California
Franchise
Tax
Board

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SUMMARY OF FEDERAL INCOME TAX CHANGES ---- 2000

Laws Affected:

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

SUMMARY OF FEDERAL INCOME TAX CHANGES 2000

Prepared by the Staff of the

FRANCHISE TAX BOARD

State of California

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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 - 1999
Prepared by the Staff of the
FRANCHISE TAX BOARD
State of California

Executive Summary

During 2000, the Internal Revenue Code or its application was changed by:

PUBLIC LAW	TITLE
106-181	Wendell H. Ford Aviation Investment and Reform Act for the 21st Century
106-200	Trade and Development Act of 2000
106-230	To Amend the Internal Revenue Code of 1986 to Require Section 527 Organizations to Disclose Their Political Activities
106-519	FSC Repeal and Extraterritorial Income Exclusion Act of 2000
106-554	Consolidated Appropriations Act, 2001
106-573	Installment Tax Correction Act of 2000

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

Following is a list of California tax provisions that expire in 2001.

Calif. Sunset	Calif. Section	Federal Sunset	Fed. Sect.	Description and Comments
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
12/31/01	18704	N/A	N/A	Voluntary Contribution: National World War II Veterans Memorial Fund
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	18844	N/A	N/A	Voluntary Contribution: California Military Museum Fund
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

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

Wendell H. Ford Aviation Investment and Reform Act for the 21st Century (P.L. 106-181)

Section	Section Title
1001	Extension of Expenditure Authority

Background

Federal excise taxes are imposed on commercial air passenger and freight transportation and on fuels used in general aviation (i.e., transportation on noncommercial aircraft which is not for hire). The excise taxes fund the Airport and Airway Trust Fund (Airport Trust Fund). The funds in the Airport Trust Fund are expended by appropriation Acts for making expenditures before October 1, 1998. The expenditures must also be used to meet obligations of the United States incurred under one of 11 different airport or airway improvement acts specified in the Internal Revenue Code (IRC).

New Federal Law (Sec. 9502)

The Act extends the expenditure authority of the Airport Trust Fund to October 1, 2003, and adds three new different airport or airway improvement acts to the list of acts specified in the IRC. The Act also limits expenditure authority of the Airport Trust Fund.

Current California Law

The Franchise Tax Board does not administer any excise taxes. When applicable, the State Board of Equalization (BOE) administers excise taxes.

Impact on California Revenue

Not applicable.

Trade and Development Act of 2000
(P.L. 106-200)

Section	Section Title
601	Provide Waiver from Denial of Foreign Tax Credits

Background

Present law in general, provides that U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of foreign tax credits that can be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. Separate limitations are applied to specific categories of income. Pursuant to special rules applicable to taxes paid to certain foreign countries, no foreign tax credit is allowed for income, war profits, or excess profits taxed paid, accrued, or deemed paid to a country which satisfies specified criteria, to the extent that the taxes are with respect to income attributable to a period during which such criteria were satisfied (sec. 901(j)). Section 901(j) applies with respect to any foreign country:

(1) the government of which the United States does not recognize, unless such government is otherwise eligible to purchase defense articles or services under the Arms Export Control Act,
(2) the United States has severed diplomatic relations,
(3) the United States has not severed diplomatic relations but does not conduct such relations, or
(4) the Secretary of State has, pursuant to section 6(j) of the Export Administration Act of 1979, as amended, designated as a foreign country that repeatedly provides support for acts of international terrorism (a “section 901(j) foreign country'').

The denial of credits applies to any foreign country during the period beginning on the later of January 1, 1987, or six months after such country becomes a section 901(j) country, and ending on the date the Secretary of State certifies to the Secretary of the Treasury that such country is no longer a section 901(j) country. Taxes treated as noncreditable under section 901(j) generally are permitted to be deducted notwithstanding the fact that the taxpayer elects use of the foreign tax credit for the taxable year with respect to other taxes. In addition, income for which foreign tax credits are denied generally cannot be sheltered from U.S. tax by other creditable foreign taxes. Under the rules of subpart F, U.S. 10-percent shareholders of a controlled foreign corporation (“CFC'') are required to include in income certain types of income of the CFC, whether or not such income is actually distributed currently to the shareholders (referred to as “subpart F income''). Subpart F income includes income derived from any foreign country during a period in which the taxes imposed by that country are denied eligibility for the foreign tax credit under section 901(j).

New Federal Law (Sec. 901(j))

The Act provides that section 901(j) no longer applies with respect to a foreign country if: (1) the President determines that a waiver of the application of section 901(j) to such foreign country is in the national interest of the United States and will expand trade opportunities for U.S. companies in such foreign country, and (2) the President reports to the Congress, not less than

30 days before the waiver is granted, the intention to grant such a waiver and the reason for such waiver.

Effective Date

The provision is effective on or after February 1, 2001.

Current California Law

California law does not have a credit comparable to the federal foreign tax credit.

Impact on California Revenue

Not applicable.

Section	Section Title
602	Accelerate Rum Excise Tax Coverover Payments to Puerto Rico and the U.S. Virgin Islands

Background

A $13.50 per proof gallon (a proof gallon is a liquid gallon consisting of 50% alcohol) excise tax is imposed on distilled spirits produced in or imported (or brought) into the United States. The excise tax does not apply to distilled spirits that are exported from the United States or to distilled spirits that are consumed in U.S. possessions (e.g., Puerto Rico and the Virgin Islands).

The IRC provides for coverover (payment) of $13.25 per proof gallon of the excise tax imposed on rum imported (or brought) into the United States (without regard to the country of origin) to Puerto Rico and the Virgin Islands during the period July 1, 1999, through December 31, 2001. Effective on January 1, 2002, the coverover rate is scheduled to return to its permanent level of $10.50 per proof gallon. The maximum amount attributable to the increased coverover rate over the permanent rate of $10.50 per proof gallon that can be paid to Puerto Rico and the Virgin Islands before October 1, 2000, is $20 million. Payment of this amount was made on January 3, 2000. Any remaining amounts attributable to the increased coverover rate were to have been paid on October 1, 2000.

The Department of the Interior, which administers the coverover payments for rum imported into the United States from the U.S. Virgin Islands, erroneously authorized full payment to the Virgin Islands of the increased coverover rate on that rum notwithstanding the statutory limit on these transfers for periods before October 1, 2000. The Bureau of Alcohol, Tobacco, and Firearms, which administers the coverover payments for the Virgin Islands' portion of tax collected on rum imported from other countries, complied with the statutory limit.

Trade and Development Act of 2000
(P.L. 106-200)

Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.

New Federal Law (Sec. 7652)

The Act provides that unpaid amounts attributable to the increase in the coverover rate to $13.25 per proof gallon for the period from July 1, 1999, through the last day of the month prior to May 18, 2000 (the date of enactment), will be paid on the first monthly payment date following May 18, 2000. Thus, this provision applies only to payments to Puerto Rico and to payments of the Virgin Islands' portion of tax on rum imported from other countries because the Interior Department erroneously has already paid in full amounts attributable to rum imported from the Virgin Islands. With respect to amounts attributable to the period beginning with the month of May 2000, payments will be based on the full $13.25 per proof gallon rate.

The Act further includes two clarifications to the rules governing coverover payments. First, clarification is provided that payments to the Virgin Islands with respect to rum imported from that possession are to be made annually in advance (based on estimates) as is the current administrative practice. Second, the Act clarifies that the Internal Revenue Code provisions governing coverover payments are the exclusive authority for making those payments.

Effective Date

The provision is effective on May 18, 2000.

California Law

The Franchise Tax Board does not administer any excise taxes. When applicable, the State Board of Equalization (BOE) administers excise taxes.

Impact on California Revenue

Not applicable.

To Amend the Internal Revenue Code of 1986 to Require 527 Organizations to Disclose Their Political Activities (P.L. 106-230)

Section	Section Title
1	Required Notification of Section 527 Status

Background

Section 527 provides a limited tax-exempt status to "political organizations,'' meaning a party, committee, association, fund, account, or other organization (whether or not incorporated) organized and operated primarily for the purpose of directly or indirectly accepting contributions or making expenditures (or both) for an "exempt function." For purposes of section 527, the term "exempt function'' means: the function of influencing or attempting to influence the selection, nomination, election, or appointment of any individual to any federal, state, or local public office or office in a political organization, or the election of Presidential or Vice-Presidential electors, whether or not such individual or electors are selected, nominated, elected, or appointed. Thus, by definition, the purpose of a section 527 organization is to accept contributions or make expenditures for political campaign (and similar) activities.

Section 527 organizations are not subject to any notification requirement when they are formed and there is no separate application for recognition of status as a section 527 organization. However, an organization wishing to receive confirmation of its status as a section 527 organization may request a written determination from the IRS in the form of a private letter ruling.

New Federal Law (Secs. 527, 6104, and 6652)

Under the Act, certain Section 527 organizations are required to notify the Secretary that they are such an organization (notice of status). Notification must be made within 24 hours after the organization is established. The notice shall include:

1. the name and address of the organization and its electronic mailing address;
2. the purpose of the organization;
3. the names and addresses of its officers, highly compensated employees, contact person, custodian of records, and members of its Board of Directors;
4. the name and address of, and relationship to, any related entities; and
5. such other information as the Secretary may require to carry out the internal revenue laws.

If such an organization fails to timely file the notice of status, it shall not be treated as an organization described in Section 527 for any period prior to giving such notice and the taxable income of such organization is computed by taking into account any exempt function income (and any deductions directly connected with the production of such income).

The IRS is required to make the notice of status, together with certain related documents, available for public inspection. In addition, the IRS is required to provide on the Internet a list of Section 527 organizations that filed such notice and provide the name, address, electronic mailing address, custodian of records, and contact person of such organization. A copy of the

notice of status or notice materials must be made available by the organization for public inspection. In addition, an individual is permitted to request in person or in writing a copy of such notice from the organization. In the case of a failure by the organization to comply with the public inspection requirement, the penalty is $20 for each day during which such failure continues and is to be paid by the person failing to meet the disclosure requirements.

Effective Date

This provision of the Act is effective on July 1, 2000, however:

- In the case of an organization established before July 1, 2000, the time to file the notice of status shall be July 31, 2000.
- The effective date for making the information available on the Internet and in person is August 15, 2000.

Current California Law

Section 23701r (political organizations) provides that the organizations described in that section are not subject to the requirement to apply for exemption. Also, if one of these organizations incorporates, it must obtain a certificate of exemption or pay the minimum tax each year.

Impact on California Revenue

Not applicable.

Section	Section Title
2	Disclosures by Political Organizations

Background

Section 527 political organizations are not required to file an annual information return. Section 527 organizations operate primarily for the purpose of directly or indirectly accepting contributions or making expenditures (or both) for the function of influencing or attempting to influence the selection, nomination, election or appointment of any individual to any federal, state, or local public office or office in a political organization, or the election of Presidential or Vice-Presidential electors, whether or not such individual or electors are selected, nominated, elected, or appointed. Thus, by definition, the purpose of a section 527 organization is to accept contributions or make expenditures for political campaign (and similar) activities. Donors are exempt from gift tax on their contributions to such section 527 organizations.

To Amend the Internal Revenue Code of 1986 to Require 527 Organizations to Disclose Their Political Activities (P.L. 106-230)

If a section 527 political organization has taxable income, it is required annually to file an income tax return; however, if the political organization does not have taxable income, the tax return is not required to be filed. In computing taxable income, section 527 political organizations are allowed a specific deduction of $100. Because it is an income tax return, the income tax return requires information related to the amount of income and deductible expenses of the filing organization (or separate segregated fund) for the year. The income tax return does not contain information relating to the political activities of the organization or contributors to the organization and does not require such organizations to report even their total expenses relating to political activities. Thus, the income tax return does not contain information relating to contributors to the organization or the specific activities of the organization (or fund).

New Federal Law (Secs. 527, 6104 and 6652)

Under the Act, certain political organizations that accept a contribution or make an expenditure for an exempt function during any calendar year must file with the Secretary, at certain times of the year, reports regarding expenditures and contributions relative to elections. The reports must include:

1. The amount of each expenditure made to a person if the aggregate amount of expenditures to such person during the calendar year equals or exceeds $500, and the name and address of the person; and
2. The name and address of all contributors that contributed an aggregate amount of $200 or more to the organization during the calendar year, and the amount of the contribution.

The IRS is required to make the organization’s report available for public inspection. Section 527 organizations are required to make a copy of their report available for public inspection. Section 527 organizations are required to comply with requests made in person or in writing by individuals who seek a copy of the organization's report. In the case of a failure to comply with the public inspection requirement, there shall be paid $20 for each day during which such failure continues and is to be paid by the person failing to meet the disclosure requirements. The maximum penalty imposed on all persons with respect to one return shall not exceed $10,000.

Effective Date

This provision of the Act is effective for expenditures made and contributions received after July 1, 2000, except that such amendment shall not apply to expenditures made, or contributions received, after such date pursuant to a contract entered into on or before such date.

Current California Law

California filing requirements are basically the same as federal requirements. Any information reported on a return – whether it is an information return or a tax return – is confidential information and may generally not be disclosed by the Franchise Tax Board. Limited exceptions

that permit disclosure include "extraneous information" as defined in R&TC Section 19543. California does not have any law requiring an exempt organization to disclose its return or its exemption application upon request.

Impact on California Revenue

Not applicable.

Section	Section Title
3	Return Requirements Relating to Section 527 Organizations

Background

Section 527 political organizations are not required to file an annual information return. If a Section 527 political organization has taxable income, it is required annually to file an income tax return. A section 527 political organization is allowed a specific deduction of $100. However, if the political organization does not have taxable income, no tax return is required to be filed.

Section 527 organizations are not required to disclose their tax returns to the general public.

Tax-exempt organizations that fail to file a required annual information return must pay a penalty of $20 for each day during which such failure continues. The maximum penalty with respect to any one return cannot exceed the lesser of $10,000 or 5 percent of the gross receipts of the organization for the year. For those tax-exempt organizations with gross receipts exceeding $1 million, the daily penalty is $100, not to exceed $50,000.

New Federal Law (Secs. 6012, 6033, and 6104)

Under the Act, section 527 organizations with gross receipts of $25,000 or more for the taxable year are generally required to file an income tax return and an information return.

The IRS is required to make both returns available for public inspection. Also, section 527 organizations are required to make a copy of both returns available for public inspection. Section 527 organizations are required to comply with requests made in person or in writing by individuals who seek a copy of the organization's returns. In the case of an organization failing to comply with the public inspection requirement, there shall be paid $20 for each day during which such failure continues and is to be paid by the person failing to meet the disclosure requirements. However, the maximum penalty imposed on all persons with respect to one return cannot exceed $10,000.

To Amend the Internal Revenue Code of 1986 to Require 527 Organizations to Disclose Their Political Activities (P.L. 106-230)

In the case of a section 527 organization that fails to comply with the filing of the information return, the penalty is the same as for the tax-exempt organizations that fail to file the required information return.

Effective Date

This provision of the Act is effective for returns for taxable years beginning after June 30, 2000.

Current California Law

R&TC Section 23701r is based on IRC section 527. The most significant difference between state and federal law is non-conformity to paragraph (1) of subsection (f) of IRC section 527. That paragraph requires other exempt organizations to include in their taxable income amounts expended for purposes of influencing the selection, etc., of political candidates. What this means, for California purposes, is that if the other exempt organization commingles all of its funds in one account and makes political expenditures from that account, it does not have to pay tax on the amount of those expenditures. However, California has conformed to IRC section 527(f)(3), which provides that if the other exempt organizations maintain a segregated fund, that fund shall be treated as a separate organization and as such is treated as an organization within the meaning of section 23701r.

Tax on the taxable income of a political organization is assessed at the general corporation income tax rate, presently 8.84%.

California law does not require section 23701r organizations to file an information return. As with federal law, if the organization has taxable income, it must file a tax return. A specific deduction of $100 is allowed in computing the taxable income of a political organization. The penalties for late filing of the return or underpayment of the tax are the same as they are for any other exempt organization. However, political organizations are not subject to estimated tax underpayment penalties.

Impact on California Revenue

The change requiring tax returns to be filed by Section 527 organizations with gross receipts of $25,000 or more would have an unknown but minor revenue impact.

FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (P.L. 106-519)

Section	Section Title
1-5	FSC Repeal and Extraterritorial Income Exclusion Act of 2000

Background

In July 1998, the European Union requested that a World Trade Organization (WTO) dispute panel determine whether the foreign sales corporation (FSC) regime of sections 921 through 927 of the Internal Revenue Code (IRC) complies with WTO rules, including the Agreement on Subsidies and Countervailing Measures. A WTO dispute settlement panel (the "Panel") was established in September of 1998 to address these issues. On October 8, 1999, the Panel ruled that the FSC regime was not in compliance with WTO obligations. The Panel specified that "FSC subsidies must be withdrawn at the latest with effect from 1 October 2000." On February 24, 2000, the Appellate Body affirmed the lower panel's ruling.

Summary of U.S. Income Taxation of Foreign Persons

Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax only when such income is distributed to any U.S. persons that hold stock in such corporation. Accordingly, a U.S. person that conducts foreign operations through a foreign corporation generally is subject to U.S. tax on the income from those operations when the income is repatriated to the United States through a dividend distribution to the U.S. person. The income is reported on the U.S. person's tax return for the year the distribution is received, and the United States imposes tax on such income at that time. An indirect foreign tax credit may reduce the U.S. tax imposed on such income.

Foreign Sales Corporations

The income of an eligible FSC is partially subject to U.S. income tax and partially exempt from U.S. income tax. In addition, a U.S. corporation generally is not subject to U.S. tax on dividends distributed from the FSC out of certain earnings.

A FSC must be located and managed outside the United States, and must perform certain economic processes outside the United States. A FSC is often owned by a U.S. corporation that produces goods in the United States. The U.S. corporation either supplies goods to the FSC for resale abroad or pays the FSC a commission in connection with such sales. The income of the FSC, a portion of which is exempt from U.S. tax under the FSC rules, equals the FSC's gross markup or gross commission income, less the expenses incurred by the FSC. The gross markup or the gross commission is determined according to specified pricing rules.

A FSC generally is not subject to U.S. tax on its exempt foreign trade income. The exempt foreign trade income of a FSC is treated as foreign-source income that is not effectively connected with the conduct of a trade or business within the United States.

Foreign trade income other than exempt foreign trade income generally is treated as U.S.-source income effectively connected with the conduct of a trade or business conducted through a

permanent establishment within the United States. Thus, a FSC's income other than exempt foreign trade income generally is subject to U.S. tax currently and is treated as U.S.-source income for purposes of the foreign tax credit limitation.

Foreign trade income of a FSC is defined as the FSC's gross income attributable to foreign trading gross receipts. Foreign trading gross receipts generally are the gross receipts attributable to the following types of transactions: the sale of export property; the lease or rental of export property; services related and subsidiary to such a sale or lease of export property; engineering and architectural services for projects outside the United States; and export management services. Investment income and carrying charges are excluded from the definition of foreign trading gross receipts.

The term "export property" generally means property (1) that is manufactured, produced, grown, or extracted in the United States by a person other than a FSC, (2) that is held primarily for sale, lease, or rental in the ordinary course of a trade or business for direct use or consumption outside the United States, and (3) not more than 50% of the fair market value is attributable to articles imported into the United States. The term "export property" does not include property leased or rented by a FSC for use by any member of a controlled group of which the FSC is a member; patents, copyrights (other than films, tapes, records, similar reproductions, and other than computer software, whether or not patented), and other intangibles; oil or gas (or any primary product thereof); unprocessed softwood timber; or products the export of which is prohibited or curtailed. Export property also excludes property designated by the President as being in short supply.

If export property is sold to a FSC by a related person (or a commission is paid by a related person to a FSC with respect to export property), the income with respect to the export transactions must be allocated between the FSC and the related person. The taxable income of the FSC and the taxable income of the related person are computed based upon a transfer price determined under section 482 or one of two alternative formulas.

The portion of a FSC's foreign trade income that is treated as exempt foreign trade income depends on the pricing rule used to determine the income of the FSC. If the amount of income earned by the FSC is based on section 482 pricing, the exempt foreign trade income generally is 30% of the foreign trade income the FSC derives from a transaction. If the income earned by the FSC is determined using one of the two formulas specified in the FSC provisions, the exempt foreign trade income generally is 15/23 of the foreign trade income the FSC derives from the transaction.

A FSC is not required or deemed to make distributions to its shareholders. Actual distributions are treated as being made first out of earnings and profits attributable to foreign trade income, and then out of any other earnings and profits. Any distribution made by a FSC out of earnings and profits attributable to foreign trade income to a foreign shareholder is treated as U.S.-source income that is effectively connected with a business conducted through a permanent establishment of the shareholder within the United States. Thus, the foreign shareholder is subject to U.S. tax on such a distribution.

A U.S. corporation generally is allowed a 100% dividends-received deduction for amounts distributed from a FSC out of earnings and profits attributable to foreign trade income. The 100% dividends-received deduction is not allowed for nonexempt foreign trade income determined under section 482 pricing.

New Federal Law (Secs. 114, 941, 942, and 943)

Repeal of the FSC Rules

The Act repeals the present-law FSC rules found in sections 921 through 927 of the Code.

Exclusion of Extraterritorial Income

The Act provides that gross income for U.S. tax purposes does not include extraterritorial income. Because the exclusion of such extraterritorial income is a means of avoiding double taxation, no foreign tax credit is allowed for income taxes paid with respect to such excluded income. Extraterritorial income is eligible for the exclusion to the extent that it is "qualifying foreign trade income." Because U.S. income tax principles generally deny deductions for expenses related to exempt income, otherwise deductible expenses that are allocated to qualifying foreign trade income generally are disallowed.

The Act applies in the same manner with respect to both individuals and corporations who are U.S. taxpayers. In addition, the exclusion from gross income applies for individual and corporate alternative minimum tax purposes.

Qualifying Foreign Trade Income

Under the Act, qualifying foreign trade income is the amount of gross income that, if excluded, would result in a reduction of taxable income by the greatest of (1) 1.2% of the "foreign trading gross receipts" derived by the taxpayer from the transaction, (2) 15% of the "foreign trade income" derived by the taxpayer from the transaction, or (3) 30% of the "foreign sale and leasing income" derived by the taxpayer from the transaction. The amount of qualifying foreign trade income determined using 1.2% of the foreign trading gross receipts is limited to 200% of the qualifying foreign trade income that would result using 15% of the foreign trade income. Notwithstanding the general rule that qualifying foreign trade income is based on one of the three calculations that results in the greatest reduction in taxable income, a taxpayer may choose instead to use one of the other two calculations that does not result in the greatest reduction in taxable income. Although these calculations are determined by reference to a reduction of taxable income (a net income concept), qualifying foreign trade income is an exclusion from gross income. Hence, once a taxpayer determines the appropriate reduction of taxable income, that amount must be "grossed up" for related expenses in order to determine the amount of gross income excluded.

If a taxpayer uses 1.2% of foreign trading gross receipts to determine the amount of qualifying foreign trade income with respect to a transaction, the taxpayer or any other related persons will

be treated as having no qualifying foreign trade income with respect to any other transaction involving the same property.

For example, assume that a manufacturer and a distributor of the same product are related persons. The manufacturer sells the product to the distributor at an arm's-length price of $80 (generating $30 of profit) and the distributor sells the product to an unrelated customer outside of the United States for $100 (generating $20 of profit). If the distributor chooses to calculate its qualifying foreign trade income on the basis of 1.2% of foreign trading gross receipts, then the manufacturer will be considered to have no qualifying foreign trade income and, thus, would have no excluded income. The distributor's qualifying foreign trade income would be 1.2% of $100, and the manufacturer's qualifying foreign trade income would be zero. This limitation is intended to prevent a duplication of exclusions from gross income because the distributor's $100 of gross receipts includes the $80 of gross receipts of the manufacturer. Absent this limitation, $80 of gross receipts would have been double counted for purposes of the exclusion. If both persons were permitted to use 1.2% of their foreign trading gross receipts in this example, then the related-person group would have an exclusion based on $180 of foreign trading gross receipts notwithstanding that the related-person group really only generated $100 of gross receipts from the transaction. However, if the distributor chooses to calculate its qualifying foreign trade income on the basis of 15% of foreign trade income (15% of $20 of profit), then the manufacturer would also be eligible to calculate its qualifying foreign trade income in the same manner (15% of $30 of profit).

Thus, in the second case, each related person may exclude an amount of income based on their respective profits. The total foreign trade income of the related-person group is $50. Accordingly, allowing each person to calculate the exclusion based on their respective foreign trade income does not result in a duplication of exclusions.

Under the Act, a taxpayer may determine the amount of qualifying foreign trade income either on a transaction-by-transaction basis or on an aggregate basis for groups of transactions, so long as the groups are based on product lines or recognized industry or trade usage. Under the grouping method, Congress intends that taxpayers be given reasonable flexibility to identify product lines or groups on the basis of recognized industry or trade usage. In general, provided that the taxpayer's grouping is not unreasonable, it will not be rejected merely because the grouped products fall within more than one of the two-digit Standard Industrial Classification codes.

The Secretary of the Treasury is granted authority to prescribe rules for grouping transactions in determining qualifying foreign trade income.

Congress intends to include industries as defined in the North American Industrial Classification System.

Qualifying foreign trade income must be reduced by illegal bribes, kickbacks and similar payments, and by a factor for operations in or related to a country associated in carrying out an international boycott or participating or cooperating with an international boycott.

In addition, the Act directs the Secretary of the Treasury to prescribe rules for marginal costing in those cases in which a taxpayer is seeking to establish or maintain a market for qualifying foreign trade property.

Foreign Trading Gross Receipts

Under the Act, "foreign trading gross receipts" are gross receipts derived from certain activities in connection with "qualifying foreign trade property" with respect to which certain "economic processes" take place outside of the United States. Specifically, the gross receipts must be (1) from the sale, exchange, or other disposition of qualifying foreign trade property; (2) from the lease or rental of qualifying foreign trade property for use by the lessee outside of the United States; (3) for services which are related and subsidiary to the sale, exchange, disposition, lease, or rental of qualifying foreign trade property (as described above); (4) for engineering or architectural services for construction projects located outside of the United States; or (5) for the performance of certain managerial services for unrelated persons. Gross receipts from the lease or rental of qualifying foreign trade property include gross receipts from the license of qualifying foreign trade property. Consistent with the policy adopted in the Taxpayer Relief Act of 1997, this includes the license of computer software for reproduction abroad.

Foreign trading gross receipts do not include gross receipts from a transaction if the qualifying foreign trade property or services are for ultimate use in the United States, or for use by the United States (or an instrumentality thereof) and such use is required by law or regulation. Foreign trading gross receipts also do not include gross receipts from a transaction that is accomplished by a subsidy granted by the government (or any instrumentality thereof) of the country or possession in which the property is manufactured.

A taxpayer may elect to treat gross receipts from a transaction as not foreign trading gross receipts. As a consequence of such an election, the taxpayer could utilize any related foreign tax credits in lieu of the exclusion as a means of avoiding double taxation. It is intended that this election be accomplished by the taxpayer's treatment of such items on its tax return for the taxable year. Provided that the taxpayer's taxable year is still open under the statute of limitations for making claims for refund under section 6511, a taxpayer can make redeterminations as to whether the gross receipts from a transaction constitute foreign trading gross receipts.

Foreign Economic Processes

Under the Act, gross receipts from a transaction are foreign trading gross receipts only if certain economic processes take place outside of the United States. The foreign economic processes requirement is satisfied if the taxpayer (or any person acting under a contract with the taxpayer) participates outside of the United States in the solicitation (other than advertising), negotiation, or making of the contract relating to such transaction and incurs a specified amount of foreign direct costs attributable to the transaction.

For this purpose, foreign direct costs include only those costs incurred in the following categories of activities: (1) advertising and sales promotion; (2) the processing of customer orders and the arranging for delivery; (3) transportation outside of the United States in connection with delivery to

the customer; (4) the determination and transmittal of a final invoice or statement of account or the receipt of payment; and (5) the assumption of credit risk. An exception from the foreign economic processes requirement is provided for taxpayers with foreign trading gross receipts for the year of $5 million or less.

The foreign economic processes requirement must be satisfied with respect to each transaction and, if so, any gross receipts from such transaction could be considered as foreign trading gross receipts. For example, all of the lease payments received with respect to a multi-year lease contract that met the foreign economic processes requirement at the time it was entered into would be considered as foreign trading gross receipts. On the other hand, a sale of property that was formerly a leased asset that was not sold pursuant to the original lease agreement generally would be considered a new transaction that must independently satisfy the foreign economic processes requirement.

A taxpayer's foreign economic processes requirement is treated as satisfied with respect to a sales transaction (solely for the purpose of determining whether gross receipts are foreign trading gross receipts) if any related person has satisfied the foreign economic processes requirement in connection with another sales transaction involving the same qualifying foreign trade property.

Qualifying Foreign Trade Property

Under the Act, the threshold for determining if gross receipts will be treated as foreign trading gross receipts is whether the gross receipts are derived from a transaction involving "qualifying foreign trade property." Qualifying foreign trade property is property manufactured, produced, grown, or extracted ("manufactured") within or outside of the United States that is held primarily for sale, lease, or rental, in the ordinary course of a trade or business, for direct use, consumption, or disposition outside of the United States.

In addition, not more than 50% of the fair market value of such property can be attributable to the sum of (1) the fair market value of articles manufactured outside of the United States plus (2) the direct costs of labor performed outside of the United States.

The Act excludes certain property from the definition of qualifying foreign trade property. The excluded property is (1) property leased or rented by the taxpayer for use by a related person, (2) certain intangibles, (3) oil and gas (or any primary product thereof), (4) unprocessed softwood timber, (5) certain products the transfer of which are prohibited or curtailed to effectuate the policy set forth in Public Law 96-72, and (6) property designated by Executive Order as in short supply. In addition, it is the intention of Congress that property that is leased or licensed to a related person who is the lessor, licensor, or seller of the same property in a sublease, sublicense, sale, or rental to an unrelated person for the ultimate and predominate use by the unrelated person outside of the United States is not excluded property by reason of such lease or license to a related person.

With respect to property that is manufactured outside of the United States, rules are provided to ensure consistent U.S. tax treatment with respect to manufacturers. The Act requires that property manufactured outside of the United States be manufactured by (1) a domestic

corporation, (2) an individual who is a citizen or resident of the United States, (3) a foreign corporation that elects to be subject to U.S. taxation in the same manner as a U.S. corporation, or (4) a partnership or other pass-through entity all of the partners or owners of which are described in (1), (2), or (3) above.

Foreign Trade Income

Under the Act, "foreign trade income" is the taxable income of the taxpayer (determined without regard to the exclusion of qualifying foreign trade income) attributable to foreign trading gross receipts. Certain dividends-paid deductions of cooperatives are disregarded in determining foreign trade income for this purpose.

Foreign Sale and Leasing Income

Under the Act, "foreign sale and leasing income" is the amount of the taxpayer's foreign trade income (with respect to a transaction) that is properly allocable to activities that constitute foreign economic processes (as described above). For example, a distribution company's profit from the sale of qualifying foreign trade property that is associated with sales activities, such as soliciting or negotiating the sale, advertising, processing customer orders, arranging for delivery, transporting outside of the United States, and other enumerated activities, would constitute foreign sale and leasing income.

Foreign sale and leasing income also includes foreign trade income derived by the taxpayer in connection with the lease or rental of qualifying foreign trade property for use by the lessee outside of the United States. Income from the sale, exchange, or other disposition of qualifying foreign trade property that is or was subject to such a lease (i.e., the sale of the residual interest in the leased property) gives rise to foreign sale and leasing income. Except as provided in regulations, a special limitation applies to leased property that (1) is manufactured by the taxpayer or (2) is acquired by the taxpayer from a related person for a price that was other than arm's length. In such cases, foreign sale and leasing income may not exceed the amount of foreign sale and leasing income that would have resulted if the taxpayer had acquired the leased property in a hypothetical arm's-length purchase and then engaged in the actual sale or lease of such property. For example, if a manufacturer leases qualifying foreign trade property that it manufactured, the foreign sale and leasing income derived from that lease may not exceed the amount of foreign sale and leasing income that the manufacturer would have earned with respect to that lease had it purchased the property for an arm's-length price on the day that the manufacturer entered into the lease. For purposes of calculating the limit on foreign sale and leasing income, the manufacturer's basis and, thus, depreciation would be based on this hypothetical arm's-length price. This limitation is intended to prevent foreign sale and leasing income from including profit associated with manufacturing activities.

For purposes of determining foreign sale and leasing income, only directly allocable expenses are taken into account in calculating the amount of foreign trade income. In addition, income properly allocable to certain intangibles is excluded for this purpose.

FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (P.L. 106-519)

The following is an example of the calculation of qualifying foreign trade income.

XYZ Corporation, a U.S. corporation, manufactures property that is sold to unrelated customers for use outside of the United States. XYZ Corporation satisfies the foreign economic processes requirement through conducting activities such as solicitation, negotiation, transportation, and other sales-related activities outside of the United States with respect to its transactions. During the year, qualifying foreign trade property was sold for gross proceeds totaling $1,000. The cost of this qualifying foreign trade property was $600. XYZ Corporation incurred $275 of costs that are directly related to the sale and distribution of qualifying foreign trade property. XYZ Corporation paid $40 of income tax to a foreign jurisdiction related to the sale and distribution of the qualifying foreign trade property. XYZ Corporation also generated gross income of $7,600 (gross receipts of $24,000 less cost of goods sold of $16,400) and direct expenses of $4,225 that relate to the manufacture and sale of products other than qualifying foreign trade property. XYZ Corporation also incurred $500 of overhead expenses. XYZ Corporation's financial information for the year is summarized as follows:

	Total	Other Property	QFTP
Gross receipts	$25,000.00	$24,000.00	$1,000.00
Cost of goods sold	17,000.00	16,400.00	600.00
Direct expenses	4,500.00	4,225.00	275.00
Overhead expenses	500.00		

Illustrated below is the computation of the amount of qualifying foreign trade income that is excluded from XYZ Corporation's gross income and the amount of related expenses that are disallowed. In order to calculate qualifying foreign trade income, the amount of foreign trade income first must be determined. Foreign trade income is the taxable income (determined without regard to the exclusion of qualifying foreign trade income) attributable to foreign trading gross receipts. In this example, XYZ Corporation's foreign trading gross receipts equal $1,000. This amount of gross receipts is reduced by the related cost of goods sold, the related direct expenses, and a portion of the overhead expenses, in order to arrive at the related taxable income.

Thus, XYZ Corporation's foreign trade income equals $100, calculated as follows:

Foreign trading gross receipts	$1,000.00	
Less: Cost of goods sold	600.00	
Gross income		400.00
Less: Direct expenses		275.00
Less: Apportioned overhead expenses		25.00
Foreign trade income		100.00

Foreign sale and leasing income is defined as an amount of foreign trade income (calculated taking into account only directly-related expenses) that is properly allocable to certain specified foreign activities. Assume for purposes of this example that of the $125 of foreign trade income ($400 of gross income from the sale of qualifying foreign trade property less only the direct expenses of $275), $35 is properly allocable to such foreign activities (e.g., solicitation,

negotiation, advertising, foreign transportation, and other enumerated sales-like activities) and, therefore, is considered to be foreign sale and leasing income.

Qualifying foreign trade income is the amount of gross income that, if excluded, will result in a reduction of taxable income equal to the greatest of (1) 30% of foreign sale and leasing income, (2) 1.2% of foreign trading gross receipts, or (3) 15% of foreign trade income. Thus, in order to calculate the amount that is excluded from gross income, taxable income must be determined and then "grossed up" for allocable expenses in order to arrive at the appropriate gross income figure. First, for each method of calculating qualifying foreign trade income, the reduction in taxable income is determined. Then, the $275 of direct and $25 of overhead expenses, totaling $300, attributable to foreign trading gross receipts is apportioned to the reduction in taxable income based on the proportion of the reduction in taxable income to foreign trade income. This apportionment is done for each method of calculating qualifying foreign trade income. The sum of the taxable income reduction and the apportioned expenses equals the respective qualifying foreign trade income (i.e., the amount of gross income excluded) under each method, as follows:

		1.2% FTGR	15% FTI	30% FS&LI
Reduction of taxable income:	12.00			
Gross-up for disallowed expenses:	36.00			
Qualifying foreign trade income		48.00	60.00	39.38

("FTGR" refers to foreign trade gross receipts, "FTI" refers to foreign trade income and "FS&LI" refers to foreign sale and leasing income.)

Because foreign sale and leasing income only takes into account direct expenses, it is appropriate to take into account only such expenses for purposes of this calculation.

In the example, the $60 of qualifying foreign trade income is excluded from XYZ Corporation's gross income (determined based on 15% of foreign trade income). (Note that XYZ Corporation could choose to use one of the other two methods notwithstanding that they would result in a smaller exclusion.)

In connection with excluding $60 of gross income, certain expenses that are allocable to this income are not deductible for U.S. federal income tax purposes. Thus, $45 ($300 of related expenses multiplied by 15%, i.e., $60 of qualifying foreign trade income divided by $400 of gross income from the sale of qualifying foreign trade property) of expenses would be disallowed. The $300 of allocable expenses includes both the $275 of direct expenses and the $25 of overhead expenses. Thus, the $45 of disallowed expenses represents the sum of $41.25 of direct expenses plus $3.75 of overhead expenses. If qualifying foreign trade income were determined using 30% of foreign sale and leasing income, the disallowed expenses would include only the appropriate portion of the direct expenses.

	Other Property	QFTP	Excluded/Disallowed	Total
Gross receipts	$24,000.00	$1,000.00		
Cost of goods sold	16,400.00	600.00		
Gross income	7,600.00	400.00	(60.00)	7,940.00
Direct expenses	4,225.00	275.00	(41.25)	4,458.75
Overhead expenses	475.00	25.00	(3.75)	496.25
Taxable income	2,985.00			

XYZ Corporation paid $40 of income tax to a foreign jurisdiction related to the sale and distribution of the qualifying foreign trade property. A portion of this $40 of foreign income tax is treated as paid with respect to the qualifying foreign trade income and, therefore, is not creditable for U.S. foreign tax credit purposes. In this case, $6 of such taxes paid ($40 of foreign taxes multiplied by 15%, i.e., $60 of qualifying foreign trade income divided by $400 of gross income from the sale of qualifying foreign trade property) is treated as paid with respect to the qualifying foreign trade income and, thus, is not creditable.

The results in this example are the same regardless of whether XYZ Corporation manufactures the property within the United States or outside of the United States through a foreign branch. If XYZ Corporation were an S corporation or limited liability company, the results also would be the same, and the exclusion would pass through to the S corporation owners or limited liability company owners as the case may be.

Other Rules

Foreign-Source Income Limitation

The Act provides a limitation with respect to the sourcing of taxable income applicable to certain sale transactions giving rise to foreign trading gross receipts. This limitation only applies with respect to sale transactions involving property that is manufactured within the United States. The special source limitation does not apply when qualifying foreign trade income is determined using 30% of the foreign sale and leasing income from the transaction.

This foreign-source income limitation is determined in one of two ways depending on whether the qualifying foreign trade income is calculated based on 1.2% of foreign trading gross receipts or on 15% of foreign trade income. If the qualifying foreign trade income is calculated based on 1.2% of foreign trading gross receipts, the related amount of foreign-source income may not exceed the amount of foreign trade income that (without taking into account this special foreign-source income limitation) would be treated as foreign-source income if such foreign trade income were reduced by 4% of the related foreign trading gross receipts.

For example, assume that foreign trading gross receipts are $2,000 and foreign trade income is $100. Assume also that the taxpayer chooses to determine qualifying foreign trade income based on 1.2% of foreign trading gross receipts. Taxable income after taking into account the exclusion of the qualifying foreign trade income and the disallowance of related deductions is $76. Assume that the taxpayer manufactured its qualifying foreign trade property in the United States and that title to such property passed outside of the United States. Absent a special sourcing rule, under

section 863(b) (and the regulations thereunder) the $76 of taxable income would be sourced as $38 U.S. source and $38 foreign source. Under the special sourcing rule, the amount of foreign-source income may not exceed the amount of the foreign trade income that otherwise would be treated as foreign source if the foreign trade income were reduced by 4% of the related foreign trading gross receipts. Reducing foreign trade income by 4% of the foreign trading gross receipts (4% of $2,000, or $80) would result in $20 ($100 foreign trade income less $80). Applying section 863(b) to the $20 of reduced foreign trade income would result in $10 of foreign-source income and $10 of U.S.-source income. Accordingly, the limitation equals $10. Thus, although under the general sourcing rule $38 of the $76 taxable income would be treated as foreign source, the special sourcing rule limits foreign-source income in this example to $10 (with the remaining $66 being treated as U.S.-source income).

If the qualifying foreign trade income is calculated based on 15% of foreign trade income, the amount of related foreign-source income may not exceed 50% of the foreign trade income that (without taking into account this special foreign-source income limitation) would be treated as foreign-source income.

For example, assume that foreign trade income is $100 and the taxpayer chooses to determine its qualifying foreign trade income based on 15% of foreign trade income. Taxable income after taking into account the exclusion of the qualifying foreign trade income and the disallowance of related deductions is $85. Assume that the taxpayer manufactured its qualifying foreign trade property in the United States and that title to such property passed outside of the United States. Absent a special sourcing rule, under section 863(b) the $85 of taxable income would be sourced as $42.50 U.S. source and $42.50 foreign source. Under the special sourcing rule, the amount of foreign-source income may not exceed 50% of the foreign trade income that otherwise would be treated as foreign source. Applying section 863(b) to the $100 of foreign trade income would result in $50 of foreign-source income and $50 of U.S.-source income. Accordingly, the limitation equals $25, which is 50% of the $50 foreign-source income. Thus, although under the general sourcing rule $42.50 of the $85 taxable income would be treated as foreign source, the special sourcing rule limits foreign-source income in this example to $25 (with the remaining $60 being treated as U.S.-source income). The foreign-source income limitation provisions also apply when source is determined solely in accordance with section 862 (e.g., a distributor of qualifying foreign trade property that is manufactured in the United States by an unrelated person and sold for use outside of the United States).

Treatment of Withholding Taxes

The Act generally provides that no foreign tax credit is allowed for foreign taxes paid or accrued with respect to qualifying foreign trade income (i.e., excluded extraterritorial income). In determining whether foreign taxes are paid or accrued with respect to qualifying foreign trade income, foreign withholding taxes generally are treated as not paid or accrued with respect to qualifying foreign trade income.

Accordingly, the Act's denial of foreign tax credits would not apply to such taxes. For this purpose, the term "withholding tax" refers to any foreign tax that is imposed on a basis other than residence and that is otherwise a creditable foreign tax under sections 901 or 903.

Congress intended that such taxes would be similar in nature to the gross-basis taxes described in sections 871 and 881.

If, however, qualifying foreign trade income is determined based on 30% of foreign sale and leasing income, the special rule for withholding taxes is not applicable. Thus, in such cases foreign withholding taxes may be treated as paid or accrued with respect to qualifying foreign trade income and, accordingly, are not creditable under the Act.

Election to be Treated as a U.S. Corporation

The Act provides that certain foreign corporations may elect, on an original return, to be treated as domestic corporations. The election applies to the taxable year when made and all subsequent taxable years unless revoked by the taxpayer or terminated for failure to qualify for the election. Such election is available for a foreign corporation (1) that manufactures property in the ordinary course of such corporation's trade or business, or (2) if substantially all of the gross receipts of such corporation reasonably may be expected to be foreign trading gross receipts. For this purpose, "substantially all" is based on the relevant facts and circumstances.

In order to be eligible to make this election, the foreign corporation must waive all benefits granted to such corporation by the United States pursuant to a treaty.

Absent such a waiver, it would be unclear, for example, whether the permanent establishment article of a relevant tax treaty would override the electing corporation's treatment as a domestic corporation under this provision. A foreign corporation that elects to be treated as a domestic corporation is not permitted to make an S corporation election. The Secretary is granted authority to prescribe rules to ensure that the electing foreign corporation pays its U.S. income tax liabilities and to designate one or more classes of corporations that may not make such an election.

If such an election is made, for purposes of section 367 the foreign corporation is treated as transferring (as of the first day of the first taxable year to which the election applies) all of its assets to a domestic corporation in connection with an exchange to which section 354 applies.

If a corporation fails to meet the applicable requirements, described above, for making the election to be treated as a domestic corporation for any taxable year beginning after the year of the election, the election will terminate. In addition, a taxpayer, at its option and at any time, may revoke the election to be treated as a domestic corporation. In the case of either a termination or a revocation, the electing foreign corporation will not be considered as a domestic corporation effective beginning on the first day of the taxable year following the year of such termination or revocation. For purposes of section 367, if the election to be treated as a domestic corporation is terminated or revoked, such corporation is treated as a domestic corporation transferring (as of the first day of the first taxable year to which the election ceases to apply) all of its property to a foreign corporation in connection with an exchange to which section 354 applies. Moreover, once a termination occurs or a revocation is made, the former electing corporation may not again elect to be taxed as a domestic corporation under the provisions of the Act for a period of five taxable years beginning with the first taxable year that begins after the termination or revocation.

For example, assume a U.S. corporation owns 100% of a foreign corporation. The foreign corporation manufactures outside of the United States and sells what would be qualifying foreign trade property were it manufactured by a person subject to U.S. taxation. Such foreign corporation could make the election under this provision to be treated as a domestic corporation. As a result, its earnings no longer would be deferred from U.S. taxation. However, by electing to be subject to U.S. taxation, a portion of its income would be qualifying foreign trade income.

The requirement that the foreign corporation be treated as a domestic corporation (and, therefore, subject to U.S. taxation) is intended to provide parity between U.S. corporations that manufacture abroad in branch form and U.S. corporations that manufacture abroad through foreign subsidiaries. The election, however, is not limited to U.S.-owned foreign corporations. A foreign-owned foreign corporation that wishes to qualify for the treatment provided under the Act could avail itself of such election (unless otherwise precluded from doing so by Treasury regulations).

Shared Partnerships

The Act provides rules relating to allocations of qualifying foreign trade income by certain shared partnerships. To the extent that such a partnership (1) maintains a separate account for transactions involving foreign trading gross receipts with each partner, (2) makes distributions to each partner based on the amounts in the separate account, and (3) meets such other requirements as the Treasury Secretary may prescribe by regulations, such partnership then would allocate to each partner items of income, gain, loss, and deduction (including qualifying foreign trade income) from such transactions on the basis of the separate accounts. It is intended that with respect to, and only with respect to, such allocations and distributions (i.e., allocations and distributions related to transactions between the partner and the shared partnership generating foreign trading gross receipts), these rules would apply in lieu of the otherwise applicable partnership allocation rules such as those in section 704(b). For this purpose, a partnership is a foreign or domestic entity that is considered to be a partnership for U.S. federal income tax purposes.

Under the Act, any partner's interest in the shared partnership is not taken into account in determining whether such partner is a "related person" with respect to any other partner for purposes of the Act's provisions. Also, the election to exclude certain gross receipts from foreign trading gross receipts must be made separately by each partner with respect to any transaction for which the shared partnership maintains a separate account.

Certain Assets Not Taken into Account for Purposes of Interest Expense Allocation

The Act also provides that qualifying foreign trade property that is held for lease or rental, in the ordinary course of a trade or business, for use by the lessee outside of the United States is not taken into account for interest allocation purposes.

Distributions of Qualifying Foreign Trade Income by Cooperatives

Agricultural and horticultural producers often market their products through cooperatives, which are member-owned corporations formed under Subchapter T of the Code. At the cooperative level, the Act provides the same treatment of foreign trading gross receipts derived from products marketed through cooperatives as it provides for foreign trading gross receipts of other taxpayers. That is, the qualifying foreign trade income attributable to those foreign trading gross receipts is excluded from the gross income of the cooperative. Absent a special rule, however, patronage dividends or per-unit retain allocations attributable to qualifying foreign trade income paid to members of cooperatives would be taxable in the hands of those members. Congress believes that this would disadvantage agricultural and horticultural producers who choose to market their products through cooperatives relative to those individuals who market their products directly or through pass-through entities such as partnerships, limited liability companies, or S corporations. Accordingly, the Act provides that the amount of any patronage dividends or per-unit retain allocations paid to a member of an agricultural or horticultural cooperative (to which Part I of Subchapter T applies), which is allocable to qualifying foreign trade income of the cooperative, is treated as qualifying foreign trade income of the member (and, thus, excludable from such member's gross income). In order to qualify, such amount must be designated by the organization as allocable to qualifying foreign trade income in a written notice mailed to its patrons not later than the payment period described in section 1382(d). The cooperative cannot reduce its income (e.g., cannot claim a "dividends-paid deduction") under section 1382 for such amounts.

Gap Period Before Administrative Guidance is Issued

Congress recognizes that there may be a gap in time between the enactment of the Act and the issuance of detailed administrative guidance. It is intended that during this gap period before administrative guidance is issued, taxpayers and the Internal Revenue Service may apply the principles of present-law regulations and other administrative guidance under sections 921 through 927 to analogous concepts under the Act. Some examples of the application of the principles of present-law regulations to the Act are described below. These limited examples are intended to be merely illustrative and are not intended to imply any limitation regarding the application of the principles of other analogous rules or concepts under present law.

Marginal Costing and Grouping

Under the Act, the Secretary of the Treasury is provided authority to prescribe rules for using marginal costing and for grouping transactions in determining qualifying foreign trade income. It is intended that similar principles under present-law regulations apply for these purposes.

Excluded Property

The Act provides that qualifying foreign trade property does not include property leased or rented by the taxpayer for use by a related person. It is intended that similar principles under present-law regulations apply for this purpose. Thus, excluded property does not apply, for example, to property leased by the taxpayer to a related person if the property is held for sublease, or is

subleased, by the related person to an unrelated person and the property is ultimately used by such unrelated person predominantly outside of the United States.

In addition, consistent with the policy adopted in the Taxpayer Relief Act of 1997, computer software that is licensed for reproduction outside of the United States is not excluded property. Accordingly, the license of computer software to a related person for reproduction outside of the United States for sale, sublicense, lease, or rental to an unrelated person for use outside of the United States is not treated as excluded property by reason of the license to the related person.

Foreign Trading Gross Receipts

Under the Act, foreign trading gross receipts are gross receipts from, among other things, the sale, exchange, or other disposition of qualifying foreign trade property, and from the lease of qualifying foreign trade property for use by the lessee outside of the United States. It is intended that the principles of present-law regulations that define foreign trading gross receipts apply for this purpose. For example, a sale includes an exchange or other disposition and a lease includes a rental or sublease and a license or a sublicense.

Foreign Use Requirement

Under the Act, property constitutes qualifying foreign trade property if, among other things, the property is held primarily for lease, sale, or rental, in the ordinary course of business, for direct use, consumption, or disposition outside of the United States.

It is intended that the principles of the present-law regulations apply for purposes of this foreign use requirement. For example, for purposes of determining whether property is sold for use outside of the United States, property that is sold to an unrelated person as a component to be incorporated into a second product which is produced, manufactured, or assembled outside of the United States will not be considered to be used in the United States (even if the second product ultimately is used in the United States), provided that the fair market value of such seller's components at the time of delivery to the purchaser constitutes less than 20% of the fair market value of the second product into which the components are incorporated (determined at the time of completion of the production, manufacture, or assembly of the second product).

In addition, for purposes of the foreign use requirement, property is considered to be used by a purchaser or lessee outside of the United States during a taxable year if it is used predominantly outside of the United States.

For this purpose, property is considered to be used predominantly outside of the United States for any period if, during that period, the property is located outside of the United States more than 50% of the time.

An aircraft or other property used for transportation purposes (e.g., railroad rolling stock, a vessel, a motor vehicle, or a container) is considered to be used outside of the United States for any period if, for the period, either the property is located outside of the United States more than 50% of the time or more than 50% of the miles traveled in the use of the property are traveled outside

of the United States. An orbiting satellite is considered to be located outside of the United States for these purposes.

Foreign Economic Processes

Under the Act, gross receipts from a transaction are foreign trading gross receipts eligible for exclusion from the tax base only if certain economic processes take place outside of the United States. The foreign economic processes requirement compares foreign direct costs to total direct costs. It is intended that the principles of the present-law regulations apply during the gap period for purposes of the foreign economic processes requirement including the measurement of direct costs. Congress recognizes that the measurement of foreign direct costs under the present-law regulations often depend on activities conducted by the FSC, which is a separate entity. Congress is aware that some of these concepts will have to be modified when new guidance is promulgated as a result of the Act's elimination of the requirement for a separate entity.

Effective Date

In general, the provisions of the Act applicable to FSCs are effective for transactions entered into after September 30, 2000. In addition, no corporation may elect to be a FSC after September 30, 2000.

The Act also provides a rule requiring the termination of a dormant FSC when the FSC has been inactive for a specified period of time. Under this rule, a FSC that generates no foreign trade income for any five consecutive years beginning after December 31, 2001, will cease to be treated as a FSC.

The Act provides a transition period for existing FSCs and for binding contractual agreements. The new rules do not apply to transactions in the ordinary course of business involving a FSC before January 1, 2002. Furthermore, the new rules do not apply to transactions in the ordinary course of business after December 31, 2001, if such transactions are pursuant to a binding contract between a FSC (or a person related to the FSC on September 30, 2000) and any other person (that is not a related person) and such contract is in effect on September 30, 2000, and all times thereafter. For this purpose, binding contracts include purchase options, renewal options, and replacement options that are enforceable against a lessor or seller (provided that the options are a part of a contract that is binding and in effect on September 30, 2000).

Similar to the limitation on use of the gross receipts method under the Act's operative provisions, the Act provides a rule that limits the use of the gross receipts method for transactions after the effective date of the Act if that same property generated foreign trade income to a FSC using the gross receipts method. Under the rule, if any person used the gross receipts method under the FSC regime, neither that person nor any related person will have qualifying foreign trade income with respect to any other transaction involving the same item of property.

Notwithstanding the transition period, FSCs (or related persons) may elect to have the rules of the Act apply in lieu of the rules applicable to FSCs. Thus, for transactions to which the transition rules apply, taxpayers may choose to apply either the FSC rules or the amendments made by this

Act, but not both. It is also intended that a taxpayer would not be able to avail itself of the rules of the Act in addition to the rules applicable to domestic international sales corporations.

California Law

In general, California does not conform to the federal rules relating to FSCs. For both worldwide and water's-edge filing purposes, FSCs are generally treated the same. The income and apportionment factors of a FSC are included in the apportionable tax base.

For purposes of a worldwide combined report, a FSC is treated in the same manner as any other corporation, foreign or domestic. A FSC is generally included in the combined report as a unitary corporation. If a taxpayer makes a “water's-edge election,” foreign corporations (except for controlled foreign corporations with subpart F income and foreign corporations with US source income) will generally be excluded from the combined reporting group for California apportionment purposes. However, the law specifically requires that the income and apportionment factors of FSCs be included in the water's-edge combined reporting group.

Impact on California Revenue

Not applicable.

Consolidated Appropriations Act, 2001
(P.L. 106-554)

The Consolidated Appropriations Act, 2001, enacted certain bills of the 106th Congress into law, including H.R. 5662, as introduced December 14, 2000. The section numbers identified below refer to sections of H.R. 5662, as introduced December 14, 2000.

Section	Section Title
101-102	Renewal Community Provisions

Background

In recent years, provisions have been added to the Internal Revenue Code that target specific geographic areas for special federal income tax treatment. For example, empowerment zones and enterprise communities generally provide tax incentives for businesses that locate within certain geographic areas designated by the Secretaries of Housing and Urban Development ('HUD") and Agriculture.

New Federal Law (Secs. 51, 469, and 1400E-J)

The Act authorizes the designation of 40 "renewal communities" within which special tax incentives would be available. The following is a description of the designation process and the tax incentives that would be available within the renewal communities.

Designation Process

The Secretary of HUD is authorized to designate up to 40 "renewal communities" from areas nominated by States and local governments. At least 12 of the designated communities must be in rural areas.

The Secretary of HUD is required to publish (within four months after enactment) regulations describing the nomination and selection process. Designations of renewal communities are to be made during the period beginning on the first day of the first month after the regulations are published and ending on December 31, 2001. The designation of an area as a renewal community generally will be effective on January 1, 2002, and will terminate after December 31, 2009.

Eligibility Criteria

To be designated as a renewal community, a nominated area must meet the following criteria:

1. each census tract must have a poverty rate of at least 20%;
2. in the case of an urban area, at least 70% of the households have incomes below 80% of the median income of households within the local government jurisdiction;
3. the unemployment rate is at least 1.5 times the national unemployment rate; and
4. the area is one of pervasive poverty, unemployment, and general distress.

Those areas with the highest average ranking of eligibility factors (1), (2), and (3) above would be designated as renewal communities. The Secretary of HUD shall take into account in

selecting areas for designation the extent to which such areas have a high incidence of crime, as well as whether the area has census tracts identified in the May 12, 1998, report of the General Accounting Office regarding the identification of economically distressed areas. In lieu of the poverty, income, and unemployment criteria, out-migration may be taken into account in the designation of one rural renewal community.

There are no geographic size limitations placed on renewal communities. Instead, the boundary of a renewal community must be continuous. In addition, the renewal community must have a minimum population of 4,000 if the community is located within a metropolitan statistical area (at least 1,000 in all other cases), and a maximum population of not more than 200,000. The population limitations do not apply to any renewal community that is entirely within an Indian reservation.

Required State and Local Commitments

In order for an area to be designated as a renewal community, state and local governments are required to submit a written course of action in which the state and local governments promise to take at least four of the following governmental actions within the nominated area: (1) a reduction of tax rates or fees; (2) an increase in the level of efficiency of local services; (3) crime reduction strategies; (4) actions to remove or streamline governmental requirements; (5) involvement by private entities and community groups, such as to provide jobs and job training and financial assistance; and (6) the gift (or sale at below fair market value) of surplus realty by the state or local government to community organizations or private companies.

In addition, the nominating state and local governments must promise to promote economic growth in the nominated area by repealing or not enforcing four of the following: (1) licensing requirements for occupations that do not ordinarily require a professional degree; (2) zoning restrictions on home-based businesses that do not create a public nuisance; (3) permit requirements for street vendors who do not create a public nuisance; (4) zoning or other restrictions that impede the formation of schools or child care centers; and (5) franchises or other restrictions on competition for businesses providing public services, including but not limited to taxicabs, jitneys, cable television, or trash hauling, unless such regulations are necessary for and well-tailored to the protection of health and safety.

Empowerment Zones and Enterprise Communities Seeking Designation as Renewal Communities

With respect to the first 20 designations of nominated areas as renewal communities, preference will be given to nominated areas that are enterprise communities and empowerment zones under present law that otherwise meet the requirements for designation as a renewal community. An empowerment zone or enterprise community can apply for designation as a renewal community. If a renewal community designation is granted, then an area’s designation as an empowerment zone enterprise community ceases as of the date the area’s designation as a renewal community takes effect.

Consolidated Appropriations Act, 2001
(P.L. 106-554)

Tax Incentives for Renewal Communities

The following tax incentives generally are available during the period beginning January 1, 2002, and ending December 31, 2009.

1. *Zero-percent capital gain rate*. A zero-percent capital gains tax rate applies with respect to gain from the sale of a qualified community asset acquired after December 31, 2001, and before January 1, 2010, and held for more than five years. A "qualified community asset" includes:

    - qualified community stock (meaning original-issue stock purchased for cash in a renewal community business);
    - a qualified community partnership interest (meaning a partnership interest acquired for cash in a renewal community business);
    - qualified community business property (meaning tangible property originally used in a renewal community business by the taxpayer) that is purchased or substantially improved after December 31, 2001.

    A "renewal community business" is similar to the present law definition of a federal enterprise zone business. Property will continue to be a qualified community asset if sold (or otherwise transferred) to a subsequent purchaser, provided that the property continues to represent an interest in (or tangible property used in) a renewal community business. The termination of an area's status as a renewal community will not affect whether property is a qualified community asset, but any gain attributable to the period before January 1, 2002, or after December 31, 2014, will not be eligible for the zero-percent rate.

2. *Renewal community employment credit*. A 15-percent wage credit is available to employers for the first $10,000 of qualified wages paid to each employee who (1) is a resident of the renewal community, and (2) performs substantially all employment services within the renewal community in a trade or business for the employer.

    The wage credit rate applies to qualifying wages paid after December 31, 2001, and before January 1, 2010. Wages that qualify for the credit are wages that are considered "qualified zone wages" for purposes of the empowerment zone wage credit (including coordination with the Work Opportunity Tax Credit). In general, any taxable business carrying out activities in the renewal community may claim the wage credit.

3. *Commercial revitalization deduction*. Each state is permitted to allocate up to $12 million of "commercial revitalization expenditures" to each renewal community located within the state for each calendar year after 2001 and before 2010. The appropriate state agency will make the allocations pursuant to a qualified allocation plan.

    A "commercial revitalization expenditure" means the cost of a new building or the cost of substantially rehabilitating an existing building. The building must be used for commercial purposes and be located in a renewal community. In the case of the rehabilitation of an existing building, the costs of acquiring the building will be treated as qualifying expenditures

only to the extent that such costs do not exceed 30% of the other rehabilitation expenditures. The qualifying expenditures for any building cannot exceed $10 million.

A taxpayer can elect either to (a) deduct one-half of the commercial revitalization expenditures for the taxable year the building is placed in service or (b) amortize all the expenditures ratably over the 120-month period beginning with the month the building is placed in service. No depreciation is allowed for amounts deducted under this provision. The adjusted basis is reduced by the amount of the commercial revitalization deduction, and the deduction is treated as a depreciation deduction in applying the depreciation recapture rules (e.g., sec. 1250). The commercial revitalization deduction is treated in the same manner as the low-income housing credit in applying the passive loss rules (sec. 469). Thus, up to $25,000 of deductions (together with the other deductions and credits not subject to the passive loss limitation by reason of section 469(i)) are allowed to an individual taxpayer regardless of the taxpayer's adjusted gross income. The commercial revitalization deduction is allowed in computing a taxpayer's alternative minimum taxable income.

4. *Additional section 179 expensing*. A renewal community business is allowed an additional $35,000 of section 179 expensing for qualified renewal property placed in service after December 31, 2001, and before January 1, 2010. The section 179 expensing allowed to a taxpayer is phased out by the amount by which 50% of the cost of qualified renewal property placed in service during the year by the taxpayer exceeds $200,000. The term "qualified renewal property" is similar to the definition of "qualified zone property" used in connection with empowerment zones.

5. *Extension of work opportunity tax credit ("WOTC")*. The Act expands the high-risk youth and qualified summer youth categories in the WOTC to include qualified individuals who live in a renewal community.

General Accounting Office Report

The General Accounting Office will audit and report to Congress on January 31, 2004, and again in 2007 and 2010, on the renewal community program and its effect on poverty, unemployment, and economic growth within the designated renewal communities.

Effective Date

Renewal communities must be designated during the period beginning on the first day of the first month after the publication of regulations by HUD, and ending on December 31, 2001. The tax benefits available in renewal communities are effective for the period beginning January 1, 2002, and ending December 31, 2009.

California Law (Sec. 17201, 17250, 17252.5, 17265, 17858, 24349, 24356.2 and 24356.3)

California law does not conform to the tax incentives related to "renewal communities." California law does provide a variety of independent state-only economic development area tax incentives to encourage revitalization of special designated areas. The Government Code

provides for the designation of enterprise zones, Local Agency Military Base Recovery Areas (LAMBRAs), a Targeted Tax Area (TTA), and Manufacturing Enhancement Areas (MEAs). California law does not provide for a lower capital gains rate in any situation. The Personal Income Tax Law conforms to the general federal rules for expensing of IRC "sec. 179" property (currently $24,000). In lieu of this deduction for Personal Income Tax Law and under the Bank and Corporation Tax Law, California allows a person with a business in an "Economic Development Area" to elect to expense $10,000 to $100,000 (depending on the designation) of certain specified equipment used in the business.

A summary of tax incentives to qualifying businesses operating in economic development areas are as follows:

Types of Incentives	EZ	LAMBRA	TTA	MEA
Sales or Use Tax Credit	X	X	X	
Hiring Credit	X	X	X	X
Construction Hiring Credit				
Employee Wage Credit	X			
Business Expense Deduction	X	X	X	
Net Interest Deduction	X			
Net Operating Loss	X	X	X	

Impact on California Revenue

Not applicable.

Section	Section Title
111-115	Extension and Expansion of Empowerment Zones

Background

The Omnibus Budget Reconciliation Act of 1993 (“OBRA 1993”) authorized the designation of nine empowerment zones (“Round I empowerment zones”) to provide tax incentives for businesses to locate within targeted areas designated by the Secretaries of HUD and Agriculture. The Taxpayer Relief Act of 1997 (“1997 Act”) authorized the designation of two additional Round I urban empowerment zones.

Businesses in the 11 Round I empowerment zones qualify for the following tax incentives:

(1) a 20-percent wage credit for the first $15,000 of wages paid to a zone resident who works in the empowerment zone,
(2) an additional $20,000 of section 179 expensing for qualifying zone property, and
(3) tax-exempt financing for certain qualifying zone facilities.

The tax incentives with respect to the empowerment zones designated by OBRA 1993 generally are available during the 10-year period of 1995 through 2004.
The tax incentives with respect to the two additional Round I empowerment zones generally are available during the 10-year period of 2000 through 2009.

Round II Empowerment Zones

The 1997 Act also authorized the designation of 20 additional empowerment zones ("Round II empowerment zones"), of which 15 are located in urban areas and five are located in rural areas. Businesses in the Round II empowerment zones are not eligible for the wage credit, but are eligible to receive up to $20,000 of additional section 179 expensing. Businesses in the Round II empowerment zones also are eligible for more generous tax-exempt financing benefits than those available in the Round I empowerment zones. Specifically, the tax-exempt financing benefits for the Round II empowerment zones are not subject to the state private activity bond volume caps (but are subject to separate per-zone volume limitations), and the per-business size limitations that apply to the Round I empowerment zones and enterprise communities (i.e., $3 million for each qualified enterprise zone business with a maximum of $20 million for each principal user for all zones and communities) do not apply to qualifying bonds issued for Round II empowerment zones. The tax incentives with respect to the Round II empowerment zones generally are available during the 10-year period of 1999 through 2008.

New Federal Law (Secs. 1391, 1394, 1396, and 1397A)

The Act conforms and enhances the tax incentives for the Round I and Round II empowerment zones and extends their designations through December 31, 2009. The Act also authorizes the designation of nine new empowerment zones ("Round III empowerment zones").

Extension of Tax Incentives for Round I and Round II Empowerment Zones.

The designation of empowerment zones status for Round I and II empowerment zones (other than the District of Columbia Enterprise Zone) is extended through December 31, 2009. In addition, the 20-percent wage credit is made available in all Round I and II empowerment zones for qualifying wages paid or incurred after December 31, 2001. The credit rate remains at 20% (rather than being phased down) through December 31, 2009, in both Round I and Round II empowerment zones.

In addition, $35,000 (rather than $20,000) of additional section 179 expensing in available for qualified zone property placed in service in taxable years beginning after December 31, 2001, by a qualified business in any of the empowerment zones. Businesses in the D.C. Enterprise Zone are entitled to the additional section 179 expensing until the termination of the D.C. Enterprise zone designation. Businesses located in Round I empowerment zones (other than the D.C. Enterprise Zone) also are eligible for the more generous tax-exempt bond rules that apply under present law to businesses in the Round II empowerment zones (sec. 1394(f)). The Act applies to tax-exempt bonds issued after December 31, 2001. Bonds that have been issued by businesses in Round I zones before January 1, 2002, are not taken into account in applying

the limitations on the amount of new empowerment zone facility bonds that can be issued under the Act

Nine New Empowerment Zones.

The Secretaries of HUD and Agriculture are authorized to designate nine additional empowerment zones ("Round III empowerment zones"). Seven of the Round III empowerment zones will be located in urban areas, and two will be located in rural areas.

The eligibility and selection criteria for the Round III empowerment zones are the same as the criteria that applied to the Round II empowerment zones. The Round III empowerment zones must be designated by January 1, 2002, and the tax incentives with respect to the Round III empowerment zones generally are available during the period beginning on January 1, 2002, and ending on December 31, 2009.

Businesses in the Round III empowerment zones are eligible for the same tax incentives that, under the Act, are available to both Round I and Round II empowerment zones (i.e., a 20% wage credit, an additional $35,000 of section 179 expensing, and the enhanced tax-exempt financing benefits presently available to Round II empowerment zones).

The Secretaries of HUD and Agriculture also are authorized to designate a replacement empowerment zone for each empowerment zone that becomes a renewal community. The replacement empowerment zone will have the same urban or rural character as the empowerment zone that it is replacing.

General Accounting Office Report

The General Accounting Office will audit and report to Congress on January 31, 2004, and again in 2007 and 2010, on the empowerment zone and enterprise community program and its effect on poverty, unemployment, and economic growth within the designated areas.

Effective Date

The extension of the existing empowerment zone designations is effective after December 21, 2000. The extension of the tax benefits to existing empowerment zones (i.e., the expanded wage credit, the additional section 179 expensing, and the more generous tax-exempt bond rules) generally is effective after December 31, 2001. The new Round III empowerment zones must be designated by January 1, 2002, and the tax incentives with respect to the Round III empowerment zones generally are available during the period beginning on January 1, 2002, and ending on December 31, 2009.

California Law

Please see the California Law discussion for Section 101-102 of the Act, located directly above.

Consolidated Appropriations Act, 2001
(P.L. 106-554)

Impact on California Revenue

Not applicable.

Section	Section Title
116	Rollover of Gain from the Sale of Qualified Empowerment Zone Investments

Background

In general, gain or loss is recognized on any sale, exchange, or other disposition of property. A taxpayer (other than a corporation) may elect to roll over without payment of tax any capital gain realized upon the sale of qualified small business stock held for more than six months where the taxpayer uses the proceeds to purchase other qualified small business stock within 60 days of the sale of the original stock.

New Federal Law (Sec. 1397B)

The Act provides that a taxpayer can elect to roll over capital gain from the sale or exchange of any qualified empowerment zone asset purchased after December 21, 2000, and held for more than one year ("original zone asset"), where the taxpayer uses the proceeds to purchase other qualifying empowerment zone assets in the same zone ("replacement zone asset") within 60 days of the sale of the original zone asset. The holding period of the replacement zone asset includes the holding period of the original zone asset, except that the replacement asset must actually be held for more than one year to qualify for another tax-free rollover. The basis of the replacement zone asset is reduced by the gain not recognized on the rollover. However, if the replacement zone asset is also qualified small business stock (as defined in sec. 1202), the exclusion under section 1202 would not apply to gain accrued on the original zone asset. A "qualified empowerment zone asset" means an asset that would be a qualified community asset if the empowerment zone were a renewal community (and the asset is acquired after December 21, 2000). Assets in the D.C. Enterprise Zone are not eligible for the tax-free rollover treatment.

Effective Date.

The provision is effective for qualifying assets purchased after December 21, 2000.

California Law (Secs. 18038.4, 18038.5, 18152.5, and 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 does not permit the rollover of gain from the sale of assets used in an economic zone.

Impact on California Revenue

Not applicable.

Section	Section Title
117	Increased Exclusion of Gain from the Sale of Qualifying Empowerment Zone Stock

Background

Under present law, an individual, subject to limitations, may exclude 50% of the gain from the sale of qualifying small business stock held for more than five years.

New Federal Law (Sec. 1202)

The Act increases the exclusion for small business stock to 60% for stock purchased after December 21, 2000, in a corporation that is a qualified business entity and that is held for more than five years. A "qualified business entity" means a corporation that satisfies the requirements of a qualifying business under the empowerment zone rules during substantially all the taxpayer's holding period.

Effective Date

The provision is effective for qualified stock purchased after December 21, 2000.

California Law (Secs. 18038.4, 18038.5, 18152.5, and 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.

Impact on California Revenue

Not applicable.

Consolidated Appropriations Act, 2001
(P.L. 106-554)

Section	Section Title
121	New Markets Tax Credit

Background

Tax incentives are available to taxpayers making investments and loans in low-income communities. For example, tax incentives are available to taxpayers that invest in specialized small business investment companies licensed by the SBA to make loans to, or equity investments in, small businesses owned by persons who are socially or economically disadvantaged.

New Federal Law (Sec. 45D)

The Act includes a provision that creates a new tax credit for qualified equity investments made to acquire stock in a selected community development entity ("CDE"). The maximum annual amount of qualifying equity investments is capped as follows:

Calendar Year	Maximum Qualifying Equity Investment
2001	$1.0 billion
2002-2003	$1.5 billion per year
2004-2005	$2.0 billion per year
2006-2007	$3.5 billion per year

The amount of the new tax credit to the investor (either the original purchaser or a subsequent holder) is:

(1) a 5% credit for the year in which the equity interest is purchased from the CDE and the first two anniversary dates after the interest is purchased from the CDE, and
(2) a 6% credit on each anniversary date thereafter for the following four years.

The taxpayer's basis in the investment is reduced by the amount of the credit (other than for purposes of calculating the capital gain exclusion under sections 1202, 1400B, and 1400F). The credit is subject to the general business credit rules.

A CDE is any domestic corporation or partnership:

(1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons,
(2) that maintains accountability to residents of low-income communities by their representation on any governing board or on any advisory board of the CDE, and
(3) is certified by the Treasury Department as an eligible CDE.

No later than 120 days after enactment, the Treasury Department shall issue regulations that specify objective criteria to be used by the Treasury to allocate the credits among eligible CDEs. In allocating the credits, the Treasury Department will give priority to entities with records of having successfully provided capital or technical assistance to disadvantaged businesses or communities, as well as to entities that intend to invest substantially all of the proceeds from

their investors in businesses in which persons unrelated to the CDE hold the majority of the equity interest.

If a CDE fails to sell equity interests to investors up to the amount authorized within five years of the authorization, then the remaining authorization is canceled. The Treasury Department can authorize another CDE to issue equity interests for the unused portion. No authorization can be made after 2014.

A “qualified equity investment” is defined as stock or a similar equity interest acquired directly from a CDE in exchange for cash. Substantially all of the investment proceeds must be used by the CDE to make “qualified low income community investments.” Qualified low-income community investments include:

(1) capital or equity investments in, or loans to, qualified active businesses located in low-income communities,
(2) certain financial counseling and other services specified in regulations to businesses and residents in low-income communities,
(3) the purchase from another CDE of any loan made by such entity that is a qualified low income community investment, or
(4) an equity investment in, or loans to, another CDE.

Treasury Department regulations will provide guidance with respect to the “substantially all” standard. The stock or equity interest cannot be redeemed (or otherwise cashed out) by the CDE for at least seven years. If an entity fails to be a CDE during the seven-year period following the taxpayer’s investment, or if the equity interest is redeemed by the issuing CDE during that seven year period, then any credits claimed with respect to the equity interest are recaptured (with interest) and no further credits are allowed.

A “low-income community” is defined as census tracts with either:

(1) poverty rates of at least 20% (based on the most recent census data), or
(2) median family income that does not exceed 80% of the greater of metropolitan area income or statewide median family income (for a non-metropolitan census tract, 80% of non-metropolitan statewide median family income).

In addition, the Secretary may designate any area within any census tract as a “low income community” provided that:

(1) the boundary of the area is continuous,
(2) the area (if it were a census tract) would satisfy the poverty rate or median income requirements within the targeted area, and
(3) an inadequate access to investment capital exists in the area.

A low-income community can include a possession of the United States (and thus investments in a U.S. possession may qualify for the new markets tax credit).

A "qualified active business" is defined as a business that satisfies the following requirements:

(1) at least 50% of the total gross income of the business is derived from the active conduct of trade or business activities in low-income communities;
(2) a substantial portion of the use of the tangible property of such business is used in low-income communities;
(3) a substantial portion of the services performed for such business by its employees is performed in low-income communities; and
(4) less than 5% of the average aggregate of unadjusted bases of the property of such business is attributable to certain financial property or to collectibles (other than collectibles held for sale to customers).

There is no requirement that employees of the business be residents of the low-income community.

Rental of improved commercial real estate located in a low-income community is a qualified active business, regardless of the characteristics of the commercial tenants of the property. The purchase and holding of unimproved real estate is not a qualified active business. In addition, a qualified active business does not include (a) any business consisting predominantly of the development or holding of intangibles for sale or license; or (b) operation of any facility described in sec. 144(c)(6)(B). A qualified active business can include an organization that is organized on a nonprofit basis.

General Accounting Office Report

The General Accounting Office will audit and report to Congress by January 31, 2004, and again in 2007 and 2010, on the new markets tax credit program, including on all qualified community development entities that receive an allocation under the new markets tax credit program.

Effective Date

The provision is effective for qualified investments made after December 31, 2000.

California Law (Sec. 23657)

California law is not conformed to the CDE credit. However, under the Personal Income Tax Law and the Bank and Corporation Tax Law, California law allows a 20% credit for the amount of each "qualified deposit" into a "community development financial institution" (CDFI).

CDFIs have emerged over the last 20 years to provide opportunities for neglected and disinvested communities, businesses, and individuals that lack access to traditional sources of financing. There are more than 310 CDFIs in urban, reservation-based, and rural settings, in the country, and together they manage $1 billion to provide financing, investments, and extensive development services. CDFIs lend to borrowers who do not satisfy the criteria for conventional lenders.

CDFIs may be banks, credit unions, or non-regulated non-profit institutions organized to gather private capital for community development lending or investing. Some CDFIs focus on a particular community while others lend to certain groups of people (minorities, women, low-income families, social service providers). All CDFIs are financial intermediaries that have a common mission of community development.

Existing federal law allows a credit equal to 5% of contributions, up to $2 million for each corporate taxpayer, to community development corporations, but not for deposits into a CDFI. Existing state law has not conformed to the federal credit for contributions to a community development corporation.

For purposes of the 20% state credit, a qualified deposit is defined as a deposit that does not earn interest, or an equity investment, that is equal to or greater than $50,000 and is made for a minimum duration of 60 months. A CDFI is defined as a private financial institution located in California and certified by the California Organized Investment Network that has community development as its primary mission and lends in urban, rural, or reservation-based communities in California. A CDFI may include a community development bank, a community development loan fund, a community development credit union, a micro-enterprise fund, a community development corporation-based lender, and a community development venture fund.

California law provides for a recapture of the credit if the qualified deposit is reduced or withdrawn before the end of the 60-month period.

This credit will sunset for taxable years beginning on or after January 1, 2002.

Impact on California Revenue

Not applicable.

Section	Section Title
131-137	Increase the Low-Income Housing Tax Credit Cap and Make Other Modifications

Background

The low-income housing tax credit may be claimed over a 10-year period for the cost of rental housing occupied by tenants having incomes below specified levels. The credit percentage for newly constructed or substantially rehabilitated housing that is not federally-subsidized is adjusted monthly by the Internal Revenue Service so that the 10 annual installments have a present value of 70% of the total qualified expenditures. The credit percentage for new substantially rehabilitated housing that is federally-subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value of 30% qualified expenditures.

Credit Cap

The aggregate credit authority provided annually to each state is $1.25 per resident, except in the case of projects that also receive financing with proceeds of tax-exempt bonds issued subject to the private activity bond volume limit and certain carry-over amounts.

Expenditure Test

Generally, the building must be placed in service in the year in which it receives an allocation to qualify for the credit. An exception is provided in the case where the taxpayer has expended an amount equal to 10 percent or more of the taxpayer's reasonably expected basis in the building by the end of the calendar year in which the allocation is received and certain other requirements are met.

Basis of Building Eligible for the Credit

Buildings receiving assistance under the HOME investment partnerships act ("HOME") are not eligible for the enhanced credit for buildings located in high cost areas (i.e., qualified census tracts and difficult development areas). Under the enhanced credit, the 70 percent and 30 percent credit are increased to a 91 percent and 39 percent credit, respectively.

Eligible basis is generally limited to the portion of the building used by qualified low-income tenants for residential living and some common areas.

State Allocation Plans

Each state must develop a plan for allocating credits and such plan must include certain allocation criteria including:

(1) project location;
(2) housing needs characteristics;
(3) project characteristics;
(4) sponsor characteristics;
(5) participation of local tax-exempts;
(6) tenant populations with special needs; and
(7) public housing waiting lists.

The state allocation plan must also give preference to housing projects (1) that serve the lowest income tenants, and (2) that are obligated to serve qualified tenants for the longest periods.

Credit Administration

There are no explicit requirements that housing credit agencies perform a comprehensive market study of the housing needs of the low-income individuals in the area to be served by the project, nor that such agency conduct site visits to monitor for compliance with habitability standards.

Stacking Rule

Authority to allocate credits remains at the state (as opposed to local) government level, unless state law provides otherwise. Generally, credits may be allocated only from volume authority arising during the calendar year in which the building is placed in service, except in the case of:

(1) credits claimed on additions to qualified basis;
(2) credits allocated in a later year pursuant to an earlier binding commitment made no later than the year in which the building is placed in service; and
(3) carryover allocations.

Each state annually receives low-income housing credit authority equal to $1.25 per state resident for allocation to qualified low-income projects. In addition to this $1.25 per resident amount, each state's "housing credit ceiling" includes the following amounts:

(1) the unused state housing credit ceiling (if any) of such state for the preceding calendar year;
(2) the amount of the state housing credit ceiling (if any) returned in the calendar year; and
(3) the amount of the national pool (if any) allocated to such state by the Treasury Department.

The national pool consists of states' unused housing credit carryovers. For each state, the unused housing credit carryover for a calendar year consists of the excess (if any) of the unused state housing credit ceiling for such year over the excess (if any) of the aggregate housing credit dollar amount allocated for such year over the sum of $1.25 per resident and the credit returns for such year. The amounts in the national pool are allocated only to a state that allocated its entire housing credit ceiling for the preceding calendar year, and requested a share in the national pool not later than May 1 of the calendar year. The national pool allocation to qualified states is made on a pro rata basis equivalent to the fraction that a state's population enjoys relative to the total population of all qualified states for that year.

The stacking rule provides that a state is treated as using its annual allocation of credit authority ($1.25 per state resident) and any returns during the calendar year followed by any unused credits carried forward from the preceding year's credit ceiling and finally any applicable allocations from the national pool.

New Federal Law (Sec. 42)

The Act makes the following changes in the low-income housing credit:

Credit cap -- Increases the per-capita low-income housing credit cap from $1.25 per capita to $1.50 per capita in calendar year 2001 and to $1.75 per capita in calendar year 2002. Beginning in calendar year 2003, the per-capita portion of the credit cap will be adjusted annually for inflation. For small states, a minimum annual cap of $2 million is provided for calendar years 2001 and 2002. Beginning in calendar year 2003, the small state minimum is adjusted for inflation.

Expenditure test -- Allows a building which receives an allocation in the second half of a calendar year to qualify under the 10 percent test if the taxpayer expends an amount equal to 10 percent or more of the taxpayer's reasonably expected basis in the building within six months of receiving the allocation, regardless of whether the 10 percent test is met by the end of the calendar year.

Basis of building eligible for the credit – The Act makes three changes to the basis rules of the credit. First, the definition of qualified census tracts for purposes of the enhanced credit is expanded to include any census tracts with a poverty rate of 25% or more. Second, the Act extends the credit to a portion of the building used as a community service facility not in excess of 10% of the total eligible basis in the building. A community service facility is defined as any facility designed to serve primarily individuals whose income is 60% or less of area median income. Third, the Act provides that assistance received under the Native American Housing Assistance and Self-Determination Act of 1996 is not taken into account in determining whether a building is federally subsidized for purposes of the credit. This allows such buildings to qualify for something other than the 30 percent credit generally applicable to federally subsidized buildings.

State allocation plans -- Strikes the plan criteria relating to participation of local tax-exempts, replacing it with two other criteria: (1) tenant populations of individuals with children, and (2) projects intended for eventual tenant ownership. It also provides that the present-law criteria relating to sponsor characteristics include whether the project involves the use of existing housing as part of a community revitalization plan. The Act adds a third category of housing projects to the preferential list, for projects located in qualified census tracts that contribute to a concerted community revitalization plan.

Credit administration --Requires a comprehensive market study of the housing needs of the low-income individuals in the area to be served by the project and a written explanation available to the general public for any allocation not made in accordance with the established priorities and selection criteria of the housing credit agency. They also require site inspections by the housing credit agency to monitor compliance with habitability standards applicable to the project.

Stacking rule -- Modifies the stacking rule so that each state is treated as using its allocation of the unused state housing credit ceiling (if any) from the preceding calendar before the current year's allocation of credit (including any credits returned to the state) and then finally any national pool allocations.

Effective Date

These provisions are generally effective for calendar years beginning after December 31, 2000, and buildings placed-in-service after such date in the case of projects that also receive financing with proceeds of tax-exempt bonds subject to the private activity bond volume limit that are issued after such date.

California Law (Secs. 17058 and 23610.5)

California is in conformity with federal law as it read on January 1, 1998, except that the state credit amount is 30% of the costs, is claimed over a four-year period, and is limited to projects located in California. The Tax Credit Allocation Committee is authorized to allocate up to a maximum of $50 million per year (effective for years beginning after 1999). The Committee provides listings of qualified taxpayers to the Franchise Tax Board. This credit may reduce the regular tax below the "tentative minimum tax." If the credit exceeds the tax, the excess may be carried over.

Impact on California Revenue

To the extent that California could conform to one or more the proposed federal changes to the low income housing credit, no revenue loss would result. The California Tax Allocation Committee currently allocates the entire amount of California credit available, $50 million per year.

Section	Section Title
161	Accelerate Scheduled Increase in State Volume Limits on Tax-Exempt Private Activity 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 (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 or are issued pursuant to the volume cap rules provided therein. Private activity bonds on which interest may be tax-exempt include bonds for privately operated transportation facilities (airports, docks and wharves, mass transit, and high speed rail facilities), privately owned and/or provided municipal services (water, sewer, solid waste disposal, and certain electric and heating facilities), economic development (small manufacturing facilities and redevelopment in economically depressed areas), and certain social programs (low-income rental housing, qualified mortgage bonds, student loan bonds, and exempt activities of charitable organizations described in 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 statewide volume limits. The current annual volume limits are $50 per resident of the state, or $150 million if greater. 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).

The current annual volume limits that apply to private activity tax-exempt bonds increase to $75 per resident of each state or $225 million, if greater, beginning in calendar year 2007. The increase is ratably phased in, beginning with $55 per capita or $165 million, if greater, in calendar year 2003.

New Federal Law (Sec. 146)

The Act increases the state volume limits from the greater of $50 per resident or $150 million, to the greater of $62.50 per resident or $187.5 million, in calendar year 2001. The volume limit will increase further, to the greater of $75 per resident or $225 million, in calendar year 2002. Beginning in calendar year 2003, the volume limit will be adjusted annually for inflation.

Effective Date

The provision is effective beginning in calendar year 2001.

California Law (Secs. 17143 and 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.

Impact on California Revenue

Not applicable.

Section	Section Title
162	Extension and Modification to Expensing of Environmental Remediation

Background

Taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred (sec. 198). The deduction applies for both regular and alternative minimum tax purposes. The expenditure

must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site.

A "qualified contaminated site" generally is any property that:

(1) is held for use in a trade or business, for the production of income, or as inventory;
(2) is certified by the appropriate state environmental agency to be located within a targeted area; and
(3) contains (or potentially contains) a hazardous substance (so-called "brownfields").

Targeted areas are defined as:

(1) empowerment zones and enterprise communities as designated under present law;
(2) sites announced before February 1997, as being subject to one of the 76 Environmental Protection Agency ("EPA") Brownfields Pilots;
(3) any population census tract with a poverty rate of 20% or more; and
(4) certain industrial and commercial areas that are adjacent to tracts described in (3) above.

However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 cannot qualify as targeted areas.

Originally, eligible expenditures were those paid or incurred before January 1, 2001. The Ticket to Work and Work Incentives Improvement Act of 1999 (P.L. 106-170) extended the eligibility of expenditures to those incurred before January 1, 2002.

New Federal Law (Sec. 198)

The Act extends the expiration date for eligible expenditures to include those paid or incurred before January 1, 2004.

In addition, the Act eliminates the targeted area requirement, thereby expanding eligible sites to include any site containing (or potentially containing) a hazardous substance that is certified by the appropriate state environmental agency. However, expenditures undertaken at sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 would continue to not qualify as eligible expenditures.

By extending and expanding section 198, the Act is not intended to displace the general tax law principle regarding expensing versus capitalization of expenditures which continues to apply to environmental remediation efforts not specifically covered under section 198.

Consolidated Appropriations Act, 2001
(P.L. 106-554)

Effective Date

The provision to extend the expiration date is effective December 21, 2000. The provision to expand the class of eligible sites is effective for expenditures paid or incurred after December 21, 2000.

California Law (Secs. 17279.4 and 24369.4)

California is in conformity with federal law as it relates to environmental remediation expenditures; however, as under prior federal law, the provision applies only to expenditures paid or incurred before January 1, 2001. In addition, an election to deduct remediation expenditures for federal purposes is applicable for California purposes. No separate election is allowed.

Impact on California Revenue

Estimated Revenue Impact of Section 152 Expenditures Paid or Incurred After December 21, 2000 and Before January 1, 2004 Enactment Assumed After 6/30/01 ($In Millions)		
2001-02	2002-03	2003-04
-$4	-$8	-$6

California is in conformity with federal law as it relates to environmental remediation expenditures incurred before January 1, 2001. The revenue is based on previous estimates related to the expensing of remediation expenditures and current federal projections.

Section Section Title
163 Expansion of District of Columbia Homebuyer Tax Credit

Background

First-time homebuyers of a principal residence in the District of Columbia are eligible for a nonrefundable tax credit of up to $5,000 of the amount of the purchase price. The $5,000 maximum credit applies both to individuals and married couples. Married individuals filing separately can claim a maximum credit of $2,500 each. The credit phases out for individual taxpayers with adjusted gross income between $70,000 and $90,000 ($110,000-$130,000 for joint filers). For purposes of eligibility, “first-time homebuyer” means any individual if such individual did not have a present ownership interest in a principal residence in the District of Columbia in the one-year period ending on the date of the purchase of the residence to which the credit applies. The credit is scheduled to expire for residences purchased after December 31, 2001.

New Federal Law (Sec. 1400C)

The Act extends the first-time homebuyer credit for two years (through December 31, 2003).

Effective Date

The provision is effective on December 21, 2000.

California Law

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
164	Extension of D.C. Enterprise Zone

Background

The Taxpayer Relief Act of 1997 designated certain economically depressed census tracts within the District of Columbia as the District of Columbia Enterprise Zone (the "D.C. Zone"), within which businesses and individual residents are eligible for special tax incentives. The D.C. Zone designation remains in effect for the period from January 1, 1998, through December 31, 2002. In addition to the tax incentives available with respect to a Round I empowerment zone (including a 20% wage credit), the D.C. Zone also has a zero-percent capital gains tax rate that applies to gains from the sale of certain qualified D.C. Zones assets acquired after December 31, 1997, and held for more than five years.

With respect to the tax-exempt financing incentives, the D.C. Zone generally is treated like a Round I empowerment zone; therefore, the issuance of such bonds is subject to the District of Columbia's annual private activity bond volume limitation. However, the aggregate face amount of all outstanding qualified enterprise zone facility bonds per qualified D.C. Zone business may not exceed $15 million (rather than $3 million, as is the case for Round I empowerment zones).

New Federal Law (Secs. 1400, 1400A and 1400B)

The Act extends the D.C. Zone designation for one year through December 31, 2003.

Effective Date

The provision is effective on December 21, 2000.

California Law

California does not have a comparable provision.

Impact on California Revenue

Not applicable.

Section	Section Title
165	Extension and Modification of Enhanced Deduction for Corporate Donations of Computer Technology

Background

The maximum charitable contribution deduction that may be claimed by a corporation for any one taxable year is limited to 10% of the corporation's taxable income for that year (disregarding charitable contributions and with certain other modifications). (Sec. 170(b)(2).) Corporations also are subject to certain limitations based on the type of property contributed. In the case of a charitable contribution of short-term gain property, inventory, or other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis (generally, cost) in the property. However, special rules in the Code provide an augmented deduction for certain corporate contributions. Under these special rules, the amount of the augmented deduction is equal to the lesser of (1) the basis of the donated property plus one-half of the amount of ordinary income that would have been realized if the property had been sold, or (2) twice the basis of the donated property.

Section 170(e)(6) allows corporate taxpayers an augmented deduction for qualified contributions of computer technology and equipment (i.e., computer software, computer or peripheral equipment, and fiber optic cable related to computer use) to be used within the United States for educational purposes in grades K-12. Eligible donees are (1) any educational organization that normally maintains a regular faculty and curriculum and has a regularly enrolled body of pupils in attendance at the place where its educational activities are regularly carried on, and (2) tax exempt charitable organizations that are organized primarily for purposes of supporting elementary and secondary education. A private foundation also is an eligible donee, provided that, within 30 days after receipt of the contribution, the private foundation contributes the property to an eligible donee described above.

Qualified contributions are limited to gifts made no later than two years after the date the taxpayer acquired or substantially completed the construction of the donated property. In

addition, the original use of the donated property must commence with the donor or the donee. Accordingly, qualified contributions generally are limited to property that is no more than two years old. Such donated property could be computer technology or equipment that is inventory or depreciable trade or business property in the hands of the donor.

Donee organizations are not permitted to transfer the donated property for money or services (e.g., a donee organization cannot sell the computers). However, a donee organization may transfer the donated property in furtherance of its exempt purposes and be reimbursed for shipping, installation, and transfer costs. For example, if a corporation contributes computers to a charity that subsequently distributes the computers to several elementary schools in a given area, the charity could be reimbursed by the elementary schools for shipping, transfer, and installation costs.

The special treatment applies only to donations made by C corporations; thus, S corporations, personal holding companies, and service organizations are not eligible donors.

As originally enacted the provision was not to apply to contributions made during taxable years beginning after December 31, 1999. The IRS Restructuring and Reform Act of 1998 (P.L. 105-206) extended the provision for one year by amending the provision to not apply to contributions made during taxable years beginning after December 31, 2000.

New Federal Law (Sec. 170(e)(6))

The Act extends the current enhanced deduction for donations of computer technology and equipment through December 31, 2003, and expands the enhanced deduction to include donations to public libraries. The Act provides that qualified contributions include gifts made no later than three years after the date the taxpayer acquired or substantially completed the construction of the donated property. Contributions may be made by a person that has reacquired the property (i.e., if a computer manufacturer reacquires the computer from the original user and then contributes it). Such reacquired property must be contributed within three years of the date the original construction of the property was substantially completed. Congress anticipates that for purposes of computing the enhanced deduction for a reacquirer, the Secretary will provide guidance in determining the retail value of donated computers (or other computer technology) in situations in which the number of actual retail sales of used computers similar to those donated is small in relation to the number of such computers that are donated. In addition, the Act provides that the Secretary may prescribe by regulation standards to ensure that the donations meet minimum functionality and suitability standards for educational purposes.

Effective Date.

The provision is effective for contributions made after December 31, 2000.

Consolidated Appropriations Act, 2001
(P.L. 106-554)

California Law

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). Thus the augmented deduction for corporate contributions of computer technology expired for taxable years beginning on or after January 1, 2000.

Impact on California Revenue

The revenue losses under the B&CT law are estimated to be as follows:

Estimated Revenue Impact Effective For Exp. After 12/31/00 and Before 1/1/04 (in millions)		
2001-02	2002-03	2003-04
($6)	($4)	($2)

Revenue estimates were based on federal projections for this provision in HR 5562.

Section	Section Title
166	Treatment of Indian Tribes as Non-Profit Organizations and State or Local Governments For Purposes of the Federal Unemployment Tax ("FUTA")

Background

Present law imposes a net tax on employers equal to 0.8% of the first $7,000 paid annually to each employee. The current gross FUTA tax is 6.2%, but employers in states meeting certain requirements and having no delinquent loans are eligible for a 5.4% credit making the net federal tax rate 0.8%. Both non-profit organizations and state and local governments are not required to pay FUTA taxes. Instead they may elect to reimburse the unemployment compensation system for unemployment compensation benefits actually paid to their former employees. Generally, Indian tribes are not eligible for the reimbursement treatment allowable to non-profit organizations and state and local governments.

New Federal Law (Sec. 3306)

The Act provides that an Indian tribe (including any subdivision, subsidiary, or business enterprise chartered and wholly owned by an Indian tribe) is treated like a non-profit organization or state or local government for FUTA purposes (i.e., given an election to choose the reimbursement treatment).

Consolidated Appropriations Act, 2001
(P.L. 106-554)

Effective Date

This provision generally is effective with respect to services performed beginning on or after December 21, 2000. Under a special transitional rule, services performed in the employ of an Indian tribe are not treated as employment for FUTA purposes if (1) it is service which is performed before December 21, 2000, and with respect to which FUTA tax has not been paid, and (2) such Indian tribe reimburses a state unemployment fund for unemployment benefits paid for services attributable to such tribe for such period.

California Law

The Franchise Tax Board does not administer employment taxes. These taxes are administered by the Employment Development Department (EDD).

Impact on California Revenue

Defer to EDD.

Section	Section Title
201	Medical Savings Accounts ("MSAs")

Background

Within limits, contributions to a medical savings account ("MSA") are deductible in determining adjusted gross income ("AGI") if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Earnings on amounts in an MSA are not currently taxable. Distributions from an MSA for medical expenses are not taxable. Distributions not used for medical expenses are taxable. In addition, distributions not used for medical expenses are subject to an additional 15 percent tax unless the distribution is made after age 65, death, or disability.

MSAs are available to self-employed individuals and to employees covered under an employer-sponsored high-deductible plan of a small employer. An employer is a small employer if it employed, on average, no more than 50 employees on business days during either the preceding or the second preceding year.

In order for an employee of a small employer to be eligible to make MSA contributions (or to have employer contributions made on his or her behalf), the employee must be covered under an employer-sponsored high deductible health plan (see the definition below) and must not be covered under any other health plan (other than a plan that provides certain permitted coverage).

Similarly, in order to be eligible to make contributions to an MSA, a self-employed individual must be covered under a high deductible health plan and no other health plan (other than a plan that provides certain permitted coverage). A self-employed individual is not an eligible individual (by reason of being self-employed) if the high deductible plan under which the individual is covered is established or maintained by an employer of the individual (or the individual's spouse).

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

A high deductible plan is a health plan with an annual deductible of at least $1,550 and no more than $2,350 in the case of individual coverage, and at least $3,100 and no more than $4,650 in the case of family coverage. In addition, the maximum out-of-pocket expenses with respect to allowed costs (including the deductible) must be no more than $3,100 in the case of individual coverage and no more than $5,700 in the case of family coverage. A plan does not fail to qualify as a high deductible plan merely because it does not have a deductible for preventive care as required by state law. A plan does not qualify as a high deductible health plan if substantially all of the coverage under the plan is for permitted coverage. In the case of a self-insured plan, the plan must in fact be insurance (e.g., there must be appropriate risk shifting) and not merely a reimbursement arrangement.

The number of taxpayers benefiting annually from an MSA contribution is limited to a threshold level (generally 750,000 taxpayers). If it is determined in a year that the threshold level has been exceeded (called a "cut-off" year) then, in general, for succeeding years during the four-year pilot period 1997-2000, only those individuals who (1) made an MSA contribution or had an employer MSA contribution for the year or a preceding year (i.e., are active MSA participants), or (2) are employed by a participating employer, are eligible for an MSA contribution. In determining whether the threshold for any year has been exceeded, MSAs of individuals who were not covered under a health insurance plan for the six-month period ending on the date on which coverage under a high deductible plan commences would not be taken into account. However, if the threshold level is exceeded in a year, previously uninsured individuals are subject to the same restriction on contributions in succeeding years as other individuals. That is, they would not be eligible for an MSA contribution for a year following a cut-off year unless they are an active MSA participant (i.e., had an MSA contribution for the year or a preceding year) or are employed by a participating employer. The number of MSAs established has not exceeded the threshold level.

After December 31, 2000, no new contributions may be made to MSAs except by or on behalf of individuals who previously had MSA contributions and employees who are employed by a participating employer. An employer is a participating employer if (1) the employer made any MSA contributions for any year to an MSA on behalf of employees, or (2) at least 20% of the employees covered under a high deductible plan made MSA contributions of at least $100 in the year 2000.

Self-employed individuals who made contributions to an MSA during the period 1997-2000 also may continue to make contributions after 2000.

New Federal Law (Sec. 220)

The Act extends the MSA program through 2002. The same rules that apply to the limitation on MSAs for 1999 also apply to 2001 and 2002. Thus, for example, the threshold level in those years is a total of 750,000 taxpayers. The Act also renamed MSAs to Archer MSAs. Finally, the Congress clarifies that, as under present law, the cap and reporting requirements do not apply for 2000.

Effective Date

This provision is effective on December 21, 2000.

California Law

California is in conformity with federal law as it relates to MSAs. Section 17215 specifically provides "that the amount allowed as a deduction shall be an amount equal to the amount allowed to that individual as a deduction under Section 220 of the IRC on the federal income tax return filed for the same taxable year by that individual." Therefore, the federal MSA extension applies for California.

Impact on California Revenue

Similar to federal impacts, annual state revenue losses are projected to be negligible (less than $150,000).

Section	Section Title
301	Exempt Certain Reports From Elimination Under the Federal Reports

Background

Section 303 of the Federal Reports Elimination and Sunset Act of 1995 eliminates many periodic federal reporting requirements effective May 15, 2000.

New Federal Law

The Act exempts certain reports from elimination and sunset pursuant to the Federal Reports Elimination and Sunset Act of 1995.

California Law

Not applicable.

Impact on California Revenue

Not applicable.

Section	Section Title
302	Extension of Deadlines for IRS Compliance With Certain Notice Requirements

Background

The Internal Revenue Service Restructuring and Reform Act of 1998 ("IRS Restructuring Act of 1998") imposed several notice requirements relating to penalties, interest, and installment agreements. Section 6715 of the Code, added by section 3306 of the IRS Restructuring Act of 1998, requires that each notice imposing a penalty include the name of the penalty, the Code section under which the penalty is imposed, and a computation of the penalty, This requirement applies to notices issued, and penalties assessed, after December 31, 2000.

Section 6631 of the Code, added by section 3308 of the IRS Restructuring Act of 1998, requires that every IRS notice sent to an individual taxpayer that includes an amount of interest required to be paid by the taxpayer also include a detailed computation of the interest charged and a citation of the Code section under which such interest is imposed. The provision is effective for notices issued after December 31, 2000.

Section 3506 of the IRS Restructuring Act of 1998 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. The provision became effective on July 1, 2000.

New Federal Law (Secs. 6631 and 6751(a))

The Act extends the deadlines for complying with the penalty, interest, and installment agreement notice requirements. Specifically, the annual installment agreement notice requirement is extended from July 1, 2000, to September 1, 2001. The deadlines for complying with the notice requirements relating to the computation of penalties and interest are both extended to June 30, 2001. In addition, for penalty notices issued after June 30, 2001, and before July 1, 2003, the notice requirements will be treated as met if the notice contains a telephone number at which the taxpayer can request a copy of the taxpayer's assessment and payment history with respect to such penalty. Similarly, for interest notices issued after June 30, 2001, and before July 1, 2003, the notice requirements will be treated as met if such notice contains a telephone number at which the taxpayer can request a copy of the taxpayer's payment history relating to interest amounts included in such notice.

Effective Date

This provision is effective on December 21, 2000.

California Law (Secs. 19117 and 19187)

Under state law, notices imposing a penalty include the name of the penalty, the IRC or RTC section that authorizes the imposition of the penalty, and an explanation of the penalty including circumstances when the penalty would be applied. A computation of the penalty is provided if requested by the taxpayer. Supervisory approval is required for all non-computer-generated penalties except penalties based on:

1. failure to file;
2. failure to pay;
3. failure to pay estimated tax penalties; or
4. a federal audit report.

Additionally, current state law requires a description of the interest computation and the Code section that authorizes imposition of interest to be included with notices sent to individuals. A detailed computation of the interest is provided if requested by the taxpayer.

Impact on California Revenue

Not applicable.

Section	Section Title
303	Extension of Authority for Undercover Operations

Background

The Anti-Drug Abuse Act of 1988 exempted IRS undercover operations from the otherwise applicable statutory restrictions controlling the use of Government funds (which generally provide that all receipts must be deposited in the general fund of the Treasury and all expenses be paid out of appropriated funds). In general, the exemption permits the IRS to “churn” the income earned by an undercover operation to pay additional expenses incurred in the undercover operation. The IRS is required to conduct a detailed financial audit of large undercover operations in which the IRS is churning funds and to provide an annual audit report to the Congress on all such large undercover operations. The exemption originally expired on December 31, 1989, and was extended by the Comprehensive Crime Control Act of 1990 to December 31, 1991. In the Taxpayer Bill of Rights II (Public Law 104-168), the authority to churn funds from undercover operations was extended for five years through 2000.

Consolidated Appropriations Act, 2001
(P.L. 106-554)

New Federal Law (Sec. 7608)

The Acts extends the authority of the IRS to "churn" the income earned from undercover operations for an additional five years, through 2005.

Effective Date

This provision is effective on December 21, 2000.

California Law

California has no counterpart to this federal law.

Impact on California Revenue

Not applicable.

Section	Section Title
304	Confidentiality of Certain Documents Relating to Closing and Similar Agreements and to Agreements with Foreign Governments

Background

Section 6103 of the Internal Revenue Code sets forth the general rule that returns and return information are confidential. A return is any tax return, information return, declaration of estimated tax, or claim for refund filed under the Code on behalf of or with respect to any person. The term "return" also includes any amendment or supplement, including supporting schedules or attachments or lists, which are supplemental to or are part of a filed return. Return information is defined broadly, and includes the following information:

- A taxpayer's identity, the nature, source or amount of income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, over assessments, or tax payments;

- Whether the taxpayer's return was, is being, or will be examined or subject to other investigations or processing;

- Any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person under this title for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense;

- Any part of any written determination or any background file document relating to such written determination which is not open to the public inspection under section 6110; and

- Any advance pricing agreement entered into by a taxpayer and the Secretary and any background information related to the agreement or any application for an advance pricing agreement.

The term “return information” does not include data in a form that cannot be associated with or otherwise identify, directly or indirectly, a particular taxpayer.

Secrecy of Information Exchanged Under Tax Treaties

U.S. tax treaties typically contain articles governing the exchange of information. These articles generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out provisions of the treaty or of the countries’ domestic tax laws. Individuals referred to as “competent authorities” are designated by each country to make written requests for information and to receive information.

The exchange of information articles typically cover information relating to taxes to which the treaty applies, but can also apply to other taxes (e.g., excise taxes) not covered by the treaty. Many of the treaties permit the exchange of information even if the taxpayer involved is not a resident of one of the treaty countries. The exchange of information articles may be similar to, or represent a variation on, Article 26 of the 1996 U.S. model income tax treaty.

Information that is received under the exchange of information articles is subject to secrecy clauses contained in the treaties. In this regard, the country requesting information under the treaties typically is required to treat any information received as secret in the same manner as information obtained under its domestic laws. In general, disclosure is not permitted other than to persons or authorities involved in the administration, assessment, collection or enforcement of taxes to which the treaty applies. For example, disclosure generally can be made to legislative bodies, such as the tax-writing committees of the Congress, and the General Accounting Office, for purposes of overseeing the administration of U.S. tax laws.

In addition to the exchange of information articles in U.S. tax treaties, exchange of information provisions are contained in tax information exchange agreements entered into between the United States and another country. In addition, information may be exchanged pursuant to the Convention on Mutual Administrative Assistance in Tax Matters developed by the Council of Europe and the Organization for Economic Cooperation and Development (the “Multilateral Mutual Assistance Convention”), which limits the use of exchanged information and permits disclosure of such information only with the prior authorization of the competent authority of the country providing the information. The United States has also entered into a number of implementation and coordination agreements with possessions that provide for the exchange of tax information. Moreover, the United States has entered into various mutual legal assistance treaties with other countries, some of which can be used to obtain tax information in criminal investigations.

Both the confidentiality provisions of section 6103, as well as treaty secrecy provisions, can cover return information.

Sections 6110 and 7121

Section 6110 of the Code provides for disclosure of written determinations. With certain exceptions, section 6110 makes the text of any written determination the Internal Revenue Service ("IRS") issues available for pubic inspection. A written determination is any ruling, determination letter, technical advice memorandum, or Chief Counsel advice. The IRS is required to redact certain material before making these documents publicly available. Among the information to be redacted is information specifically exempted from disclosure by any statute (other than Title 26) that is applicable to the IRS. Once the IRS makes the written determination publicly available, the background file documents associated with such written determination are available for public inspection upon written request. Section 6110 defines "background file documents" as any written material submitted by the taxpayer or other requester in support of the request. Background file documents also include any communications between the IRS and persons outside the IRS concerning such written determination that occur before the IRS issues the determination.

Section 6110 was added to the Code in 1976. The legislative history provided that a written determination would not be considered a ruling, technical advice memorandum, or determination letter, unless the document satisfies three criteria:

(1) The document recites the relevant facts;
(2) The document explains the applicable provisions of law; and
(3) The document shows the application of law to the facts.

The legislative history further provided that section 6110 "does not require public disclosure of a closing agreement entered into between the IRS and a taxpayer which finally determines the taxpayer's tax liability with respect to a taxable year. . . . Your committee understands that a closing agreement is generally the result of a negotiated settlement and, as such, does not necessarily represent the IRS view of the law. Your committee intends, however, that the closing agreement exception is not to be used as a means of avoiding pubic disclosure of determinations which, under present practice, would be issued in a form which would be open to pubic inspection [under the bill]."

Closing agreements are entered into under the authority of section 7121. Closing agreements finally and conclusively settle a tax issue between the IRS and a taxpayer. Closing agreements may (1) determine a taxpayer's entire tax liability for a previous tax period or (2) fix the tax treatment of one or more specific items affecting tax liability for any tax period. Thus, closing agreements may settle the treatment of a specific item for periods ending after the execution of the agreement. A single closing agreement may cover both the determination of a taxpayer's entire tax liability for a previous tax period and fix the tax treatment of specific items for any tax period.

Consolidated Appropriations Act, 2001
(P.L. 106-554)

Freedom of Information Act

The Freedom of Information Act ("FOIA"), enacted in 1966, established a statutory right to access government information. While the purpose of section 6103 is to restrict access to returns and return information, the basic purpose of the FOIA is to ensure that the public has access to government documents. In general, the FOIA provides that any person has a right of access to federal agency records, except to the extent that such records (or portions thereof) are protected from disclosure by one of nine exemptions or by one of three special law enforcement record exclusions. Exemption 3 of the FOIA allows the withholding of information prohibited from disclosure by another statue if certain requirements are met. The right of access is enforceable in court.

Pending FOIA Requests and Litigation Involving IRS Records

Records Covered by Treaty Secrecy Clauses

A publisher of tax related material and commentary has made a FOIA request for the disclosure of competent authority agreements. The request has been pending since March 14, 2000. The IRS has not denied the request, nor has it produced any documents responsive to the request. At this time, no suit has been filed to compel disclosure of these documents, although such a suit may be brought in the future.

In connection with a separate request, the IRS was sued under the FOIA to compel disclosure of Field Service Advice memoranda ("FSAs"). FSAs are prepared by attorneys in the IRS National Office of the Office of Chief Counsel. They are prepared in response to requests from IRS field personnel for legal guidance, usually with respect to issues relating to a particular taxpayer. FSAs usually contain a statement of issues, facts, legal analysis, and conclusions. The primary purpose of FSAs is to ensure that IRS field personnel apply the law correctly and uniformly. The D.C. Circuit determined that FSAs are subject to disclosure. However, the court remanded the case to district court to address assertions of privilege, including those based on treaty secrecy. A decision on this issue by the district court is still pending.

Pre-filing Agreements

On February 11, 2000, the IRS issued Notice 2000-12, in which the IRS established a pilot program for "Pre-filing Agreements." Under this program, large businesses may request a review and resolution of specific issues relating to tax returns they expect to file between September and December of 2000. The purpose of the program is to enable taxpayers and the IRS to resolve issues that are likely to be disputed in post-filing audits. Examples of such issues include:

(1) asset valuation and the allocation of a business's purchase or sale price among the assets acquired or sold;
(2) the identification and documentation of hedging transactions; and

(3) the determination of "market" for taxpayers using the lower of cost or market method of inventory valuation in situations involving the inactive markets. The program is intended to address issues for which the law is settled.

In Notice 2000-12, the IRS stated that pre-filing agreements are closing agreements entered into pursuant to section 7121. As such, the notice provides that the information generated or received by the IRS during the prefiling agreement process constitutes return information. The notice further provides that pre-filing agreements are not written determinations as defined in section 6110, nor are they subject to disclosure under the FOIA.

New Federal Law (Secs. 6103, 6110, and 6105)

The Act affirms that closing and similar agreements, and information exchanged and agreements reached pursuant to a tax treaty, are confidential. Further, the provision clarifies that such protected documents are not to be disclosed under the FOIA or section 6110.

Clarification that return information includes closing agreements and similar dispute resolution agreements.

Protection for Closing Agreements, Pre-filing Agreements and Similar Agreements Not Containing an Exposition of the Tax Law

The Act provides that agreements entered into under section 7121 or similar agreements are confidential return information. Similar agreements are intended to include negotiated agreements that (1) are the result of an alternative dispute resolution or dispute avoidance process relating to liability of any person under the Code for any tax, penalty, interest, fine or forfeiture, or other imposition or offense, and (2) do not establish, set forth, or resolve the government's interpretation of the relevant tax law. This is not meant to preclude citation, or repetition of, the Code, Treasury regulations, or other published rules.

Congress intended that pre-filing agreements be covered by this provision. It is the understanding of Congress that pre-filing agreements do not explain the applicable provisions of law or otherwise contain any exposition of the tax law or the position of the IRS. In addition, it is not intended that the closing and similar agreement exception be used as a means of avoiding public disclosure of determinations that, under present law, would be issued in a form that would be open to public inspection. Thus, technical advice memoranda, chief counsel advice, or other material clearly available to the public under present law section 6110, would not be exempt from disclosure by virtue of the fact that such material is contained in a background file for a closing agreement. For example, if a revenue agent seeks technical advice in connection with a pre-filing agreement, such technical advice would remain subject to the requirements of section 6110. Since the pre-filing agreement program involves only settled issues of law, it is the understanding of Congress that documents of this nature generally would not be generated in the pre-filing agreement process.

The provision is not intended to foreclose the disclosure of tax-exempt organization closing agreements to the extent such disclosure is authorized under section 6104. Since section 6103 permits the disclosure of return information as authorized by Title 26, a disclosure authorized by section 6104 is permissible, notwithstanding the fact that a closing agreement is return information.

Report on Pre-filing Agreement Program

It is intended that the Secretary make publicly available an annual report relating to the pre-filing agreement program operations for the preceding calendar year. The annual reporting requirement is for five years, or the duration of the program, whichever is shorter. The report is to include (1) the number of pre-filing agreements completed, (2) the number of applications received, (3) the number of applications withdrawn, (4) the types of issues which are resolved by completed agreements, (5) whether the program is being utilized by taxpayers who were previously subject to audit by the IRS, (6) the average length of time required to complete an agreement, (7) the number, if any, and subject of technical advice and chief counsel advice memoranda issued to address issues arising in connection with any pre-filing agreement, (8) any model agreements, and (9) any other information the Secretary deems appropriate. The first report, covering the calendar year 2000, is to be issued no later than March 30, 2001. The information required for the annual report is subject to the restrictions of section 6103. Therefore, the Secretary will disclose information only in a form that cannot be associated with or otherwise identify, directly or indirectly, a particular taxpayer. The Joint Committee on Taxation periodically may review pre-filing agreements to determine whether they contain legal interpretations that should be disclosed to the public.

Clarification that information protected by treaty is confidential.

Protection for Agreements and Information Exchanged Pursuant to Tax Treaty

The provision adds a new Code section 6105, which provides that tax convention information, with limited exceptions, cannot be disclosed. Thus, the provision confirms that agreements concluded under, and information received pursuant to, a tax convention are confidential and can only be disclosed as provided in such tax convention.

Under the provision, a tax convention is defined to include any income tax or gift and estate tax convention, or any other convention or bilateral agreement (including multilateral conventions and agreements and any agreement with a possession of the United States) providing for the avoidance of double taxation, the prevention of fiscal evasion, nondiscrimination with respect to taxes, the exchange of tax relevant information with the United States, or mutual assistance in tax matters.

It is the understanding of Congress that competent authority agreements (also referred to as mutual agreements) generally do not contain an explanation of the law or application of law to facts. Instead, such agreements are negotiated arrangements to resolve issues

of double taxation. Thus, the term “tax convention information” for purposes of the provision includes:

(1) any agreement entered into with the competent authority of one or more foreign governments pursuant to a tax convention;
(2) an application for relief under a tax convention (sought by either a taxpayer or another competent authority);
(3) any background information related to such agreement or application;
(4) documents implementing such agreement; and
(5) any other information exchanged pursuant to a tax convention that is treated as confidential or secret under such tax convention.

Congress intends that tax convention information would include documents and any other information that reflects tax convention information, including the association of a particular treaty partner with a specific issue or matter.

The general rule that tax convention information cannot be disclosed does not apply to the disclosure of tax convention information to persons or authorities (including courts and administrative bodies) that are entitled to disclosure under the tax convention. It also does not apply to any generally applicable procedural rules regarding applications for relief under a tax convention. This exception is intended to ensure that there is no restriction on the release by the Secretary of publicly available procedural rules concerning matters such as how or when to make a request for competent authority assistance. Thus, certain material generated by IRS, i.e., its Competent Authority procedures (primarily reflected in Rev. Proc. 96-13), or similar material produced by a treaty partner (for example, an Information Circular produced and published by the Canadian tax authority) may be made available to the public. The general rule does not apply to the disclosure of information not relating to a particular taxpayer if, after consultation with the parties to a tax convention, the Secretary determines that such disclosure would not impair tax administration. This is consistent with current practice.

An example of a general agreement that could be disclosed under this provision is the agreement between the competent authorities of Mexico and the United States regarding the maquiladora industry. That agreement, which was not taxpayer specific, was publicized by press release IR-INT-1999-13. Congress intends that the “impairment of tax administration” for purposes of this provision include, but not be limited to, the release of documents that would adversely affect the working relationship of the treaty partners. Under the provision, except as otherwise provided, taxpayer-specific tax convention information could not be publicly disclosed, even if it would not impair tax administration.

A taxpayer-specific competent authority agreement that relates to the existence or possible existence of liability (or amount thereof) of any person for any tax, penalty, interest, fine, forfeiture, or other imposition or offense under the Code is return information under section 6103. It is also an agreement pursuant to a tax convention under section 6105. Return information, including taxpayer-specific competent authority agreements, remains subject to the confidentiality provisions of section 6103. Thus, civil

and criminal penalties for the unauthorized disclosure of returns and return information continue to apply to return information that is also covered by section 6105. However, tax convention information that is return information may only be disclosed to the extent provided in, and subject to the terms and conditions of, the relevant tax convention.

Interaction with FOIA and Section 6110

Under the provision, closing agreements and similar agreements would not be considered written determinations for purposes of section 6110 and, thus, would not be subject to public disclosure. Such agreements would be defined as return information under section 6103 and, therefore, such documents would be protected from disclosure pursuant to Exemption 3 of the FOIA in conjunction with section 6103.

In addition, under the provision, section 6110 would not apply to material covered by section 6105. In the litigation over FSAs, there has been some dispute as to whether treaties qualify as statutes for purposes of withholding information pursuant to Exemption 3 of the FOIA. Congress believes that treaties are the equivalent of statutes for purposes of Exemption 3 of the FOIA. Section 6105 satisfies Exemption 3 of the FOIA. Taxpayer-specific tax convention information concerning a taxpayer's tax liability, such as taxpayer-specific competent authority agreements, would be exempt from the FOIA as both return information under section 6103 and information protected from disclosure by tax convention under section 6105. Agreements not relating to a particular taxpayer, and other tax convention information related to such agreements, could be disclosed under FOIA if it is determined that the disclosure would not impair tax administration.

Effective Date

This provision applies to disclosures on, or after, December 21, 2000, and thus, applies to all documents in existence on, or created after, December 21, 2000.

Current California Law (Secs. 19542, 19551, 19441, 19442, and 19443)

California's Information Practices Act of 1997 (Government Code section 1798.24, et. seq) provides conditions for disclosure of personal information maintained by governmental agencies. In addition, California tax law sets forth the general rule that amounts of income or any particulars, including the business affairs of a corporation, cannot be disclosed by FTB to other than the taxpayer or the taxpayer's representative. In general, California's rules regarding disclosure are comparable to the federal section 6103 rules explained above.

California's Public Records Act (PRA) (Government Code section 6250 et.`seq) provides a statutory right to access state and local government information. The basic purpose of the PRA, like the federal FOIA, is to ensure that the public has access to government documents. Like the FOIA, the PRA provides that any person has a right of access to state or local government agency records, except to the extent that such records are exempt from disclosure. In general, rules regarding disclosure under the PRA are comparable to rules under the FOIA.

There is no counterpart under California law to section 6110 of the Internal Revenue Code (related to the disclosure of written determinations of the IRS). In addition, FTB does not use many procedures used by the IRS that were addressed by the Act. For example, FTB does not enter into advance pricing agreements (alternative dispute resolutions), pre-filing agreements, or make treaties with other countries.

Where the IRS uses its closing agreement authority to settle and compromise cases, FTB has separate statutory authority for each process. FTB enters into closing, settlement, and compromise agreements with taxpayers. In general, taxpayer-specific information relating to all these agreements is confidential and is not subject to public disclosure. For settlement agreements, California law specifically provides that any settlement entered into is confidential tax information. However, if the amount of settlement or compromise exceeds $500, then certain limited information regarding that settlement or compromise, including the taxpayer's name and the amounts at issue, must be retained as a public record.

Though FTB does not enter into treaties as previously mentioned, FTB is authorized by law to exchange tax information with the tax officials of Mexico under a reciprocal agreement. The reciprocal agreement to exchange information is limited to information that is essential for tax administration purposes only. This information is confidential and is not subject to public disclosure.

Impact on California Revenue

Not applicable.

Section	Section Title
305	Increase Joint Committee on Taxation Refund Review Threshold to $2 Million

Background

No refund or credit in excess of $1,000,000 of any income tax, estate or gift tax, or certain other specified taxes may be made until 30 days after the date a report on the refund is provided to the Joint Committee on Taxation (sec. 6405). A report is also required in the case of certain tentative refunds. Additionally, the staff of the Joint Committee on Taxation conducts post-audit reviews of large deficiency cases and other select issues.

New Federal Law (Sec. 6405)

The Act increases the threshold above which refunds must be submitted to the Joint Committee on Taxation for review from $1,000,000 to $2,000,000. The staff of the Joint Committee on Taxation would continue to exercise its existing statutory authority to conduct a program of expanded post-audit reviews of large deficiency cases and other select issues. The IRS is expected to cooperate fully in this expanded program.

Effective Date

This provision is effective on December 21, 2000, except that the higher threshold does not apply to a refund or credit with respect to which a report was made before December 21, 2000.

Current California Law

California law has no comparable provision.

Impact on California Revenue

Not applicable.

Section	Section Title
306	Clarifying the Allowance of Certain Tax Benefits with Respect to Kidnapped Children

Background

The Code generally requires that a taxpayer provide over one-half of the support for each individual claimed as that taxpayer's dependent. Similarly, the child credit, the surviving spouse filing status, and the head of household filing status require that a taxpayer satisfy certain requirements with regard to individuals that qualify as the taxpayer's dependent(s). Finally, the earned income credit for taxpayers with qualifying children generally is available only if the taxpayer has the same principal place of abode for more than one-half the taxable year with an otherwise qualifying child.

Recently published IRS guidance first denied a dependency exemption to certain taxpayers with kidnapped children (TAM 200034029), then later allowed these tax benefits to such taxpayers (TAM 200038059).

New Federal Law (Secs. 2, 24, 32, and 151)

The Act clarifies that the dependency exemption, the child credit, the surviving spouse filing status, the head of household filing status, and the earned income credit are available to an otherwise qualifying taxpayer with respect to a child who is presumed by law enforcement authorities to have been kidnapped by someone who is not a member of the family of such child or the taxpayer. Generally, this treatment continues for all taxable years ending during the period that the child is treated as kidnapped. However, this treatment ends for the taxable year ending after the calendar year in which it is determined that the child is dead (or, if earlier, in which the child would have attained age 18).

Effective Date

This provision is effective for taxable years ending after December 21, 2000.

Current California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to the definition of dependents and head of household. Thus, a kidnapped child would be allowed to be treated as a dependent under the rationale of TAM 200038059. California law does not provide an earned income or young child credit. California law has not conformed to the changes made to the IRC by the Consolidated Appropriations Act, 2001.

Impact on California Revenue

Similar to federal projections, this provision would result in a negligible state revenue loss annually.

Section	Section Title
307	Amendments to Statutes Referencing Yield on 52-Week Treasury Bills

Background

Code section 995(f)(4), dealing with the interest charge on the deferred tax liability of the shareholders of a domestic international sales corporation, provides that the interest rate be determined by reference to the average investment yield on United States Treasury bills with maturities of 52 weeks. In addition, provisions of federal law relating to interest on monetary judgments in civil cases recovered in federal district court and on a judgment against the United States affirmed by the Supreme Court (Title 28), interest on certain unpaid criminal fines and penalties (Title 18), and interest on compensation for certain takings of property (Title 40), determine the applicable interest rate by reference to 52-week Treasury bills.

As a result of prior Congressional efforts at budgetary control, current and projected federal budget surpluses are reducing the need of the Treasury Department to issue certain securities. The Treasury Department has informed the Congress that on grounds of efficient debt management, and predictability and liquidity for the financial markets, the Treasury Department has announced it is likely to cease issuing 52-week Treasury bills.

New Federal Law (Sec. 995(f)(4))

The Act modifies the Code (sec. 995(f)(4)) and certain other parts of federal law relating to interest on monetary judgments in civil cases recovered in federal district court and on a judgment against the United States affirmed by the Supreme Court (Title 28), interest on certain

unpaid criminal fines and penalties (Title 18), and interest on compensation for certain takings of property (Title 40) that make specific reference to yields on 52-week Treasury bills. The Act generally replaces the reference to 52-week Treasury bills with a reference to the weekly average one-year constant maturity Treasury yield, as published by the Board of Governors of the Federal Reserve System.

Effective Date

This provision is effective December 21, 2000.

Current California Law

In general, California does not conform to the federal rules relating to the deferred tax liability of the shareholders of a domestic international sales corporation. For both worldwide and water's-edge filing purposes, domestic international sales corporations are generally treated the same.

Impact on California Revenue

Not applicable.

Section	Section Title
308	Adjustments for Consumer Price Index Error

Background

Code section 1(f) provides for adjustments in the tax tables so that inflation itself will not result in tax increases. Numerous other provisions of the Code are indexed as well. Section 1(f) provides that inflation is measured by changes in the consumer price index ("CPI") for the preceding year, as published by the Department of Labor, compared to the CPI for the calendar year 1992. Section 1(f) directs the Secretary to publish tables with applicable tax rates based upon calculated inflation adjustments by December 15th of the year before the year to which the tables are to apply.

In addition, payments made under Social Security, certain federal employee retirement programs, and certain payments to individuals under various welfare and income support programs are adjusted annually by changes in the CPI.

On September 28, 2000, the Bureau of Labor Statistics ("BLS") announced that the agency had discovered a computational error in quality adjustments of air conditioning as a part of the cost of housing resulting in errors in the reported CPI between January 1999 and August 2000. The BLS reported that the CPI levels starting in January 1999 have been 0.0, 0.1, or 0.2 index points lower than the levels that would have been published without the error. Consistent with agency guidelines and past practices, the BLS announced that it is revising the reported CPI back to

January 2000 to the fully correct levels. The BLS will make no changes to reported levels for January through December 1999. However, the BLS will make the corrected levels of the CPI for 1999 available upon request.

New Federal Law

The Act authorizes the Secretary of the Treasury to use the corrected levels of the CPI for 1999 and 2000 for all purposes of the Code to which they might apply. The Act directs the Secretary to prescribe new tables reflecting the correct levels of the CPI for the 2001 tax year.

In addition, the Act provides that the Director of the Office of Management and Budget ("OMB") shall assess federal benefit programs to ascertain the extent to which the CPI error has or will result in a shortfall in program payments to individuals for 2000 and future years. The Director is directed to issue guidelines to agency administrators to determine the extent, if any, of such shortfalls in payments to individuals. The agency administrators are to report their findings to the Director and to Congress within 30 days. The Act provides that, within 60 days of December 21, 2000, the Director must instruct the head of any federal agency that administers an affected program to make a payment or payments to compensate for the shortfall. Such payments are targeted to the amount of the shortfall experienced by individual beneficiaries. Applicable federal benefit programs include the old-age and survivors insurance program, the disability insurance program, and the supplemental security income program under the Social Security Act and other programs as determined by the Director. The Act directs the Director to report to the Congress on the activities performed pursuant to this provision by April 1, 2001.

Further, the Congress strongly encourages the Commissioner of the Bureau of Labor Statistics to review carefully the agency's current policy with respect to publishing as part of an official series corrections to data found to be in error for reasons of computational error. The Congress believes the review should be made both with respect to the error announced on September 28, 2000, and as a matter for the future for those rate circumstances when such a similar computational error might once again arise.

Effective Date

This provision is effective on December 21, 2000.

Current California Law

California indexes various items in the Revenue & Taxation Code to inflation based on the California consumer price index developed by the BLS. The IRS indexes in October prior to the year being indexed, while the FTB indexes in the August of the current year. Therefore, errors found by the BLS subsequent to the original published date are less likely to affect California's indexed figures. Through normal procedures, the FTB used the corrected figures issued by the BLS on September 28, 2000.

Consolidated Appropriations Act, 2001
(P.L. 106-554)

Impact on California Revenue

Not applicable.

Section	Section Title
309	Prevention of Duplication of Loss Through Assumption of Liabilities Giving Rise to Deduction

Background

Generally, no gain or loss is recognized when one or more persons transfer property to a corporation in exchange for stock and immediately after the exchange such person or persons control the corporation. However, a transfer recognizes gain to the extent it receives money or other property ("boot") as part of the exchange (sec. 351).

The assumption of liabilities by the controlled corporation generally is not treated as boot received by the transferor, except that the transferor recognizes gain to the extent that the liabilities assumed exceed the total of the adjusted basis of the property transferred to the controlled corporation pursuant to the exchange (sec. 357(c)).

The assumption of liabilities by the controlled corporation generally reduces the transferor's basis in the stock of the controlled corporation that assumed the liabilities. The transferor's basis in the stock of the controlled corporation is the same as the basis of the property contributed to the controlled corporation, increased by the amount of any gain (or dividend) recognized by the transferor on the exchange, and reduced by the amount of any money or property received and by the amount of any loss recognized by the transferor (sec. 358). For this purpose, the assumption of a liability is treated as money received by the transferor.

An exception to the general treatment of assumption of liabilities applies to assumptions of liabilities that would give rise to a deduction, provided the incurrence of such liabilities did not result in the creation or increase of basis of any property. The assumption of such liabilities is not treated as money received by the transferor in determining whether the transferor has gain on the exchange. Similarly, the transferor's basis in the stock of the controlled corporation is not reduced by the assumption of such liabilities. The Internal Revenue Service has ruled that the assumption by an accrual basis corporation of certain contingent liabilities for soil and groundwater remediation would be covered by this exception.

New Federal Law (Sec. 358)

The Act contains a provision to limit the acceleration or duplication of losses through assumption of liabilities.

Under the Act, if the basis of stock (determined without regard to this provision) received by a transferor as part of a tax-free exchange with a controlled corporation exceeds the fair market value of the stock, then the basis of the stock received is reduced (but not below the fair market value) by the amount (determined as of the date of the exchange) of any liability that (1) is assumed in exchange for such stock, and (2) did not otherwise reduced the transferor's basis of the stock by reason on the assumption. Except as provided by the Secretary of the Treasury, this provision does not apply where the trade or business with which the liability is associated is transferred to the corporation as part of the exchange, or where substantially all the assets which the liability is associated are transferred to the corporation as part of the exchange.

The exception for transfers of a trade or business, or substantially all the assets with which a liability is associated, are intended to obviate the need for valuation or basis reduction in such cases. The exceptions are not intended to apply to a situation involving the selective transfer of assets that may bear some relationship to the liability, but that do not represent the full scope of the trade or business (or substantially all the assets) with which the liability is associated.

For purposes of this provision, the term "liability" includes fixed or contingent obligation to make payments, without regard to whether such obligation or potential obligation is otherwise taken into account under the Code. The determination whether a liability (as more broadly defined for purposes of this provision) has been assumed is made in accordance with the provisions of section 357(d)(1) of the Code. Under the standard of 357(d)(1), a recourse liability is treated as assumed if, based on all the facts and circumstances, the transferee has agreed to and is expected to satisfy such liability (or portion thereof), whether or not the transferor has been relieved of the liability. For example, if a transferee corporation does not formally assume a recourse obligation or potential obligation of the transferor, but instead agrees and is expected to indemnify the transferor with respect to all or a portion of such an obligation, then the amount that is agreed to be indemnified is treated as assumed for purposes of the provision, whether or not the transferor has been relieved of such liability. Similarly, a nonrecourse liability is treated as assumed by the transferee of any asset subject to such liability.

The application of the provision is illustrated as follows: Assume a taxpayer transfers assets with an adjusted basis and fair market value of $100 to its wholly owned corporation and the corporation assumes $40 of liabilities (the payment of which would give rise to a deduction). Thus, the value of the stock received by the transferor is $60. Under present law, the basis of the stock would be $100. The provision requires that the basis of the stock be reduced to $60 (i.e., a reduction of $40). Except as provided by the Secretary, no basis reduction is required if the transferred assets consisted of the trade or business, or substantially all of the assets, with which the liability associated.

The provision does not change the tax treatment with respect to the transferee corporation.

The Secretary of the Treasury is directed to prescribe rules providing appropriate adjustments to prevent the acceleration or duplication of losses through the assumption of liabilities (as defined in the provision) in transactions involving partnerships. The Secretary may also provide appropriate adjustments in the case of transactions involving S corporations. In the case of S

corporations, such rules may be applied instead of the otherwise applicable basis reduction rules.

Effective Date

This provision is effective for assumption of liabilities on or after October 19, 1999. Except as provided by the Secretary, the rule addressing transactions involving partnerships is effective with the same effective date. Any rules addressing transactions involving S corporations may likewise be effective for assumptions of liabilities on or after October 19, 1999, or such later date as may be prescribed in such rules.

Current California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to transfers of property for stock to a controlled corporation. California law has not conformed to the changes made to the IRC by the Consolidated Appropriations Act, 2001.

Impact on California Revenue

Conforming to this federal provision would result in minor revenue gains of less than $500,000 each in 2001-02 and 2002-03, increasing to a revenue gain of $1 million in 2003-04. The provision would be effective with the assumption of liabilities on or after October 19, 1999. Estimates were based on a proration of federal projections developed for the Consolidated Appropriations Act of 2001.

Section	Section Title
310	Disclosure of Certain Information to the Congressional Budget Office

Background

Federal tax returns and return information are confidential and cannot be disclosed unless authorized by the Code. Section 6103 authorizes certain agencies to receive tax returns and return information for statistical use and for other specified purposes. Section 6103 also permits the Secretary of the Treasury (the "Secretary") to provide return information to any person authorized to receive it by any mode or means that the Secretary determines necessary or appropriate. Persons making unauthorized disclosures or inspections of tax returns and return information are subject to criminal and civil penalties.

The Congressional Budget Office ("CBO") is in the process of developing the capability to make projections of the Social Security and Medicare programs over long periods of time. To facilitate the development and operation of long-term models of Social Security and Medicare, CBO needs continuing access to records from the IRS. Specifically, CBO seeks two SSA files that contain return information--the Social Security Earnings Record and the Master Beneficiary

Record. These files contain individual earnings data compiled from tax returns (Forms W-2), which are protected from disclosure by section 6103. In addition, CBO may request other records, including those matched with survey data.

New Federal Law (Sec. 6103(j)(6))

The Act amends section 6103 to permit the Secretary to furnish to CBO return information to the extent such information is necessary for purposes of CBO's long-term models of Social Security and Medicare. This authority extends to the development, operation, and maintenance by CBO of its long-term models of Social Security and Medicare. It is the intent of Congress that all requests for information made by CBO under this provision be made to the Secretary and that the Secretary use his authority under section 6103(p)(2) such that the SSA or other agency can furnish directly to CBO, for purposes of CBO's long-term models of Social Security and Medicare, the files they possess that incorporate return information. It is also the intent of Congress that the Secretary furnish such other return information under this provision as is necessary for purposes of CBO's Social Security and Medicare long-term models.

Under the Act, CBO is subject to the safeguard requirements for tax returns and return information. Further, CBO is prohibited from disclosing any tax returns and return information received under this provision except in a form that cannot be associated with, or otherwise identify, directly or indirectly a particular taxpayer. Present-law civil and criminal penalties apply to the unauthorized disclosure or inspection of tax returns or return information.

The Act adds to the Congressional Budget Act of 1974 additional confidentiality provisions which would require CBO to provide the same level of confidentiality to data it obtains from other agencies as that to which the agencies themselves are subject. Officials and employees of CBO would be subject to the same statutory penalties for unauthorized disclosure as the employees of the agencies from which CBO obtains the data.

Current California Law (Sec. 19542, et.seq.)

Under state tax law and the Information Practices Act of 1977, tax returns and information filed with the FTB are confidential and cannot be disclosed unless otherwise provided. Under state tax law, it is a misdemeanor to make unauthorized disclosures of confidential tax or information returns or return information. FTB is expressly authorized to exchange tax information with the IRS and other state taxing agencies for tax purposes. In general, FTB is authorized to publish or disclose statistical information as long as the information is in a form that will not identify a particular return or taxpayer. As such, FTB routinely provides upon request statistical tax information to the Department of Finance, legislative committees, and others that have a need for and right to the information.

Impact on California Revenue

Not applicable.

Consolidated Appropriations Act, 2001
(P.L. 106-554)

Section	Section Title
311-319	Tax Technical Corrections

Except as otherwise provided, the technical corrections contained in the Act generally are effective as if included in the originally enacted related legislation. The provisions under the IRS Restructuring Act of 1998 relating to innocent spouse and to procedural and administrative issues (other than the provision relating to clarification of Tax Court authority to issue appealable decisions) are effective December 21, 2000.

New Federal Law

Amendments Relating to the Ticket to Work and Work Incentives Improvement Act of 1999

Research credit. The provision clarifies the anti-double dip rule coordinating the research credit (sec. 41) and the Puerto Rico economic activity credit (sec. 30A). It is arguable that the present-law provisions could be construed so that the amount of wages on which a taxpayer could claim the section 30A credit is reduced only by the amount of credit claimed under section 41, rather than by the amount of wages upon which the section 41 credit is based. This result is inconsistent with the legislative history of the original provisions. The provision deletes the words “or credit” after “deduction” in section 280C(c)(1), and adds a new subsection in section 30A specifying that wages or other expenses taken into account for section 30A may not be taken into account for section 41.

Taxable REIT subsidiaries. The provision clarifies that a REIT’s redetermined rents (described in sec. 857(b)(7)(B)) that are subject to tax under section 857(b)(7)(A) do not include amounts received from a taxable REIT subsidiary that would be excluded from unrelated business taxable income (under sec. 512(b)(3), relating to certain rents, if received by certain types of organizations described in sec. 511(a)(2)).

Partnership basis adjustments. The provision provides that the rule in the consolidated return regulations (Treas. Reg. sec. 1.1502-34) aggregating stock ownership for purposes of section 332 (relating to complete liquidation of a subsidiary that is a controlled corporation) also applies for purposes of section 732(f) (relating to basis adjustments to assets of a controlled corporation received in a partnership distribution).

Current California Law

In general, California law is in conformity with federal law as of January 1, 1998, for purposes of the research credit, REITs, and partnership basis adjustments. California law has not conformed to the changes made to the IRC by the Ticket to Work and Work Incentives Improvement Act of 1999.

Impact on California Revenue

Not applicable. California has not conformed to the Ticket to Work and Work Incentives Improvement Act of 1999

Consolidated Appropriations Act, 2001
(P.L. 106-554)

New Federal Law

Amendments Related to the Tax and Trade Relief Extension Act of 1998

> *Exempt organizations*. The provision clarifies that nonexempt charitable trusts and nonexempt private foundations are subject to the public disclosure requirements of section 6104(d).
>
> *Capital gains*. The provision clarifies that if:(1) a charitable remainder trust (CRT) sold section 1250 property after July 28, 1997, and before January 1, 1998,
> (2) the property was held more than one year but not more than 18 months, and
> (3) the capital gain is distributed after December 31, 1997,

then any capital gain attributable to depreciation will be taxed at 25% (rather than 28%). Treasury has published a notice (Notice 99-17, 1999-14 I.R.B., April 5, 1999) providing that the gain is taxed at 25%.

Current California Law

The Tax and Trade Relief Extension Act of 1998 provisions that are amended by the Act are comparable to state tax law, as follows:

California law provides that an organization's application for exemption and any underlying documents that supported the application must 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.

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%.

New Federal Law

Amendments Related to the Internal Revenue Service Restructuring and Reform Act of 1998.

> *Innocent spouse*
>
> *Timing of request for relief.* Confusion currently exists as to the appropriate point at which a request for innocent spouse relief should be made by the taxpayer and considered by the IRS. Some have read the statute to prohibit consideration by the IRS of requests for relief until after an assessment has been made, i.e., after the examination has been concluded, and if challenged, judicially determined. Others have read the statute to permit claims for relief from deficiencies to be made upon the filing of the return before any preliminary determination as to whether a deficiency exists or whether the return will be

examined. The consideration of innocent spouse relief requires that the IRS focus on the particular items causing a deficiency. Until such items are identified, the IRS cannot consider these claims.

Congress did not intend that taxpayers be prohibited from seeking innocent spouse relief until after an assessment has been made. Congress intended the proper time to raise and have the IRS consider a claim to be at the same point where a deficiency is being considered and asserted by the IRS. This is the least disruptive for both the taxpayer and the IRS since it allows both to focus on the innocent spouse issue while also focusing on the items that might cause a deficiency. It also permits every issue, including the innocent spouse issue, to be resolved in a single administrative and judicial process. The Act clarifies the intended time by permitting the election under (b) and (c) to be made at any point after a deficiency has been asserted by the IRS. For this purpose, a deficiency is considered to have been asserted by the IRS at the time the IRS states that additional taxes may be owed. Most commonly, this occurs during the examination process. It does not require an assessment to have been made, nor does it require the exhaustion of administrative remedies in order for a taxpayer to be permitted to request innocent spouse relief.

Allowance of refunds. The current placement in the statute of the provision for allowance of refunds may inappropriately suggest that the provision applies only to the United States Tax Court, whereas it was intended to apply administratively and in all courts. The Act clarifies this by moving the provision to its own subsection.

Non-exclusivity of judicial remedy. Some have suggested that the IRS Restructuring Act administrative and judicial process for innocent spouse relief was intended to be the exclusive avenue by which relief could be sought. The Act clarifies Congressional intent that the procedures of section 6015(e) were intended to be additional, non-exclusive avenues by which innocent spouse relief could be considered.

Time for filing a petition with the Tax Court. As enacted, the time period for seeking a redetermination in the Tax Court of innocent spouse relief begins on the date of the determination as opposed to the date after the determination. This period is one day shorter than that generally applicable to petition the Tax Court with respect to a deficiency notice (sec. 6213) and the period during which collection activities are prohibited and the limitations period is suspended. The Act clarifies the computation of this period and conforms it to the generally applicable 90-day period for petitioning the Tax Court. Conforming amendments are made as to the period for which collection activities are prohibited and collection limitations suspended.

Waiver of final determination upon agreement as to relief. Congress intended in enacting section 6015 to provide a simple and efficient procedure by which the IRS could consider relief. If relief was denied (in whole or in part) and the spouse requesting such relief did not agree with such denial, such issue could be considered by the Tax Court. Congress did not intend to require a rigid formal process when the IRS and the spouse requesting relief agreed on the extent of relief to be granted. However, the provisions of section 6015(e)

have been interpreted as requiring the issuance in all circumstances of a formal "Notice of Determination," which contains a statement of the time period within which a petition may be filed with the Tax Court and which delays final resolution of the request for relief until the expiration of the period for filing a petition with the Tax Court. The issuance of the Notice of Determination is confusing to the taxpayer when the requested relief was fully granted or when the IRS and the taxpayer otherwise agreed on the application of the innocent spouse provisions to the taxpayer's case. It also may cause unnecessary filings with the Tax Court and delay the closing of the case until the time for filing with the Tax Court expires.

Congress has addressed the analogous situation in the deficiency context in section 6213(d). In such situations, upon written agreement, the IRS may adjust the taxpayer's liability as agreed, and no additional formal notice is necessary. The Act reflects that an analogous waiver was intended to apply in the innocent spouse context. The Act consequently permits taxpayers and the IRS to enter into a similar written agreement in innocent spouse cases, which allows for the taxpayer's liability to be immediately adjusted as agreed, and makes unnecessary a formal Notice of Determination or Tax Court review. This written agreement is to specify the details of the agreement between the IRS and the taxpayer as to the nature and extent of innocent spouse relief that will be provided. Conforming amendments are made as to the period for which collection activities are prohibited and collection limitations suspended.

Procedural and Administrative Issues

Disputes involving $50,000 or less. The Act clarifies that the small case procedures of the Tax Court are available with respect to innocent spouse disputes and disputes continuing from the pre-levy administrative due process hearing. The small case procedures provide an accessible forum for taxpayers who have small claims with less formal rules of evidence and procedure. Use of the procedure is optional to the taxpayer, with the concurrence of the Tax Court. In view of the recent enactment of the innocent spouse and pre-levy administrative due process hearing provisions, it is anticipated that the Tax Court will give careful consideration to (1) a motion by the Commissioner of Internal Revenue to remove the small case designation (as authorized by Rules 172 and 173 of the Tax Court Rules) when the orderly conduct of the work of the Court or the administration of the tax laws would be better served by a regular trial of the case, as well as (2) the financial impact upon the taxpayer, including additional legal fees and costs, of not utilizing small case treatment. For example, removing the small case designation may be appropriate when a decision in the case will provide a precedent for the disposition of a substantial number of other cases. It is anticipated that motions by the Commissioner to remove the small case designation will be made infrequently.

Authority to enjoin collection actions. Previously, while a dispute is pending under the pre-levy administrative due process hearing procedures, levy action is statutorily suspended for that period. The Tax Court and district courts are expressly granted authority to enjoin improper levy action in general, but that authority does not explicitly extend to improper levy action that occurs during the period when levy action is statutorily suspended under

the administrative due process provisions. The Act clarifies the ability of the courts (including the Tax Court) to enjoin levy during the period that levy is required to be suspended with respect to a dispute under the pre-levy administrative due process hearing procedures.

Clarification of permissible extension of limitations period for installment agreements. Uncertainty exists as to whether the permissible extension of the period of limitations in the context of installment agreements is governed by reference to an agreement of the parties pursuant to section 6502 or by reference to the period of time during which the installment agreement is in effect pursuant to sections 6331(k)(3) and (i)(5). The provision clarifies that the permissible extension of the period of limitations in the context of installment agreements is governed by the pertinent provisions of section 6502.

Clarification of Tax Court authority to issue appealable decisions. The statutory provision for judicial review of a dispute concerning the pre-levy administrative due process hearing may be unclear as to whether a determination of the Tax Court is an appealable decision. The Act clarifies that the determination of the Tax Court (other than under the smal case procedures) in a dispute concerning the pre-levy administrative due process hearing is a decision of the Tax Court and would be reviewable as such.

Other Issues

IRS restructuring. When the Office of the Chief Inspector was replaced by the Treasury Inspector General for Tax Administration (TIGTA) under the IRS Restructuring and Reform Act of 1998, Inspection's responsibilities were assigned to the TIGTA. TIGTA personnel are Treasury, rather than IRS, personnel. TIGTA personnel still need to make investigative disclosures to carry out the duties they took over from Inspection and their additional tax administration responsibilities. However, section 6103(k)(6) refers only to "internal revenue" personnel. The Act clarifies that section 6103(k)(6) permits TIGTA personnel to make investigative disclosures.

Compliance. Section 3509 of the IRS Restructuring and Reform Act of 1998 expanded the disclosure rules of section 6110 to also cover Chief Counsel advice (sec. 6110(i)). This is a conforming change related to ongoing investigations. The Act adds "or Chief Counsel advice" to section 6110(g)(5)(A) after the words "technical advice memorandum."

California Law (Secs. 18533 and 19006)

The Internal Revenue Service Restructuring and Reform Act of 1998 provisions that are amended by the Act are comparable to state tax law, as follows:

Innocent spouse. California tax law generally conforms to the federal innocent spouse relief provisions, with modifications. For example, under state tax law, the same tax protest and appeal process applicable to proposed deficiency assessments is substituted for the Tax Court jurisdiction that is provided under federal law.

Timing of request for relief. Under state tax law, before innocent spouse relief may be requested, a tax liability must exist. Therefore, in the case where an audit is in process, no consideration can be given to a request for innocent spouse relief until the notice of proposed deficiency assessment is actually issued.

Allowance of refunds. Under state tax law, a refund based on innocent spouse relief may be allowed through either the administrative or judicial process.

Non-exclusivity of judicial remedy. Under state tax law, an innocent spouse may seek relief through several avenues:

- the audit process for deficiency assessments,
- the collection process for final assessments, or
- the claim for refund process, which requires the taxpayer to pay the amount due and submit a claim for refund. In the event a claim for refund is denied, the taxpayer may bring an action for refund in court.

Time for filing a protest or appeal. Under state tax law, the timing of a protest and appeal relating to innocent spouse relief mirrors that for filing a protest or appeal for a notice of proposed deficiency assessment.

Waiver of final determination upon agreement as to relief. State tax law does not authorize the waiver of a notice of proposed deficiency assessment upon agreement of the FTB and the taxpayer as to innocent spouse relief; rather, there must first be a liability from which to grant relief. Therefore, to process innocent spouse relief requests relating to a deficiency assessment, FTB follows its usual business practice of issuing the underlying proposed deficiency assessment jointly. The innocent spouse then protests that deficiency assessment requesting innocent spouse relief. In the event relief is provided, a Notice of Action is issued revising the innocent's tax liability.

Procedural and Administrative Issues and *Other Issues*

State tax law does not conform to these various underlying federal provisions at issue that are amended by the Act.

Impact on California Revenue

Not applicable. California has stand-alone procedures dealing with these tax relief and protest issues.

New Federal Law

Amendments Related to the Taxpayer Relief Act of 1997

Deficiency created by overstatement of refundable child credit. The Act treats the refundable portion of the child credit under section 24(d) as part of a “deficiency.” Thus,

the usual assessment procedures applicable to income taxes will apply to both the nonrefundable and the refundable portions of the child credit. (This will reverse the conclusion reached by Internal Revenue Service Chief Counsel Memorandum 199948027.)

Roth IRAs. Code section 3405 provides for withholding with respect to designated distributions from certain tax-favored arrangements, including IRAs. In general, section 3405(e)(1)(B)(ii) excludes from the definition of a designated distribution the portion of any distribution which it is reasonable to believe is excludable from gross income. However, all distributions from IRAs are included in income. The exception was consistent with prior law when all IRA distributions were taxable, but does not account for the tax-free nature of certain Roth IRA distributions. The Act extends the exception to Roth IRAs.

Capital gain election. The Act provides that an election to recognize gain or loss made pursuant to section 311(e) of the Taxpayer Relief Act of 1997 does not apply to assets disposed of in a recognition transaction within one year of the date the election would otherwise have been effective. Thus, for example, if an asset is sold in 2001, no election may be made with respect to that asset. In addition, it is clarified that the deemed sale and repurchase by reason of the election is not taken into account in applying the wash sale rules of section 1091.

Straight-line depreciation under AMT. The Act clarifies that the Taxpayer Relief Act of 1997 did not change the requirement that the straight-line method of depreciation be used in computing the alternative minimum tax ("AMT") depreciation allowance for section 1250 property. It is arguable that the changes made by Taxpayer Relief Act could be read as inadvertently allowing accelerated depreciation under the AMT for section 1250 property that is allowed accelerated depreciation under the regular tax.

Transportation benefits. Salary reduction amounts are generally treated as compensation for purposes of the limits on contributions and benefits under qualified plans. In addition, an employer can elect whether or not to include such amounts for nondiscrimination testing purposes. The IRS Reform Act permitted employers to offer a cash option in lieu of qualified transportation benefits. The Act treats salary reduction amounts used for qualified transportation benefits the same as other salary reduction amounts for purposes of defining compensation under the qualified plan rules.

Tax Court jurisdiction. The Tax Court recently held that its jurisdiction pursuant to section 7436 extends only to employment status, not to the amount of employment tax in dispute. (*Henry Randolph Consulting v. Comm'r* (1999) 112 T.C. #1.) The Act provides that the Tax Court also has jurisdiction over the amount.

Amendments Related to the Balanced Budget Act of 1997

Tobacco floor stocks tax. The Act clarifies that the floor stocks taxes imposed on January 1, 2000, and January 1, 2002, apply only to cigarettes rather than to all tobacco products.

Previously, the law could be construed as ambiguous, referring to imposition on all tobacco products but imposing liability only with respect to cigarettes.

Tobacco excise tax. The Act provides conforming amendments to two provisions to reflect the fact that the tax on cigarette papers is not imposed on "books" or papers since January 1, 2000.

Coordination of trade rules and tobacco excise tax. The Act clarifies that the penalty on reimporting cigarettes other than for return to a manufacturer (effective January 1, 2000) does not apply to cigarettes re-imported by individuals to the extent those cigarettes can be entered into the U.S. without duty or tax under the Harmonized Tariff Schedule.

California Law (Secs. 17062, 17201, and 23457)

The Taxpayer Relief Act of 1997 provisions that are amended by the Act are comparable to state tax law, as follows:

- California law is in conformity with federal law as it read on January 1, 1998, as it relates to Roth IRAs, transportation parking benefits and straight-line depreciation and AMT. The FTB does not administer any type of withholding except for nonresidents. Voluntary withholding on IRAs is administered by the EDD.
- California law does not provide a young child credit.
- California tax rates on ordinary income and net capital gains are the same. California generally conforms to federal law on the definition of a capital asset and how gain or loss is calculated.
- The FTB does not administer excise or employment taxes; BOE and EDD administer these taxes, respectively.

Impact on California Revenue

Defer to BOE and EDD.

New Federal Law

Amendments Related to the Small Business Job Protection Act of 1996

Work opportunity tax credit. Section 51(d)(2) refers to eligibility for the work opportunity tax credit with respect to certain welfare recipients without taking into account the enactment of the temporary assistance for needy families ("TANF") program. The Act conforms references in the work opportunity tax credit to the operation of TANF.

Electing small business trusts holding S corporation stock. The Act allows an electing small business trust (sec. 1361(e)) to have an organization described in section 170(c)(1)

(relating to state and local governments) as a beneficiary if the organization holds a contingent interest and is not a potential current beneficiary.

Definition of lump-sum distribution. Section 1401(b) of the Small Business Job Protection Act of 1996 Act repealed five-year averaging for lump-sum distributions. The definition of lump-sum distribution was preserved for other provisions, primarily those relating to certain arrangements in employer securities. The definition was moved from section 402(d)(4)(A) to section 402(e)(4)(D)(i). This definition included the following sentence: "A distribution of an annuity contract from a trust or annuity plan referred to in the first sentence of this subparagraph shall be treated as a lump sum distribution." The Act adds this language back into the definition of lump-sum distribution. The sentence is relevant to section 401(k)(1)(B), which permits certain distributions if made as a "lump-sum distribution."

IRAs for nonworking spouses. Section 1427 of the Small Business Job Protection Act of 1996 expanded the IRA deduction for nonworking spouses. The maximum permitted IRA contribution is generally limited by the individual's earned income. Previously, it was possible for a nonworking (or lesser earning) spouse to make IRA contributions in excess of the couple's combined earned income. The following example illustrates previous law.

> Example: Suppose H and W retire in the middle of January 1999. In that year, H earns $1,000 and W earns $500. Both are active participants in an employer-sponsored retirement plan. Their modified AGI is $60,000. They make no Roth IRA contributions. Before application of the income phase-out rules, the maximum deductible IRA contribution that H can make is $1,000 (sec. 219(b)(1)). After application of the income phase-out rule in section 219(g), H's maximum contribution is $200, and H contributes that amount to an IRA. Under 408(o)(2)(B), H can make nondeductible contributions of $800 ($1,000-$200).
>
> W's maximum permitted deductible contribution under section 219(c)(1)(B), before the income phase-out, is $1,300 (the sum of H and W's earned income ($1,500) less H's deductible IRA contribution ($200)). Under the income phase-out, W's deductible contribution is limited to $200, and she can make a nondeductible contribution of $1,100 ($1,300-$200).
>
> The total permitted contributions for H and W are $2,400 ($1,100 for H plus $1,300 for W). The combined contribution should have been limited to $1,500, their combined earned income of the spouses.

The Act provides that the contributions for the spouse with the lesser income cannot exceed the combined earned income of both spouses.

California Law (Secs. 17501, 17504, 17507, 17507.4, and 23800)

The Small Business Job Protection Act of 1996 provisions that are amended by the Act are comparable to state tax law. Specifically, California law is in conformity with federal law as it read on January 1, 1998, as it relates to electing small business trusts holding S corporation

stock, lump-sum distribution definition, and IRAs for nonworking spouses. California law does not provide a work opportunity tax credit. California law has not conformed to the changes made to the IRC by the Consolidated Appropriations Act, 2001.

Impact on California Revenue

The above changes would result in a negligible gain.

New Federal Law

Amendment Related to the Revenue Reconciliation Act of 1990

> *Qualified tertiary injectant expenses*. The Act clarifies that the enhanced oil recovery credit (sec. 43) applies with respect to qualified tertiary injectant expenses described in section 193(b) that are paid or incurred in connection with a qualified enhanced oil recovery project, and that are deductible for the taxable year (regardless of the provision allowing the deduction). Purchased and self-produced injectants are treated the same for purposes of the section 43 credit.

California Law (Secs. 17052.8 and 23604)

California law is in conformity with federal law as it read on January 1, 1998, as it relates to the enhanced oil recovery credit except that California's credit is one-third of the federal credit amount. California law has not conformed to the changes made to the IRC by the Consolidated Appropriations Act, 2001.

Impact on California Revenue

No federal or state revenue impact due to clarification of current law.

New Federal Law

Amendments to Other Acts

> *Insurance.* The legislative history of section 7702A(a) (enacted in the Technical and Miscellaneous Revenue Act of 1988) indicated that if a life insurance contract became a modified endowment contract ("MEC"), then the MEC status could not be eliminated by exchanging the MEC for another contract. Section 7702A(a)(2), however, arguably might have been read to allow a policyholder to exchange a MEC for a contract that does not fail the seven-pay test of section 7702A(b), then exchange the second contract for a third contract, which would not literally have been received in exchange for a contract that failed to meet the seven-pay test. The Act clarifies section 7702A(a)(2) to correspond to the legislative history, effective as if enacted with the Technical and Miscellaneous Revenue Act of 1988 (generally, for contracts entered into on or after June 21, 1988).

Insurance. Under section 7702A, if a life insurance contract that is not a modified endowment contract is actually or deemed exchanged for a new life insurance contract, then the seven-pay limit under the new contract is first computed without reference to the premium paid using the cash surrender value of the old contract. Then, it would be reduced by 1/7 of the premium paid taking into account the cash surrender value of the old contract.

For example, if the old contract had a cash surrender value of $14,000 and the seven-pay premium on the new contract would equal $10,000 per year but for the fact that there was an exchange, the seven-pay premium on the new contract would equal $8,000 ($10,000-$14,000/7). However, section 7702A(c)(3)(A) arguably might have been read to suggest that if the cash surrender value on the new contract was $0 in the first two years (due to surrender charges), then the seven-pay premium might be $10,000 in this example, unintentionally permitting policyholders to engage in a series of “material changes” to circumvent the premium limitations in section 7702A. The Act clarifies section 7702A(c)(3)(A) to refer to the cash surrender value of the old contract, effective as if enacted with the Technical and Miscellaneous Revenue Act of 1988 (generally, for contracts entered into on or after June 21, 1988).

Worthless securities. Section 165(g)(3) provides a special rule for worthless securities of an affiliated corporation. The test for affiliation in section 165(g)(3)(A) is the 80 percent vote test for affiliated groups under section 1504(a) that was in effect prior to 1984. When section 1504(a) was amended in the Deficit Reduction Act of 1984 to adopt the vote and value test of present law, no corresponding change was made to section 165(g)(3)(A), even though the tests had been identical until then. The Act conforms the affiliation test of section 165(g)(3)(A) to the test in section 1504(a)(2), effective for taxable years beginning after December 31, 1984.

Exception for certain annuities under OID rules. The Deficit Reduction Act of 1984 expanded the prior law rules for inclusion in income of original issue discount (“OID”) on debt instruments. It provided an exception from the definition of a debt instrument for certain annuity contracts, including any annuity contract to which section 72 applies and that is issued by an insurance company subject to tax under subchapter L of the Code (and that meets certain other requirements). (See sec. 1275(a)(1)(B)(ii).) The Act clarifies that an annuity contract otherwise meeting the applicable requirements also comes within the exception of section 1275(a)(1)(B)(ii) if it is issued by an entity described in section 501(c) and exempt from tax under section 501(a), that would be subject to tax as an insurance company under subchapter L if it were not exempt under section 501(a). For example, the Act clarifies that an annuity contract otherwise meeting the requirements that is issued by a fraternal beneficiary society which is exempt from federal income tax under section 501(a), and which is described in section 501(c)(8), comes within the exception under section 1275(a)(1)(B)(ii). It is understood that charitable gift annuities (as defined in sec. 501(m)) depend (in whole or in substantial part) on the life expectancy of one or more individuals, and thus come within the exception under section 1275(a)(1)(B)(i). This provision of the Act is effective as if included with section 41 of the Deficit Reduction Act of 1984 (i.e., for taxable years ending after July 18, 1984).

Losses from section 1256 contracts. Section 6411 allows tentative refunds for NOL carrybacks, business credit carrybacks and, for corporations only, capital loss carrybacks. Individuals normally cannot carry back a capital loss. However, section 1212(c) does allow a carryback of section 1256 losses, if elected by the taxpayer. The Act amends section 6411(a) by including a reference to section 1212(c), effective as if included with section 504 of the Economic Recovery Tax Act of 1981.

Highway Trust Fund. The Act modifies administrative procedures of the Highway Trust Fund to conform to the 1993 repeal of the special tax rate applicable to ethanol prior to 1994. The provision of the Act is effective for taxes received after December 21, 2000. This ensures that retroactive adjustments, if any, are not made to the Highway Trust Fund.

Conforming amendment for expenditures from Vaccine Injury Compensation Trust Fund. The Act makes a conforming amendment to the expenditure purposes of the Vaccine Injury Compensation Trust Fund to enable certain payments to be made from the Trust Fund.

<u>California Law</u> (Secs. 17020.6, 17131, 18031, 18151, 18177, 18649, 24990, and 24991)

California law is in conformity with federal law as it read on January 1, 1998, as it relates to insurance contracts, worthless securities, annuities under OID rules, and losses from section 1256 contracts. California law has not conformed to the changes made to the IRC by the Consolidated Appropriations Act, 2001.

FTB does not administer funds comparable to the federal Highway Trust Fund or Vaccine Injury Compensation Trust Fund.

<u>Impact on California Revenue</u>

No impact, clerical changes.

Clerical Changes

The Act makes a number of clerical and typographical amendments to the Code.

Consolidated Appropriations Act, 2001
(P.L. 106-554)

Section	Section Title
401	Tax Treatment Of Securities Futures Contracts

Background

Generally, gain or loss from the sale of property, including stock, is recognized at the time of sale or other disposition of the property, unless there is a specific statutory provision of nonrecognition (sec. 1001).

Gains and losses from the sale or exchange of capital assets are subject to special rules. In the case of individuals, net capital gain is generally subject to a maximum tax rate of 20% (sec. 1(h)). Net capital gain is the excess of net long-term capital gains over net short-term capital losses. Also, capital losses are allowed only to the extent of capital gains plus, in the case of individuals, $3,000 (sec. 1211). Capital losses of individuals may be carried forward indefinitely and capital losses of corporations may be carried back three years and forward five years (sec. 1212).

Generally, in order for gains or losses on a sale or exchange of a capital asset to be long-term capital gains or losses, the asset must be held for more than one year (sec. 1222). A capital asset generally includes all property held by the taxpayer, except certain enumerated types of property such as inventory (sec. 1221).

Section 1256 Contracts

Special rules apply to “section 1256 contracts,” which include regulated futures contracts, certain foreign currency contracts, nonequity options, and dealer equity options. Each section 1256 contract is treated as if it were sold (and repurchased) for its fair market value on the last business day of the year (i.e., “marked to market”). Any gain or loss with respect to a section 1256 contract that is subject to the mark-to-market rule is treated as if 40% of the gain or loss were short-term capital gain or loss and 60% were long-term capital gain or loss. This results in a maximum rate of 27.84% on any gain for taxpayers other than corporations. The mark-to-market rule (and the special 60/40 capital treatment) is inapplicable to hedging transactions.

A “regulated futures contract” is a contract (1) which is traded on or subject to the rules of a national securities exchange registered with the Securities Exchange Commission, a domestic board of trade designated a contract market by the Commodities Futures Trading Commission, or similar exchange, board of trade, or market, and (2) with respect to which the amount required to be deposited and which may be withdrawn depends on a system of marking to market.

A “dealer equity option” means, with respect to an options dealer, an equity option purchased in the normal course of the activity of dealing in options and listed on the qualified board or exchange on which the options dealer is registered. An equity option is an option to buy or sell stock or an option the value of which is determined by reference to any stock, group of stocks, or stock index, other than an option on certain broad-based groups of stock or stock index. An options dealer is any person who is registered with an appropriate national securities exchange

as a market maker or specialist in listed options, or whom the Secretary of the Treasury determines performs functions similar to market makers and specialists.

Mark to Market Accounting for Dealers in Securities

Previously, a dealer in securities computed its income from dealing in securities pursuant to the mark-to-market method of accounting (sec. 475). Gains and losses are treated as ordinary income and loss. Traders in securities, and dealers and traders in commodities may elect to use this method of accounting, including the ordinary income treatment. Section 1256 contracts are not treated as securities for purposes of section 475.

Short Sales

In the case of a "short sale" (i.e., where the taxpayer sells borrowed property and later closes the sale by repaying the lender with substantially identical property), any gain or loss on the closing transaction is considered gain or loss from the sale or exchange of a capital asset if the property used to close the short sale is a capital asset in the hands of the taxpayer, but the gain is ordinarily treated as short-term gain (sec. 1233(a)).

The Internal Revenue Code (the "Code") also contains several rules intended to prevent the transformation of short-term capital gain into long-term capital gain or long-term capital loss into short-term loss by simultaneously holding property and selling short substantially identical property (sec. 1233(b) and (d)). Under these rules, if a taxpayer holds property for less than the long-term holding period and sells short substantially identical property, any gain or loss upon the closing of the short sale is considered short-term capital gain, and the holding period of the substantially identical property is generally considered to begin on the date of the closing of the short sale. Also, if a taxpayer has held property for more than the long-term holding period and sells short substantially identical property, any loss on the closing of the short sale is considered a long-term capital loss.

For purposes of these short sale rules, property includes stock, securities, and commodity futures, but commodity futures are not considered substantially identical if they call for delivery in different months.

For purposes of the short-sale rules relating to short-term gains, the acquisition of an option to sell at a fixed price is treated as a short sale, and the exercise or failure to exercise the option is considered a closing of the short sale.

The Code also treats a taxpayer as recognizing gain where the taxpayer holds appreciated property and enters into a short sale of the same or substantially identical property, or enters into a contract to sell that same or substantially identical property (sec. 1259).

Wash Sales

The wash-sale rule (sec. 1091) disallows certain losses from the disposition of stock or securities if substantially identical stock or securities (or an option or contract to acquire such

property) are acquired by the taxpayer during the period beginning 30 days before the date of sale and ending 30 days after such date of sale. Commodity futures are not treated as stock or securities for purposes of this rule. The basis of the substantially identical stock or securities is adjusted to include the disallowed loss.

Similar rules apply to disallow any loss realized on the closing of a short sale of stock or securities where substantially identical stock or securities are sold (or a short sale, option or contract to sell is entered into) during the applicable period before and after the closing of the short sale.

Straddle Rules

If a taxpayer realizes a loss with respect to a position in a straddle, the taxpayer may recognize that loss for the taxable year only to the extent that the loss exceeds the unrecognized gain (if any) with respect to offsetting positions in the straddle (sec. 1092). Disallowed losses are carried forward to the succeeding taxable year and are subject to the same limitation in that taxable year.

A “straddle” generally refers to offsetting positions with respect to actively traded personal property. Positions are offsetting if there is a substantial diminution of risk of loss from holding one position by reason of holding one or more other positions in personal property. A “position” in personal property is an interest (including a futures or forward contract or option) in personal property.

The straddle rules provide that the Secretary of the Treasury may issue regulations applying the short sale holding period rules to positions in a straddle. Temporary regulations have been issued setting forth the holding period rules applicable to positions in a straddle. To the extent these rules apply to a position, the rules in section 1233(b) and (d) do not apply.

The straddle rules generally do not apply to positions in stock. However the straddle rules apply if one of the positions is stock and at least one of the offsetting positions is either (1) an option with respect to stock or (2) a position with respect to substantially similar or related property (other than stock) as defined in Treasury regulations. Under proposed Treasury regulations, a position with respect to substantially similar or related property does not include stock or a short sale of stock, but includes any other position with respect to substantially similar or related property.

If a straddle consists of both positions that are section 1256 contracts and positions that are not such contracts, the taxpayer may designate the positions as a mixed straddle. Positions in a mixed straddle are not subject to the mark-to-market rule of section 1256, but instead are subject to rules written under regulations to prevent the deferral of tax or the conversion of short-term capital gain to long-term capital gain or long-term capital loss into short-term capital loss.

Transactions by a Corporation in its Own Stock

A corporation does not recognize gain or loss on the receipt of money or other property in exchange for its own stock. Likewise, a corporation does not recognize gain or loss when it redeems its stock with cash, for more or less than it received when the stock was issued. In addition, a corporation does not recognize gain or loss on any lapse or acquisition or an option to buy or sell its stock (sec. 1032).

New Federal Law (Secs. 1234B and 1256)

Except in the case of dealer securities futures contracts described below, securities futures contracts are not treated as section 1256 contracts. Thus, holders of these contracts are not subject to the mark-to-market rules of section 1256 and are not eligible for 60-percent long-term capital gain treatment under section 1256. Instead, gain or loss on these contracts will be recognized under the general rules relating to the disposition of property.

A securities futures contract is defined by reference to section 3(a)(55)(A) of the Securities Exchange Act of 1934, and is added by the Act to the Code. In general, that definition provides that a securities futures contract means a contract of sale for future delivery of a single security or a narrow-based security index. A securities futures contract will not be treated as a commodities futures contract for purposes of the Code.

Treatment of Gains and Losses

The Act provides that any gain or loss from the sale or exchange of a securities futures contract (other than a dealer securities futures contract) will be considered as gain or loss from the sale or exchange of property which has the same character as the property to which the contract relates has (or would have) in the hands of the taxpayer. Thus, if the underlying security would be a capital asset in the taxpayer's hands, then gain or loss from the sale or exchange of the securities futures contract would be capital gain or loss. The Act also provides that the termination of a securities futures contract that is a capital asset will be treated as a sale or exchange of the contract.

Capital gain treatment will not apply to contracts which themselves are not capital assets because of the exceptions to the definition of a capital asset relating to inventory (sec. 1221(a)(1)) or hedging (sec. 1221(a)(7)), or to any income derived in connection with a contract which would otherwise be treated as ordinary income.

Except as otherwise provided in regulations under section 1092(b) (which treats certain losses from a straddle as long term capital losses) and section 1234B, as added by the Act, any capital gain or loss from the sale or exchange of a securities futures contract to sell property (i.e., the short side of a securities futures contract) will be short-term capital gain or loss. In other words, a securities futures contract to sell property is treated as equivalent to a short sale of the underlying property.

Consolidated Appropriations Act, 2001
(P.L. 106-554)

Wash Sale Rules

The Act clarifies that, under the wash sale rules, a contract or option to acquire or sell stock or securities shall include options and contracts that are (or may be) settled in cash or property other than the stock or securities to which the contract relates. Thus, for example, the acquisition, within the period set forth in section 1091, of a securities futures contract to acquire stock of a corporation could cause the taxpayer's loss on the sale of stock in that corporation to be disallowed, notwithstanding that the contract may be settled in cash.

Short Sale Rules

In applying the short sale rules, a securities futures contract to acquire property will be treated in a manner similar to the property itself. Thus, for example, the holding of a securities futures contract to acquire property and the short sale of property that is substantially identical to the property under the contract will result in the application of the rules of section 1233(b). In addition, as stated above, a securities futures contract to sell is treated in a manner similar to a short sale of the property.

Straddle Rules

Stock that is part of a straddle where at least one of the offsetting positions is a securities futures contract with respect to the stock or substantially identical stock will be subject to the straddle rules of section 1092. Treasury regulations under section 1092 applying the principles of the section 1233(b) and (d) short sale rules to positions in a straddle will also apply.

For example, assume a taxpayer holds a long-term position in actively traded stock (which is a capital asset in the taxpayer's hands) and enters into a securities futures contract to sell substantially identical stock (at a time when the position in the stock has not appreciated in value so that the constructive sale rules of section 1259 do not apply). The taxpayer has a straddle. Treasury regulations prescribed under section 1092(b) applying the principles of section 1233(d) will apply, so that any loss on closing the securities futures contract will be a long-term capital loss.

Section 1032

A corporation will not recognize gain or loss on transactions in securities futures contracts with respect to its own stock.

Holding Period

If property is delivered in satisfaction of a securities futures contract to acquire property (other than a contract to which section 1256 applies), the holding period for the property will include the period the taxpayer held the contract, provided that the contract was a capital asset in the hands of the taxpayer.

Regulations

The Secretary of the Treasury or his delegate has the authority to prescribe regulations to provide for the proper treatment of securities futures contracts under provisions of the Internal Revenue Code.

Dealers in Securities Futures Contracts

In general, the Act provides that securities futures contracts and options on such contracts are not section 1256 contracts. The Act provides, however, that "dealer securities futures contracts" will be treated as section 1256 contracts.

The term ''dealer securities futures contract" means a securities futures contract which is entered into by a dealer in the normal course of his or her trade or business activity of dealing in such contracts, and is traded on a qualified board of trade or exchange. The term also includes any option to enter into securities futures contracts purchased or granted by a dealer in the normal course of his or her trade or business activity of dealing in such options. The determination of who is to be treated as a dealer in securities futures contracts is to be made by the Secretary of the Treasury or his delegate not later than July 1, 2001. Accordingly, the Act authorizes the Secretary to treat a person as a dealer in securities futures contracts or options on such contracts if the Secretary determines that the person performs, with respect to such contracts or options, functions similar to an equity options dealer, as defined under present law.

The determination of who is a dealer in securities futures contracts is to be made in a manner that is appropriate to carry out the purposes of the provision, which generally is to provide comparable tax treatment between dealers in securities futures contracts, on the one hand, and dealers in equity options, on the other. Although traders in securities futures contracts (and options on such contracts) may not have the same market-making obligations as market makers or specialists in equity options, many traders are expected to perform analogous functions to such market makers or specialists by providing market liquidity for securities futures contracts (and options) even in the absence of a legal obligation to do so. Accordingly, the absence of market-making obligations is not inconsistent with a determination that a class of traders are dealers in securities futures contracts (and options), if the relevant factors, including providing market liquidity for such contracts (and options), indicate that the market functions of the traders is comparable to that of equity options dealers.

As in the case of dealer equity options, gains and losses allocated to any limited partner or limited entrepreneur with respect to a dealer securities futures contract will be treated as short-term capital gain or loss.

Treatment of Options Under Section 1256

The Act modifies the definition of "equity option" for purposes of section 1256 to take into account changes made by the non-tax provisions of the Act. Only options dealers are eligible for section 1256 with respect to equity options. The term "equity option" is modified to include an option to buy or sell stock, or an option the value of which is determined, directly or indirectly, by

reference to any stock, or any "narrow-based security index," as defined in section 3(a)(55) of the Securities Exchange Act of 1934 (as modified by the Act). An equity option includes an option with respect to a group of stocks only if the group meets the requirements for a narrow based security index.

As under present law, listed options that are not "equity options" are considered "nonequity options" to which section 1256 applies for all taxpayers. For example, options relating to broad-based groups of stocks and broad based stock indexes will continue to be treated as nonequity options under section 1256.

Definition of Contract Markets

The non-tax provisions of the Act designate certain new contract markets. The new contract markets will be contract markets for purposes of the Code, except to the extent provided in Treasury regulations.

Effective Date

These provisions take effect on December 21, 2000.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to securities futures contracts. California law has not conformed to the changes made to the IRC by the Consolidated Appropriations Act, 2001.

Impact on California Revenue

Based on federal estimates of inconsequential revenue effects for this provision in the Consolidated Appropriations Act of 2001, conforming to the provision would result in negligible revenue effects for state tax purposes.

Installment Tax Correction Act of 2000
(P. L. 106-573)

Section	Section Title
2	Repeal of Modification of Installment Method

Background

Effective for dispositions on or after December 17, 1999, federal law prohibited the use of the installment method of accounting for a transaction that would otherwise be required to be reported using the accrual method of accounting. The pledge rule generally provides that if an installment obligation is pledged as security for any debt, the net proceeds of the debt are treated as a payment on the obligation, triggering the recognition of income. A 1999 modification to the pledge rule provides that the right to satisfy a loan with an installment obligation is treated as a pledge of the installment obligation, effective for dispositions on or after December 17, 1999.

New Federal Law (Sec. 455)

The Act repeals the prohibition on the use of the installment method of accounting for dispositions of property that would otherwise be required to be reported using the accrual method of accounting. The Act leaves unchanged the 1999 modification to the pledge rule.

Effective Date

This provision is effective for sales or dispositions occurring on or after December 17, 1999.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to installment sales. California law has not conformed to the 1999 federal changes. Therefore, California is in conformity regarding who may use the installment of accounting but not in conformity with respect to the 1999 federal modification to the pledge rule.

Impact on California Revenue

No impact.

EXHIBIT A

EXPIRING TAX PROVISIONS

Calif. Sunset*	Calif. Section	Federal Section	Fed. Sect.	Description and Comments
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
12/31/01	18704	N/A	N/A	Voluntary Contribution: National World War II Veterans Memorial Fund
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	18844	N/A	N/A	Voluntary Contribution: California Military Museum Fund
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	17052.17 23638	N/A	N/A	Employer Child Care Facility Credit
12/31/02	17052.18 23617.5	N/A	N/A	Employer Dependent Care Plan Credit
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
12/01/03	18855	N/A	N/A	Voluntary Contribution: Emergency Food Assistance Program

EXHIBIT A

EXPIRING TAX PROVISIONS

Calif. Sunset*	Calif. Section	Federal Section	Fed. Sect.	Description and Comments
12/31/04	18724	N/A	N/A	Voluntary Contribution: California Fund for Senior Citizens
12/31/04	18766	N/A	N/A	Voluntary Contribution: Alzheimer's Disease and Related Disorders Research Fund
12/01/04	18824	N/A	N/A	Voluntary Contribution: Mexican American Veterans' Memorial Account
12/31/04	18835	N/A	N/A	Voluntary Contribution: California Lung Disease & Asthma Research Fund
12/31/04	18865	N/A	N/A	Voluntary Contribution: Birth Defects Research Fund
13/31/05	18804	N/A	N/A	Voluntary Contribution: California Firefighter Memorial Fund
12/31/05	18807	N/A	N/A	Voluntary Contribution: California Peace Officer Memorial Fund
12/31/05	21028	Title 31	Perm.	Taxpayer's Bill of Rights: Attorney Client Privilege
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

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 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) designates an area as a LAMBRA. The TCA is authorized to designate eight LAMBRAs in the state. As of January 2000, three areas have been designated and the remaining five sites have received conditional designations. The expiration date listed for LAMBRAs is the earliest date the tax preferences or incentives will expire.

EXHIBIT B
REVENUE TABLE

Act Section	Act Title	Comments	(in millions) 2001-02	2002-03	2003-04
1001	Extension of expenditure authority	N/A			
601	Provide Waiver from Denial of Foreign Tax Credits	N/A			
602	Accel. Rum Excise Tax Coverover Payments	N/A			
1-2	527 Organizations, Notification & Disclosure	N/A			
3	527 Organizations, Return Requirements		Minor Gain	Minor Gain	Minor Gain
1-5	FSC Repeal & Income Exclusion	N/A			
101-102	Renewal Community Provisions	N/A			
111-115	Extension and Expansion of Empowerment Zones	N/A			
116	Rollover of Gain from the Sale of Qualified EZ Investments	N/A			
117	Exclusion of Gain - EZ	N/A			
121	New Markets Tax Credit	N/A			
131-137	Low Income Housing Credit	(a)	No Impact	No Impact	No Impact
151	Accelerate Scheduled Increase in State Volume Limits on Tax Exempt Private Activity Bonds	N/A			
152	Environmental Remediation		($4)	($8)	($6)
153	Expansion of D.C. Homebuyer Tax Credit	N/A			
154	Extension of D.C. Enterprise Zone	N/A			
155	Corporate Donation of Computers		($6)	($4)	($2)
156	Treatment of Indian Tribes as Non-Profits and State or Local Government For FUTA	Defer to EDD			
201	Medical Savings Accounts		Neg.Loss	Neg.Loss	Neg.Loss
301	Exempt Certain Reports From Elimination Under Federal Reports	N/A			
302	Extension of Deadlines for IRS Compliance with Certain Notice Requirements	N/A			
303	Ext. of Authority for Undercover Operations	N/A			
304	Competent Authority and Pre-Filing Agreements	N/A			
305	Incr.JCT Refund Review Threshold to $2 Mill.	N/A			
306	Tax Benefits - Kidnapped Children		Neg.Loss	Neg.Loss	Neg.Loss
307	Conforming Changes To Accommodate Reduced Issuances of Certain Treasury Securities	N/A			
308	Authorization of Agencies to Use Corrected Consumer Price Index	N/A			
309	Assumption of Liabilities - Corporations		Minor Loss	Minor Loss	($1)
310	Discl.of Return Info to Congressional Budget	N/A			
311-319	Tax Technical Corrections				
	Ticket to Work and Work Incentives Improv. Act	N/A			
	Tax and Trade Relief Extension Act of 1998	N/A			
	Taxpayer Relief Act of 1997	Defer to SBE/ EDD			
	Small Business Job Protection Act of 1996		Neg.Gain	Neg.Gain	Neg.Gain
	Revenue Reconciliation Act of 1990	(b)	No Impact	No Impact	No Impact
	Other Acts	(b)	No Impact	No Impact	No Impact
401	Securities Futures Contracts	(c)	Neg. Impact	Neg. Impact	Neg. Impact
2	Repeal of Modification of Installment Method	N/A			
	Totals		($10)	($12)	($9)

EXHIBIT B
REVENUE TABLE

* Assumes enactment after June 30, 2001.
N/A – Not Applicable.
Neg – Negligible loss (or gain) less than $250,000 annually.
Minor – Loss (or gain) less than $500,000 annually.

(a) No impact due to the fact that the California Tax Allocation Committee already allocates entire amount of credit available.
(b) No impact, clerical change or clarification.
(c) Based on federal estimate of "Negligible Revenue Effect".

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