrib, Inc. Thereafter, pursuant to a plan or series of related transactions, Distrib, Inc (worth 100x) merges with Acq, Inc. (worth 900x) to form AcqD, Inc. After the merger, each of the former shareholders of Distrib, Inc. owns stock of AcqD, Inc. reflecting the vote and value attributable to that shareholder's respective 10% former stock ownership of Distrib, Inc. Each of the former shareholders of Distrib, Inc. owns 1% of the stock of AcqD, Inc., except that Geoff (who owned 100% of Acq, Inc. and 10% of Distrib, Inc. before the merger) now owns 91% of the stock of AcqD, Inc. In determining whether a 50% or greater interest in Distrib, Inc has been merged with Acq, Inc., the interest of each of the continuing shareholders is disregarded only to the extent there has been no decrease in such shareholder's direct or indirect ownership. Thus, Geoff's 10% interest in Distrib, Inc., and the 1% interest of each of the nine other former shareholders of Distrib, Inc., is not counted. Thus, for purposes of calculating any gain that should be recognized, 81% ownership of AcqD, Inc., representing a decrease of 9% in the interests of each of the nine former shareholders other than Geoff and Geoff's 10%, is counted in determining the extent of an acquisition. Therefore, a 50% or greater interest in Distrib, Inc. has been acquired.

Treasury Regulatory Authority. The provision also clarifies that the regulatory authority of the Treasury Department under section 358(c) applies to distributions after April 16, 1997, without regard to whether a distribution involves a plan (or series of related transactions) which involves an acquisition. As stated in the Conference Report to the TRA of 1997, with respect to the Treasury Department regulatory authority under section 358(c) as applied to intragroup spin-off transactions that are not part of a plan or series of related transactions that involve an acquisition of a 50% or greater interest under new section 355(f), it is expected that any Treasury regulations will be applied prospectively, except in cases to prevent abuse.

Section 351(c) and Section 368(a)(2)(H) "Control Immediately After" Requirement. In general, the TRA of 1997 modifications to the control immediately after requirement of by Section 351(c) and section 368(a)(2)(H) were intended to minimize certain differences in the results of a transaction involving a contribution of assets to a controlled corporation prior to a section 355 spin-off that could occur depending on whether the distributing or controlled corporation were acquired subsequent to the spin-off.

The provision clarifies that in the case of certain divisive transactions in which a corporation contributes assets to a controlled corporation and then distributes the stock of the controlled corporation in a transaction that meets the requirements of section 355 (or so much of section 356 as relates to section 355), solely for purposes of determining the tax treatment of the transfers of property to the controlled corporation by the distributing corporation, the fact that the shareholders of the distributing corporation dispose of part or all of the distributed stock shall not be taken into account for purposes of the control immediately after requirement of section 351(a) or 368(a)(1)(D). For purposes of determining the tax treatment of transfers of property to the controlled corporation by parties other than the distributing corporation, the disposition of part or all of the distributed stock continues to be taken into account, as under prior law, in determining whether the control immediately after requirement is satisfied.

Example 1: Distributing corporation D transfers appreciated business X to subsidiary C in exchange for 100% of C stock. D distributes its stock of C to D shareholders. As part of a plan or series of related transactions, C merges into unrelated acquiring corporation A, and the C shareholders receive 25% of the vote or value of A stock. If the requirements of section 355 are met with respect to the distribution, then the control immediately after requirement will be satisfied solely for purposes of determining the tax treatment of the transfers of property by D to C. Accordingly, the business X assets transferred to C and held by A after the merger will have a carryover basis from D. Section 355(e) will require D to recognize gain as if the C stock had been sold at fair market value.

Example 2: Distributing corporation D transfers appreciated business X to subsidiary C in exchange for 85% of C stock. Unrelated persons transfer appreciated assets to C in exchange for the remaining 15% of C stock. D distributes all its stock of C to D shareholders. As part of a plan or series of related transactions, C merges into acquiring corporation A, and the interests attributable to the D shareholders' receipt of C stock with respect to their D stock in the distribution represent 25% of the vote and value of A stock. If the requirements of section 355 are met with respect to the distribution, then the control immediately after requirement will be satisfied solely for purposes of determining the tax treatment of the transfers of property by D to C. Section 355(e) will require recognition of gain as if the C stock had been sold for fair market value. The business X assets transferred to C and held by A after the merger will have a carryover basis from D. The persons other than D who transferred assets to C for 15% of C stock will recognize gain on the appreciation in their assets transferred to C if the control immediately after requirement is not satisfied after taking into account any post-spin-off dispositions that would have been taken into account under prior law.

Current California Law (R&TC Sec. 23251, 24451)

California law is in conformity with federal law as it read on January 1, 1998, as it relates to distributions of controlled corporations (AB 2797, Stat. 1998, Ch. 322). California law has not conformed to the federal changes made by the IRS Reform Act.

Effective Date

The provision generally is effective for distributions after April 16, 1997.

Impact on California Revenue

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be insignificant.

Section	Section Title
6010(d)	Application of Section 304 to Certain International Transactions.

Background

Under section 304, if one corporation purchases stock of a related corporation, the transaction generally is recharacterized as a redemption. Under section 304(a), as amended by the TRA of 1997, to the extent that a section 304 transaction is treated as a distribution under section 301, the transferor and the acquiring corporation are treated as if (1) the transferor had transferred the stock involved in the transaction to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and (2) the acquiring corporation had then redeemed the stock it is treated as having issued. In the case of a section 304 transaction, both the amount which is a dividend and the source of such dividend is determined as if the property were distributed by the acquiring corporation to the extent of its earnings and profits and then by the issuing corporation to the extent of its earnings and profits (sec. 304(b)(2)). Section 304(b)(5), as added by the TRA of 1997, provides special rules that apply if the acquiring corporation in a section 304 transaction is a foreign corporation. Under section 304(b)(5), the earnings and profits of the acquiring corporation that are taken into account are limited to the portion of such earnings and profits that (1) is attributable to stock of such acquiring corporation held by a corporation or individual who is the transferor (or a person related thereto) and who is a U.S. shareholder (within the meaning of section 951(b)) of such corporation and (2) was accumulated during periods in which such stock was owned by such person while such acquiring corporation was a controlled foreign corporation. For purposes of this rule, except as otherwise provided by the Secretary of the Treasury, the rules of section 1248(d) (relating to certain exclusions from earnings and profits) apply.

The Secretary is to prescribe regulations as appropriate, including regulations determining the earnings and profits that are attributable to particular stock of the acquiring corporation. For foreign tax credit purposes, under section 902, a U.S. corporation that receives a dividend from a foreign corporation in which it owns at least 10% of the voting stock is treated as if it had paid the foreign income taxes paid by the foreign corporation which are attributable to such dividend. The Internal Revenue Service issued rulings providing that a domestic corporation that is a transferor in a section 304 transaction may compute foreign taxes deemed paid under section 902 on the dividends from both a foreign acquiring corporation and a foreign issuing corporation. Rev. Rul. 92-86, 199212 C.B. 199; Rev. Rul. 91-5, 1991-1 C.B. 114. Both rulings involve section 304 transactions in which both the domestic transferor and the foreign acquiring corporation are wholly owned by a domestic parent corporation.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

New Federal Law (Sec. 304)

Under the provision, in the case of a section 304 transaction in which the acquiring corporation or the issuing corporation is a foreign corporation, the Secretary of the Treasury is to prescribe regulations providing rules to prevent the multiple inclusion of an item of income and to provide appropriate basis adjustments, including rules modifying the application of sections 959 and 961 in the case of a section 304 transaction. It is expected that such regulations will provide for an exclusion from income for distributions from earnings and profits of the acquiring corporation and the issuing corporation that represent previously taxed income under subpart F. It further is expected that such regulations will provide for appropriate adjustments to the basis of stock held by the corporation treated as receiving the distribution or by the corporation that had the prior inclusion with respect to the previously taxed income. No inference is intended regarding the treatment of previously taxed income in a section 304 transaction under present law. The TRA of 1997 amendments to section 304, including the modifications under this provision, are not intended to change the foreign tax credit results reached in Rev. Ruls. 92-86 and 91-5. The provision also eliminates the cross-reference to the rules of section 1248(d) for purposes of determining the earnings and profits to be taken into account under section 304(b)(5).

Current California Law (R&TC Sec. 24551, 24966)

California law is in conformity with federal law as it read on January 1, 1998, as it relates to corporate stock transfers (AB 2797, Stat. 1998, Ch. 322). California law has not conformed to the federal changes made by the IRS Reform Act.

Effective Date

The provision generally is effective for distributions or acquisitions after June 8, 1997.

Impact on California Revenue

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be insignificant.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6010(e)	Certain Preferred Stock Treated as "Boot."

Background

Statute of Limitations. Under the TRA of 1997, certain preferred stock received in otherwise tax-free transactions is treated as "other property" (i.e., "boot"). Exchanges of stock in certain recapitalizations of family-owned corporations are excepted from this rule. A family-owned corporation is defined as any corporation if at least 50% of the total voting power and value of the stock of such corporation is owned by the same family for five years preceding the recapitalization. In addition, a recapitalization does not qualify for the exception if the same family does not own 50% of the total voting power and value of the stock throughout the three-year period following the recapitalization.

Treatment of Transferor. The TRA of 1997 amended section 351 of the Code to provide that in the case of a person who transfers property to a controlled corporation and receives nonqualified preferred stock, section 351(b) will apply to such person. Section 351(b) provides that if section 351(a) of the Code would apply to an exchange but for the fact that there is received, in addition to stock permitted to be received under section 351(a), other property or money, then gain but no loss to such recipient shall be recognized. The Conference Report to the TRA of 1997 states that if nonqualified preferred stock is received, gain but not loss shall be recognized.

New Federal Law (Sec. 351(g), 354(a))

Statute of Limitations. The provision provides that the statutory period for the assessment of any deficiency attributable to a corporation failing to be a family-owned corporation shall not expire before the expiration of three years after the date the Secretary of the Treasury is notified by the corporation (in such manner as the Secretary may prescribe) of such failure, and such deficiency may be assessed before the expiration of such three-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment

Treatment of Transferor. The provision clarifies that section 351(b) applies to a transferor who transfers property in a section 351 exchange and receives nonqualified preferred stock in addition to stock that is not treated as "other property" under that section. Thus, if a transferor received only nonqualified preferred stock but the transaction in the aggregate otherwise qualified as a section 351 exchange, such a transferor would recognize loss and the basis of the nonqualified preferred stock and of the property in the hands of the transferee corporation would reflect the transaction in the same manner as if that particular transferor had received solely "other property" of any other type. As under the TRA of 1997, the nonqualified preferred stock continues to be treated as stock received by a transferor for purposes of qualification of a transaction under section 351(a), unless and until regulations may provide otherwise.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Current California Law (R&TC Sec. 24451, 24951)

California law is in conformity with federal law as it read on January 1, 1998, as it relates to "boot" received in a reorganization (AB 2797, Stat. 1998, Ch. 322). California law has not conformed to the federal changes made by the IRS Reform Act.

Effective Date

The provision applies to transactions after June 8, 1997.

Impact on California Revenue

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be insignificant.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6010(f)	Establish IRS Continuous Levy and Improve Debt Collection.

Background

If any person is liable for any internal revenue tax and does not pay it within 10 days after notice and demand by the IRS, the IRS may then collect the tax by levy upon all property and rights to property belonging to the person, unless there is an explicit statutory restriction on doing so. A levy is the seizure of the person's property or rights to property. A levy on salary and wages is continuous from the date it is first made until the date it is fully paid or becomes unenforceable.

The TRA of 1997 provides that a continuous levy is also applicable to non-means-tested recurring federal payments and specified wage replacement payments.

New Federal Law (Sec. 6331)

The provision clarifies that the IRS must approve the use of a continuous levy before it may take effect.

Current California Law (R&TC Sec. 18671)

FTB, in concept, basically has the same collection remedies as the IRS. To collect on property of a tax debtor, FTB has the authority to issue orders to withhold to seize cash and cash equivalents and use warrants to have the property seized and sold. However, for California purposes, property or the value of property that is exempt from levy is provided under the Code of Civil Procedure, which is applicable to California judgment creditors, and for purposes of tax debts is subject to inflation adjustments under the Taxpayers' Bill of Rights. To garnish wages, which in essence is a continuous levy, FTB must follow the California Wage Garnishment Law that is applicable to California judgment creditors and generally limits the garnishment to 25% of each payment, with certain minimum wage restrictions, as required under federal law (75% of wages/salary is exempt from levy). In addition, FTB has the authority to issue continuous levies for 25% of the specific payment due or becoming due an individual (75% is exempt from levy) or 100% of the specific payment due or becoming due a corporate taxpayer (no payment is exempt from levy but a levy may be released due to hardship). The specific payments addressed in the new federal law (social security payments, railroad retirement, unemployment benefits, worker's compensation and certain public assistance) are basically 100% exempt from levy for California income or franchise tax collection purposes by virtue of the underlying federal laws that provide the benefits.

Effective Date

The provision is effective for levies issued after August 5, 1997, the date of enactment of the TRA of 1997.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6010(g)	Clarification Regarding Aviation Gasoline Excise Tax.

Background

Before enactment of the TRA of 1997, aviation gasoline was subject to a 19.3-cents-per-gallon tax rate, with 15 cents per gallon being deposited in the Airport and Airway Trust Fund and 4.3 cents per gallon being retained in the General Fund. The TRA of 1997 extended the 15-cents-per-gallon rate for 10 years, through September 30, 2007, and expanded deposits to the Trust Fund to include revenues from the 4.3-cents-per-gallon rate. The tax does not apply to fuel used in flight segments outside the United States or to flight segments from the United States to foreign countries.

New Federal Law (Sec. 4041, 6421, 9502)

The provision clarifies the application of the gasoline tax refund provisions to aviation gasoline used in flight segments outside the United States and to flight segments from the United States to foreign countries.

Current California Law

California fuel taxes are administered by the BOE.

Effective Date

The provision is effective as if included in the TRA of 1997.

Impact on California Revenue

Defer to the BOE.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6010(h)	Extension of Diesel Fuel Excise Taxes to Kerosene and Clarification of Requirement that Registered Fuel Terminals Offer Dyed Fuel.

Background

The TRA of 1997 contains rules which outline when aviation grade kerosene can be removed for use as an aviation fuel without payment of highway excise taxes.

The TRA of 1997 provides that fuel terminals are eligible to register to handle non-tax-paid diesel fuel and kerosene only if the terminal operator offers both undyed (taxable) and dyed (nontaxable) fuel. S. 1173, as passed by the Senate, and H.R. 2400, as passed by the House, would delay the effective date of this requirement for two years, until July 1, 2000.

New Federal Law (Sec. 4082, 4101)

The provision clarifies TRA of 1997 rules that outline when aviation grade kerosene can be removed for use as a aviation fuel without payment of highway excise taxes.

The provision also clarifies that the Code requires terminals eligible to handle non-tax-paid diesel to offer dyed diesel fuel and terminals eligible to handle non-tax-paid kerosene (including diesel fuel #1 and kerosene-type aviation fuel) to offer dyed kerosene. The provision does not require that a terminal offer for sale kerosene as a condition of receiving diesel fuel on a non-tax-paid basis. Similarly, the proposal does not require terminals that sell only kerosene to offer diesel fuel as a condition of receiving non-tax-paid kerosene.

Current California Law

California fuel taxes are administered by the BOE.

Effective Date

The provision is effective as if included in the TRA of 1997.

Impact on California Revenue

Defer to the BOE.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6010(i)	Clarification of Prepaid Telephone Cards.

A 3% excise tax is imposed on amounts paid for local and toll (long-distance) telephone service and teletypewriter exchange service. The tax is collected by the provider of the service from the consumer. In the case of so-called "prepaid telephone cards", the tax is treated as paid when the card is transferred by any telecommunications carrier to any person who is not a telecommunications carrier.

A "prepaid telephone card" is defined as any card or other similar arrangement which permits its holder to obtain communications services and pay for such services in advance.

New Federal Law (Sec. 4521)

The provision inserts the word "any" prior to "other similar arrangement" to clarify that payment to a telecommunications carrier from a third party such as a joint venture credit card company is treated as payment made by the holder of the credit card to obtain communication services and the tax is treated as paid in a manner similar to that applied to prepaid telephone cards. The tax applies to payments if the rights to telephone service for which payments are made can be used in whole or in part for telephone service that, if purchased directly, would be subject to the 3% excise tax on telephone service. Also, the tax applies without regard to whether telephone service ultimately is provided pursuant to the transferred rights.

Current California Law

Taxes on interstate telephone communication services are administered by the BOE.

Effective Date

The provision is effective as if included in the TRA of 1997.

Impact on California Revenue

Defer to BOE.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6010(j)	Modify UBI Rules Applicable to Second-Tier Subsidiaries.

Background

In general, interest, rents, royalties and annuities are excluded from the unrelated business income (UBI) of tax-exempt organizations. However, section 512(b)(13) treats otherwise excluded rent, royalty, annuity, and interest income as UBI if such income is received from a taxable or tax-exempt subsidiary that is controlled by the parent tax-exempt organization.

Interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization are subject to the unrelated business income tax to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity. In this regard, section 512(b)(13)(B)(i)(I) cross references a non-existent Code section.

Under the TRA of 1997, the above generally applies to taxable years beginning after the date of enactment. However, the provision does not apply to payments made during the first two taxable years beginning on or after the date of enactment if such payments are made pursuant to a binding written contract in effect as of June 8, 1997, and at all times thereafter before such payment.

New Federal Law (Sec. 512(b)(12))

The provision clarifies that rent, royalty, annuity, and interest income that would otherwise be excluded from UBI is included in UBI under section 512(b)(13) if such income is received or accrued from a taxable or tax-exempt subsidiary that is controlled by the parent tax-exempt organization. The provision further clarifies that the provision does not apply to any payment received or accrued during the first two taxable years beginning on or after the date of enactment if such payment is received or accrued pursuant to a binding written contract in effect on June 8, 1997, and at all times thereafter before such payment (but not pursuant to any contract provision that permits optional accelerated payments).

Current California Law (R&TC Sec. 23732)

California law is in conformity with modifications to federal law as it relates to UBI of tax-exempt organizations.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Effective Date

The provision is effective as of August 5, 1997, the date of enactment of the TRA of 1997.

Impact on California Revenue

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be insignificant.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6010(k)	Application of Foreign Tax Credit Holding Period Rule to RICs.

Background

Section 901(k), as added by the TRA of 1997, generally imposes a holding period requirement for claiming foreign tax credits with respect to dividends. Under section 901(k), foreign tax credits with respect to a dividend from a foreign corporation or a regulated investment company (RIC) are disallowed if the shareholder has not held the stock for more than 15 days in the case of common stock or more than 45 days in the case of preferred stock. This disallowance applies both to foreign tax credits for foreign withholding taxes that are paid on the dividend where the dividend-paying stock is not held for the required period and to indirect foreign tax credits for taxes paid by a lower-tier foreign corporation or a RIC where any of the stock in the required chain of ownership is not held for the required period. Foreign taxes for which credits are disallowed under section 901(k) may be deducted.

Under section 853, a RIC may elect to flow through to its shareholders the foreign tax credits for foreign taxes paid by the RIC. Under this election, the RIC is not entitled to a deduction or credit for foreign taxes paid; the shareholders of an electing RIC are treated as having paid their proportionate shares of the foreign taxes paid by the RIC. Accordingly, foreign tax credits are claimed at the shareholder level and not at the RIC level.

The TRA of 1997 added section 901(k), which denies a shareholder foreign tax credits normally available with respect to a dividend if the shareholder has not held the stock for a minimum period. Section 901(k)(4), "Exception for certain taxes paid by securities dealers," provides an exception for foreign tax credits with respect to certain dividends received on stock held in the active conduct of a securities business in a foreign country.

New Federal Law (Sec. 853, 901(k)(4))

Under the provision, the flow-through election of section 853 does not apply to any foreign taxes paid by the RIC for which a credit is disallowed under section 901(k) because the RIC did not satisfy the applicable holding period. Accordingly, such taxes are deductible at the RIC level. The election of section 853 applies only to foreign taxes with respect to which the RIC has satisfied any applicable holding period requirement.

The provision clarifies that the exception of section 901(k)(4) is available only for dividends received on stock that the shareholder holds in its capacity as a dealer in securities.

Current California Law

California does not have a comparable credit.

Effective Date

The provision is effective for dividends paid or accrued more than 30 days after the date of enactment of the TRA of 1997.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6010(m)	Clarification of Allocation of Basis of Properties Distributed to a Partner by a Partnership.

Background

Prior to the passage of the IRS Reform Act, federal law, as amended by the TRA of 1997, provided rules for allocating basis to property in the hands of a partner that received a distribution from a partnership. Under these rules, basis is first allocated to unrealized receivables and inventory items in an amount equal to the partnership's adjusted basis in each property. If the basis to be allocated is less than the sum of the adjusted bases of the properties in the hands of the partnership, then, to the extent a decrease is required to make the total adjusted bases of the properties equal the basis to be allocated, the decrease is allocated (as described below) for adjustments that are decreases. To the extent of any basis not allocated to inventory and unrealized receivables under the above rules, basis is allocated to other distributed properties, first to the extent of each distributed property's adjusted basis to the partnership. Any remaining basis adjustment, if an increase, is allocated among properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation (to the extent of each property's appreciation), and then in proportion to their respective fair market values. If the remaining basis adjustment is a decrease, it is allocated among properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation (to the extent of each property's depreciation), and then in proportion to their respective adjusted bases (taking into account the adjustments already made).

For purposes of these rules, “unrealized receivables” has the meaning set forth in section 751(c) (as provided in sec. 732(c)(1)(A)(i)). Section 751(c) provides that the term “unrealized receivables” includes certain accrued but unreported income. In addition, the last two sentences of section 751(c) provide that for purposes of certain specified partnership provisions (sections 731, 741 and 751), the term "unrealized receivables" includes certain property the sale of which will give rise to ordinary income (for example, depreciation recapture under sections 1245 or 1250), but only to the extent of the amount that would be treated as ordinary income on a sale of that property at fair market value.

New Federal Law (Sec. 751(c))

The technical correction clarifies that for purposes of the allocation rules of section 732(c), “unrealized receivables” has the meaning in section 751(c) including the last two sentences of section 751(c), relating to items of property that give rise to ordinary income. Thus, in applying the allocation rules of section 732(c) to property listed in the last two sentences of section

751(c), such as property giving rise to potential depreciation recapture, the amount of unrealized appreciation in any such property does not include any amount that would be treated as ordinary income if the property were sold at fair market value, because such amount is treated as a separate asset for purposes of the basis allocation rules.

Treasury regulations under section 751(b) provide for a similar bifurcation of assets among potential ordinary income amounts and other amounts in applying the definition of “unrealized receivables” for purposes of that section. Treas. Reg. 1.751-1(c)(4).

For example, assume that a partnership has three partners, A, C and D. The partnership has six assets. Three are capital assets each with adjusted basis equal to fair market value of $20,000. The other three are depreciable equipment each with adjusted basis of $5,000 and fair market value of $30,000. Each of the pieces of equipment would have $25,000 of depreciation recapture if sold by the partnership for its $30,000 value. A has a basis in its partnership interest of $60,000. Assume that one of the capital assets and one of the pieces of equipment is distributed to A in liquidation of its interest. A is treated as receiving three assets: (1) depreciation recapture (an unrealized receivable) with a basis to the partnership of zero and a value of $25,000; (2) a piece of equipment with a basis to the partnership of $5,000 and a value of $5,000 (its $30,000 value reduced by the $25,000 of depreciation recapture); and (3) a capital asset with a basis to the partnership of $20,000 and a value of $20,000.

Under the provision, as clarified by the technical correction, A's $60,000 basis in its partnership interest is allocated as follows. First, basis is allocated to the depreciation recapture, an unrealized receivable, in an amount equal to the partnership's adjusted basis in it, or zero (sec. 732(c)(1)(A)). Then basis is allocated to the extent of each of the other distributed properties' adjusted basis to the partnership, or $5,000 to the equipment (not including the depreciation recapture), and $20,000 to the capital asset. A's remaining $35,000 of basis is allocated next among properties (other than inventory and unrealized receivables) with unrealized appreciation, in proportion to their respective amounts of unrealized appreciation (to the extent of each property's appreciation), but neither of the distributed properties to which basis may be allocated has unrealized appreciation. Basis is then allocated in proportion to the properties' respective fair market values ($5,000 for the equipment and $20,000 for the capital asset). Thus, of the remaining $35,000, $7,000 is allocated to the equipment, so that its total basis in the partner's hands is $12,000; and $28,000 is allocated to the capital asset, so that its total basis in the partner's hands is $48,000.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Current California Law (R&TC Sec. 17851)

California law is in conformity with federal law as it read on January 1, 1998, as it relates to partnership distributions (AB 2797, Stat. 1998, Ch. 322). California law has not conformed to the federal changes made by the IRS Reform Act.

Effective Date

The provision is effective as if enacted with the TRA of 1997.

Impact on California Revenue

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be insignificant.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6010(o)	Clarification of Expanding the Limitations on Deductibility of Premiums and Interest with Respect to Life Insurance, Endowment and Annuity Contracts.

Background

Master Contracts. The TRA of 1997 provided limitations on the deductibility of interest and premiums with respect to life insurance, endowment and annuity contracts. Under the pro rata interest disallowance provision added by the Act, an exception is provided for any policy or contract owned by an entity engaged in a trade or business, covering an individual who is an employee, officer or director of the trade or business at the time first covered. The exception applies to any policy or contract owned by an entity engaged in a trade or business, which covers one individual who (at the time first insured under the policy or contract) is (1) a 20% or more owner of the entity, or (2) an individual (who is not a 20% owner) who is an officer, director or employee of the trade or business. The exception also applies in the case of a joint-life policy or contract under which the sole insureds are a 20% owner and the spouse of the 20% owner. A joint-life contract under which the sole insureds are a 20% owner and his or her spouse is the only type of policy or contract with more than one insured that comes within the exception.

The provision is silent as to the treatment of coverage of such an individual under a master contract.

Reporting. The TRA of 1997 provision does not apply to any policy or contract held by a natural person; however, if a trade or business is directly or indirectly the beneficiary under any policy or contract, the policy or contract is treated as held by the trade or business and not by a natural person. In addition, the provision includes a reporting requirement. Specifically, the provision provides that the Treasury Secretary shall require such reporting from policyholders and issuers as is necessary to carry out the rule applicable when the trade or business is directly or indirectly the beneficiary under any policy or contract held by a natural person. Any report required under this reporting requirement is treated as a statement referred to in Code section 6724(d)(1) (relating to information returns). The provision does not specifically refer to Code section 6724(d)(2) (relating to payee statements).

Additional Covered Lives. The TRA of 1997 provision limiting the deductibility of certain interest and premiums is effective generally with respect to contracts issued after June 8, 1997. To the extent of additional covered lives under a contract after June 8, 1997, the contract is treated as a new contract.

New Federal Law (Sec. 264(f), 6724(d))

Master Contracts. The technical correction clarifies that if coverage for each insured individual under a master contract is treated as a separate contract for purposes of sections 817(h), 7702, and 7702A of the Code, then coverage for each such insured individual is treated as a separate contract for purposes of the exception to the pro rata interest disallowance rule for a policy or contract covering an individual who is a 20% owner, employee, officer or director of the trade or business at the time first covered. A master contract does not include any contract if the contract (or any insurance coverage provided under the contract) is a group life insurance contract within the meaning of Code section 848(e)(2). No inference is intended that coverage provided under a master contract, for each such insured individual, is not treated as a separate contract for each such individual for other purposes under present law.

Reporting. The technical correction clarifies that the required reporting to the Treasury Secretary is an information return (within the meaning of section 6724(d)(1)), and any reporting required to be made to any other person is a payee statement (within the meaning of section 6724(d)(2)). Thus, the $50-per-report penalty imposed under sections 6722 and 6723 of the Code for failure to file or provide such an information return or payee statement apply. It is clarified that the Treasury Secretary may require reporting by the issuer or policyholder of any relevant information either by regulations or by any other appropriate guidance (including but not limited to publication of a form).

Additional covered lives. The technical correction clarifies that the treatment of additional covered lives under the effective date of the TRA of 1997 provision applies only with respect to coverage provided under a master contract, provided that coverage for each insured individual is treated as a separate contract for purposes of Code sections 817(h), 7702 and 7702A, and the master contract or any coverage provided thereunder is not a group life insurance contract within the meaning of Code section 848(e)(2).

Current California Law (R&TC Sec. 17201, 17279.5, 24424)

California law is in conformity with federal law as it read on January 1, 1998, as it relates to the deductibility of premiums and interest with respect to life insurance, endowment and annuity contracts (AB 2797, Stat. 1998, Ch. 322). California law has not conformed to the federal changes made by the IRS Reform Act.

Effective Date

The provisions are effective as if included in the TRA of 1997 (contracts issued after June 8, 1997).

Impact on California Revenue

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be insignificant.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6010(p)	Clarification to the Definition of Modified AGI for Purposes of the Earned Income Credit Phaseout.

Background

The earned income credit (EIC) is phased out above certain income levels. For individuals with earned income (or modified adjusted gross income (modified AGI), if greater) in excess of the beginning of the phaseout range, the maximum credit amount is reduced by the phaseout rate multiplied by the amount of earned income (or modified AGI, if greater) in excess of the beginning of the phaseout range. For individuals with earned income (or modified AGI, if greater) in excess of the end of the phaseout range, no credit is allowed. The definition of modified AGI used for the phase out of the earned income credit is the sum of: (1) AGI with certain losses disregarded, and (2) certain nontaxable amounts not generally included in AGI. The losses disregarded are: (1) net capital losses (if greater than zero); (2) net losses from trusts and estates; (3) net losses from nonbusiness rents and royalties; and (4) 75% of the net losses from business, computed separately with respect to sole proprietorships (other than in farming), sole proprietorships in farming, and other businesses.

The nontaxable amounts included in modified AGI which are generally not included in AGI are: (1) tax-exempt interest; and (2) nontaxable distributions from pensions, annuities, and individual retirement arrangements (but only if not rolled over into similar vehicles during the applicable rollover period).

New Federal Law (Sec. 32(c))

The provision clarifies that the two nontaxable amounts that are added to adjusted gross income to compute modified AGI for purposes of the EIC phaseout are additions to adjusted gross income, and not the disregarded losses.

Current California Law

California does not have a comparable credit.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

Impact on California Revenue

Not applicable.

Section	Section Title
6011	Clarification of Treatment of Passive Foreign Investment Company.

Background

Option Holders. Under the provisions of subpart F, a controlled foreign corporation (CFC) is defined generally as any foreign corporation if U.S. persons own more than 50% of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10% of the stock (measured by vote only) (sec. 957). Stock ownership includes not only stock owned directly, but also stock owned indirectly through a foreign entity or constructively (sec. 958). Pursuant to the constructive ownership rules, a person that has an option to acquire stock generally is treated as owning such stock (secs. 958(b) and 318(a)(4)).

The U.S. 10% shareholders of a CFC are subject to current U.S. tax on their pro rata shares of certain income of the CFC and their pro rata shares of the CFC's earnings invested in certain U.S. property (sec. 951). For purposes of determining the U.S. shareholder's includible pro rata share of the CFC's income and earnings, only stock held directly or indirectly through a foreign entity (and not stock held constructively) is taken into account (secs. 951(b) and 958(a)). A foreign corporation is a passive foreign investment company (PFIC) if it satisfies a passive income test or a passive assets test for the taxable year (sec. 1297). A U.S. shareholder of a PFIC generally is subject to U.S. tax, plus an interest charge, on distributions from a PFIC and gain realized upon a disposition of PFIC stock (sec. 1291). Alternatively, the U.S. shareholder may elect either to be subject to current U.S. tax on the shareholder's share of the PFIC's earnings or, in the case of PFIC stock that is marketable, to mark to market the PFIC stock (secs. 1293 and 1296). For purposes of the PFIC provisions, constructive ownership rules apply (sec. 1298(a)). Under these rules, an option to acquire stock is treated as stock for purposes of applying the interest charge regime to a disposition of such option, and the holding period for stock acquired pursuant to the exercise of an option includes the holding period for such option (sec. 1298(a)(4) and Prop. Treas. Reg. secs. 1.1291-1(d) and (h)(3)).

A corporation that is a CFC is also a PFIC if it meets the passive income test or the passive assets test. Under section 1297(e), as added by the TRA of 1997, a corporation is not treated as a PFIC with respect to a shareholder during the period after December 31, 1997 in which the corporation is a CFC and the shareholder is a U.S. shareholder (within the meaning of section 951(b)) thereof. Under this rule eliminating the overlap between the PFIC and CFC provisions, a shareholder that is subject to the subpart F rules with respect to a corporation is not also subject to the PFIC rules with respect to such corporation.

Application of PFIC Mark-to-Market Rules to RICs. Under section 1296, as added by the TRA of 1997, a shareholder of a PFIC may make a mark-to-market election with respect to the stock of the PFIC, provided that such stock is marketable. Under this election, the shareholder includes in income each year an amount equal to the excess, if any, of the fair market value of the PFIC stock as of the close of the taxable year over the shareholder's adjusted basis in such stock. The shareholder is allowed a deduction for the excess, if any, of the shareholder's adjusted basis in the PFIC stock over its fair market value as of the close of the taxable year, but only to the extent of any net mark-to-market gains with respect to such stock included by the shareholder under section 1296 for prior years.

The mark-to-market election of section 1296 is effective for taxable years of U.S. persons beginning after December 31, 1997, and taxable years of foreign corporations ending with or within such taxable years of U.S. persons. Prior to the enactment of section 1296, a proposed Treasury regulation provided for a mark-to-market election with respect to PFIC stock held by certain regulated investment companies (RICs) (Prop. Treas. Reg. sec. 1.1291-8). Under this mark-to-market election, gains but not losses were recognized.

Section 1296(j) provides rules applicable in the case of a shareholder that makes a mark-to-market election under section 1296 later than the beginning of the shareholder's holding period for the PFIC stock. Special rules apply in the case of a RIC that makes such a mark-to-market election under section 1296 with respect to PFIC stock that the RIC had previously marked to market under the proposed Treasury regulation.

Interaction Between the PFIC Provisions and Other Mark-to-Market Rules. A U.S. shareholder of a PFIC generally is subject to U.S. tax, plus an interest charge, on distributions from a PFIC and gain realized upon a disposition of PFIC stock (sec. 1291). As an alternative to this interest charge regime, the U.S. shareholder may elect to be subject to current U.S. tax on the shareholder's share of the PFIC's earnings (sec. 1293). Section 1296, as added by the TRA of 1997, provides another alternative available in the case of a PFIC the stock of which is marketable; under section 1296, a U.S. shareholder of a PFIC may make a mark-to-market election with respect to the stock of the PFIC.

The interest charge regime generally does not apply to distributions from, and dispositions of stock of, a PFIC for which the U.S. shareholder has made either a mark-to-market election under section 1296 or an election to include the PFIC's earnings in income currently (sec. 1291(d)(1)). However, special coordination rules provide for limited application of the interest charge regime in the case of a U.S. shareholder that makes a mark-to-market election under section 1296 later than the beginning of the shareholder's holding period for the PFIC stock (sec. 1296(j)).

Under section 475(a), a dealer in securities is required to mark to market certain securities held by the dealer. Under section 475(f), as added by the TRA of 1997, a trader in securities may elect to mark to market securities held in connection with the person's trade or business as a trader in securities. Other provisions similarly allow stock to be marked to market (e.g., sec. 1092(b)(1) and Temp. Treas. Reg. sec. 1.1092-4T).

New Federal Law (Sec. 1296, 1297, 1298, 1291(d))

Option Holders. Under the provision, the elimination of the overlap between the PFIC and the CFC provisions generally does not apply to a U.S. person with respect to PFIC stock that such person is treated as owning by reason of an option to acquire such stock. Accordingly, for example, the PFIC rules continue to apply to a U.S. person that holds only an option on stock of a corporation that is a CFC because such person does not own stock of such corporation directly or indirectly through a foreign entity and therefore is not subject to the current inclusion rules of subpart F with respect to such corporation. However, under the provision, the elimination of the overlap will apply to a U.S. person that holds an option on stock if such stock is held by a person that is subject to the current inclusion rules of subpart F with respect to such stock and is not a tax-exempt person. Accordingly, an option holder is not subject to the PFIC rules with respect to an option if the option is on stock that is held by a non-tax-exempt person that is subject to the current inclusion rules of subpart F with respect to such stock.

Application of PFIC Mark-to-Market Rules to RICs. Under the provision, for purposes of determining allowable deductions for any excess of the shareholder's adjusted basis in PFIC stock over the fair market value of the stock as of the close of the taxable year, deductions are allowed to the extent not only of prior mark-to-market inclusions under section 1296 but also of prior mark-to-market inclusions under the proposed Treasury regulation applicable to a RIC that holds stock in a PFIC.

Interaction Between the PFIC Provisions and Other Mark-to-Market Rules. Under the provision, the interest charge regime generally does not apply to distributions from, and dispositions of stock of, a PFIC where the U.S. shareholder has marked to market such stock under section 475 or any other provision (in the same manner that such regime does not apply where the shareholder has marked to market such stock under section 1296). In addition, under the provision, coordination rules like those provided in section 1296(j) apply in the case of a U.S. shareholder that marks to market PFIC stock under section 475 or any other provision later than the beginning of the shareholder's holding period for the PFIC stock. No inference is intended regarding the treatment of PFIC stock that was marked to market prior to the effective date of the provision.

Current California Law

California does not follow the PFIC rules and in general, does not conform to the federal rules relating to controlled foreign corporations. However, for California water’s-edge purposes, a controlled foreign corporation (CFC) is required to be included in the water’s-edge combined report if the CFC has Subpart F income defined in Section 952 of the IRC.

With respect to a "water's-edge election," the income subject to California apportionment is generally the income for federal purposes of the corporations within the electing group, including the income under the federal rules for Subpart F income.

Effective Date

The provision is effective for taxable years of U.S. persons beginning after December 31, 1997, and taxable years of foreign corporations ending with or within such taxable years of U.S. persons.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6011(f)	Information Reporting with Respect to Certain Foreign Corporations and Partnerships.

Background

The TRA of 1997 provides that reporting rules apply to controlled foreign corporations and foreign partnerships (sec. 6038).

New Federal Law (Sec. 6038)

The provision provides clarification and guidance relating to the furnishing of required information to be provided by the Secretary of the Treasury (not specifically through regulations) and conforms the use of the defined term "foreign business entity."

Current California Law (R&TC Sec. 19141.5)

California law conforms to the foreign partnership reporting requirement with the exception that the penalty for failure to furnish such information shall not apply for California purposes. California has not conformed to the changes made by the IRS Reform Act.

Effective Date

The provision is effective as if enacted with the TRA of 1997.

Impact on California Revenue

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be insignificant.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6012(a)	Travel Expenses of Federal Employees Participating in a Federal Criminal Investigation.

Background

Unreimbursed ordinary and necessary travel expenses paid or incurred by an individual in connection with temporary employment away from home (e.g., transportation costs and the cost of meals and lodging) are generally deductible, subject to the 2% floor on miscellaneous itemized deductions. Travel expenses paid or incurred in connection with indefinite employment away from home, however, are not deductible. A taxpayer's employment away from home in a single location is indefinite rather than temporary if it lasts for one year or more; thus, no deduction is permitted for travel expenses paid or incurred in connection with such employment (sec. 162(a)). If a taxpayer's employment away from home in a single location lasts for less than one year, whether such employment is temporary or indefinite is determined on the basis of the facts and circumstances.

The TRA of 1997 provided that the one-year limitation with respect to deductibility of expenses while temporarily away from home does not include any period during which a federal employee is certified by the Attorney General (or the Attorney General's designee) as traveling on behalf of the federal Government in a temporary duty status to investigate or provide support services to the investigation of a federal crime. Thus, expenses for these individuals during these periods are fully deductible, regardless of the length of the period for which certification is given (provided that the other requirements for deductibility are satisfied).

New Federal Law (Sec. 162(a))

The provision clarifies that prosecuting a federal crime or providing support services to the prosecution of a federal crime is considered part of investigating a federal crime.

Current California Law (R&TC Sec. 17201)

California law is in conformity with federal law as it read on January 1, 1998, as it relates to travel expenses of certain federal employees (AB 2797, Stat. 1998, Ch. 322). California law has not conformed to the federal changes made by the IRS Reform Act.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Effective Date

The provision is effective for amounts paid or incurred with respect to taxable years ending after the date of enactment of the TRA of 1997.

Impact on California Revenue

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be insignificant.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6012(d)	Magnetic Media Returns for Partnerships With More Than 100 Partners.

Background

The TRA of 1997 provides that the Treasury Secretary is to require partnerships with more than 100 partners to file returns on magnetic media (sec. 6011(e)). A penalty is to be imposed in the case of failure to meet magnetic media requirements.

New Federal Law (Sec. 6724(c))

The provision clarifies that the penalty under section 6724(c) for failure to comply with the requirement of filing returns on magnetic media applies to the extent such a failure occurs with respect to more than 100 information returns, in the case of a partnership with more than 100 partners.

Current California Law (R&TC Sec. 17524)

California does not have a requirement that partnerships of any size file on magnetic media. However, the Franchise Tax Board does allow a partnership to file its tax return on magnetic media. For the 1996 processing year, approximately 250 partnerships (encompassing almost 1 million K-1s) filed on magnetic media.

Effective Date

The provision is effective as if enacted with the TRA of 1997.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6012(e)	Effective Date for Provisions Relating to Electing Large Partnerships, Partnership Returns Required on Magnetic Media, and Treatment of Partnership Items of IRAs.

Background

Rules for simplified flow through and simplified audit procedures for electing large partnerships, as well as a March 15 due date for furnishing information to partners of an electing large partnership, were added to present law by the TRA of 1997. The TRA of 1997 also added a rule providing that partnership returns are required on magnetic media, and modified the treatment of partnership items of individual retirement arrangements. The TRA of 1997 statement of managers provided that these provisions apply to partnership taxable years beginning after December 31, 1997. The statute provided that the rules for simplified flow through for electing large partnerships apply to partnership taxable years beginning after December 31, 1997 (Act sec. 1221(c)), although the statute also provided that all the provisions apply to partnership taxable years ending on or after December 31, 1997 (Act sec. 1226).

New Federal Law

The technical correction provides that these provisions apply to partnership taxable years beginning after December 31, 1997.

Current California Law

California law has not conformed to the "electing large partnership" provisions and the mandatory electronic filing requirements of partnership returns.

Effective Date

The provision is effective as if enacted in the TRA of 1997.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6012(g)	Modification of Distribution Rules for REITs.

Background

In general, a real estate investment trust (REIT) is an entity that receives most of its income from passive real estate investments and meets certain other requirements. A REIT receives conduit treatment (i.e., one level of tax) for income distributed to its shareholders. A REIT generally must distribute 95% of its earnings (sec. 857(a)(1)). An entity loses its status as a REIT if it retains non-REIT earnings and profits (sec. 857(a)(2)). A REIT simplification provision in the TRA of 1997 provides that any distribution from a REIT will be deemed to first come from the earliest earnings and profits of the entity. As a result, in the case of a REIT with accumulated REIT earnings and profits that inherits subsequently earned non-REIT earnings and profits (e.g., by way of merger with a C corporation), the entity must distribute both the accumulated REIT earnings and profits as well as the inherited non-REIT earnings and profits under the TRA of 1997 provision in order to retain its REIT status.

New Federal Law (Sec. 857(d)(3)(A))

The provision amends the simplification provision to provide that any distribution from a REIT will be deemed to first come from earnings and profits that were generated when the entity did not qualify as a REIT. The provision does not change the requirement that a REIT must distribute 95% of its REIT earnings, or any other requirement.

Current California Law (R&TC Sec. 17088, 24870, 24872-24874)

California conforms to the federal treatment of REITs prior to the passage of the IRS Reform Act with the following modifications:

- REIT taxable income does
  - not include a deduction for dividends received,
  - not include a deduction for the tax imposed for not meeting the 95% or 75% income test,
  - include income from foreclosure property,
  - include income from prohibited transactions.

- Taxes on “income from foreclosed property," “income of a prohibited transaction," “alternative tax on capital gains” and failure to meet the 95% or 75% income test do not apply.

- A REIT is subject to the corporate minimum tax (currently $800).

- A REIT cannot be part of a stapled group.

However, to avoid state and federal law differences in whether a REIT will qualify as such for state purposes, California has a rule whereby if the REIT satisfies the distribution requirements of federal law so as to be treated as a REIT, it will be deemed to satisfy such requirements for state purposes (even if federal-state REIT income differences make it otherwise impossible for the REIT to satisfy the distribution requirements for state purposes).

Effective Date

The provision is effective for taxable years beginning after August 5, 1997.

Impact on California Revenue

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be insignificant.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6013(a)	Clarification of Treatment of Revocable Trusts for Purposes of the Generation-Skipping Transfer Tax.

Background

The TRA of 1997 provided an irrevocable election to treat a qualified revocable trust as part of the decedent's estate for federal income tax purposes. For this purpose, a qualified revocable trust is any trust (or portion thereof) which was treated as owned by the decedent with respect to whom the election is being made, by reason of a power in the grantor (i.e., trusts that are treated as owned by the decedent solely by reason of a power in a nonadverse party would not qualify). A conforming change was also made to section 2652(b) for generation-skipping transfer tax purposes.

New Federal Law (Sec. 654, 2652, 2654)

The provision clarifies that the election to treat a qualified revocable trust as part of the decedent's estate would apply for generation-skipping transfer tax purposes only with respect to the application of section 2654(b) (describing when a single trust may be treated as two or more trusts). The election has no other effect for generation-skipping transfer tax purposes.

Current California Law (R&TC Secs. 17731-17737 and 17742-17745.1)

California does not impose a gift tax, and the California estate tax is a "pick-up" tax, that is, the state tax is equal to the maximum credit for a state tax on the federal estate tax return for that particular decedent's estate. This "pick-up" tax is administered by the State Controller's Office.

In general, except for those provisions not applicable because they relate directly to either the federal estate or gift tax (as distinguished from income tax provisions affecting estates, trusts, beneficiaries and decedents), California law conforms to federal law relating to estates, trusts, beneficiaries, and decedents as it read January 1, 1998.

Effective Date

The provision applies to decedents dying after the date of enactment of the TRA of 1997.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6013(b)	Provision of Regulatory Authority for Simplified Reporting of Funeral Trusts Terminated During the Taxable Year.

Background

The TRA of 1997 provided an election which allows the trustee of a qualified pre-need funeral trust to elect special tax treatment for such a trust, to the extent the trust would otherwise be treated as a grantor trust. As part of this provision, the Secretary of the Treasury was granted regulatory authority to prescribe rules for simplified reporting of all trusts having a single trustee.

New Federal Law (Sec. 685(b) & (f))

The provision clarifies that a pre-need funeral trust may continue to qualify for these special rules for the 60-day period after the decedent's death, even though the trust ceases to be a grantor trust during that time. In addition, the provision extends the Secretary's regulatory authority to include rules providing for the inclusion of trusts terminated during the year (e.g., in the event of the death of the beneficiary) in the simplified reporting.

Current California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to qualified funeral trusts. California law has not conformed to the federal changes made by the IRS Reform Act.

Effective Date

The provision applies to decedents dying after the date of enactment of the TRA of 1997.

Impact on California Revenue

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be insignificant.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6014	Excise Tax Provisions Relating to Wine and Beer.

Background

The TRA of 1997 added a provision that tax is refunded when tax-paid wine is returned to a winery or tax-paid beer is returned to a brewery (secs. 5044 and 5056). The Code provisions allowing these refunds speak of beverages produced in the United States. A separate provision of the TRA of 1997 provided that beer and wine imported “in bulk” would be taxed under the rules for domestically produced beverages.

Prior to the TRA of 1997, imported beer and wine always were taxed upon importation (secs. 5043 and 5054). The TRA of 1997 added provisions for non-tax-paid transfers of bulk imports to breweries and wineries (secs. 5364 and 5418).

Wine is subject to an excise tax ranging from $1.07 per gallon to $3.40 per gallon, depending on its alcohol content. Distilled spirits are subject to excise tax at a rate of $13.50 per proof gallon. A tax credit equal to the difference between the distilled spirits tax rate and the wine tax rate is allowed for wine that is blended into distilled spirits products (sec. 5010). The wine excise tax is imposed on removal of the beverage from a winery, or on importation. The TRA of 1997 included a provision allowing wine to be imported in bulk and transferred to a U.S. winery without payment of tax (generally until the wine is removed from the winery).

U.S. law defines wine generally as alcohol that is derived from fruit or fruit residues (“natural wine”). Natural wine may not be fortified with grain or other non-fruit derived alcohol if produced in the U.S. Certain other countries allow wine that is marketed as a natural wine to be fortified with alcohol from other sources. U.S. law follows the laws of the country of origin in classifying imported wine.

New Federal Law (Sec. 5043(a), 5044(a), 5054, 5056, 5364)

The provision provides that the two sets of refund provisions (Code sections 5044 and 5056 and the TRA of 1997) are coordinated with the provision on tax treatment of bulk imports. Transfers of bulk imports of wine to wineries or beer to breweries.

The provision conforms the excise tax in all cases on importation to recognize these allowed transfers. Under the provision, liability for tax payment shifts to the brewery or winery when bulk imports are transferred with payment of tax, just as those parties are liable for payment of tax on domestically produced beer and wine.

The provision clarifies that the provision of the TRA of 1997 liberalizing rules for bulk importation of wine applies only to alcohol that would qualify as a natural wine if produced in the United States.

Current California Law

The Franchise Tax Board does not administer excise taxes. Where applicable, excise taxes are normally administered by the BOE.

Effective Date

The provision is effective as if included in the TRA of 1997.

Impact on California Revenue

Defer to the BOE.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6015(c)	Treatment of Certain Disability Payments to Public Safety Employees.

Background

Under present law, certain payments made on behalf of full-time employees of any police or fire department organized and operated by a state (or any political subdivision, agency, or instrumentality thereof) are excludable from income. This treatment applies to payments made on account of heart disease or hypertension of the employee and that were received in 1989, 1990, or 1991 pursuant to a state law as amended on May 19, 1992, which irrebuttably presumed that heart disease and hypertension are work-related illnesses (but only for employees separating from service before July 1, 1992). Claims for refund or credit for overpayments resulting from the provision may be filed up to one year after August 5, 1997, without regard to the otherwise applicable statute of limitations.

New Federal Law (Sec. 6015(c))

In order to address problems taxpayers are encountering with the IRS in seeking refunds under the old provision, the new provision clarifies the scope of the provision.

The provision provides that payments made on account of heart disease or hypertension of the employee and that were received in 1989, 1990, or 1991 pursuant to a state law as described under present law, or received by an individual referred to in such state law under any other statute, ordinance, labor agreement, or similar provision as a disability pension payment or in the nature of a disability pension payment attributable to employment as a police officer or as a fireman, will be excludable from income.

Current California Law (R&TC Sec. 17501)

California law is in conformity with federal law as it read on January 1, 1998, as it relates to disability payments made to public safety employees (AB 2797, Stat. 1998, Ch. 322). However, California law was not amended on May 19, 1992; therefore, the above provision has no impact on California.

Effective Date

The provision is effective as if included in the TRA of 1997.

Impact on California Revenue

No impact.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6016(a)	Application of Requirements for SIMPLE IRAs in the Case of Mergers and Acquisitions.

Background

If an employer maintains a qualified plan and a SIMPLE IRA in the same year due to an acquisition, disposition or similar transaction, the SIMPLE IRA is treated as a qualified salary reduction arrangement for the year of the transaction and the following calendar year, provided rules similar to the special coverage rules of section 410(b)(6)(C) apply. There is a similar provision with respect to an employer who, because of an acquisition, disposition or similar transaction, fails to be an eligible employer because such employer employs more than 100 employees. In this situation, the employer is treated as an eligible employer for two years following the transaction, provided rules similar to the coverage rules of section 410(b)(6)(C)(i) apply.

New Federal Law (Sec. 408(p))

The provision conforms the treatment applicable to SIMPLE IRAs upon acquisition, disposition or similar transactions for purposes of (1) the 100 employee limit, (2) the exclusive plan requirement, and (3) the coverage rules for participation. In the event of such a transaction, the employer will be treated as an eligible employer and the arrangement will be treated as a qualified salary reduction arrangement for the year of the transaction and the two following years, provided rules similar to the rules of section 410(b)(6)(C)(i) are satisfied and the arrangement would satisfy the requirements to be a qualified salary reduction arrangement after the transaction if the trade or business that maintained the arrangement prior to the transaction had remained a separate employer.

Current California Law (R&TC Sec. 17501)

California law is in conformity with federal law as it read on January 1, 1998, as it relates to SIMPLE IRAs. California law has not conformed to the federal changes made by the IRS Reform Act.

Effective Date

The provision is effective as if included in the Small Business Job Protection Act of 1996.

Impact on California Revenue

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be insignificant.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6016(a)	Treatment of Indian Tribal Governments.

Background

Any 403(b) annuity contract purchased by an Indian tribal government in a plan year beginning before January 1, 1995, is treated as purchased by an entity permitted to maintain a tax-sheltered annuity plan. Such contracts may be rolled over into a section 401(k) plan maintained by the Indian tribal government in accordance with the rollover rules of section 403(b)(8). An employee participating in a 403(b) annuity contract of the Indian tribal government may roll over amounts from such contract to a section 401(k) plan maintained by the Indian tribal government whether or not the annuity contract is terminated.

New Federal Law

The provision clarifies that an employee participating in a 403(b)(7) custodial account of the Indian tribal government may roll over amounts from such account to a section 401(k) plan maintained by the Indian tribal government.

Current California Law

California law has no comparable provisions relating to Indian tribal governments.

Effective Date

The provision is effective as if included in the Small Business Job Protection Act of 1996.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6017	Simplified Refund Provisions for Tax on Gasoline, Diesel Fuel and Kerosene.

The Transportation Equity Act for the 21st Century (TEA 21) (1998) included a provision combining the Code refund provisions for gasoline, diesel fuel, and kerosene, and reducing the minimum claim amount. Under TEA 21, claims may be filed once a $750 threshold is reached for gasoline, diesel fuel, and kerosene combined, and overpayments attributable to multiple calendar quarters may be aggregated in determining whether this threshold is met (rather than claims being filed only with respect to a single calendar quarter).

New Federal Law (Sec. 6427(i))

The provision provides a current Code timing provision to reflect the portion of the TEA 21 provision that allows aggregation of multiple calendar quarters into a single refund claim.

Current California Law

California fuel taxes are administered by BOE.

Effective Date

The provision is effective as if included in Transportation Equity Act for the 21st Century.

Impact on California Revenue

Defer to BOE.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6018(f)	Treatment of Adoption Tax Credit Carryovers.

Background

Under present law taxpayers are allowed a maximum nonrefundable credit against income tax liability of $5,000 per child for qualified adoption expenses paid or incurred by the taxpayer. In the case of a special needs adoption, the maximum credit amount is $6,000 ($5,000 in the case of a foreign special needs adoption). To the extent the otherwise allowable credit exceeds the tax liability limitation of section 26 (reduced by other personal credits) the excess is carried forward as an adoption credit into the next taxable year, up to a maximum of five taxable years.

The credit is phased out ratably for taxpayers with modified adjusted gross income (AGI) above $75,000, and is fully phased out at $115,000 of modified AGI. For these purposes modified AGI is computed by increasing the taxpayer's AGI by the amount otherwise excluded from gross income under Code sections 911, 931, or 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands, and residents of Puerto Rico, respectively).

New Federal Law (Sec. 23(b)(2))

The provision clarifies that the AGI phaseout applies only in the year that the credit is generated and is not reapplied to further reduce any carryforward amounts.

Current California Law (R&TC Sec. 17052.25)

Since 1994, California allows a credit equal to 50% of the cost of adopting a minor child who is an American citizen and is in the custody of a California public agency or a political subdivision of California. The credit is to be claimed in the taxable year in which the decree or order of adoption is entered, although qualifying costs paid or incurred in prior years can qualify for the credit. Costs eligible for the credit include:

- fees for required services of either the Department of Social Services or a licensed adoption agency;
- travel and related expenses for the adoptive family that are directly related to the adoption process; and
- medical fees and expenses that are not reimbursed by insurance and are directly related to the adoption process.

The maximum allowable credit cannot exceed $2,500 per minor child; however, credit amounts exceeding the net tax may be carried over to succeeding taxable years until exhausted. Otherwise deductible medical expenses relating to child adoption costs are reduced by the amount of the credit.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

California law has conformed to federal provision that provides a maximum $5,000 ($6,000 for certain special needs adoptions) exclusion from the gross income of an employee for specified certain adoption expenses paid by the employer. The limit is a per child limit, not an annual limitation. The exclusion is phased out ratably for taxpayers with modified AGI above $75,000 and is fully phased out at $115,000 of modified AGI.

Effective Date

The provision is effective as if included in the Small Business Job Protection Act of 1996.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6019(a)	Disclosure Requirements for Apostolic Organizations.

Background

Section 501(d) provides tax-exempt status to certain religious or apostolic associations or corporations, if such associations or corporations have a common treasury or community treasury, even if such associations or corporations engage in business for the common benefit of the members, but only if the members thereof include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the taxable income of the association or corporation for such year. Under section 501(d), the requirement of a “common treasury” or “community treasury” is satisfied when all of the income generated from property owned by the organization is placed into a common fund that is maintained by such organization and is used for the maintenance and support of its members, with all members having equal, undivided interests in this common fund, but no right to claim title to any part thereof.

Any amount so included in the gross income of a member is treated as a dividend received. The effect of section 501(d) is to exempt the religious and apostolic associations or corporations which conduct communal activities (such as farming) from the Federal corporate-level income tax and the undistributed-profits tax, provided that members claim their shares of the corporation's income on their own individual returns.

Section 6033 generally requires tax-exempt organizations to file annual information returns, and such information returns are available for public inspection under sections 6104(b) and 6104(e), except that public disclosure is not required of the identity of contributors to an organization. Section 501(d) entities must include with their annual information return (Form 1065) a Schedule K-1 that identifies the members of the association or corporation and their ratable portions of net income and expenses.

New Federal Law (Sec. 6104)

The provision amends sections 6104(b) and 6104(e) to provide that public disclosure is not required of a Schedule K-1 filed by a religious or apostolic organization described in section 501(d).

Current California Law (R&TC Sec. 19565)

California law provides that an organization's application for exemption and any underlying documents that supported the application be open to public inspection. The Franchise Tax Board is to withhold information from public inspection that relates to trade secrets, patents, work process or style of work of the organization. Additionally, the Franchise Tax Board shall withhold information from public inspection that would adversely affect national defense if released.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Effective Date

The provision is effective on the date of enactment.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6019(c)	Disclosure of Returns and Return Information.

Background

The rules regarding disclosure of returns and return information were amended in 1996 by the Taxpayer Bill of Rights 2 to permit certain disclosures in two additional circumstances. The law provided that, in the case of a deficiency with respect to a joint return of individuals who are no longer married or no longer residing in the same household, the Treasury Secretary is permitted to disclose to one such individual whether there has been an attempt to collect the deficiency from the other individual, the general nature of such collection activities, and the amount collected (sec. 6103(e)(8)). The law also provided that if the Treasury Secretary determines that a person is liable for a penalty for failure to collect and pay over tax, the Secretary is permitted to disclose to that person the name of any other person liable for that penalty, and whether there has been an attempt to collect the deficiency from the other individual, the general nature of such collection activities, and the amount collected (sec. 6103(e)(9)).

New Federal Law (Sec. 6103(e)(6)

The provision clarifies that these disclosures, like certain other disclosures permitted under present law, may be made under section 6103(e)(6) to the duly authorized attorney in fact of the person making the disclosure request.

California Law (R&TC Sec. 21023)

California law is conformed to the federal provision permitting disclosure of collection information regarding a joint return where the spouses are no longer married or no longer living together.

Effective Date

The provision takes effect on July 22, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

<u>Section</u> <u>Section Title</u>
6020 Allow Deduction for Unused Employer Social Security Credit.

<u>Background</u>

The general business credit (GBC) consists of various individual tax credits (including the employer social security credit of Code section 45B) allowed with respect to certain qualified expenditures and activities. In general, the various individual tax credits contain provisions that prohibit “double benefits," either by denying deductions in the case of expenditure-related credits or by requiring income inclusions in the case of activity-related credits. Unused credits may be carried back one year and carried forward 20 years. Section 196 allows a deduction to the extent that certain portions of the GBC expire unused after the end of the carryforward period. Section 196 does not allow a deduction to the extent that the portion of the GBC that expires unused after the end of the carryforward period relates to the employer social security credit.

<u>New Federal Law (Sec. 196(c))</u>

The provision allows a deduction to the extent that the portion of the GBC relating to the employer social security credit expires unused after the end of the carryforward period.

<u>Current California Law</u>

California does not have a comparable credit to the employer social security credit or the GBC.

<u>Effective Date</u>

The provision is effective as if included in the Omnibus Budget Reconciliation Act of 1993.

<u>Impact on California Revenue</u>

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
6021	Earned Income Credit Qualification Rules.

Background

In order to claim the earned income credit (EIC), an individual must be an eligible individual. To be an eligible individual, an individual must include a taxpayer identification number (TIN) for the taxpayer and the taxpayer's spouse and must either have a qualifying child or meet other requirements. In order to claim the EIC without a qualifying child, an individual must not be a dependent and must be over age 24 and under age 65.

A qualifying child must meet a relationship test, an age test, an identification test, and a residence test. Under the relationship and age tests, an individual is eligible for the EIC with respect to another person only if that other person: (1) is a son, daughter, or adopted child (or a descendent of a son, daughter, or adopted child); a stepson or stepdaughter; or a foster child of the taxpayer (a foster child is defined as a person whom the individual cares for as the individual's child; it is not necessary to have a placement through a foster care agency); and (2) is under the age of 19 at the close of the taxable year (or is under the age of 24 at the end of the taxable year and was a full-time student during the taxable year), or is permanently and totally disabled. Also, if the qualifying child is married at the close of the year, the individual may claim the EIC for that child only if the individual may also claim that child as a dependent.

To satisfy the identification test, an individual must include on their tax return the name, age, and TIN of each qualifying child.

The residence test requires that a qualifying child must have the same principal place of abode as the taxpayer for more than one-half of the taxable year (for the entire taxable year in the case of a foster child), and that this principal place of abode must be located in the United States. For purposes of determining whether a qualifying child meets the residence test, the principal place of abode shall be treated as in the United States for any period during which a member of the Armed Forces is stationed outside the United States while serving on extended active duty.

New Federal Law (Sec. 32(c))

The provision clarifies that the identification requirement is a requirement for claiming the EIC, rather than an element of the definitions of “eligible individual” and “qualifying child.”

Current California Law

California does not have a comparable credit to the earned income credit.

Effective Date

The provision is effective as if included in the originally enacted related legislation.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
7001	Employer Deductions for Vacation and Severance Pay.

Background

For deduction purposes, any method or arrangement that has the effect of a plan deferring the receipt of compensation or other benefits for employees is treated as a deferred compensation plan (sec 404(b)). In general, contributions under a deferred compensation plan (other than certain pension, profit-sharing and similar plans) are deductible in the taxable year in which an amount attributable to the contribution is includible in income of the employee. However, vacation pay which is treated as deferred compensation is deductible for the taxable year of the employer in which the vacation pay is paid to the employee (sec. 404(a)(5)).

Temporary Treasury regulations provide that a plan, method, or arrangement defers the receipt of compensation or benefits to the extent it is one under which an employee receives compensation or benefits more than a brief period of time after the end of the employer's taxable year in which the services creating the right to such compensation or benefits are performed. A plan, method or arrangement is presumed to defer the receipt of compensation for more than a brief period of time after the end of an employer's taxable year to the extent that compensation is received after the 15th day of the 3rd calendar month after the end of the employer's taxable year in which the related services are rendered (the "2 1/2 month" period). A plan, method or arrangement is not considered to defer the receipt of compensation or benefits for more than a brief period of time after the end of the employer's taxable year to the extent that compensation or benefits are received by the employee on or before the end of the applicable 2 1/2 month period. (Temp. Treas. Reg. Sec. 1.404(b)-1T, A-2).

The Tax Court recently addressed the issue of when vacation pay and severance pay are considered deferred compensation in Schmidt Baking Co., Inc., 107 T.C. 271 (1996). In Schmidt Baking, the taxpayer was an accrual basis taxpayer with a fiscal year that ended December 28, 1991. The taxpayer funded its accrued vacation and severance pay liabilities for 1991 by purchasing an irrevocable letter of credit on March 13, 1992. The parties stipulated that the letter of credit represented a transfer of substantially vested interest in property to employees for purposes of section 83, and that the fair market value of such interest was includible in the employees' gross incomes for 1992 as a result of the transfer. While the rules of section 83 may govern the income inclusion, section 404 governs the deduction if the amount involved is deferred compensation. The Tax Court held that the purchase of the letter of credit, and the resulting income inclusion, constituted payment of the vacation and severance pay within the 2 1/2 month period. Thus, the vacation and severance pay were treated as received by the employees within the 2 1/2 month period and were not treated as deferred compensation. The vacation pay and severance pay were deductible by the taxpayer for its 1991 fiscal year pursuant to its normal accrual method of accounting.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

New Federal Law (Sec. 404(a))

For purposes of determining whether an item of compensation is deferred compensation (under Code sec. 404), the compensation is not considered to be paid or received until actually received by the employee. In addition, an item of deferred compensation is not considered paid to an employee until actually received by the employee. The provision is intended to overrule the result in Schmidt Baking. For example, with respect to the determination of whether vacation pay is deferred compensation, the fact that the value of the vacation pay is includible in the income of employees within the applicable 2 1/2 month period is not relevant. Rather, the vacation pay must have been actually received by employees within the 2 1/2 month period in order for the compensation not to be treated as deferred compensation.

It is intended that similar arrangements, in addition to the letter of credit approach used in Schmidt Baking, do not constitute actual receipt by the employee, even if there is an income inclusion. Thus, for example, actual receipt does not include the furnishing of a note or letter or other evidence of indebtedness of the taxpayer, regardless of whether the evidence is guaranteed by any other instrument or by any third party. As a further example, actual receipt does not include a promise of the taxpayer to provide service, or property in the future (regardless of whether the promise is evidenced by a contract or other written agreement). In addition, actual receipt does not include an amount transferred as a loan, refundable deposit, or contingent payment. Amounts set aside in a trust for employees generally are not considered to be actually received by the employee.

The provision does not change the rule under which deferred compensation (other than vacation pay and sick pay and deferred compensation under qualified plans) is deductible in the year includible in the gross income of employees participating in the plan if separate accounts are maintained for each employee.

While Schmidt Baking involved only vacation pay and severance pay, there is concern that this type of arrangement may be tried to circumvent other provisions of the Code where payment is required in order for a deduction to occur. Thus, it is intended that the Secretary will prevent the use of similar arrangements. No inference is intended that the result in Schmidt Baking is present law beyond its immediate facts or that the use of similar arrangements is permitted under present law.

Current California Law (R&TC Sec. 17563)

California law is in full conformity with federal law as it read on January 1, 1998, as it relates to employer deductions for vacation and severance pay.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Effective Date

The provision is effective for taxable years ending after July 22, 1998. Any change in method of accounting required by the provision will be treated as initiated by the taxpayer with the consent of the Secretary of the Treasury. Any adjustment required by section 481 as a result of the change will be taken into account over a three-year period beginning with the first year for which the provision is effective.

Impact on California Revenue

It is projected that the majority of taxpayers(90%) will no longer use letters of credit for state tax purposes due to the federal law change.

Based on federal estimates with adjustments made to reflect a January 1, 1999 state effective date, it is estimated that baseline revenue gains will be on the order of $65 million for 1999-0 and $3 million annually thereafter. Conformity revenue gains (for a 3 year 481 spread) are estimated to be $2 million for 1999-0 and $3 million for fiscal years 2000-1 and 2001-2. The much larger 1999-0 baseline impact reflects the discontinuance of accelerated deductions prior to actual distributions to employees.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
7002	Freeze Grandfather Status of Stapled REITs.

Background

In general. A real estate investment trust (REIT) is an entity that receives most of its income from passive real estate related investments and that essentially receives pass-through treatment for income that is distributed to shareholders. If an electing entity meets the qualifications for REIT status, the portion of its income that is distributed to the investors each year generally is taxed to the investors without being subjected to a tax at the REIT level. In general, a REIT must derive its income from passive sources and not engage in any active trade or business.

Requirements for REIT status. A REIT must satisfy a number of tests on a year-by-year basis that relate to the entity's (1) organizational structure, (2) source of income, (3) nature of assets, and (4) distribution of income. These tests are intended to allow pass-through treatment only if there is a pooling of investment arrangement, if the entity's investments are basically in real estate assets, and its income is passive income from real estate investment, as contrasted with income from the operation of a business involving real estate. In addition, substantially all of the entity's income must be passed through to its shareholders on a current basis.

Under the organizational structure tests, except for the first taxable year for which an entity elects to be a REIT, the beneficial ownership of the entity must be held by 100 or more persons. Generally, no more than 50% of the value of the REIT's stock can be owned by five or fewer individuals during the last half of the taxable year.

Under the source-of-income tests, at least 95% of its gross income generally must be derived from rents, dividends, interest and certain other passive sources (the "95% test"). In addition, at least 75% of its income generally must be from real estate sources, including rents from real property and interest on mortgages secured by real property (the "75% test").

For purposes of these tests, rents from real property generally include charges for services customarily rendered in connection with the rental of real property, regardless of whether such charges are separately stated. Where a REIT furnishes non-customary services to tenants, amounts received generally are not treated as qualifying rents unless the services are furnished through an independent contractor from whom the REIT does not derive any income. In general, an independent contractor is a person who does not own more than a 35% interest in the REIT, and in which no more than a 35% interest is held by persons with a 35% or greater interest in the REIT.

To satisfy the REIT asset requirements, at the close of each quarter of its taxable year, an entity must have at least 75% of the value of its assets invested in real estate assets, cash and cash items, and government securities. No more than 25% of the value of the REIT's assets can be invested in securities (other than government securities and other securities described in the preceding sentence). The securities of any one issuer may not comprise more than five percent of the value of a REIT's assets. Moreover, the REIT may not own more than 10% of the outstanding securities of any one issuer, determined by voting power.

A REIT is permitted to have a wholly-owned subsidiary subject to certain restrictions. A REIT's subsidiary is treated as one entity with the REIT parent.

The income distribution requirement provides generally that at least 95% of a REIT's income (with certain minor exceptions) must be distributed to shareholders as dividends.

Stapled REITs. In a stapled REIT structure, both the shares of a REIT and a C corporation may be traded, but are subject to a provision that they may not be sold separately. Thus, the REIT and the C corporation have identical ownership at all times.

In the Deficit Reduction Act of 1984 (the "1984 Act"), Congress required that, in applying the tests for REIT status, all stapled entities are treated as one entity (sec. 269B(a)(3)). The 1984 Act included grandfather rules, one of which provided that certain then-existing stapled REITs were not subject to the new provision (sec. 136(c)(3) of the 1984 Act). That grandfather rule provided that the new provision did not apply to a REIT that was a part of a group of stapled entities if the group of entities was stapled on June 30, 1983, and included a REIT on that date.

New Federal Law

Overview. Under the provision, rules similar to the rules of present law treating a REIT and all stapled entities as a single entity for purposes of determining REIT status (sec. 269B) apply to real property interests acquired after March 26, 1998. The provision applies if the real property is acquired by an existing stapled REIT, a stapled entity, or a subsidiary or partnership in which a 10% or greater interest is owned by an existing stapled REIT or stapled entity (together referred to as the "stapled REIT group"), unless the real property interest is grandfathered as described below. Special rules apply to certain mortgages acquired by the stapled REIT group after March 26, 1998, where a member of the stapled REIT group performs services with respect to the property secured by the mortgage.

Rules for real property interests. The provision generally applies to real property interests acquired by a member of the stapled REIT group after March 26, 1998. Real property interests acquired by a member of the REIT group after such date, and which are not grandfathered under the rules described below, are referred to as "nonqualified real property interests." The provision treats activities and gross income of a stapled REIT group with respect to nonqualified real property interests held by any member of the stapled REIT group as activities and income of the REIT for certain purposes in the same manner as if the stapled REIT group were a single entity. This treatment applies for purposes of the following provisions that depend on a REIT's gross income: (1) the 95% test (sec. 856(c)(2)); (2) the 75% test (sec. 856(c)(3)); (3) the "reasonable cause" exception for failure to meet either test (sec. 856(c)(6)); and (4) the special tax on excess gross income for REITs with net income from prohibited transactions (sec. 857(b)(5)).

Thus, for example, where a stapled entity leases nonqualified real property from the REIT and earns gross income from operating the property, such gross income will be subject to the provision. The REIT and the stapled entity will be treated as a single entity, with the result that the lease payments from the stapled entity to the REIT would be ignored. The gross income earned by the stapled entity from operating the property will be treated as gross income of the REIT, with the result that either the 75% or 95% test might not be met and REIT status might be lost. Similarly, where a stapled entity leases property from a third party after March 26, 1998, and uses that property in a business, the gross income it derives will be treated as income of the REIT because the lease would be a nonqualified real property interest.

Grandfathered real property interests. Under the provision, all real property interests acquired by a member of the stapled REIT group after March 26, 1998, are treated as nonqualified real property interests subject to the general rules described above, unless they qualify under one of the grandfather rules. An option to acquire real property is generally treated as a real property interest for purposes of the provision. However, a real property interest acquired by exercise of an option after March 26, 1998, is treated as a nonqualified real property interest, even though the option was acquired before such date.

Under the provision, grandfathered real property interests include properties acquired by a member of the stapled REIT group after March 26, 1998, pursuant to a written agreement which was binding on March 26, 1998, and all times thereafter. Grandfathered properties also include certain properties, the acquisition of which were described in a public announcement or in a filing with the Securities and Exchange Commission on or before March 26, 1998.

A real property interest does not generally lose its status as a grandfathered interest by reason of a repair to, an improvement of, or a lease of, the real property. Thus, if a REIT leases a grandfathered real property to a stapled entity, a renewal of the lease does not cause the property to lose its grandfathered status, whether the renewal is pursuant to the terms of the lease or otherwise. Similarly, if a REIT owns a grandfathered real property interest that is leased to a third party and, at the expiration of that lease, the REIT leases the property to a stapled entity, the interest would remain a grandfathered interest.

Finally, if a stapled entity leases a grandfathered property interest from a third party and the property is repaired or improved, the interest would remain a grandfathered interest except as described below.

An improvement of a grandfathered real property interest will cause loss of grandfathered status and become a nonqualified real property interest in certain circumstances. Any expansion beyond the boundaries of the land of the otherwise grandfathered interest occurring after March 26, 1998, will be treated as a non-qualified real property interest to the extent of such expansion. Moreover, any improvement of an otherwise grandfathered real property interest (within its land boundaries) that is placed in service after December 31, 1999, is treated as a separate nonqualified real property interest in certain circumstances. Such treatment applies where (1) the improvement changes the use of the property and (2) its cost is greater than (a) 200% of the undepreciated cost of the property (prior to the improvement) or (b) in the case of property acquired where there is a substituted basis, the fair market value of the property on the date that the property was acquired by the stapled entity or the REIT. There is an exception for improvements placed in service before January 1, 2004, pursuant to a binding contract in effect on December 31, 1999, and at all times thereafter. The rule treating improvements as nonqualified real property interests could apply, for example, if a member of the stapled REIT group constructs a building after December 31, 1999, on previously undeveloped raw land that had been acquired on or before March 26, 1998.

The provision clarifies that a real property interest acquired pursuant to the exercise of a put option, buy-sell agreement or an agreement relating to a third party default that was binding on March 26, 1998, and at all times thereafter, is generally treated as a grandfathered real property interest. This rule is to apply only to substantive economic arrangements that are outside of the control of the stapled REIT group. A renewal of a lease of property from a third party to a member of the stapled REIT group, like a lease or renewal between group members, does not generally terminate grandfather status, whether the renewal is pursuant to the terms of the lease or otherwise. In the case of a lease from a third party, a renewal will not qualify if there is a significant time period between the two tenancies. The renewal of a lease can cause loss of grandfather status if the property is improved to the extent that grandfather status would be lost under the improvement rules described above. Moreover, the provision provides that, for leases and renewals entered into after March 26, 1998 (whether from members of the stapled REIT group or third parties), grandfather status is lost if the rent on the lease or renewal exceeds an arm's length rate.

Ownership through entities. If a REIT or stapled entity owns, directly or indirectly, a 10% or greater interest in a corporate subsidiary or partnership (or other entity described below) that owns a real property interest, the above rules apply with respect to a proportionate part of the entity's real property interest, activities and gross income. Thus, any real property interest acquired by such a subsidiary or partnership that is not grandfathered under the rules described above is treated as a nonqualified real property interest held by the REIT or stapled entity in the same proportion as its ownership interest in the entity. The same proportion of the subsidiary's or partnership's gross income from any nonqualified real property interest owned by it or another member of the stapled REIT group will be treated as income of the REIT under the rules described above. However, an interest in real property acquired by a grandfathered 10% or greater partnership or subsidiary is treated as grandfathered if such interest would be a grandfathered interest if held directly by the REIT or stapled entity. Thus, for example, if a REIT contributes a grandfathered real property interest to a partnership 10% or more of which is owned on March 26, 1998, the interest will not cease to be a grandfathered interest. Nevertheless, under the rules below, if the REITs partnership interest increases as a result of the contribution, a portion of each of the partnership's real estate interests, reflecting the proportionate increase in the partnership interest, will be treated as a nonqualified real property interest.

Similar rules attributing the proportionate part of the subsidiary's or partnership's real property interests and gross income will apply when a REIT or stapled entity acquires a 10% or greater interest (or in the case of a previously-owned entity, acquires an additional interest) after March 26, 1998, with exceptions for interests acquired pursuant to binding written agreements or public announcements described above. Transition relief can apply to both an entity's assets and the interest in the entity under the above rules. Thus, if on March 26, 1998, and at all times thereafter, a stapled entity has a binding written contract to buy 10% or more of the stock of a corporation and the corporation also has a binding written contract to buy real property, no portion of the property will be treated as a nonqualified real property interest as a result of the transaction.

Under the above rules, gross income of a REIT or stapled entity with respect to a nonqualified real property interest held by a 10%-or-greater partnership or subsidiary is subject to the rules for nonqualified real property interests only in proportion to the interest held in the partnership or subsidiary. For example, assume that a stapled entity has a contract to manage a nonqualified real property interest held by a partnership in which the stapled entity owns an 85% interest. Under the above rules, for purposes of applying the gross income tests, 85% of the partnership's activities and gross income from the property are attributed to the REIT. As a result, 85% of the stapled entity's income from the management contract is ignored under the single-entity analysis described above. The remaining 15% of the management fee is not treated as gross income of the REIT because it is not income from a nonqualified real property interest held or deemed held by the REIT or a stapled entity.

Under the provision, the percentage ownership interest in a partnership is to be determined by the owner's share of capital or profits, whichever is larger. The provision clarifies that an interest in real property acquired by a 10% or greater partnership or subsidiary pursuant to a binding written agreement, public announcement, SEC filing, put option, buy-sell agreement or agreement relating to a third-party default (a "qualified transaction") is treated as grandfathered if such interest would be a grandfathered interest if acquired directly by the REIT or stapled entity. The provision also provides that the exception for 10%-or-greater interests in partnerships or subsidiaries acquired pursuant to a qualified transaction applies to interests acquired by any member of the stapled REIT group. All real property interests, mortgages, activities and gross income of a qualified REIT subsidiary are to be treated as attributes of the REIT for purposes of the provision.

Grandfathered real property interests that are deemed owned by a REIT or a stapled entity under the rules for 10% or greater interests will not be treated as acquired after March 26, 1998, if the REIT or a stapled entity subsequently becomes the actual owner. For example, assume a REIT has a 50% interest in a partnership that distributes a grandfathered real property interest to the REIT in complete liquidation of its interest. The 50% interest that was previously deemed owned by the REIT will continue to be grandfathered; the remaining 50% interest will be a nonqualified real property interest because it was acquired by the REIT after March 26, 1998.

Mortgage rules. Under the provision, special rules apply where a member of the stapled REIT group holds a mortgage (that is not an existing obligation under the rules described below) that is secured by an interest in real property, and a member of the stapled REIT group engages in certain activities with respect to that property. The activities that have this effect under the provision are activities that would result in impermissible tenant service income (as defined in sec. 856(d)(7)) if performed by the REIT with respect to property it held. In such a case, all interest on the mortgage that is allocable to that property and all gross income received by a member of the stapled REIT group from the activity will be treated as impermissible tenant service income of the REIT, which is not qualifying income under either the 75% or 95% tests. For example, assume that the REIT makes a mortgage loan on a hotel owned by a third party which is operated by a stapled entity under a management contract. Unless an exception applies, both the management fees earned by the stapled entity and the interest earned by the REIT will be treated as impermissible tenant services income of the REIT.

An exception to the above rules is provided for mortgages the interest on which does not exceed an arm's-length rate and which would be treated as interest for purposes of the REIT rules. An exception also is available for mortgages that are held by a member of the stapled REIT group on March 26, 1998, and at all times thereafter, and which are secured by an interest in real property on that date, and at all times thereafter (the "existing mortgage exception"). The existing mortgage exception ceases to apply if the mortgage is refinanced and the principal amount is increased in such refinancing.

In the case of a partnership or subsidiary in which the REIT or a stapled entity owns a 10% or greater interest, a proportionate part of the entity's mortgages, interest and gross income from activities would be attributed to the REIT or the stapled entity, subject to rules similar to those for nonqualified real property interests. Thus, if a REIT or a stapled entity acquires a 10% or greater interest in a partnership or corporation after March 26, 1998, no mortgage held by the partnership or subsidiary at such time would qualify for the existing mortgage exception. Similarly, if a REIT or stapled entity owns a 10% or greater interest in a partnership or subsidiary on March 26, 1998, and the REIT or the stapled entity subsequently acquires a greater interest, a portion of each of the partnership's or subsidiary's mortgages that is the same as the proportionate increase in the ownership interest would fail to qualify for the existing mortgage exception.

Under the provision's priority rules, the mortgage rules do not apply to any part of a real property interest that is owned or deemed owned by the REIT or a stapled entity under the rules for real property interests described above. Thus, for example, if the REIT makes a mortgage loan on real property owned by a stapled entity, the mortgage rules would not apply. If the property is a nonqualified real property interest, the interest on the mortgage would be ignored under the single-entity analysis described above, and the gross income of the stapled entity from the property would be treated as income of the REIT. Similarly, assume that a stapled entity owns 75% of the stock of a subsidiary and has a management contract to operate a hotel owned by the subsidiary. Assume also that the REIT makes a mortgage loan for the hotel. Under the real property interest rules, 75% of the hotel is treated as owned by the stapled entity. Thus, if the hotel is a nonqualified real property interest, 75% of the subsidiary's gross income from the hotel is treated as income of the REIT and 75% of the income on the management contract is ignored under the single-entity analysis. With respect to the remaining 25% interest in the subsidiary, the real property interest rules do not apply, but the mortgage rules would treat 25% of the mortgage interest and 25% of management contract income as impermissible tenant services income of the REIT.

Other rules. For purposes of both the real property interest and mortgage rules, if a stapled REIT is not stapled as of March 26, 1998, and at all times thereafter, or if it fails to qualify as a REIT as of such date or any time thereafter, no assets of any member of the stapled REIT group would qualify under the grandfather rules. Thus, all of the real property interests held by the group would be nonqualified real property interests and none of the mortgages held by the group would qualify for the existing mortgage exception.

For a corporate subsidiary owned by a stapled entity, the 10% ownership test would be met if a stapled entity owns, directly or indirectly, 10% or more of the corporation's stock, by either vote or value. The provision does not apply to a stapled REIT's ownership of a corporate subsidiary, although the REIT would be subject to the normal restrictions on a REIT's ownership of stock in a corporation. For this purpose, any change in proportionate ownership that is attributable solely to fluctuations in the relative fair market values of different classes of stock is not taken into account. For interests in partnerships, the ownership test would be met if either the REIT or a stapled entity owns, directly or indirectly, a 10% or greater interest in the partnership's assets or net profits. Interests in other entities, such as trusts, are treated in the same manner as 10%-or-greater interests in partnerships or corporations if the REIT or a stapled entity owns, directly or indirectly, 10% or more of the beneficial interests in the entity.

The provision also adds a rule that provides that a transfer, direct or indirect, of a grandfathered real property interest between members of a stapled REIT group does not result in a loss of grandfather status if the total direct and indirect interests of both the exempt REIT and stapled entity in the real property interest does not increase as a result of the transfer. If the total direct and indirect interest of the exempt REIT and stapled entity increases, the transferred real property interest will be deemed to lose grandfather status only to the extent of such increase. The provision applies to all types of transfers of real property interests among group members, such as sales, contributions and distributions, whether taxable or tax-free. Moreover, the provision applies both to direct transfers of real property interests and transfers of such interests indirectly through transfer of interests in 10% or greater owned partnerships and subsidiaries.

The application of the new provision is illustrated by the following examples. First, assume that an exempt REIT sells a portion of a grandfathered real property interest to a stapled entity. The real property interest remains grandfathered because there is no increase in the total interests of the REIT and the stapled entity (100% both before and after the transfer). Second, assume that a grandfathered real property interest is contributed by a stapled entity to a partnership or subsidiary in which the stapled entity owns a 10%-or-greater interest (either prior to, or as a result of, the contribution). The real property interest remains grandfathered because the previous total interests of the exempt REIT and stapled entity (the stapled entity's 100% interest) are not increased by the transfer. Nevertheless, if the REIT's interest in the partnership or subsidiary increases as a result of the contribution, a portion of each of the entity's real property interests other than the interest contributed, reflecting the proportionate increase in the REIT's interest in the entity, will be treated as a non-grandfathered real property interest. Third, assume a REIT owns a 50% interest in a partnership that distributes a grandfathered real property interest to the REIT in complete liquidation of its interest. The 50% interest that was previously deemed owned by the REIT will continue to be grandfathered; the remaining 50% interest will become a non-grandfathered interest because it represents an increase in the total direct and indirect interests of the REIT and stapled entity in the real property interest. Fourth, assume that a partnership in which an exempt REIT or stapled entity owns a 10% or greater interest terminates as a result of a sale of 50% or more of the total partnership interests during a 12-month period that does not involve the REIT or a stapled entity (sec. 708(b)(1)(B)). Grandfather status of real property interests owned by the partnership is not lost in the transfer because, as a result of the termination, the partnership's assets are deemed contributed to a new partnership and interests in that partnership are deemed distributed to the purchasing and other partners in proportion to their interests (Treas. reg. sec. 1.708-1(b)(1)(iv)). Thus, there is no change in the total interest of the REIT and stapled entity in the partnership's assets.

The provision adds a provision intended to deal with the special situation of so-called "UPREIT" partnerships (see Treas. reg. 1.701-2(d)(example 4)), which generally treats 100% of the real property interests, mortgages, activities and gross income of such partnerships as interests, activities and gross income of the REIT or stapled entity that owns a partnership interest. The provision applies where (i) an exempt REIT or stapled entity owned directly or indirectly) at least a 60% interest in a partnership as of March 26, 1998, (ii) 90% or more of the interests in the partnership (other than those held by the exempt REIT or stapled entity) are or will be redeemable or exchangeable for consideration with a value determined with reference to the stock of the REIT or stapled entity or both. The provision also applies to an interest in a partnership formed after March 26, 1998, which meets the provision's other requirements, where the partnership was formed to mirror the stapling of an exempt REIT and a stapled entity in connection with an acquisition agreed to or announced on or before March 26, 1998. If, as of January 1, 1999, more than one partnership owned (directly or indirectly) by either an exempt REIT or stapled entity meets the requirements of the provision, only the largest such partnership (determined by aggregate asset bases) is treated as meeting such requirements.

The provision provides that, for purposes of the exception to the mortgage rules for mortgages held on March 26, 1998, an increase in interest payable on a mortgage (except pursuant to an interest arrangement, such as variable interest, under the mortgage's terms as of March 26, 1998), or an increase in interest payable as a result of a refinancing, causes the mortgage to cease to qualify for the exception unless the new interest rate meets an arm's-length standard.

The provision also clarifies that in the event that a stapled REIT group ceases to be stapled, the rules treating assets, activities and gross income of members or the stapled REIT group as attributes of the REIT apply only to the portion of the year in which the group was a stapled REIT group. Similarly, where a REIT's or stapled entity's interest in a partnership or subsidiary changes during the year, the rules treating a proportionate part of the assets, activities and gross income of the partnership or subsidiary as attributes of the REIT or stapled entity also apply on a partial-year basis.

Under the provision, terms used that are also used in the stapled stock rules (sec. 269B) or the REIT rules (sec. 856) have the same meanings as under those rules.

The Secretary of the Treasury is given authority to prescribe such guidance as may be necessary or appropriate to carry out the purposes of the provision, including guidance to prevent the double counting of income and to prevent transactions that would avoid the purposes of the provision.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Current California Law

California Bank and Corporation Tax Law does not conform to the federal stapled REIT provisions (IRC section 269B). For California purposes, each member of a federal stapled group would be treated as a separate corporation or business trust.

Effective Date

The provision is effective for taxable years ending after March 26, 1998.

Impact on California Revenue

Not applicable.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
7003	Certain Trade Receivables Ineligible for Mark-To-Market Treatment.

Background

In general, dealers in securities are required to use a mark-to-market method of accounting for securities (sec. 475). Exceptions to the mark-to-market rule are provided for securities held for investment, certain debt instruments and obligations to acquire debt instruments and certain securities that hedge securities. A dealer in securities is a taxpayer who regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or who regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in certain types of securities with customers in the ordinary course of a trade or business.

A security includes (1) a share of stock, (2) an interest in a widely held or publicly traded partnership or trust, (3) an evidence of indebtedness, (4) an interest rate, currency, or equity notional principal contract, (5) an evidence of an interest in, or derivative financial instrument in, any of the foregoing securities, or any currency, including any option, forward contract, short position, or similar financial instrument in such a security or currency, or (6) a position that is an identified hedge with respect to any of the foregoing securities.

Treasury regulations provide that if a taxpayer would be a dealer in securities only because of its purchases and sales of debt instruments that, at the time of purchase or sale, are customer paper with respect to either the taxpayer or a corporation that is a member of the same consolidated group, the taxpayer will not normally be treated as a dealer in securities. However, the regulations allow such a taxpayer to elect out of this exception to dealer status. For this purpose, a debt instrument is customer paper with respect to a person if: (1) the person's principal activity is selling nonfinancial goods or providing nonfinancial services; (2) the debt instrument was issued by the purchaser of the goods or services at the time of the purchase of those goods and services in order to finance the purchase; and (3) at all times since the debt instrument was issued, it has been held either by the person selling those goods or services or by a corporation that is a member of the same consolidated group as that person.

New Federal Law (Sec. 475)

The provision provides that certain trade receivables are not eligible for mark-to-market treatment. A trade receivable is covered by the provision if it is a note, bond or debenture arising out of the sale of goods by a person the principal activity of which is selling or providing nonfinancial goods and services and it is held by such person or a related person at all times since it was issued.

Under the provision, a receivable meeting the above definition is not treated as a security for purposes of the mark-to-market rules (sec. 475). Thus, such receivables are not marked-to-market, even if the taxpayer qualifies as a dealer in other securities. A taxpayer will not be treated as a dealer in securities based on sales to unrelated persons of receivables subject to the new provision unless the regulatory exception for receivables held for sale to customers applies.

The new provision applies to trade receivables arising from services performed by independent contractors, as well as employees. Thus, for example, if a taxpayer's principal activity is selling non-financial services and some or all of such services are performed by independent contractors, no receivables that the taxpayer accepts for services can be marked-to-market under the new provision.

Pursuant to the authority granted by section 475(g)(1), the Secretary of the Treasury is authorized to issue regulations to prevent abuse of the new exception, including through independent contractor arrangements. The provision provides that, to the extent provided in Treasury regulations, trade receivables that are held for sale to customers by the taxpayer or a related person may be treated as "securities" for purposes of the mark-to-market rules, and transactions in such receivables could result in a taxpayer being treated as a dealer in securities (sec. 475(c)(1)).

For trade receivables that are excepted from the statutory mark-to-market rules (sec. 475) under the new provision, mark-to-market or lower-of-cost-or-market will not be treated as methods of accounting that clearly reflect income under general tax principles (see sec. 446(b)).

Current California Law

California law is in full conformity with federal law as it read on January 1, 1998, as it relates to the "mark to market" method of accounting.

Effective Date

The provision generally is effective for taxable years ending after the date of enactment. Adjustments required under section 481 as a result of the change in method of accounting generally are required to be taken into account ratably over the four-year period beginning in the first taxable year for which the provision is in effect. However, where the taxpayer terminates its existence or ceases to engage in the trade or business that generated the receivables (except as a result of a tax-free transfer), any remaining balance of the section 481 adjustment is taken into account entirely in the year of such cessation or termination (see sec. 5.04(c) of Rev. Proc. 97-37, 1997-33 I.R.B. 18).

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Impact on California Revenue

Consistent with other mark-to-market conformity issues analyzed in prior years, it is assumed that of the total state revenue impact, one-half will occur automatically (i.e. baseline) as some taxpayers report the same way for state purposes, and half will result from actual conformity legislation.

Based on federal estimates, conformity revenue gains will be $5 million, $9 million, and $6 million over the initial three years beginning with 1999-0. Baseline revenue gains will be of the same magnitude but beginning with 1998-9.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Section	Section Title
7004	Exclusion of Minimum Required Distributions from AGI for Roth IRA Conversions.

Background

Under present law, uniform minimum distribution rules generally apply to all types of tax-favored retirement vehicles, including qualified retirement plans and annuities, individual retirement arrangements (IRAs) other than Roth IRAs, and tax-sheltered annuities (sec 403(b)).

Under present law, distributions are required to begin no later than the individual's required beginning date (sec. 401(a)(9)). In the case of an IRA, the required beginning date, means the April 1 of the calendar year following the calendar year in which the IRA owner attains age 70½. The IRS has issued extensive regulations for purposes of calculating minimum distributions. In general, minimum distributions are includible in gross income in the year of distribution. An excise tax equal to 50% of the required distribution applies to the extent a required distribution is not made.

Under present law, all or any part of amounts in a deductible or nondeductible IRA may be converted into a Roth IRA. Only taxpayers with modified adjusted gross income (AGI) of $100,000 or less are eligible to convert an IRA into a Roth IRA. In the case of a married taxpayer, AGI is the combined AGI of the couple. Married taxpayers filing a separate return are not eligible to make a conversion.

New Federal Law (Sec. 408A(c)(3)(C))

The provision excludes minimum required distributions from IRAs from the definition of modified AGI solely for purposes of determining eligibility to convert from an IRA to a Roth IRA. As under present law, the required minimum distribution would not be eligible for conversion and would be includible in gross income.

Current California Law (R&TC Sec. 17507.5)

California law is in full conformity with federal law as it read on January 1, 1998, as it relates to Roth IRAs. California has conformed to changes made by the IRS Reform Act.

Effective Date

The provision is effective for taxable years beginning after December 31, 2004.

IRS Restructuring and Reform Act of 1998
(P.L. 105-206)

Impact on California Revenue

The estimated California baseline impacts are gains of $84 million (2004-5), $101 million (2005-6), and $99 million (2006-7). Conformity gains are estimated to be $1 million annually beginning with the fiscal year 2004-5.

This estimate is based on information and data provided by the federal Joint Committee on Taxation and the IRS. This estimate takes into account California’s share of national income, California’s tax rates relative to the U.S., and the baseline revenue impacts that would result without conformity.

Note that federal analysts estimate that this provision would be revenue neutral over the first ten years.

Tax and Trade Relief Extension Act of 1998 (P.L. 105-277)

Section	Section Title
1001	Research Credit Extension.

Background

Section 41 provides for a research tax credit equal to the sum of (1) 20% of the amount that qualified research expenditures for a taxable year exceed the taxpayer’s base amount, and (2) the basic research credit which is 20% of the excess of (a) 100% of corporate cash expenditures paid for basic research done by universities and certain other qualified organizations over (b) the sum of (A) the greater of two minimum basic research floors plus (B) an amount reflecting any decrease in nonresearch contributions to universities compared to such contributions during a base period, as adjusted for inflation.

Taxpayers are allowed to elect an alternative incremental research credit regime. If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced. Under the alternative credit regime, a credit rate of 1.65% applies to the extent that a taxpayer's current-year research expenses exceed a base amount, computed by using a fixed-base percentage of 1% (i.e., the base amount equals 1% of the taxpayer's average gross receipts for the four preceding years), but do not exceed a base amount computed by using a fixed-base percentage of 1.5%. A credit rate of 2.2% applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5% but do not exceed a base amount computed by using a fixed-base percentage of 2%. A credit rate of 2.75% applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 2%. An election to be subject to this alternative incremental credit regime may be made for any taxable year beginning after June 30, 1996, and such an election applies to that taxable year and all subsequent years unless revoked with the consent of the Secretary of the Treasury.

The research tax credit expired and generally does not apply to amounts paid or incurred after June 30, 1998.

New Federal Law (Sec. 41)

The provision extends the research credit for 12 months, generally, for the period July 1, 1998, through June 30, 1999.

In extending the credit, Congress expressed its intent to reaffirm the scope of the term “qualified research.” Section 41 targets the credit to research undertaken for the purpose of discovering information that is technological in nature and the application of which is intended to be useful in the development of a new or improved business component of the taxpayer. However, eligibility for the credit does not require that the research be successful, i.e., the research need not achieve its desired result. Moreover, evolutionary research activities intended to improve functionality, performance, reliability, or quality are eligible for the credit, as are research activities intended to achieve a result that has already been achieved by other persons but is not yet within the common knowledge (e.g., freely available to the general public) of the field (provided that the research otherwise meets the requirements of section 41, including not being excluded by subsection (d)(4)).

Activities constitute a process of experimentation, as required for credit eligibility, if they involve evaluation of more than one alternative to achieve a result where the means of achieving the result are uncertain at the outset, even if the taxpayer knows at the outset that it may be technically possible to achieve the result. Thus, even though a researcher may know of a particular method of achieving an outcome, the use of the process of experimentation to effect a new or better method of achieving that outcome may be eligible for the credit (provided that the research otherwise meets the requirements of section 41, including not being excluded by subsection (d)(4)).

Lastly, Congress noted the lack of clarity in the interpretation of the distinction between internal-use software, the costs of which may be eligible for the credit if additional tests are met, and other software. Congress emphasized that application of the definition of internal-use software should fully reflect Congressional intent.

Current California Law

Existing state law conforms to the federal research credit with specific modifications to the federal research credit, as follows:

- For corporate taxpayers engaged in specified biopharmaceutical research and biotech research and development, the definition of “qualified organization” includes hospitals run by public universities and certain cancer centers.
- “Basic research” must be conducted in California to qualify for the California credit.
- Research that has a specific commercial objective may qualify as “basic research.”
- The credit percentage is 11% for qualified research and 24% for corporations for “basic research.” To duplicate the federal provision that allows the credit for “basic research” payments only to corporate taxpayers, the Bank and Corporation Tax Law (B&CTL) allows the credit based on “qualified research” expenses and “basic research” payments, while the Personal Income Tax Law (PITL) allows the credit only for “qualified research” expenses.
- The state alternative incremental credit amount is 80% of the federal alternative incremental credit formula amount.
- A taxpayer's federal election is not binding for state purposes.
- The state definition of “gross receipts” for purposes of the credit differs from that used in the federal credit.
- The state credit specifies that “qualified research expense” would not include any amount paid or incurred for tangible personal property that

is eligible for the sales tax exemption provided under Section 6378 of the Revenue and Taxation Code (relating to teleproduction and postproduction activities).

- The termination dates provided under federal law do not apply for state purposes. The California research credit is allowed indefinitely for taxable and income years beginning on or after January 1, 1987.

Effective Date

The extension of the research credit is effective for qualified research expenditures paid or incurred during the period July 1, 1998, through June 30, 1999.

Impact on California Revenue

Not applicable.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
1002	Extension of the Work Opportunity Tax Credit.

Background

The work opportunity tax credit (WOTC), which expired on June 30, 1998, was available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The credit equals 40% (25% for employment of 400 hours or less) of qualified wages. Qualified wages are wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. For a vocational rehabilitation referral, however, the period begins on the day the individual began work for the employer on or after the beginning of the individual’s vocational rehabilitation plan.

The maximum credit per employee is $2,400 (40% of the first $6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is $1,200 (40% of the first $3,000 of qualified first-year wages).

The employer’s deduction for wages is reduced by the amount of the credit.

New Federal Law (Sec. 51)

The provision extends the WOTC for 12 months (through June 30, 1999).

Current California Law

California has no comparable credit.

Effective Date

The provision is effective for wages paid or incurred to qualified individuals who begin work for the employer on or after July 1, 1998, and before July 1, 1999.

Impact on California Revenue

Not applicable.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
1003	Extension of the Welfare-To-Work Tax Credit.

Background

The IRC provides employers a tax credit on the first $20,000 of eligible wages paid to qualified long-term family assistance (AFDC or its successor program) recipients during the first two years of employment. The credit is equal to 35% of the first $10,000 of eligible wages in the first year of employment and 50% of the first $10,000 of eligible wages in the second year of employment. The maximum credit is $8,500 per qualified employee.

Qualified long-term family assistance recipients are: (1) members of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) members of a family that has received family assistance for a total of at least 18 months (whether or not consecutive) after the date of enactment of this credit if they are hired within two years after the date that the 18-month total is reached; and (3) members of a family who are no longer eligible for family assistance because of either federal or state time limits, if they are hired within two years after the federal or state time limits made the family ineligible for family assistance.

Eligible wages include cash wages paid to an employee plus amounts paid by the employer for the following: (1) educational assistance excludable under a section 127 program (or that would be excludable but for the expiration of sec. 127); (2) health plan coverage for the employee, but not more than the applicable premium defined under section 4980B(f)(4); and (3) dependent care assistance excludable under section 129.

The welfare to work credit is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 1998, and before May 1, 1999.

New Federal Law (Sec. 51A)

The provision extends the welfare-to-work tax credit for two months.

Current California Law

California has no comparable credit.

Effective Date

The provision extends the welfare-to-work credit effective for wages paid or incurred to a qualified individual who begins work for an employer on or after May 1, 1999, and before July 1, 1999.

Impact on California Revenue

Not applicable.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
1004	Extend the Deduction for Contributions of Appreciated Stock to Private Foundations; Public Inspection of Private Foundation Returns

Background

Contributions of appreciated stock to private foundations.

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the fair market value of property contributed to a charitable organization. However, in the case of a charitable contribution of short-term gain, inventory, or other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose.

In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property. However, under a special rule contained in section 170(e)(5), taxpayers are allowed a deduction equal to the fair market value of "qualified appreciated stock" contributed to a private foundation prior to July 1, 1998. Qualified appreciated stock is defined as publicly traded stock which is capital gain property. The fair-market-value deduction for qualified appreciated stock donations applies only to the extent that total donations made by the donor to private foundations of stock in a particular corporation did not exceed 10% of the outstanding stock of that corporation. For this purpose, an individual is treated as making all contributions that were made by any member of the individual's family.

Public inspection of private foundation returns.

Tax-exempt organizations (other than churches and certain small organizations) are required to file an annual information return (Form 990) with the IRS, setting forth the organization's items of gross income and expenses attributable to such income, disbursements for tax-exempt purposes, plus certain other information for the taxable year.

Private foundations are required to make the current year's annual information return (Form 990-PF) available for public inspection at the foundation's principal office during regular business hours (sec. 6104(d)). Such return must be made available for inspection by any citizen on request made within 180 days after the date of publication of notice of its availability. Notice must be published, not later than the day the return is required to be filed, in a newspaper having general circulation in the county in which the principal office of the foundation is located. The notice must state that the annual return is available for public inspection by any citizen who requests it, and must state the address and telephone number of the private foundation's principal office and the name of its principal manager.

Tax and Trade Relief Extension Act of 1998 (P.L. 105-277)

Tax-exempt organizations (other than private foundations) that are required to file a Form 990, including public charities, are required to allow public inspection at the organization's principal office (and certain regional or district offices) of their Forms 990 for the three most recent taxable years (sec. 6104(e)).

The Taxpayer Bill of Rights 2 imposed additional public inspection requirements on tax-exempt organizations. All tax-exempt organizations, except private foundations, are required to comply with requests made in person or in writing by individuals who seek a copy of the organization's Form 990 for any of the organization's three most recent taxable years. Upon such a request, the organization is required to supply copies without charge other than a reasonable fee for reproduction and mailing costs. If the request for copies is made in person, then the organization must immediately provide such copies. If the request for copies is made in writing, then copies must be provided within 30 days. In addition, all tax-exempt organizations, including private foundations, will be required to comply in the same manner with requests made in person or in writing by individuals who seek a copy of the organization's application for recognition of tax-exempt status and certain related documents. However, an organization may be relieved of its obligation to provide copies if, in accordance with regulations to be promulgated by the Secretary of Treasury, (1) the organization has made the requested documents widely available or (2) the Secretary of the Treasury determined, upon application by the organization, that the organization was subject to a harassment campaign such that a waiver of the obligation to provide copies would be in the public interest. These additional public inspection provisions apply to requests made no earlier than 60 days after the date on which the Treasury Department publishes regulations defining when requested documents have been made widely available or when a request is part of a harassment campaign. While proposed regulations have been issued, final regulations have not been published; therefore, the provision is not yet in effect.

Upon written request to the IRS, members of the general public also are permitted to inspect annual information returns of tax-exempt organizations and applications for recognition of tax-exempt status (and related documents) at the National Office of the IRS in Washington, D.C. A person making such a written request is notified by the IRS when the material is available for inspection at the National Office, where notes may be taken of the material open for inspection, photographs taken with the person's own equipment, or copies of such material obtained from the IRS for a fee (Treas. Reg. secs. 301.6104(a)-6 and 301.6104(b)-1).

<u>New Federal Law (Sec. 170(e)(5), 6104)</u>

Contributions of appreciated stock to private foundations.

The provision extends permanently the special rule contained in section 170(e)(5).

Public inspection of private foundation returns.

Under the provision, private foundations are subject to the public inspection requirements that currently apply to public charities and all other tax-exempt organizations that file annual information returns. Accordingly, private foundations will be required to comply with requests from individuals who seek a copy of the foundation’s annual information return for any of the foundation’s three most recent taxable years. Private foundations are no longer subject to the publication requirements of section 6104(d).

Current California Law

Contributions of appreciated stock to private foundations.

California, in general, is conformed to the federal “itemized deduction” charitable contribution deduction. However, the special rule for contributions of qualified appreciated stock made to private foundations expired on December 31, 1994, and California has not conformed to its extension.

In addition, California law did not conform to the repeal of the treatment of contributions of appreciated property (real, personal, and intangible) as a tax preference for AMT purposes. Thus, for California purposes, the difference between the adjusted basis of the contributed appreciated property and its fair market value is an item of tax preference.

Public inspection of private foundation returns (R&TC Sec. 19565).

California law provides that an organization's application for exemption and any underlying documents that supported the application be open to public inspection. The Franchise Tax Board is to withhold information from public inspection that relates to trade secrets, patents, work process or style of work of the organization. Additionally, the Franchise Tax Board shall withhold information from public inspection that would adversely affect national defense if released.

Effective date

Contributions of appreciated stock to private foundations.

The provision is effective for contributions of qualified appreciated stock to private foundations made on or after July 1, 1998.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Public inspection of private foundation returns.

The additional public inspection provisions apply to requests made after the later of: (1) the date which is 60 days after the date on which the Treasury Department publishes regulations defining when requested documents have been made widely available or when a request is part of a harassment campaign, or (2) December 31, 1998. The repeal of the present-law publication requirement shall apply only to those returns the due date for filing of which is on or after the date the public inspection requirements become effective.

Impact on California Revenue

Based on the federal projection and consistent with previous estimates for conforming, revenue losses from allowing enhanced deductions for such contributions would be on the order of $3 million annually.

The public inspection of private foundation returns provision is not applicable.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
1005	Exceptions Under Subpart F for Certain Active Financing Income.

Background

In general.

Under the subpart F rules, certain U.S. shareholders of a controlled foreign corporation (CFC) are subject to U.S. tax currently on certain income earned by the CFC, regardless whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, "foreign personal holding company income" and insurance income. The U.S. 10% shareholders of a CFC also are subject to current inclusion with respect to their shares of the CFC's foreign base company services income (i.e., income derived from services performed for a related person outside the country in which the CFC is organized).

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities transactions; (4) net gains from foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other-country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income (Prop. Treas. Reg. sec. 1.953-1(a)).

Temporary exceptions from foreign personal holding company income and foreign base company services income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, insurance, or similar business. These exceptions (described below) are applicable only for taxable years beginning in 1998.

Income from the active conduct of a banking, financing, or similar business.

A temporary exception from foreign personal holding company income applies to income that is derived in the active conduct of a banking, financing, or similar business by a CFC that is predominantly engaged in the active conduct of such business. For this purpose, income derived in the active conduct of a banking, financing, or similar business generally is determined under the principles applicable in determining financial services income for foreign tax credit limitation purposes. However, in the case of a corporation engaged in the active conduct of a banking or securities business, the income that is eligible for this exception is determined under the principles applicable in determining the income that is treated as nonpassive income for purposes of the passive foreign investment company provisions. In this regard, the income of a corporation engaged in the active conduct of a banking or securities business that is eligible for this exception is the income treated as nonpassive under the regulations proposed under section 1296(b) (as in effect prior to the enactment of the Taxpayer Relief Act of 1997). See Prop. Treas. Reg. secs. 1.1296-4 and 1.1296-6. The Secretary of the Treasury is directed to prescribe regulations applying look-through treatment in characterizing for this purpose dividends, interest, income equivalent to interest, rents and royalties from related persons.

For purposes of the temporary exception, a corporation is considered to be predominantly engaged in the active conduct of a banking, financing, or similar business if it is engaged in the active conduct of a banking or securities business or is a qualified bank affiliate or qualified securities affiliate. In this regard, a corporation is considered to be engaged in the active conduct of a banking or securities business if the corporation would be treated as so engaged under the regulations proposed under prior law section 1296(b) (as in effect prior to the enactment of the Taxpayer Relief Act of 1997); qualified bank affiliates and qualified securities affiliates are as determined under such proposed regulations. See Prop. Treas. Reg. secs. 1.1296-4 and 1.1296-6.

Alternatively, a corporation is considered to be engaged in the active conduct of a banking, financing, or similar business if more than 70% of its gross income from such business is derived from transactions with unrelated persons located within the country under the laws of which the corporation is created or organized. For this purpose, income derived by a qualified business unit (QBU) of a corporation from transactions with unrelated persons located in the country in which the QBU maintains its principal office and conducts substantial business activity is treated as derived by the corporation from transactions with unrelated persons located within the country in which the corporation is created or organized. A person other than a natural person is considered to be located within the country in which it maintains an office through which it engages in a trade or business and by which the transaction is effected. A natural person is treated as located within the country in which such person is physically located when such person enters into the transaction.

Income from the active conduct of an insurance business.

A temporary exception from foreign personal holding company income applies for certain investment income of a qualifying insurance company with respect to risks located within the CFC’s country of creation or organization. These rules differ from the rules of section 953 of the Code, which determines the subpart

F inclusions of a U.S. shareholder relating to insurance income of a CFC. Such insurance income under section 953 generally is computed in accordance with the rules of subchapter L of the Code.

A temporary exception applies for income (received from a person other than a related person) from investments made by a qualifying insurance company of its reserves or 80% of its unearned premiums. For this purpose, in the case of contracts regulated in the country in which they are sold as property, casualty or health insurance contracts, unearned premiums and reserves are defined as unearned premiums and reserves for losses incurred determined using the methods and interest rates that would be used if the qualifying insurance company were subject to tax under subchapter L of the Code. Thus, for this purpose, unearned premiums are determined in accordance with section 832(b)(4), and reserves for losses incurred are determined in accordance with section 832(b)(5) and 846 of the Code (as well as any other rules applicable to a U.S. property and casualty insurance company with respect to such amounts).

In the case of a contract regulated in the country in which sold as a life insurance or annuity contract, the following three alternative rules for determining reserves apply. Any one of the three rules can be elected with respect to a particular line of business.

First, reserves for such contracts can be determined generally under the rules applicable to domestic life insurance companies under subchapter L of the Code, using the methods there specified, but substituting for the interest rates in Code section 807(d)(2)(B) an interest rate determined for the country in which the qualifying insurance company was created or organized, calculated in the same manner as the mid-term applicable Federal interest rate (“AFR”) (within the meaning of section 1274(d)).

Second, the reserves for such contracts can be determined using a preliminary term foreign reserve method, except that the interest rate to be used is the interest rate determined for the country in which the qualifying insurance company was created or organized, calculated in the same manner as the mid-term AFR. If a qualifying insurance company uses such a preliminary term method with respect to contracts insuring risks located in the country in which the company is created or organized, then such method is the method that applies for purposes of this election.

Third, reserves for such contracts can be determined to be equal to the net surrender value of the contract (as defined in section 807(e)(1)(A)).

In no event can the reserve for any contract at any time exceed the foreign statement reserve for the contract, reduced by any catastrophe or deficiency reserve. This rule applies whether the contract is regulated as a property, casualty, health, life insurance, annuity or any other type of contract.

A temporary exception from foreign personal holding company income also applies for income from investment of assets equal to: (1) one-third of premiums earned during the taxable year on insurance contracts regulated in the country in which they are sold as property, casualty, or health insurance contracts; and (2) the greater of 10% of reserves, or, in the case of a qualifying insurance company that is a startup company, $10 million. For this purpose, a startup company is a company (including any predecessor) that has not been engaged in the active conduct of an insurance business for more than five years. In general, the five-year period commences when the foreign company first is engaged in the active conduct of an insurance business. If the foreign company was formed before being acquired by the U.S. shareholder, the five-year period commences when the acquired company first was engaged in the active conduct of an insurance business. In the event of the acquisition of a book of business from another company through an assumption or indemnity reinsurance transaction, the five-year period commences when the acquiring company first engaged in the active conduct of an insurance business, except that if more than a substantial part (e.g., 80%) of the business of the ceding company is acquired, then the five-year period commences when the ceding company first engaged in the active conduct of an insurance business. Reinsurance transactions among related persons may not be used to multiply the number of five-year periods.

Under rules prescribed by the Secretary, income is allocated to contracts as follows. In the case of contracts that are separate account-type contracts (including variable contracts not meeting the requirements of sec. 817), only the income specifically allocable to such contracts is taken into account. In the case of other contracts, income not specifically allocable is allocated ratably among such contracts.

A qualifying insurance company is defined as any entity which: (1) is regulated as an insurance company under the laws of the country in which it is incorporated; (2) derives at least 50% of its net written premiums from the insurance or reinsurance of risks situated within its country of incorporation; and (3) is engaged in the active conduct of an insurance business and would be subject to tax under subchapter L if it were a domestic corporation.

The temporary exceptions do not apply to investment income (includable in the income of a U.S. shareholder of a CFC pursuant to sec. 953) allocable to contracts that insure related party risks or risks located in a country other than the country in which the qualifying insurance company is created or organized.

Anti-abuse rule.

An anti-abuse rule applies for purposes of these temporary exceptions. For purposes of applying these exceptions, items with respect to a transaction or series of transactions are disregarded if one of the principal purposes of the transaction or transactions is to qualify income or gain for these exceptions, including any change in the method of computing reserves or any other transaction or transactions one of the principal purposes of which is the acceleration or deferral of any item in order to claim the benefits of these exceptions.

Foreign base company services income.

A temporary exception from foreign base company services income applies for income derived from services performed in connection with the active conduct of a banking, financing, insurance or similar business by a CFC that is predominantly engaged in the active conduct of such business or is a qualifying insurance company.

New Federal Law (Sec. 953, 954)

In general.

The provision extends and modifies the present-law temporary exceptions from subpart F for income that is derived in the active conduct of a banking, financing, or similar business or in the conduct of an insurance business. These exceptions (as modified) are applicable only for taxable years beginning in 1999.

With respect to income derived in the active conduct of a banking, financing, or similar business, the provision differs from the present-law temporary exceptions in the following significant respects. First, the provision requires a CFC to conduct substantial activity with respect to its business in order to qualify for the exceptions. Second, the provision adds certain nexus requirements which require that income which is derived by a CFC or QBU from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Third, the provision modifies the tests for determining whether a CFC is predominantly engaged in the active conduct of a banking, financing, or similar business, including modifications for income derived from a lending or finance business. Fourth, the provision extends the exceptions to income derived from certain cross border transactions, provided that certain requirements are met. Fifth, the determination of where a customer is treated as located is made under rules prescribed by the Secretary of the Treasury. Finally, the look-through rule that was included in the present-law provision for purposes of determining the income eligible for the exceptions is eliminated.

In the case of insurance, the provision differs from present law in the following significant respects. In addition to the present exception for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization, the provision provides additional exceptions. First, the provision provides temporary exceptions from insurance income and from foreign personal holding company income for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, the provision adds additional temporary exceptions from insurance income and from foreign personal holding company income for certain income of certain CFCs or branches with respect to risks located in any country other than the United States, provided that the requirements for these exceptions are met.

Income from the active conduct of a banking, financing, or similar business.

Substantial activity requirement.

The provision modifies the exceptions from subpart F for income derived in the active conduct of a banking, financing, or similar business by, among other things, incorporating a substantial activity requirement. Under the provision, the subpart F exceptions apply to a CFC that is an eligible controlled foreign corporation (an “eligible CFC”). An eligible CFC is defined as a CFC that is predominantly engaged in the active conduct of a banking, financing, or similar business, but only if it conducts substantial activity with respect to such business.

Whether a CFC is considered to conduct substantial activity with respect to a banking, financing, or similar business is determined under all the facts and circumstances. Congress intended that, as part of this facts and circumstances analysis in determining whether the activities conducted by the CFC are substantial, all relevant factors are taken into account, including the overall size of the CFC, the amount of its revenues and expenses, the number of its employees, the ratio of its revenues per employee, the amount of property it owns, and the nature, size, and relative significance of the applicable activities conducted by the CFC. Under the provision, the Treasury Secretary is granted the authority to prescribe regulations to carry out the purposes of these exceptions. Congress further intended that such authority includes the authority to prescribe rules relating to whether a CFC (or, as relevant, a QBU) is considered to conduct substantial activity.

Congress also intended that as part of this facts and circumstances analysis, a CFC is required to conduct substantially all of the activities necessary for the generation of income with respect to the business, which generally include the following:

- initial solicitation of customers (including vendors);
- advising customers on financial needs, including funding and financial products;
- providing financial and technical advice to customers;
- designing or tailoring financial products to customers’ needs;
- negotiating terms with customers;
- performing credit analysis on customers and evaluating noncredit risks;
- providing related services to customers;
- making loans, entering into leases, extending credit or entering into other transactions with customers that generate income that would be considered derived in the active conduct of a banking, financing, or similar business;
- collecting from customers;

- performing remarketing activities (including sales) following termination of transactions with customers;
- responding to customers' failure to satisfy their obligations under transactions, including enforcement or renegotiation of terms, liquidation of collateral, foreclosure, and/or institution of litigation; and
- holding collateral for transactions with customers.

Congress intended that the performance of back-office functions (including accounting for income or loss, recordkeeping, and routine communicating with customers) not be taken into account in determining whether the substantial activity requirement is satisfied. Congress also intended that the relevant activities of the business may be modified by Treasury regulation to take into account future changes in the operations of these businesses.

In general, the substantial activity requirement is applied based on the activities of the CFC as a whole, including the activities of any QBUs of the CFC. In determining whether the substantial activity requirement is satisfied, activities performed in the country in which the CFC is incorporated (or in the country in which the QBU has its principal office) by employees of a related person of the CFC are taken into account, but only to the extent that the related person is compensated on an arm's-length basis for the services of such employees and such compensation is includible in the related person's income in such country for purposes of such country's income tax laws. For this purpose, a related person has the meaning provided in section 954(d)(3), substituting "at least 80%" for "more than 50%." Congress intended that the activities of such a related person are not again taken into account in determining whether another CFC or QBU (e.g., the related person) satisfies the substantial activity requirement.

Predominantly engaged requirement.

The provision also modifies the rules for determining whether a CFC is predominantly engaged in the active conduct of a banking, financing, or similar business. Alternative rules apply for this purpose.

Banking or securities business. The provision modifies the present-law application of the banking or securities business tests for determining whether a CFC is predominantly engaged in the active conduct of a banking, financing, or similar business. Under the provision, a CFC is considered to be predominantly engaged in the active conduct of a banking, financing, or similar business if it is engaged in the active conduct of a banking business and is an institution licensed to do business as a bank in the United States (or is any other corporation not so licensed which is specified in regulations). In addition, a CFC is considered to be predominantly engaged in the active conduct of a banking, financing, or similar business if it is engaged in the active conduct of a securities business and is registered as a securities broker or dealer under applicable U.S. securities laws (or is any other corporation not so registered which is specified in regulations). Congress generally intended that these requirements for the active conduct of a banking or securities business be interpreted in the manner provided in the regulations proposed under prior law section 1296(b) (as in effect prior to the enactment of the Taxpayer Relief Act of 1997). See Prop. Treas. Reg. secs. 1.1296-4 and 1.1296-6. Specifically, Congress intended that these requirements include the requirements for foreign banks under Prop. Treas. Reg. sec. 1.1296-4 as currently drafted. However, Congress did not intend that these requirements be considered to be satisfied by a CFC merely because it is a qualified bank affiliate or a qualified securities affiliate within the meaning of the proposed regulations under former section 1296(b).

Lending or finance business. The provision modifies the present-law 70% test for determining whether a CFC is predominantly engaged in the active conduct of a banking, financing, or similar business. Under the provision, a CFC is considered to be predominantly engaged in the active conduct of such business if more than 70% of its gross income is derived directly from the active and regular conduct of a lending or finance business from transactions with customers which are unrelated persons. For this purpose, Congress intended that transactions with customers located in the United States not be taken into account in determining whether the 70% test is satisfied.

For this purpose, a CFC is considered to be engaged in a lending or finance business if it is engaged in the business of:

1. making loans;
2. purchasing or discounting accounts receivable, notes (including loans), or installment obligations;
3. engaging in leasing (including entering into leases and purchasing, servicing and disposing of leases and leased assets);
4. issuing letters of credit and providing guarantees;
5. providing charge and credit card services; or
6. rendering services or making facilities available in connection with the foregoing activities carried on by the corporation rendering such services or facilities, or by another corporation which is a member of the same affiliated group.

For this purpose, whether two corporations are affiliated is determined by reference to section 1504 with one modification: the exclusion for foreign corporations is disregarded.

Whether any portion of a CFC’s gross income is derived directly from the active and regular conduct of a lending or finance business is determined under all the facts and circumstances. Under the provision, the Treasury Secretary is granted the authority to prescribe regulations to carry out the purposes of these exceptions. Congress intended that such authority includes the authority to prescribe rules relating to this determination.

Qualified banking or financing income exempt from subpart F.

In general. If a CFC is treated as an eligible CFC (i.e., it satisfies the substantial activity and predominantly engaged requirements), the subpart F exceptions apply to qualified banking or financing income of such corporation. Qualified banking or financing income is defined as income which is derived in the active conduct of a banking, financing, or similar business by an eligible CFC or a QBU of such CFC if: (1) the income is derived from transactions with customers not located in the United States, (2) substantially all of the activities in connection with such transactions are conducted directly by the corporation or unit in its home country, and (3) the income is treated as earned by such corporation or unit in its home country for purposes of such country's tax laws. For this purpose, income is considered to be earned by a CFC or a QBU in its home country if such income is sourced and allocable to such CFC or QBU in its home country for purposes of such country's tax laws. In addition, for this purpose, activities are considered to be conducted by a CFC or QBU if such activities are performed by employees of the CFC or QBU. Except as provided by regulations, a CFC's home country is defined as its country of creation or organization, and a QBU's home country is defined as the country in which the unit maintains its principal office. Moreover, income derived from transactions with customers apply only to transactions with customers acting in their capacity as such.

For this purpose, Congress intended that income derived by an eligible CFC or QBU of such CFC from the following types of activities be considered to be income derived in the active conduct of a banking, financing, or similar business (provided that the other requirements for these exceptions are satisfied):

1. regularly making personal, mortgage, industrial, or other loans in the ordinary course of the corporation's trade or business;
2. factoring evidences of indebtedness for customers;
3. purchasing, selling, discounting, or negotiating for customers notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness;
4. issuing letters of credit and negotiating drafts drawn thereunder for customers;
5. performing trust services, including as a fiduciary, agent, or custodian, for customers, provided such trust activities are not performed in connection with services provided by a dealer in stock, securities or similar financial instruments;
6. arranging foreign exchange transactions (including any section 988 transaction within the meaning of section 988(c)(1)) for, or engaging in foreign exchange transactions with, customers;
7. arranging interest rate or currency futures, forwards, options or notional principal contracts for, or entering into such transactions with, customers;
8. underwriting issues of stock, debt instruments or other securities under best efforts or firm commitment agreements for customers;
9. engaging in leasing (including entering into leases and purchasing, servicing and disposing of leases and leased assets);
10. providing charge and credit card services for customers or factoring receivables obtained in the course of providing such services;

11. providing traveler's check and money order services for customers;
12. providing correspondent bank services for customers;
13. providing paying agency and collection agency services for customers;
14. maintaining restricted reserves (including money or securities) in a segregated account in order to satisfy a capital or reserve requirement imposed by a local banking or securities regulatory authority;
15. engaging in hedging activities directly related to another activity described herein;
16. repackaging mortgages and other financial assets into securities and servicing activities with respect to such assets (including the accrual of interest incidental to such activity);
17. engaging in financing activities typically provided in the ordinary course by an investment bank, such as project financing provided in connection with construction projects, structured finance (including the extension of a loan and the sale of participations or interests in the loan to other financial institutions or investors), and leasing activities to the extent incidental to such financing activities;
18. providing financial or investment advisory services, investment management services, fiduciary services, or custodial services;
19. purchasing or selling stock, debt instruments, interest rate or currency futures or other securities or derivative financial products (including notional principal contracts) from or to customers and holding stock, debt instruments and other securities as inventory for sale to customers, unless the relevant securities or derivative financial products are not held in a dealer capacity;
20. effecting transactions in securities for customers as a securities broker; and
21. any other activity that the Secretary of the Treasury determines to be a financing activity conducted by active corporations in the ordinary course of their business.

Qualified banking or financing income of an eligible CFC or QBU of such CFC is determined separately for the CFC and each QBU, taking into account, in the case of an eligible CFC, only items of income, gain, deduction, loss or other items, as well as activities, of such CFC that are not properly allocable to any QBUs. Similarly, in the case of a QBU, qualified banking or financing income is determined by taking into account such applicable items (e.g., income and activities) that are properly allocable to such QBU. Under the provision, the Treasury Secretary is granted the authority to prescribe regulations to carry out the purposes of these exceptions. Congress intended that such authority includes the authority to prescribe rules for properly allocating items and activities among branches or units of a CFC, and between the CFC and its branches or units.

Income from local customer transactions. If the requirements above are satisfied, the exceptions apply to income that is derived from transactions with customers located in the CFC's home country. In addition, the exceptions apply to income that is derived by a QBU of an eligible CFC from transactions with customers located in the QBU's home country.

For example, assume that a CFC is incorporated in the United Kingdom and has operations in France that constitute a QBU. Also assume that the activities of the U.K. CFC's head office together with the activities of the French QBU satisfy the substantial activity requirement. Under the provision, income derived by the U.K. CFC from transactions with customers in the United Kingdom is eligible for the exceptions if substantially all of the activities in connection with the transaction are performed in the United Kingdom by employees of the U.K. CFC, and the income is treated as earned by the U.K. CFC in the United Kingdom for U.K. income tax purposes. In addition, income derived by the French QBU from transactions with customers in France is eligible for the exceptions if substantially all of the activities in connection with the transactions are performed in France by employees of the French QBU, and the income is treated as earned by the French QBU in France for French income tax purposes.

Income from cross border transactions. If the requirements above are satisfied, the exceptions also apply to income from certain cross border transactions, but only if a higher standard with respect to the substantial activity requirement is satisfied. Under the provision, income derived by a CFC from transactions with customers not located in the CFC's home country or the United States is eligible for the exceptions if the CFC conducts substantial activity with respect to a banking, financing, or similar business in its home country. In addition, income derived by a QBU of an eligible CFC from transactions with customers not located in the QBU's home country, or the United States, is eligible for the exceptions, but only if the QBU conducts substantial activity with respect to such a business in its home country. For this purpose, the substantial activity requirement is applied by looking only at the activities of the applicable CFC or QBU on a stand-alone basis. Thus, income derived by a QBU from transactions with customers not located in its home country (or in the United States) is eligible for the exceptions if the activities of the QBU itself constitute substantial activities (provided that the other requirements are satisfied).

Consider again the U.K. CFC and the French QBU. If the head office of the U.K. CFC derives income from a transaction with a customer in Germany, the income is eligible for the exceptions if the activities of the CFC itself (without regard to those of the French QBU) satisfy the substantial activity requirement. Alternatively, if the French QBU derives income from a transaction with a German customer, the income is eligible for the exceptions if the activities of the French QBU itself satisfy the substantial activity requirement.

Home country requirement for income earned with respect to a lending or finance business. In the case of a lending or finance business, in addition to the requirements described above, the provision includes an additional requirement to qualify for the exceptions in the case of income earned by a CFC which qualifies as an eligible CFC by satisfying the predominantly engaged requirement for an active lending or finance business. For such an eligible CFC, income derived by such CFC is eligible for the exceptions only if such CFC derives more than 30% of its gross income directly from the active and regular conduct of a lending or finance business from transactions with customers that are unrelated persons and that are located within the CFC's home country (the "home country" requirement). In addition, income derived by a QBU of such an eligible CFC is eligible for the exceptions only if such QBU derives more than 30% of its gross income directly from the active and regular conduct of a lending or finance business from transactions with customers that are unrelated persons and that are located within the QBU's home country. For this purpose, Congress intended that transactions with customers located in the United States not be taken into account.

The home country requirement is applied on a stand-alone basis to the particular CFC or QBU. Thus, the 30% gross income test takes into account only the gross income of a particular CFC (without regard to the income of its QBUs) from transactions with its home-country unrelated customers. Similarly, in the case of a QBU, there is taken into account the gross income of the particular QBU (without regard to the income of the CFC or other QBUs) from transactions with its home-country unrelated customers. Accordingly, if more than 70% of the CFC's gross income is derived directly from the active and regular conduct of a lending or finance business from transactions with unrelated customers, and one of the CFC's QBUs satisfies the home country requirement but another QBU does not satisfy such requirement, income derived by the QBU that satisfies the home country requirement is eligible for the exceptions from subpart F (provided that the other requirements are satisfied), but income derived by the other QBU is not eligible for the exceptions.

Coordination with other rules. The provision provides that the exceptions under section 954(h) for income derived in the active conduct of a banking, financing, or similar business do not apply to income described in the dealer exception under section 954(c)(2)(C)(ii) (described below) for a dealer in securities which is an eligible CFC that satisfies the predominantly engaged requirement for a securities business.

In addition, Congress expected that the Treasury Department and the Internal Revenue Service will issue timely guidance to make currently effective conforming changes to existing regulations in order to reflect the exceptions under section 954(h), including conforming changes to the regulations under section 954(c)(3).

Exception for securities dealers.

The provision provides an additional exception from foreign personal holding company income for certain income derived by a securities dealer within the meaning of section 475 (the so-called "dealer exception"). The dealer exception applies to interest or dividends (or equivalent amounts described in sec. 954(c)(1)(E) or (G)) from any transaction (including a hedging transaction or a transaction consisting of a deposit of collateral or margin described in sec. 956(c)(2)(J)) entered into in the ordinary course of the dealer's trade or business as such a securities dealer, but only if the income is attributable to activities of the dealer in the country in which the dealer is created or organized (or, in the case of a QBU of the dealer, is attributable to activities of the QBU in the country in which the QBU both maintains its principal office and conducts substantial business activity). For this purpose, income is considered to be attributable to activities of the dealer in its country of incorporation (or to a QBU in the country in which the QBU both maintains its principal office and conducts substantial business activity), if such income is attributable to activities performed in such country by employees of the dealer (or QBU), and such income is treated as earned in such country by the dealer (or QBU) for purposes of such country's tax laws. For this purpose, income is considered to be earned in the country in which the dealer is created or organized (or, in the case of a QBU, in the country in which the QBU both maintains its principal office and conducts substantial business activity), if such income is sourced and allocable to such dealer (or QBU) in such country for purposes of such country's tax laws. Congress intended that the dealer exception not apply to income from transactions with persons located in the United States with respect to U.S. securities. This reflects the understanding that the exception from current inclusion under subpart F for income earned by dealers in securities does not apply to activities that would otherwise be conducted in the United States. In addition, Congress intended that the dealer exception will apply to interest paid by customers to the dealer on margin loans in connection with sales of securities (provided that the other requirements of the provision are satisfied).

Insurance income.

In general.

The provision provides a temporary exception to insurance income under section 953. For purposes of the exception to insurance income, reserves for an exempt insurance or annuity contract are determined in the same manner as under the temporary exception, described below, for foreign personal holding company income relating to certain insurance contracts (sec. 954(i), as added by the provision). For purposes of these provisions, Congress intended that reserves include discounted unpaid losses or losses incurred, as appropriate, for property and casualty contracts.

Operation of the exception.

The provision provides an exception from insurance income for income derived by a qualifying insurance company that is attributable to the issuing (or reinsuring) of an exempt contract by the qualifying insurance company or a qualifying insurance company branch of such a company, and that is treated as earned by the company or branch in that company's, or branch's, home country for purposes of that country's tax laws. The exception from insurance income does not apply to income attributable to the issuing (or reinsuring) of an exempt contract as the result of any arrangement whereby another corporation receives a substantially equal amount of premiums or other consideration in respect of issuing (or reinsuring) a contract that is not an exempt contract. An exempt contract is an insurance or annuity contract issued or reinsured by a qualifying insurance company or qualified insurance company branch in connection with property in, liability arising out of activity in, or the lives or health of residents of, a country other than the United States.

No contract is treated as an exempt contract unless the qualifying insurance company or branch derives more than 30% of its net written premiums from exempt contracts (determined without regard to this sentence) covering applicable home country risks, and with respect to which no policyholder, insured, annuitant, or beneficiary is a related person (within the meaning of sec. 954(d)(3)). Applicable home country risks are risks in connection with property in, liability arising out of activity in, or the lives or health of residents of the home country of the qualifying insurance company or branch, as the case may be. In all cases, the 30% test is applied on a unit-by-unit basis. Accordingly, income derived by a qualifying insurance company branch of a CFC qualifies only if such branch alone satisfies the 30% test (without regard to the net written premiums of any other branch). Income derived by the CFC qualifies only if the CFC alone satisfies the 30% test without regard to the net written premiums of any other unit or branch of the CFC.

When determinations under the provision are made separately with respect to a qualifying insurance company and its qualifying insurance company branch or branches, then in the case of the qualifying insurance company, only income, gain, or loss and activities of the company not properly allocable or attributable to any qualifying insurance company branch are taken into account. In the case of a qualifying insurance company branch, only income, gain, or loss and activities of the branch that are properly allocable or attributable to it are taken into account. Under the provision, the Treasury Secretary is granted the authority to carry out the purposes of these exceptions. Congress intended that such authority includes the authority to prescribe rules for properly allocating items and activities among branches or units of a CFC, and among the CFC and its branches or units.

The home country of a CFC is the country in which the CFC is created or organized. The home country of a qualified business unit that is a qualifying insurance company branch of a qualifying insurance company means the country in which the principal office of such unit is located and in which such unit is licensed, authorized, or regulated by the applicable insurance regulatory body to sell insurance, reinsurance or annuity contracts to persons other than related persons (within the meaning of sec. 954(d)(3)) in that country.

Qualifying insurance company.

A qualifying insurance company is a CFC that meets the following requirements, which are intended to distinguish firms that have a real business nexus with a foreign country or countries from firms that do not. The first requirement is that the CFC be subject to regulation as an insurance (or reinsurance) company by its home country, and that the CFC be licensed, authorized, or regulated by the applicable insurance regulatory body for its home country to sell insurance, reinsurance, or annuity contracts to persons other than related persons (within the meaning of section 954(d)(3)) in its home country.

The second requirement is that the CFC derive more than 50% of its aggregate net written premiums from the insurance or reinsurance by the CFC (on an aggregate basis, including qualifying insurance company branches) covering applicable home country risks (as described above) of the CFC or branch, as the case may be. For purposes of this rule, if a policyholder, insured, annuitant, or beneficiary is a related person, then the contract is treated as not covering home country risks. A related person has the meaning set forth in section 954(d)(3). In the case of a qualifying insurance company branch, premiums are taken into account under this second requirement only to the extent that the premiums are treated as earned by the branch in its home country for purposes of that country's tax laws.

The 50% test applies on an aggregate basis. For example, assume that a German CFC has a branch in France and a branch in Italy. Assume that $50 of net written premiums are properly allocable to the Italian branch,. $100 of net written premiums are properly allocable to the French branch, and $100 of net written premiums are properly allocable to the CFC in Germany. For the Italian branch, assume $20 of the $50, or 40%, is from home country risks. For the French branch, assume that $80 of the $100, or 80%, is from home country risks. For the CFC in Germany, assume that $60 of the $100, or 60%, is from home country risks. Taking into account the respective amounts and percentages, the CFC has 64% of its net written premiums from home country risks on an aggregate basis.

The third requirement is that the CFC be engaged in the insurance business and that it would be subject to tax under subchapter L if it were a domestic corporation. A CFC is considered to be engaged in the insurance business, within the meaning of this provision, if it operates in a manner consistent with the operation of other bona fide commercial insurance companies that sell insurance products to unrelated parties in its home country, and conducts managerial activities in that country with respect to the major functions of the insurance business. A factor, among others, that could be considered in determining whether it conducts managerial activities in its home country with respect to the major functions of the insurance business may be whether in its home country it exercises key decision making in determining business strategy with respect to the major functions of the insurance business. For purposes of the requirement that the CFC be engaged in the insurance business, activities performed in the home country of the CFC by employees of the CFC and of a related person are taken into account to the extent that the related person is compensated on an arm's-length basis for the services of such employees and such compensation is includible in the related person's income in such country for purposes of that country's tax laws. For this purpose, a related person has the meaning provided in section 954(d)(3), substituting "at least 80%" for "more than 50%." In determining whether a CFC is engaged in the insurance business, for example, an entity that is not engaged in regular and continuous transactions with persons that are not related persons (as described in the anti-abuse rules) is not considered as engaged in the insurance business.

Qualifying insurance company branch.

A qualifying insurance company branch is a qualified business unit of a CFC that meets two requirements. A qualified business unit means any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records (within the meaning of sec. 989(a)). The first requirement is that the unit be licensed, authorized, or regulated by the applicable insurance regulatory body for its home country to sell insurance, reinsurance or annuity contracts to persons other than related persons (within the meaning of sec. 954(d)(3)) in that country. Congress intended that the applicable insurance regulatory body be the regulatory body that has the authority to license, authorize, or regulate with respect to the insurance business in the country where the branch is located and a branch that is regulated by such a body be considered to be regulated in the country where the branch is located. The second requirement is that the CFC (of which the branch is a unit) be a qualifying insurance company, taking the unit into account for purposes of the applicable tests (above) as if it were a qualifying insurance company branch.

Additional requirements in the case of cross border risks.

The provision imposes additional requirements with respect to any contract that covers cross border risks (that is, risks other than applicable home country risks), due to the increased concern about mobility of income in cross border business. A contract issued by a qualifying insurance company or qualifying insurance company branch that covers risks other than applicable home country risks is not treated as an exempt contract unless such company or branch, as the case may be, (1) conducts substantial activity in its home country with respect to the insurance business, and (2) performs in its home country substantially all of the activities necessary to give rise to the income generated by the contract.

Whether a CFC or unit thereof is considered to perform in its home country substantial activities with respect to the insurance business is determined under all the facts and circumstances. Congress intended that, as part of this facts and circumstances analysis in determining whether the activities conducted by the CFC or unit are substantial, all relevant factors are taken into account, including the overall size of the CFC or unit, the amount of its revenues and expenses, the number of its employees, the ratio of its revenues per employee, the amount of property it owns, and the nature, size and relative significance of the applicable activities conducted by the CFC or unit. Under the provision, the Treasury Secretary is granted the authority to carry out the purposes of these exceptions. Congress intended that such authority includes the authority to prescribe regulations relating to whether a CFC or unit is considered to conduct substantial activity.

Congress also intended that as part of this facts and circumstances analysis, a CFC or unit is required to conduct substantially all of the activities necessary for the generation of income with respect to the insurance business. Such activities of an insurance business generally depend on the line of business, and could include:

1. designing or tailoring insurance products to meet market or customer requirements;
2. performing actuarial analysis with respect to insurance products;
3. determining investment options for separate account-type products;
4. performing underwriting functions with respect to insurance products;
5. performing analysis for purposes of risk assessment;
6. performing analysis for purposes of setting premium rates;
7. performing analysis for purposes of calculating reserves;
8. performing claims management and adjustment functions;
9. developing marketing strategies, advertising and other public image activities;
10. making (or arranging for) sales to customers;
11. maintaining reserves and surplus (other than excess surplus);
12. making (or arranging for) investments; and
13. collecting from customers.

Congress further intended that the performance of back-office functions (including accounting for income or loss, recordkeeping, and routine communicating with customers) not be taken into account in determining whether the substantial activity requirement is satisfied. Congress also intended that the relevant activities of the business may be modified by Treasury regulation to take into account the actual operation of lines of insurance business and future changes in the operation of lines of insurance business.

Congress further intended that activities performed in the CFC's or unit's home country by employees of a related person (within the meaning of sec. 954(d)(3), substituting "at least 80%" for "more than 50%") be taken into account, to the extent that the related person is compensated on an arm's-length basis for the services of such employees and such compensation is includible in the related person's income in that country for purposes of such country's tax laws. Congress also intended that the activities of such a related person are not again taken into account in determining whether another CFC or unit (e.g., the related person) satisfies the substantial activity requirement.

In addition, with respect to a contract issued by a qualifying insurance company or qualifying insurance company branch that covers risks other than applicable home country risks, the qualifying insurance company or qualifying insurance company branch is required to perform in its home country substantially all of the activities necessary to give rise to the income generated by the contract.

Foreign personal holding company income with respect to insurance.

The provision provides a temporary exception from foreign personal holding company income for certain investment income derived by a qualifying insurance company and by certain qualifying insurance company branches.

The exception applies to income (received from a person other than a related person) from investments made by a qualifying insurance company or qualifying insurance company branch of its reserves allocable to exempt contracts or 80%

of its unearned premiums from exempt contracts. For this purpose, an exempt contract has the meaning provided under the provision.

In the case of exempt contracts that are property, casualty, or health insurance contracts, unearned premiums and reserves mean unearned premiums and reserves for losses incurred determined using the methods and interest rates that would be used if the qualifying insurance company or qualifying insurance company branch were subject to tax under subchapter L of the Code, with certain modifications. For this purpose, unearned premiums and losses incurred are determined in accordance with section 832(b) and 846 of the Code (as well as any other rules applicable to a U.S. property and casualty insurance company with respect to such amounts). However, in applying these rules, there is substituted for the applicable federal interest rate the interest rate determined for the functional currency of the company or branch and which (except as provided by the Treasury Secretary) is calculated in the same manner as the Federal mid-term rate under section 1274(d). In addition, substituted for the loss payment pattern under section 846 is the appropriate foreign loss payment pattern determined by the Treasury Secretary for the line of business. In the case of health insurance contracts, Congress intended that appropriate foreign mortality and morbidity tables be used for this purpose. In the case of disability contracts (other than credit disability), which are subject to section 846(f)(6)(A), Congress intended that mortality and morbidity tables reasonably reflect appropriate experience and foreign mortality and morbidity factors.

In the case of an exempt contract that is a life insurance or annuity contract, reserves for such contracts are determined as follows. The reserves equal the greater of: (1) the net surrender value of the contract (as defined in section 807(e)(1)(A)), including in the case of pension plan contracts; or (2) the amount determined by applying the tax reserve method that would apply if the qualifying insurance company were subject to tax under Subchapter L of the Code, with the following modifications: First, substituted for the applicable federal interest rate is an interest rate determined for the functional currency of the qualifying insurance company's home country, calculated (except as provided by the Treasury Secretary in order to address insufficient data and similar problems) in the same manner as the mid-term applicable Federal interest rate (AFR) (within the meaning of section 1274(d)). Second, substituted for the prevailing state assumed rate is the highest assumed interest rate permitted to be used for purposes of determining statement reserves in the foreign country for the contract. Third, in lieu of U.S. mortality and morbidity tables, applied mortality and morbidity tables reasonably reflect the current mortality and morbidity risks in the foreign country. Fourth, the Treasury Secretary may provide that the interest rate and mortality and morbidity tables of a qualifying insurance company may be used for one or more of its branches when appropriate.

In no event may the reserve for any contract at any time exceed the foreign statement reserve for the contract, reduced by any catastrophe, equalization, or deficiency reserve or any similar reserve. In the case of a contract that is a property, casualty, or health insurance contract, Congress intended that this limitation applies with respect to unpaid losses by line of business (similar to sec. 846(a)(3)). These rules apply whether the contract is regulated as a property, casualty, health, life insurance, annuity, or any other type of contract.

The provision also provides an exception from foreign personal holding company income for income from investment of assets equal to (1) one-third of premiums earned during the taxable year on exempt contracts regulated in the country in which sold as property, casualty, or health insurance contracts, and (2) 10% of reserves (determined for purposes of the provision) for contracts regulated in the country in which sold as life insurance or annuity contracts. In no event does the exception from foreign personal holding company income apply to investment income with respect to excess surplus.

To prevent the shifting of relatively high-yielding assets to generate investment income that qualifies under this temporary exception, the provision provides that, except as provided by the Treasury Secretary, income is allocated to contracts as follows. In the case of a separate account-type contract (including a variable contract not meeting the requirements of section 817), the income credited under the contract is allocable only to that contract. Income not so allocated generally is allocated ratably among all contracts that are not separate account-type contracts, subject to the anti-abuse rules (described below).

Other definitions and anti-abuse rules relating to insurance.

The provision provides that the present-law statutory definition of a life insurance contract (under secs. 7702 or 101(f)), as well as the distribution on death requirement of section 72(s) and the diversification requirement of section 817(h), do not apply for purposes of determining reserves for a life insurance or annuity contract under sections 953 and 954 of the Code, provided that neither the policyholders, the insureds or annuitants, nor the beneficiaries with respect to the contract, are U.S. persons.

The provision provides a rule coordinating the exception to insurance income with the present-law special rule for certain captive insurance companies (sec. 953(c)). Under the coordination rule, the scope of the present-law rule that related party insurance income is treated as subpart F income is retained. The exception under the provision from the definition of insurance income does not include income derived from exempt contracts that cover risks other than applicable home country risks for purposes of the rules of section 953(c).

The anti-abuse rules applicable under the subpart F exceptions provided in section 954(h) (other than sec. 954(h)(7)(B) as added by the provision) apply to these exceptions for insurance. In addition, the provision provides anti-abuse rules applicable under the exceptions from subpart F income relating to insurance.

The provision provides that there shall be disregarded any item of income, gain, loss, or deduction of, or derived from, an entity which is not engaged in regular and continuous transactions with persons that are not related persons. Congress intended this rule, for example, address the use of fronting companies or similar entities (that are not engaged in regular and continuous transactions with persons that are not related persons) to reinsure risks in a manner to cause a CFC or branch to qualify as a qualifying insurance company or qualifying insurance company branch by meeting percentage requirements with respect to home country risks that it would not otherwise meet.

The provision provides that there shall be disregarded any change in the method of computing reserves or any other transaction or transactions one of the principal purposes of which is the acceleration or deferral of any item in order to claim the benefits of these exceptions.

The provision also provides that a contract is not treated as an exempt contract (as described above) if any policyholder, insured, annuitant, or beneficiary is a resident of the United States; the contract was marketed to the U.S. resident; and it was written to cover a risk outside the United States.

The provision also provides that a contract is not treated as an exempt contract if the contract covers risks located both within and outside the United States, and the qualifying insurance company or branch does not maintain such records and file such reports with respect to the contract as the Treasury Secretary requires. Congress intended that documentation that is contemporaneous with the issuance of the contract be maintained by the qualifying insurance company or branch.

The provision also provides that the Treasury Secretary may prescribe rules for the allocation of contracts (and income from contracts) among two or more qualifying insurance company branches of a qualifying insurance company in order to clearly reflect the income of such branches.

The provision also provides that premiums from a contract are treated as not covering home country risks (and are treated as covering risks other than home country risks) for purposes of the tests for 30% and 50%, respectively, of net written premiums if the contract reinsures a contract issued or reinsured by a related person (within the meaning of sec. 954(d)(3)).

The provision also provides that the Treasury Secretary may prescribe regulations as may be necessary or appropriate to carry out the purposes of the exceptions from insurance income and foreign personal holding company income provided under sections 953(e) and 954(i) (as added by the provision).

Other anti-abuse rules.

The provision generally includes the anti-abuse rules of the present-law provision, with certain further refinements. Under the provision, the anti-abuse rules provide that items with respect to a transaction or series of transactions are disregarded if one of the principal purposes of the transaction or transactions is to qualify income or gain for these exceptions, including any transaction or a series of transactions a principal purpose of which is the acceleration or deferral of any item in order to claim the benefits of these exceptions. In addition, the anti-abuse rules provide that items of an entity which is not engaged in regular and continuous transactions with customers which are not related persons are disregarded. Moreover, items with respect to a transaction or series of transactions are disregarded if one of the principal purposes of the transaction or transactions is to qualify income or gain for these exceptions, including utilizing or doing business with: (1) one or more entities in order to satisfy any home country requirement, or (2) a special purpose entity or arrangement, including a securitization or financing arrangement or any similar entity or arrangement. Finally, the anti-abuse rules provide that a related person, officer, director, or employee with respect to any CFC (or QBU) which otherwise would be treated as a customer of such corporation or unit with respect to any transaction is not treated as a customer, if a principal purpose of such transaction is to satisfy any requirement for these exceptions.

Sale of assets of an active financing business.

The provision includes a modification to address the treatment of sales of assets of an active financing business. In general, foreign personal holding company income includes net gains from the sale or exchange of property that gives rise to dividends, interest, royalties, rents, or annuities. The provision provides an exception from this rule for income that qualifies for the exception from subpart F for income derived in the active conduct of a banking, financing, or similar business. Under the provision, foreign personal holding company income does not include net gains from the sale or exchange of property that gives rise to dividends, interest, royalties, rents, or annuities if such property gives rise to income not treated as foreign personal holding company income for the taxable year by reason of the exceptions under section 954(h) or (i) (as added by the provision) for income derived in the active conduct of a banking, financing, or similar business or in the conduct of an insurance business. Congress intended that this exception apply only to the extent that, prior to its disposition, the property was held to generate or generated income which qualifies for the exceptions under section 954(h) or (i) (and such property was not so held for a principal purpose of taking advantage of such exception).

Exceptions from foreign base company services income.

The present-law provision includes a corresponding exception from foreign base company services income for income derived by a CFC from the performance of services that are directly related to a transaction entered into by the CFC that gives rise to income that is eligible for these exceptions from subpart F. Under the provision, foreign base company services income does not include income that is not treated as foreign personal holding company income by reason of the exceptions under section 954(h) or 954(i), or the securities dealer exception under section 954(c)(2)(C)(ii), or treated as exempt insurance income by reason of section 953(e) (as added by the provision).

Other matters.

Congress also stated that nothing in this provision was intended to alter the Treasury Department’s agreement, as reflected in Notice 98-35, not to finalize regulations regarding so-called hybrid entities prior to January 1, 2000, in order to allow Congress the opportunity to fully consider the tax policy issues involved.

Current California Law (R&TC Sec. 25110)

In general, California does not conform to the federal rules relating to controlled foreign corporations. However, for California water's-edge purposes, a controlled foreign corporation (CFC) is required to be included in the water's-edge combined report if the CFC has Subpart F income defined in Section 952 of the Internal Revenue Code.

The income of the CFC that will be subject to California apportionment is the CFC's net income computed under the Rev. & Tax Code, multiplied by the ratio of subpart F income defined by Section 952 of the Internal Revenue Code over earnings and profits defined in Section 964 of the Internal Revenue Code.

The subpart F income that is reported by the U.S. shareholder for federal purposes is not included in the income subject to California apportionment.

Under California law, insurance companies are generally not subject to the income or franchise tax. Instead, insurers pay a tax based generally on premiums received during the year from business transacted in California. The gross premiums tax rate is set each year and administered by the State Board of Equalization. Since 1990, the tax has been set at 2.35%.

Effective Date

The provision applies only to taxable years of foreign corporations beginning in 1999, and to taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

Impact on California Revenue

Based on a review of issues for state tax purposes by audit personnel, this provision affecting certain financial service corporations filing on a water's-edge basis with CFC's will produce minor revenue losses on the order of $500,000 for 1999-0 and 2000-1. Largely because of the above entity requirements, California's impact is less than the otherwise standard proportional estimate of the federal impact.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
1006	Disclosure of Return Information to Department of Education in Connection with Income Contingent Loans.

Background

Under section 6103(1)(13) of the Code, the Secretary of Treasury was authorized to disclose to the Department of Education certain return information with respect to any taxpayer who has received an “applicable student loan.” An “applicable student loan” is any loan made under (1) part D of title IV of the Higher Education Act of 1965 or (2) parts B or E of title IV of the Higher Education Act of 1965, which is in default and has been assigned to the Department of Education, if the loan repayment amounts are based in whole or in part on the taxpayer’s income. The Secretary is permitted to disclose only taxpayer identification information and the adjusted gross income of the taxpayer. The Department of Education may use the information only to establish the appropriate income contingent repayment amount for an applicable student loan.

The disclosure authority under section 6103(1)(13) terminated with respect to requests made after September 30, 1998.

New Federal Law (Sec. 6103(1)(13)

The provision reinstates the disclosure authority under section 6103(1)(13) with respect to requests made after the date of enactment and before October 1, 2003.

Current California Law

Not applicable.

Effective Date

The disclosure authority under section 6103(1)(13) applies to requests made after the date of enactment and before October 1, 2003.

Impact on California Revenue

Not applicable.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
2001	Personal Credits Fully Allowed Against Regular Tax Liability During 1998.

Background

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit, the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, and the D.C. homebuyer's credit). Generally, these credits are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax (determined without regard to the AMT foreign tax credit).

The 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 gains 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) $45,000 in the case of married individuals filing a joint return and surviving spouses; (2) $33,750 in the case of other unmarried individuals; and (3) $22,500 in the case of married individuals filing a separate return, estates and trusts. 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 trust. These amounts are not indexed for inflation.

For families with three or more qualifying children, an additional child credit is provided which may offset the liability for social security taxes to the extent that tax liability exceeds the amount of the earned income credit. The additional child credit is reduced by the amount of the individual's minimum tax liability (i.e., the amount by which the tentative minimum tax exceeds the regular tax liability).

New Federal Law (Sec. 26)

The provision allows the nonrefundable personal credits to offset the individual's regular tax in full for taxable years beginning in 1998 (as opposed to only the amount by which the regular tax exceeds the tentative minimum tax).

In addition, the provision of present law that reduces the additional child credit by the amount of an individual's AMT does not apply for taxable years beginning in 1998.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Current California Law

California's "personal" exemption credits for 1998 are $70 for single, head of household and married filing separate, $140 for married filing joint return, blind and age 65, and $253 for dependents. In addition, California law allows an adoption credit, joint custody head of household credit, care of dependent credit, parent and renter's credit. California law limits the use of all the above credits by not allowing them to reduce regular tax below tentative minimum tax.

Effective Date

The provisions apply to taxable years beginning in 1998.

Impact on California Revenue

Based on model simulations, eliminating the tentative minimum tax interaction with regard to all "personal credits" would result in estimated revenue losses of approximately $1.5 million annually.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
2002	Acceleration of the Increased Deduction for Health Insurance Expenses of Self-Employed Individuals.

Background

Under present law, self-employed individuals are entitled to deduct a portion of the amount paid for health insurance for the self-employed individual and the individual's spouse and dependents.

The portion of health insurance expenses of self-employed individuals that is deductible is 45% for taxable years beginning in 1998 and 1999, 50% for taxable years beginning in 2000 and 2001, 60% for taxable years beginning in 2002, 80% for taxable years beginning in 2003, 2004, and 2005, 90% for taxable years beginning in 2006, and 100% for taxable years beginning in 2007 and thereafter.

Under present law, employees can exclude from income 100% of employer-provided health insurance.

New Federal Law (Sec. 162(l))

The provision increases the deduction for health insurance expenses of self-employed individuals to 60% for taxable years beginning in 1999 through 2001, to 70% for taxable years beginning in 2002, and to 100% for taxable years beginning in 2003 and thereafter.

Current California Law

California is in conformity with the definition of deductible health insurance payments for the self-employed and other individuals. However, California only allows 40% of health insurance costs incurred by self-employed individuals as a "above the line" deduction in computing AGI. The remaining 60% is may be deductible as an itemized deduction in computing AGI.

Effective Date

The provision is effective for taxable years beginning after December 31, 1998.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Impact on California Revenue

The revenue losses from conforming to this provision are estimated as follows:

Fiscal Year Cash Flow Impact Effective 1/1/99 Enacted Assumed After 6/30/99 $ Millions				
1999-00	2000-01	2001-02	2002-03	2003-04
$ (21)	$ (19)	$ (25)	$ (49)	$ (83)

The above estimate was based on the current average self-employed insurance deduction taken on tax returns (derived from the personal income tax microsimulation model), adjusted to reflect the proposed deduction percentages.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
2003	Modification of Individual Estimated Tax Safe Harbors.

Background

An individual taxpayer generally is subject to an addition to tax for any underpayment of estimated tax. An individual generally does not have an underpayment of estimated tax if he or she makes timely estimated tax payments at least equal to: (1) 100% of the tax shown on the return of the individual for the preceding year (the “100% of last year’s liability safe harbor”) or (2) 90% of the tax shown on the return for the current year. The 100% of last year’s liability safe harbor is generally modified to be a 110% of last year’s liability safe harbor for any individual with an AGI of more than $150,000 as shown on the return for the preceding taxable year, except that it is 105% of last year’s liability for taxable years beginning in 1999, 2000, and 2001, and 112% of last year’s liability for taxable years beginning in 2002. If a married individual files a separate return for the year for which an estimated tax installment payment was due, the $150,000 amount becomes $75,000.

New Federal Law (Sec. 6654)

For taxable years beginning in 2000 and 2001, the 105% of last year’s liability safe harbor for any individual with an AGI of more than $150,000 as shown on the return for the preceding taxable year is modified to be a 106% of last year’s liability safe harbor.

Current California Law

California law is in conformity with federal law as it relates to estimate payment safe harbors for individuals with AGI of more than $150,000 prior to the enactment of the Tax and Trade Relief Extension Act of 1998. For taxable years beginning in 2000 and 2001, 105% of the prior year tax must be paid in order for the individual to qualify for the exception to the underpayment of tax penalty.

Effective Date

The provision is effective for taxable years beginning in 2000 and 2001.

Impact on California Revenue

Cash flow revenue accelerations that would result if California conformed to this provision would be on the order of $1 million for 1999-0 and minor thereafter.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
2011	Permanent Extension of Income Averaging for Farmers.

Background

An individual engaged in a farming business may elect to compute his or her current year tax liability by averaging, over the prior three-year period, all or a portion of the taxable income that is attributable to the farming business.

In general, an individual who makes the election (1) designates all or a portion of his or her taxable income attributable to any farming business from the current year as "elected farm income;" (2) allocates one-third of the elected farm income to each of the three prior taxable years; and (3) determines the current year section 1 tax liability by combining (a) his or her current year section 1 tax liability excluding the elected farm income allocated to the three prior taxable years, plus (b) the increases in the section 1 tax liability for each of the three prior taxable years caused by including one-third of the elected farm income in each such year. Any allocation of elected farm income pursuant to the election applies for purposes of any election in a subsequent taxable year.

The provision does not apply for employment tax purposes, or to an estate or a trust. The provision also does not apply for purposes of the alternative minimum tax. The provision is effective for taxable years beginning after December 31, 1997, and before January 1, 2001.

New Federal Law (Sec. 1301)

The provision permanently extends the income averaging provision for farmers.

Current California Law

California law does not provide for income averaging for farmers.

Effective Date

The provision is effective for taxable years beginning after December 31, 2000.

Impact on California Revenue

Not applicable.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
2012	Farm Production Flexibility Contract Payments.

Background

A taxpayer generally is required to include an item in income no later than the time of its actual or constructive receipt, unless such amount properly is accounted for in a different period under the taxpayer's method of accounting. If a taxpayer has an unrestricted right to demand the payment of an amount, the taxpayer is in constructive receipt of that amount regardless of whether the taxpayer makes the demand and actually receives the payment.

The Federal Agriculture Improvement and Reform Act of 1996 (the FAIR Act) provides for production flexibility contracts between certain eligible owners and producers and the Secretary of Agriculture. These contracts generally cover crop years from 1996 through 2002. Annual payments are made under such contracts at specific times during the federal government's fiscal year. Section 112(d)(2) of the FAIR Act, provides that one-half of each annual payment is to be made on either December 15th or January 15th of the fiscal year, at the option of the recipient. This option to receive the payment on December 15th potentially results in the constructive receipt (and thus potential inclusion in income) of one-half of the annual payment at that time, even if the option to receive the amount on January 15th is elected.

The remaining one-half of the annual payment must be made no later than September 30th of the fiscal year. The Emergency Farm Financial Relief Act of 1998 added section 112(d)(3) to the FAIR Act which provides that all payments for fiscal year 1999 are to be paid at such time or times during fiscal year 1999 as the recipient may specify. Thus, the one-half of the annual amount that would otherwise be required to be paid no later than September 30, 1999, can be specified for payment in calendar year 1998. This potentially results in the constructive receipt (and thus required inclusion in taxable income) of such amounts in calendar year 1998, regardless of whether the amounts actually are received or the right to their receipt is fixed.

New Federal Law

The time a production flexibility contract payment under the FAIR Act properly is includible in income would be determined without regard to the options granted by section 112(d)(2) (allowing receipt of one-half of the annual payment on either December 15th or January 15th of the fiscal year) or section 112(d)(3) (allowing the acceleration of all payments for fiscal year 1999) of that Act.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Current California Law

California law follows federal law in regards to the tax accounting concept of "constructive receipt.". Therefore, the time a production flexibility contract payment received under the FAIR Act properly is includible in income would be determined by taking into account the options granted under the FAIR Act.

Effective Date

The provision is effective for production flexibility contract payments made under the FAIR Act in taxable years ending after December 31, 1995.

Impact on California Revenue

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be insignificant.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
2013	Extend the Net Operating Loss Carryback Period for Farmers.

Background

A net operating loss ("NOL") is, generally, the amount by which business deductions of a taxpayer exceed business gross income. An NOL may be carried back two years and carried forward 20 years to offset taxable income in such years. A taxpayer may elect to forgo the carryback of an NOL. In the case of an NOL (1) arising from casualty or theft losses of individual taxpayers, or (2) attributable to Presidentially declared disasters for taxpayers engaged in a farming business or a small business, the NOL can be carried back three years. A farming business includes the trade or business of farming, as well as the trade or business of operating a nursery or sod farm, or the raising or harvesting of certain trees. Special rules apply to real estate investment trusts (no carrybacks), specified liability losses (10-year carryback), and excess interest losses (no carrybacks).

A carryback of an NOL will result in the refund of federal income tax for the carryback year. A carry forward of an NOL will reduce federal income tax for the carryforward year.

New Federal Law (Sec. 172)

The provision provides a special five-year carryback period for a farming loss, regardless of whether the loss was incurred in a Presidentially declared disaster area. The carryforward period remains at 20 years. A "farming loss" is defined as the amount of any net operating loss attributable to the income and deductions of a farming business (as defined in section 263A(e)(4)). A farming loss cannot exceed the taxpayer's NOL for the taxable year. In calculating the amount of a taxpayer's NOL carrybacks, the portion of the NOL that is attributable to a farming loss is treated as a separate NOL and is taken into account after the remaining portion of the NOL for the taxable year.

A taxpayer can elect to forgo the five-year carryback period for a farming loss. The election to forgo the five-year carryback period is made in the manner prescribed by the Secretary of the Treasury and must be made by the due date of the return (including extensions) for the year of the loss. The election is irrevocable. If a taxpayer elects to forgo the five-year carryback period, then the farming losses are subject to the rules that otherwise would have applied under section 172 absent the five-year rule. The three-year carryback period continues to apply to an NOL incurred in a Presidentially declared disaster area if such NOL is not eligible for the five-year carryback period.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Current California Law (R&TC Sec. 17276, 24416)

Existing state law generally conforms to the computation of federal NOLs. However, California does not allow NOL carrybacks. In addition, California law contains a series of special NOL rules applicable to certain taxpayers and the conduct of business activities in certain locations which determine the amount of the NOL that is eligible to be carried forward and the number of years it can be carried forward:

Type of NOL	NOL % Allowed to be Carried Over	Carryover Period
General NOL	50%	5 Years
New Business Year 1 Year 2 Year 3	100% 100% 100%	8 Years 7 Years 6 Years
Eligible Small Business	100%	5 Years
Specified Disaster Loss	100% 50%	5 Years 10 Years
LARZ, LAMBRA & EZ	100%	15 Years

Effective Date

The provision is effective for NOLs arising in taxable years beginning after December 31, 1997.

Impact on California Revenue

Not applicable.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
2021	Increase State Volume Limits on Private Activity Tax-Exempt Bonds.

Background

Interest on bonds issued by states and local governments is excluded from income if the proceeds of the bonds are used to finance activities conducted and paid for by the governmental units (Code sec. 103). Interest on bonds issued by these governmental units to finance activities carried out and paid for by private persons ("private activity bonds") is taxable unless the activities are specified in the Internal Revenue Code. Private activity bonds on which interest may be tax-exempt include bonds for privately operated transportation facilities (e.g., airports, docks and wharves, mass transit, and high speed rail facilities), privately owned and/or provided municipal services (e.g., water, sewer, solid waste disposal, and certain electric and heating facilities), economic development (e.g., small manufacturing facilities and redevelopment in economically depressed areas), and certain social programs (e.g., low-income rental housing, qualified mortgage bonds, student loan bonds, and exempt activities of charitable organizations described in Code sec. 501(c)(3)).

The volume of tax-exempt private activity bonds that states and local governments may issue for most of these purposes in each calendar year is limited by state-wide volume limits. The current annual volume limit for any state is the greater of $50 per resident of the state or $150 million. The volume limits do not apply to private activity bonds to finance airports, docks and wharves, certain governmentally owned, but privately operated, solid waste disposal facilities, certain high speed rail facilities, and to certain types of private activity tax-exempt bonds that are subject to other limits on their volume (qualified veterans' mortgage bonds and certain "new" empowerment zone and enterprise community bonds).

New Federal Law (Sec. 146)

The provision increases the present-law annual state private activity bond volume limits to $75 per resident of each state or $225 million (if greater) beginning in calendar year 2007. The increase is phased-in as follows, beginning in calendar year 2003:

Calendar Year	Volume Limit
2003	$55 per resident ($165 million if greater)
2004	$60 per resident ($180 million if greater)
2005	$65 per resident ($195 million if greater)
2006	$70 per resident ($210 million if greater)

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Current California Law (R&TC Sec. 17143, 24272)

The PITL specifically does not conform to federal law regarding private activity bonds. The California Constitution provides an exemption from income taxation for all interest from bonds issued by this state or a local government of this state. Federal law, other than the IRC, prohibits state taxation of interest on federal bonds, if the interest on state obligations is exempt from tax. Taxpayers subject to the corporate franchise tax must include in the measure of franchise tax all interest received, whether taxable or tax-exempt. Interest received from federal obligations and California obligations or its political subdivisions is excluded from income subject to the corporation and personal income tax.

Effective Date

The provision is effective beginning in calendar year 2003.

Impact on California Revenue

Not applicable.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
2022	Comprehensive Study of Recovery Periods and Depreciation Methods Under Section 168.

Background

A taxpayer is allowed to deduct a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property that is used in a trade or business or is held for the production of income. For most tangible personal and real property placed in service after 1986, the amount of the deductible allowance is determined under section 168 using the applicable recovery period, the applicable depreciation method, and the applicable convention specified in section 168.

For some types of assets, the applicable recovery period is specified in section 168. In other cases, the recovery period is determined by reference to its class life. The class life of an asset may be provided by section 168, or may be determined with regard to the list of class lives provided by the Treasury that was in effect on January 1, 1986. The Treasury Department is required to monitor and analyze actual experience with respect to all depreciable assets.

The applicable depreciation method determines the rate at which the cost of the property is recovered. In general, the applicable depreciation method specified in section 168 varies with the recovery period of the property. For property with a recovery period of 10 years or less, the applicable method is the 200% declining balance method, switching to straight-line in the first year in which that method yields a larger allowance. The 150% declining balance (switching to straight-line method) is the applicable method for property with a recovery period of 15 or 20 years, as well as for all property used in the trade or business of farming. The straight-line method must be used for property with a longer recovery period, as well as for certain specified types of property.

The applicable convention determines the point in time during the year that the property is considered placed in service. Applicable conventions specified in section 168 include the mid-year, the mid-quarter and the mid-month conventions.

New Federal Law (Sec. 168)

The Secretary of the Treasury (or his delegate) is directed to conduct a comprehensive study of the recovery periods and depreciation methods under section 168 of the Code and to provide recommendations for determining such periods and methods in a more rational manner.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Current California Law (R&TC Sec. 17250, 24349)

The Personal Income Tax Law is generally conformed to federal law as it relates to depreciation. In addition, S corporations are permitted to use depreciation methods acceptable under the Personal Income Tax Law. The Bank and Corporation Tax Law has not conformed to the federal Modified Accelerated Cost Recovery System (MACRS) as permitted by IRC section 168. Both the PITL and B&CTL contain special provisions for economic zones (enterprise zones, etc.)for favorable depreciation methods (additional first year expensing, shorten recovery period, etc.) for various types of property.

Effective Date

The Secretary of the Treasury (or his delegate) is directed to submit the results of the study and recommendations to the House Ways and Means and Senate Finance Committees by March 31, 2000.

Impact on California Revenue

Not applicable.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
2023	State Election to Exempt Student Employees from Social Security.

Background

The Social Security Amendments of 1972 provided an opportunity for states to obtain exemptions from social security coverage for student employees of public schools, colleges, and universities. states choosing to opt out had to do so prior to January 1, 1974. Most states did. Student employees in these states do not have to pay FICA taxes on their wages, allowing them to keep more of their earnings.

New Federal Law

The provision allows a limited window of time (January 1 through March 31, 1999) for states to modify existing state agreements to exempt students (including graduate assistants) from social security coverage who are employed by a public school, university, or college in a nonexempted state.

Current California Law

Not applicable.

Effective Date

The provision permitting states to modify existing agreement is effective with respect to services performed after June 30, 2000.

Impact on California Revenue

Not applicable.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
3001	Treatment of Certain Deductible Liquidating Distributions of Regulated Investment Companies and Real Estate Investment Trusts.

Background

Regulated investment companies (RICs) and real estate investment trusts (REITs) are allowed a deduction for dividends paid to their shareholders. The deduction for dividends paid includes amounts distributed in liquidation which are properly chargeable to earnings and profits, as well as, in the case of a complete liquidation occurring within 24 months after the adoption of a plan of complete liquidation, any distribution made pursuant to such plan to the extent of earnings and profits. Rules that govern the receipt of dividends from RICs and REITs generally provide for including the amount of the dividend in the income of the shareholder receiving the dividend that was deducted by the RIC or REIT. Generally, any shareholder realizing gain from a liquidating distribution of a RIC or REIT includes the amount of gain in the shareholder's income. However, in the case of a liquidating distribution to a corporation owning 80% of the stock of the distributing corporation, a separate rule generally provides that the distribution is tax-free to the parent corporation. The parent corporation succeeds to the tax attributes, including the adjusted basis of assets, of the distributing corporation. Under these rules, a liquidating RIC or REIT might be allowed a deduction for amounts paid to its parent corporation, without a corresponding inclusion in the income of the parent corporation, resulting in income being subject to no tax.

A RIC or REIT may designate a portion of a dividend as a capital gain dividend to the extent the RIC or REIT itself has a net capital gain, and a RIC may designate a portion of the dividend paid to a corporate shareholder as eligible for the 70% dividends-received deduction to the extent the RIC itself received dividends from other corporations. If certain conditions are satisfied, a RIC also is permitted to pass through to its shareholders the tax-exempt character of the RIC's net income from tax-exempt obligations through the payment of "exempt interest dividends," though no deduction is allowed for such dividends.

New Federal Law (Sec. 332, 334)

Any amount which a liquidating RIC or REIT may take as a deduction for dividends paid with respect to an otherwise tax-free liquidating distribution to an 80% corporate owner is includible in the income of the recipient corporation. The includible amount is treated as a dividend received from the RIC or REIT. The liquidating corporation may designate the amount distributed as a capital gain dividend or, in the case of a RIC, a dividend eligible for the 70% dividends received deduction or an exempt interest dividend, to the extent provided by the RIC or REIT provisions of the Code.

The provision does not otherwise change the tax treatment of the distribution to the parent corporation or to the RIC or REIT. Thus, for example, the liquidating corporation will not recognize gain (if any) on the liquidating distribution and the recipient corporation will hold the assets at a carryover basis, even where the amount received is treated as a dividend.

Current California Law (R&TC Sec. 24870-3)

California law conforms to the federal treatment of RICs and REITs with certain modifications. California is conformed to the federal treatment of a liquidating distribution from a RIC or a REIT prior to the enactment of the Tax and Trade Relief Extension Act of 1998. Additionally, California has not conformed to the modification made by IRS Reform Act section 6012(g) relating to "earnings and profits" ordinary distributions of REITs.

Effective Date

The provision is effective for distributions on or after May 22, 1998, regardless of when the plan of liquidation was adopted. No inference is intended regarding the treatment of such transactions under present law.

Impact on California Revenue

This provision has both conformity and baseline impacts. Under conformity, California would be taxing liquidating distributions by certain pass-through investment entities to 80% corporate owners. The baseline effect, which will occur automatically for state tax purposes, represents the substitution of other investments that will not in all cases be protected from income tax.

Conforming to this provision would result in revenue gains estimated to be on the order of $40 million in 1999-00 and $5 million in 2000-01. Baseline revenue gains are projected to be on the order of $15 million annually beginning in 1998-99. Conformity estimates assume the provision would be effective for liquidating distributions occurring in income years beginning on or after January 1, 1999. Revenue estimates were based on federal projections for this provision.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
3002	Add Vaccines Against Rotavirus Gastroenteritis to the List of Taxable Vaccines.

Background

A manufacturer's excise tax is imposed at the rate of 75 cents per dose on the following vaccines routinely recommended for administration to children: diphtheria, pertussis, tetanus, measles, mumps, rubella, polio, HIB (haemophilus influenza type B), hepatitis B, and varicella (chicken pox). Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund.

New Federal Law (Sec. 4132)

The provision adds any vaccine against rotavirus gastroenteritis to the list of taxable vaccines.

Current California Law

Not applicable.

Effective Date

The provision is effective for vaccines sold by a manufacturer or importer after the date of enactment.

Impact on California Revenue

Not applicable.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
3003	Clarify and Expand Mathematical Error Procedures.

Background

Taxpayer identification numbers (TINs). The IRS may deny a personal exemption for a taxpayer, the taxpayer's spouse or the taxpayer's dependents if the taxpayer fails to provide a correct TIN for each person for whom the taxpayer claims an exemption. This TIN requirement also indirectly affects other tax benefits currently conditioned on a taxpayer being able to claim a personal exemption for a dependent (e.g., head-of-household filing status and the dependent care credit). Other tax benefits, including the adoption credit, the child tax credit, the Hope Scholarship credit, the Lifetime Learning credit, and the earned income credit also have TIN requirements. For most individuals, their TIN is their Social Security Number (SSN). The mathematical and clerical error procedure currently applies to the omission of a correct TIN for purposes of personal exemptions and all of the credits listed above except for the adoption credit.

Mathematical or clerical errors. The IRS may summarily assess additional tax due as a result of a mathematical or clerical error without sending the taxpayer a notice of deficiency and giving the taxpayer an opportunity to petition the Tax Court. Where the IRS uses the summary assessment procedure for mathematical or clerical errors, the taxpayer must be given an explanation of the asserted error and a period of 60 days to request that the IRS abate its assessment. The IRS may not proceed to collect the amount of the assessment until the taxpayer has agreed to it or has allowed the 60-day objection period to expire. If the taxpayer files a request for abatement of the assessment specified in the notice, the IRS must abate the assessment. Any reassessment of the abated amount is subject to the ordinary deficiency procedures. The request for abatement of the assessment is the only procedure a taxpayer may use prior to paying the assessed amount in order to contest an assessment arising out of a mathematical or clerical error. Once the assessment is satisfied, however, the taxpayer may file a claim for refund if he or she believes the assessment was made in error.

New Federal Law (Sec. 6213)

The provision provides that in the application of the mathematical and clerical error procedure, a correct TIN is a TIN that was assigned by the Social Security Administration (or in certain limited cases, the IRS) to the individual identified on the return. For this purpose, the IRS is authorized to determine that the individual identified on the tax return corresponds in every aspect (including name, age, date of birth, and SSN) to the individual to whom the TIN is issued. The IRS also is authorized to use the mathematical and clerical error procedure to deny eligibility for the dependent care tax credit, the child tax credit, and the earned income credit even though a correct TIN has been supplied if the IRS determines that the statutory age restrictions for eligibility for any of the respective credits is not satisfied (e.g., the TIN issued for the child claimed as the basis of the child tax credit identifies the child as over the age of 17 at the end of the taxable year).

Current California Law

California law does not require a TIN for dependents, but does contain various credits for dependents. Revenue and Taxation Code section 17054(e) states that the credit shall not be denied if the identification number is not included on the return claiming the credit

Effective Date

The provision is effective for taxable years ending after October 21, 1998.

Impact on California Revenue

Not applicable.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
3004	Restrict 10-Year Net Operating Loss Carryback Rules for Specified Liability Losses.

Background

Under present law, that portion of a net operating loss that qualifies as a “specified liability loss” may be carried back 10 years rather than being limited to the general two-year carryback period. A specified liability loss includes amounts allowable as a deduction with respect to product liability and also certain liabilities that arise under federal or state law or out of any tort of the taxpayer. In the case of a liability arising out of a federal or state law, the act (or failure to act) giving rise to the liability must occur at least three years before the beginning of the taxable year. In the case of a liability arising out of a tort, the liability must arise out of a series of actions (or failures to act) over an extended period, a substantial portion of which occurred at least three years before the beginning of the taxable year. A specified liability loss cannot exceed the amount of the net operating loss and is only available to taxpayers that used an accrual method of accounting throughout the period that the acts (or failures to act) occurred.

New Federal Law (Sec. 172)

Under the provision, specified liability losses are limited to product liability losses and amounts allowable as a deduction (other than a deduction under sec. 468(a)(1) or sec. 468A(a)) that are in satisfaction of a liability under a federal or state law requiring the reclamation of land, decommissioning of a nuclear power plant (or any unit thereof), dismantlement of a drilling platform, remediation of environmental contamination, or a payment under any workers compensation act (within the meaning of sec. 461(h)(2)(C)(i)), if the act (or failure to act) giving rise to such liability occurs at least three years before the beginning of the taxable year. As under present law, the specified liability loss (as redefined) cannot exceed the amount of the net operating loss and is only available to taxpayers that used an accrual method of accounting throughout the period that the act (or failure to act) giving rise to the liability occurred. No inference regarding the interpretation of the specified liability loss carryback rules under present law is intended.

Current California Law (R&TC Sec. 17276, 24416)

California law does not permit "net operating" or "specified liability" loss carrybacks. Generally, only 50% of the losses of this nature may be carried forward for five years.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Effective Date

The provision is effective for net operating losses arising in taxable years ending after October 21, 1998.

Impact on California Revenue

No applicable.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
4003(a)	Treatment of Interest on Qualified Education Loans

Background

Present law, as modified by the TRA of 1997, provides that certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expense, up to a maximum dollar amount per year ($1,000 for taxable years beginning in 1998), subject to certain income limit phaseouts (sec. 221). The maximum deduction is phased out ratably for individual taxpayers with modified AGI between $40,000 and $55,000 ($60,000 and $75,000 for joint returns). Present law also provides that in the case of a taxpayer other than a corporation, no deduction is allowed for personal interest (sec. 163(h)). For this purpose, personal interest means any interest allowable as a deduction, other than certain types of interest listed in the statute. This provision does not specifically provide that otherwise deductible qualified education loan interest is not treated as personal interest. Present law provides that a qualified education loan does not include any indebtedness owed to a person who is related (within the meaning of sec. 267(b) or 707(b)) to the taxpayer (sec. 221(e)(1)).

New Federal Law (Sec. 221 & 163(h))

The provision clarifies that otherwise deductible qualified education loan interest is not treated as nondeductible personal interest. The provision also clarifies that, for purposes of section 221, modified AGI is determined after application of section 135 (relating to income from certain U.S. saving bonds) and section 137 (relating to adoption assistance programs).

The provision also provides that a qualified education loan does not include any indebtedness owed to any person by reason of a loan under any qualified employer plan (as defined in section 72(p)(4)) or under any contract purchased under a qualified employer plan (as described in sec. 72(p)(5)).

Current California Law (R&TC Sec. 17201)

California law is in conformity with federal law as it read on January 1, 1998, as it relates to student loan interest (AB 2797, Stat. 1998, Ch. 322). California law has not conformed to the changes made by the IRS Reform Act and the Tax and Trade Relief Act.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Effective Date

This provision is effective for interest payments made after December 31, 1998.

Impact on California Revenue

California has already conformed to the basic underlying provisions. Most taxpayers will likely apply these clarifying measures at the state level as well. Any additional impact from state legislation would be insignificant.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
4003(b)	Capital Gain Distributions of Charitable Remainder Trusts.

Background

The income beneficiary of a charitable remainder trust (CRT) includes the trust's capital gain in income when the gains are distributed to the beneficiary. IRS Notice 98-20 provides guidance with respect to classifying long-term capital gain distributions from a CRT under the capital gain rules enacted by the TRA of 1997. Under the Notice, long-term capital gains properly taken into account by the trust before January 1, 1997, are treated as falling in the 20% group of gain (i.e., gain not in the 28% rate gain or unrecaptured sec. 1250 gain categories). Long-term capital gains properly taken into account by the trust after December 31, 1996, and before May 7, 1997, are included in 28% rate gain. Long-term capital gains properly taken into account by the trust after May 6, 1997, are treated as falling into the category which would apply if the trust itself were subject to tax.

New Federal Law (Sec. 1(h))

The provision provides that, in the case of a capital gain distribution by a CRT after December 31, 1997, with respect to amounts properly taken into account by the trust during 1997, amounts will not be included in the 28% rate gain category solely by reason of being properly taken into account by the trust before May 7, 1997, or by reason of the property being held not more than 18 months. Thus, for example, gain on the sale of stock by a CRT on February 1, 1997, will not be taken into account in determining 28% rate gain where the gain is distributed after 1997.

The Tax and Trade Relief Extension Act of 1998 contains a similar amendment to section 1(h)(13), as amended by section 5001 of the IRS Reform Act (discussion included in the Act section 5001), to provide that, for purposes of taxing the recipient of a distribution made after 1997 by a CRT, amounts will not be taken into account in computing 28% rate gain by reason of being properly taken into account before May 7, 1997, or by reason of the property being held for not more than 18 months. Thus, no amount distributed by a CRT after 1997 will be treated as in the 28% category (other than by reason of the disposition of collectibles or small business stock).

Current California Law

California law is in full conformity with federal law as it read on January 1, 1998, as it relates to CRTs. However, California law does not provide different tax rates for capital gains, therefore, all income of a CRT, ordinary or capital, is taxed at the same rate of 9.3%. .

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Effective Date

The provision applies to taxable years beginning after December 31, 1997.

Impact on California Revenue

California has already conformed to the basic underlying provisions. Most taxpayers will likely apply these clarifying measures at the state level as well. Any additional impact from state legislation would be insignificant.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
4003(c)	Gifts May Not Be Revalued for Estate Tax Purposes After Expiration of Statute of Limitations.

Background

Basic structure of federal estate and gift taxes. The federal estate and gift taxes are unified so that a single progressive rate schedule is applied to an individual's cumulative gifts and bequests. The tax on gifts made in a particular year is computed by determining the tax on the sum of the taxable gifts made in that year and in all prior years and then subtracting the tax on the prior years' taxable gifts and the unified credit. Similarly, the estate tax is computed by determining the tax on the sum of the taxable estate and prior taxable gifts and then subtracting the tax on taxable gifts, the unified credit, and certain other credits.

This structure raises two different, but related, issues: (1) what is the period beyond which additional gift taxes cannot be assessed or collected, generically referred to as the "period of limitations", and (2) what is the period beyond which the amount of prior transfers cannot be revalued for the purpose of determining the amount of tax on subsequent transfers.

Gift and estate tax period of limitations. Section 6501(a) provides the general rule that any tax (including gift and estate tax) must be assessed, or a proceeding begun in a court for the collection of such tax without assessment, within three years after the return is filed by the taxpayer. Under section 6501(e)(2), the period for assessments of gift or estate tax is increased to six years where there is more than a 25% omission in the amount of the total gifts or gross estate disclosed on the gift or estate tax return. Section 6501(c)(9) provides an exception to these rules under which gift tax may be assessed, or a proceeding in a court for collection of gift tax may be begun, at any time unless the gift is disclosed on a gift tax return or a statement attached to a gift tax return.

Revaluation of gifts for estate tax purposes. The value of a gift is its value as finally determined under the rules for purposes of determining the applicable estate tax bracket and available unified credit. The value of a gift is finally determined if (1) the value of the gift is shown on a gift tax return for that gift and that value is not contested by the Treasury Secretary before the expiration of the period of limitations on assessment of gift tax even where the value of the gift as shown on the return does not result in any gift tax being owed (e.g., through use of the unified credit), (2) the value is specified by the Treasury Secretary pursuant to a final notice of redetermination of value (a final notice) within the period of limitations applicable to the gift for gift tax purposes (generally, three years) and the taxpayer does not timely contest that value, or (3) the value is determined by a court or pursuant to a settlement agreement between the taxpayer and the Treasury Secretary under an administrative appeals process whereby a taxpayer can challenge a redetermination of value by the IRS prior to issuance of a final notice. In the event the taxpayer and the IRS cannot agree on the value of a gift, the TRA of 1997 provided the U.S. Tax Court with jurisdiction to issue a declaratory judgment on the value of a gift (section 7477). A taxpayer who is mailed a final notice may challenge the redetermined value of the gift (as contained in the final notice) by filing a motion for a declaratory judgment with the U.S. Tax Court. The motion must be filed on or before 90 days from the date that the final notice was mailed. The statute of limitations is tolled during the pendency of the Tax Court proceeding. Similarly, under a rule applicable to the computation of the gift tax (sec. 2504(c)), the value of gifts made in prior years is its value as finally determined if the period of limitations for assessment of gift tax on the prior gifts has expired.

New Federal Law (Sec. 2001(f))

The provision clarifies the rules relating to revaluations of prior transfers for computation of the estate or gift tax to provide that the value of a prior transfer cannot be redetermined after the period of limitations if the transfer was disclosed in a statement attached to the gift tax return in a manner sufficient to adequately apprise the Secretary of the Treasury of the nature of the transfer, even if there was no gift tax imposed on that transfer.

Current California Law

California does not impose a gift tax; the California estate tax is a "pick-up" tax, that is, the state tax is equal to the maximum credit for a state death tax on the federal estate tax return for that particular decedent's estate. This "pick-up" tax is administered by the State Controller's Office.

Effective Date

The provision is effective for gifts made after August 5, 1997, the date of enactment of TRA of 1997.

Impact on California Revenue

Not applicable.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
4003(g)	Treatment of Affiliated Group Including Formerly Tax-Exempt Organizations.

Background

Present law provides that an organization described in sections 501(c)(3) or (4) of the Code is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance. When this rule was enacted in 1986, certain treatment applied to Blue Cross and Blue Shield organizations providing health insurance that were subject to this rule and that met certain requirements. Treasury regulations were promulgated providing rules for filing consolidated returns for affiliated groups including such organizations (Treas. Reg. sec. 1.1502-75(d)(5)).

The TRA of 1997 repealed the grandfather rules provided in 1986 (permitting the retention of tax-exempt status) that were applicable to that portion of the business of the Teachers Insurance Annuity Association and College Retirement Equities Fund attributable to pension business and to the portion of the business of Mutual of America attributable to pension business. The TRA of 1997 did not specifically provide rules for filing consolidated returns for affiliated groups including such organizations.

Present law with respect to consolidated returns provides for an election to treat a life insurance company as an includible corporation, and also provides that a life insurance company may not be treated as an includible corporation for the five taxable years immediately preceding the taxable year for which the consolidated return is filed (sec. 1504(c)(2)). Present law also provides that a corporation that is exempt from taxation under Code section 501 is not an includible corporation (sec. 1504(b)(1)).

New Federal Law

The provision provides rules for filing consolidated returns for affiliated groups including any organization with respect to which the grandfather rule under Code section 501(m) was repealed by section 1042 of the TRA of 1997. The provision provides that rules similar to the rules of Treasury Regulation section 1.1502-75(d)(5) apply in the case of such an organization. Thus, an affiliated group including such an organization may make the election described in section 1504(c)(2) (relating to a five-year period) without regard to whether the organization was previously exempt from tax under Code section 501.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Current California Law

Under California law, insurance companies are generally not subject to the income or franchise tax and thus are included in a combined report. Instead, insurers pay a tax based generally on premiums received during the year from business transacted in California. The gross premiums tax rate is set each year by the State Board of Equalization. Since 1990, the tax has been set at 2.35%.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

Impact on California Revenue

Not applicable.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
4003(h)	Treatment of Net Operating Losses Arising from Certain Eligible Losses.

Background

The TRA of 1997 changed the general net operating loss (NOL) carryback period of a taxpayer from three years to two years. The three-year carryback period was retained in the case of an NOL attributable to an eligible loss. An eligible loss is defined as (1) a casualty or theft loss of an individual taxpayer, or (2) an NOL attributable to a Presidentially declared disaster area by a taxpayer engaged in a farming business or a small business. Other special rules apply to real estate investment trusts (REITs) (no carrybacks), specified liability losses (10-year carryback), and excess interest losses (no carrybacks).

New Federal Law (Sec. 172(b)(1)(F))

The provision coordinates the use of eligible losses with the general rule for NOLs in the same manner as a loss arising from a specified liability loss. Thus, an eligible loss for any year is treated as a separate net operating loss and is taken into account after the remaining portion of the net operating loss for the taxable year.

Current California Law

California does not allow NOL carrybacks. California law does generally conform to the computation of the federal NOL, however.

Effective Date

The provision is effective for NOLs arising in taxable years beginning after the August 5, 1997.

Impact on California Revenue

Not applicable.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
4003(i)	Determination of Unborrowed Policy Cash Value Under COLI Pro Rata Interest Disallowance Rules.

Background

In the case of a taxpayer other than a natural person, no deduction is allowed for the portion of the taxpayer's interest expense allocable to unborrowed policy cash surrender values with respect to any life insurance policy or annuity or endowment contract issued after June 8, 1997. Interest expense is allocable to unborrowed policy cash values based on the ratio of (1) the taxpayer's average unborrowed policy cash values of life insurance policies and annuity and endowment contracts issued after June 8, 1997, to (2) the sum of (a) in the case of assets that are life insurance policies or annuity or endowment contracts, the average unborrowed policy cash values, and (b) in the case of other assets, the average adjusted bases for all such other assets of the taxpayer. The unborrowed policy cash values means the cash surrender value of the policy or contract determined without regard to any surrender charge, reduced by the amount of any loan with respect to the policy or contract. The cash surrender value is to be determined without regard to any other contractual or noncontractual arrangement that artificially depresses the unborrowed policy cash value of a contract.

New Federal Law (Sec. 264(f)(3))

The provision clarifies the meaning of "unborrowed policy cash value" under section 264(f)(3) with respect to any life insurance, annuity or endowment contract. The technical correction clarifies that under section 264(f)(3), if the cash surrender value (determined without regard to any surrender charges) with respect to any policy or contract does not reasonably approximate its actual value, then the amount taken into account for this purpose is the greater of (1) the amount of the insurance company's liability with respect to the policy or contract, as determined for purposes of the annual statement approved by the National Association or Insurance Commissioners, (2) the amount of the insurance company's reserve with respect to the policy or contract for purposes of such annual statement; or (3) such other amount as is determined by the Treasury Secretary. No inference is intended that such amounts may not be taken into account in determining the cash surrender value of a policy or contract in such circumstances for purposes of any other provision of the Code.

Current California Law (R&TC Secs. 17201, 17279.5, 24424)

California law is in full conformity with federal law as it read on January 1, 1998, as it relates to interest expenses relating to insurance contracts.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Effective Date

The provision generally applies to contracts issued after June 8, 1997.

Impact on California Revenue

California has already conformed to basic underlying provisions. These clarifying measures will be applied by IRS, and most taxpayers will anticipate continued state conformity and report in the same manner. Any additional impact from state legislation would be insignificant.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
4003(k)	Payment of Taxes By Commercially Acceptable Means.

Background

The Code generally permits the payment of taxes by commercially acceptable means (such as credit cards) (sec. 6311(d)). The Treasury Secretary may not pay any fee or provide any other consideration in connection with this provision. This fee prohibition may have an unintended impact on Treasury contracts for the provision of services unrelated to the payment of income taxes by commercially acceptable means.

New Federal Law (Sec. 6311(d)(2))

The provision clarifies that the prohibition on paying any fees or providing any other consideration applies to the use of credit, debit, or charge cards for the payment of income taxes.

Current California Law (R&TC Sec. 19005(b))

The FTB currently has the authority to accept credit cards for payment of taxes. However, credit card remittances are required to include an additional amount, not to exceed 2% of the amount owed, to pay the discount fee imposed by the credit card company.

Additionally, AB 1374 (Stats. 1995, Ch. 926) requires all state agencies to accept credit card payments effective January 1, 1997, unless the Department of General Services (DGS) grants an exemption. In November 1996, the DGS entered into master service agreements (MSAs) with American Heritage Bankcard, First USA Paymentech and Novus Services to process credit card transactions for the State of California.

Due to the cost attributable to the absorption of the credit card discount fee, the FTB initially requested and received an exemption from the DGS not to implement the requirements of AB 1374. In September 1998, citing the department's readiness to implement a credit card program, the FTB requested from the DGS Director the withdrawal of the department's original exemption request. Department staff has received verbal acknowledgment that the FTB has been removed from the exemption list.

The FTB is currently negotiating with a vendor to accept credit card payment of taxes. If an agreement is reached, a six-month pilot program is tentatively planned, targeting approximately 1.1 million personal income taxpayers. The pilot program would include a tiered convenience fee. The convenience fee includes the discount rate (generally 1% to 4%) imposed by the credit card company for its authorization to accept payment by credit card and related administrative costs. After the pilot program, credit card payments for involuntary notices, Notices of Proposed Assessment, Return Information Notices, estimated tax payments and remit tax returns would be phased in. The program may ultimately include bank and corporation taxpayers and non-tax debt collection payments.

Effective Date

The federal provision is effective after May 5, 1998.

Impact on California Revenue

Not applicable.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
4004	Casualty Loss Deductions.

The Tax Reform Act of 1984 (1984 Act) deleted casualty and theft losses from property connected with a nonbusiness transaction entered into for profit from the list of losses set forth in section 165(c)(3). This amendment was made in order to provide that these losses were deductible in full and not subject to the $100 per casualty limitation or the 10% adjusted gross income floor applicable to personal casualty losses. However, the amendment inadvertently eliminated the deduction for these losses from the computation of the NOL. Also, the Tax Reform Act of 1986 provided that casualty losses described in section 165(c)(3) are not miscellaneous itemized deductions subject to the 2% adjusted gross income floor, and the Revenue Reconciliation Act of 1990 provided that these losses are not treated as itemized deductions in computing the overall limitation on itemized deductions. The losses of nonresident aliens are limited to deductions described in section 165(c)(3). Because of the change made by the 1984 Act, the reference to section 165(c)(3) does not include casualty and theft losses from nonbusiness transactions entered into for profit.

New Federal Law (Sec. 172(d)(4), 67(b)(3), 68(c)(3),& 873(b))

The provision provides that all deductions for nonbusiness casualty and theft losses are taken into account in computing the NOL. Also, these deductions are not treated as miscellaneous itemized deductions subject to the 2% adjusted gross income floor, or as itemized deductions subject to the overall limitation on itemized deductions, and are allowed to nonresident aliens.

Current California Law

California law is in full conformity with federal law as it read on January 1, 1998, as it relates to the computation of a casualty loss deduction and an NOL.

Effective Dates

The provision relating to the NOL and the deduction for nonresident aliens applies to taxable years beginning after December 31, 1983.

The provision relating to miscellaneous itemized deductions applies to taxable years beginning after December 31, 1986. The provision relating to the overall limitation on itemized deductions applies to taxable years beginning after December 31, 1990.

Impact on California Revenue

California has already conformed to the basic underlying provisions. Most taxpayers will apply these clarifying measures at the state level as well. Any additional impact from state legislation would be insignificant.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
4006(a)	Disclosure of Tax Return Information to the Department Of Agriculture

Background

Tax return information generally may not be disclosed, except as specifically provided by statute. Disclosure is permitted to the Bureau of the Census for specified purposes, which include the responsibility of structuring, conducting, and preparing the census of agriculture (sec. 6103(j)(1)). The Census of Agriculture Act of 1997 (P.L. 105 113) transferred this responsibility from the Bureau of the Census to the Department of Agriculture.

New Federal Law (Sec. 6103(j))

The provision permits the continuation of disclosure of tax return information for the purpose of structuring, conducting, and preparing the census of agriculture by authorizing the Department of Agriculture to receive this information.

Current California Law

California law does not permit the FTB to disclose tax return information to the U.S. Department of Agriculture.

Effective Date

The provision is effective October 21, 1998.

Impact on California Revenue

Not applicable.

Tax and Trade Relief Extension Act of 1998
(P.L. 105-277)

Section	Section Title
5301	Tax Treatment of Cash Options for Qualified Prizes.

Background

A taxpayer generally is required to include an item in income no later than the time of its actual or constructive receipt, unless the item properly is accounted for in a different period under the taxpayer's method of accounting. If a taxpayer has an unrestricted right to demand the payment of an amount, the taxpayer is in constructive receipt of that amount regardless of whether the taxpayer makes the demand and actually receives the payment. Under the principle of constructive receipt, the winner of a contest who is given the option of receiving either a lump-sum distribution or an annuity is required to include the value of the award in gross income, even if the annuity option is exercised.

New Federal Law

The existence of a "qualified prize option" is disregarded in determining the taxable year for which any portion of a qualified prize is to be included in income. A qualified prize option is an option that entitles a person to receive a single cash payment in lieu of a qualified prize (or portion thereof), provided such option is exercisable not later than 60 days after the prize winner becomes entitled to the prize. Thus, a qualified prize winner who is provided the option to choose either cash or an annuity not later than 60 days after becoming entitled to the prize is not required to include amounts in gross income immediately if the annuity option is exercised merely by reason of having the option. This provision applies with respect to any qualified prize to which a person first becomes entitled after October 21, 1998.

In addition, the provision also applies to any qualified prize to which a person became entitled on or before October 21, 1998, if the person has an option to receive a lump-sum cash payment only during some portion of the 18-month period beginning on July 1, 1999. This is intended to give previous prize winners a one-time option to alter previous payment arrangements.

Qualified prizes are prizes or awards from contests, lotteries, jackpots, games or similar arrangements that provide a series of payments over a period of at least 10 years, provided that the prize or award does not relate to any past services performed by the recipient and does not require the recipient to perform any substantial future service. Appearing in advertising relating to the prize or award is not (in and of itself) substantial. The provision applies to individuals on the cash receipts and disbursements method of accounting. Income and deductions resulting from this provision retain their character as ordinary, not capital. In addition, the Secretary is to provide for the application of this provision in the case of a partnership or other pass-through entity consisting entirely of individuals on the cash receipts and disbursements method of accounting.

Any offer of a qualified prize option must include disclosure of the methodology used to compute the single cash payment, including the discount rate that makes equivalent the present values of the prize to which the prize winner is entitled (or relevant portion thereof) and the single cash payment offered. Any offer of a qualified prize option must also clearly indicate that the prize winner is under no obligation to accept any offer of a single cash payment and may continue to receive the payments to which he or she is entitled under the terms of the qualified prize.

Current California Law

California law is generally conformed to federal law as of January 1, 1998, as it relates to the taxation of awards and prizes. California law specifically exempts California lottery winnings paid by the California Lottery Commission from taxable income for state purposes.

Effective Date

The provision applies with respect to any qualified prize to which a person first becomes entitled after October 21, 1998. In addition, the provision also applies to any qualified prize to which a person became entitled on or before October 21, 1998, if the person has an option to receive a lump-sum payment only during some portion of the 18-month period beginning on July 1, 1999.

Impact on California Revenue

This provision does not remove the tax obligation on income from various prizes, contests, etc. only the timing of tax payments in certain cases. This cash flow shift between years would be minor (less than $500,000 annually) beginning in 1999-0. This impact is based on federal projections and takes into account that California lottery winnings are not taxed by California.

Surface Transportation Revenue Act of 1998 (P.L. 105-178)

Section	Section Title
9010	Exclusion from Income for Employer-Provided Transportation Benefits.

Background

Qualified transportation fringe benefits provided by an employer are excluded from an employee's gross income. Qualified transportation fringe benefits include parking, transit passes, and vanpool benefits. In addition, in the case of employer-provided parking, no amount is includible in income of an employee merely because the employer offers the employee a choice between cash and employer-provided parking. Under prior law, transit passes and vanpool benefits were excludable only if provided in addition to, and not in lieu of, any compensation otherwise payable to an employee. Up to $175 per month of employer-provided parking is excludable from income. Under prior law, up to $65 per month of employer-provided transit and vanpool benefits were excludable from gross income. Under prior law, these dollar amounts were indexed annually for inflation, rounded to the nearest multiple of $5.

Under present and prior law, qualified transportation fringe benefits include a cash reimbursement by an employer to an employee. However, in the case of transit passes, a cash reimbursement is considered a qualified transportation fringe benefit only if a voucher or similar item which may be exchanged only for a transit pass is not readily available for direct distribution by the employer to the employee. The position of the Treasury Department is that a voucher or similar item is "readily available" if an employer can obtain it on terms no less favorable than those available to an individual employee and without incurring a significant administrative cost (I.R.S. Notice 94-3, 1994 C.B. 327.).

Present and prior law impose limits on the amount of annual additions that can be made to a tax-qualified pension plan. In the case of defined contribution plans, the limit is the lesser of $30,000 or 25% of compensation. For this purpose, under section 415(c)(3), compensation is generally taxable compensation, plus salary reduction contributions under a qualified cash or deferred arrangement (a "sec. 401(k) plan"), a tax-sheltered annuity (a "section 403(b) annuity"), a SIMPLE plan, certain plans of deferred compensation for state and local government employees and employees of tax-exempt organizations (a "sec. 457 plan"), and a cafeteria plan. Tax-qualified pension plans are also subject to nondiscrimination rules designed to ensure that an employer's pension plans benefit a broad cross section of employees. For purposes of applying these rules, compensation is generally defined as under Code section 415(c)(3). However, an employer can elect not to include as compensation salary reduction contributions under a section 401(k) plan, 403(b) annuity, or cafeteria plan. In addition, as provided by the Secretary, an employer can use an alternative definition of compensation for nondiscrimination testing purposes. Any such alternative definitions must not discriminate in favor of highly compensated employees.

Surface Transportation Revenue Act of 1998
(P.L. 105-178)

New Federal Law (Sec. 132(f))

The provision permits employers to offer employees a choice between cash compensation or any qualified transportation benefit or a combination of any of such benefits. Thus, under the provision, no amount is includible in gross income or wages merely because the employee is offered the choice of cash in lieu of one or more qualified transportation benefits (up to the applicable dollar limit). Also, no amount is includible in income or wages merely because the employee is offered a choice among qualified transportation benefits. The amount of cash offered is includible in income and wages only to the extent the employee elects cash.

It is intended that salary reduction amounts used to provide qualified transportation benefits under the provision be treated for pension plan purposes the same as other salary reduction contributions. Thus, it is intended that such amounts be included for purposes of applying the limits on contributions and benefits, and that an employer may elect whether to include such amounts in compensation for nondiscrimination testing. It is expected that the Secretary, in prescribing rules regarding the alternative definition of compensation, will treat salary reduction amounts under this provision the same as other salary reduction contributions.

The provision does not change the rules regarding when a cash reimbursement for transit passes is treated as a qualified transportation fringe benefit.

In addition, beginning in 2002, the Act increases the exclusion for transit passes and vanpooling to $100 per month. Beginning in 2003, the $100 amount is indexed as under prior law.

Further, the provision provides that no indexing of any qualified transportation benefit in 1999.

Current California Law (R&TC Sec. 17090, 17131, 17149)

California law is in full conformity with federal law as it read on January 1, 1998, as it relates to qualified transportation fringe benefits and annual additions to tax-qualified pension plans.

In addition, California law provides that gross income of an employee does not include benefits received for participation in any ridesharing arrangement in California. A ridesharing arrangement includes:

- commuting in a carpool, vanpool, buspool, or taxipool.
- monthly transit passes use by the employee or the employee's dependents, other than dependents attending elementary or secondary school.
- free or subsidized parking.
- commuting by ferry or bicycling.

- travel to or from a telecommuting facility.
- the use of any transportation used to go to or from the place of employment that reduces the use of a motor vehicle occupied by a single person.

Effective Date

The provision permitting a cash option for any transportation benefit is effective for taxable years beginning after December 31, 1997; the increase in the exclusion for transit passes and vanpooling to $100 per month is effective for taxable years beginning after December 31, 2001; and indexing on the $100 amount for transit passes and vanpooling is effective for taxable years beginning after December 31, 2002.

Impact on California Revenue

Based on projections for the federal law and allowing for California law being more liberal, conforming to this provision would have minimal impact.

Ricky Ray Hemophilia Relief Fund Act of 1998 (P.L. 105-369)

Background

Under present and prior law, gross income does not include any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of a personal physical injury or physical sickness (Code sec. 104(a)(2)). If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness regardless of whether the recipient of the damages is the injured party. The term "damages received whether by suit or agreement" is defined under Treasury regulations to mean an amount received (other than workmen's compensation) through prosecutions of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution. Under prior law, payments not meeting the requirements of section 104 were not excludable from income under that section.

New Federal Law

The Act provides that payments pursuant to the provisions of the Act to certain individuals with blood-clotting disorders who contracted the human immunodeficiency virus (HIV) due to contaminated blood products are treated for purposes of the Internal Revenue Code as damages received on account of personal physical injury or physical sickness described in section 104(a)(2). Thus, such payments made to individuals are excluded from gross income.

Current California Law (R&TC Sec. 17131)

California law is in full conformity with federal law as it read on January 1, 1998, as it relates to the exclusion from income any damages received on account of a personal physical injury or physical sickness.

Effective Date

The provision is effective on November 12, 1998, the date of enactment.

Impact on California Revenue

Based on the low levels of the federal estimates for this Act, any revenue losses from excluding these payments from income would be insignificant, less than $25,000 annually beginning with the 1999 tax year.

EXHIBIT A

EXPIRING TAX PROVISIONS

Calif. Sunset*	Calif. Section	Federal Section*	Fed. Sect.	Description and Comments
12/31/98	18152.5	Permanent	1202	Exclusion: Capital Gain on Sale of Small Business Stock
01/01/99	19290.1	N/A	N/A	Collections for the Department of Industrial Relations under Sect. 62.9 of the Labor Code
01/01/99	19432	N/A	N/A	Cancellation of Tax, Penalties & Interest for Inactive Corporations
12/31/99	17053.66 23666	N/A	N/A	Credit: Restoration of Habitat for Salmon and Steelhead Trout
12/31/99	17091 24272.3	Permanent	865	Sourcing Rules: Unprocessed Timber
12/31/99	25135	N/A	N/A	Apportionment Formula: Sales of Unprocessed Timber
12/31/99	18724	N/A	N/A	Voluntary Contribution: California Fund for Senior Citizens
12/31/99	18766	N/A	N/A	Voluntary Contribution: Alzheimer's Disease and Related Disorders Research Fund
12/31/99	18844	N/A	N/A	Voluntary Contribution: California Military Museum Fund
01/01/00	24357.9	12/31/99	170(e)	Deduction: Augmented Corporate Computer Contribution
12/31/00[1]	17053.49 23649	N/A	N/A	Credit: Manufacturer's Investment
12/31/00	17279.4 24369.4	12/31/00	198	Deduction: Expensing of Environmental Remediation Costs (Brownfields)
12/31/00	18804	N/A	N/A	Voluntary Contribution: California Firefighters' Memorial Fund
12/31/01	17053.57 23657	N/A	N/A	Credit: Community Development Financial Institution Deposits
12/31/01	17131	12/31/01	137	Deduction: Adoption Assistance
12/31/01	17502 24602	N/A	N/A	Exclusion: California Stock Options

EXHIBIT A

EXPIRING TAX PROVISIONS

Calif. Sunset*	Calif. Section	Federal Section*	Fed. Sect.	Description and Comments
12/31/01	18715	N/A	N/A	Voluntary Contribution: Children's Trust Fund for the Prevention of Child Abuse
12/31/01	18744	N/A	N/A	Voluntary Contribution: Rare and Endangered Species Preservation Program
12/31/01	19283	N/A	N/A	Collection of Amounts Due a Court
12/31/01	19568	N/A	N/A	Collection: Delinquent Student Loans
12/31/02	17053.45 23645	N/A	N/A	Credit: Sales and Use taxes Paid in the LA Revitalization Zone
12/31/02[2]	17053.46 23646	N/A	N/A	Credit: Hiring in the Local Agency Military Base Recovery Area
12/31/02[2]	17268 24356.8	N/A	N/A	Deduction: Expensing Business Property in Local Agency Military Base Recovery Area
12/31/02[2]	17276.2 24416.2	N/A	N/A	Deduction: Net Operating Losses in the Local Agency Military Base Recovery Area
12/31/02	18796	N/A	N/A	Voluntary Contribution: California Breast Cancer Research Fund
12/31/03	18785	N/A	N/A	Voluntary Contribution: D.A.R.E. California (Drug Abuse Resistance Education) Fund
12/31/03	18816	N/A	N/A	Voluntary Contribution: California Public School Library Protection Fund
12/31/03	18855	N/A	N/A	Voluntary Contribution: Emergency Food Assistance Program
12/31/04	18824	N/A	N/A	Voluntary Contribution: Mexican American Veterans' Memorial Account
01/01/06	17053.36 17053.37 23636 23637	N/A	N/A	Credit: Joint Strike Fighters Wage & Property
12/31/07	17052.10 23610	N/A	N/A	Credit: Rice Straw

EXHIBIT A

EXPIRING TAX PROVISIONS

Footnotes

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

[1] The actual date this provision expires is unknown at this time. The law provides that the credit will expire on January 1, 2001 or on January 1 of the earliest year thereafter, if the total employment in this state on the preceding January 1, does not exceed by 100,000 jobs the total employment in this state on January 1, 1994. EDD is to make this determination.

[2] The LAMBRA provisions expire eight years after the Trade & Commerce Agency (TCA) designate an area as a LAMBRA. The TCA is authorized to designate eight LAMBRAs within the state. As of September 1998, two areas have received designation and an additional three sites have received a conditional designation. The expiration date listed for LAMBRAs is the earliest date the tax preferences or incentives will expire.

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