California
Franchise
Tax
Board

SUMMARY OF FEDERAL INCOME TAX CHANGES ---- 2001

Laws Affected:

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

SUMMARY OF FEDERAL INCOME TAX CHANGES 2001

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 - 2001
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Executive Summary

During 2001, the Internal Revenue Code or its application was changed by:

PUBLIC LAW	TITLE
107-15	Fallen Hero Survivor Benefit Fairness Act of 2001
107-16	Economic Growth & Tax Relief Act of 2001
107-22	Rename Education IRA to Coverdell Education Savings Account

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 2002.

Calif. Sunset	Calif. Section	Federal Sunset	Fed. Sect.	Description and Comments
12/31/02	18704	N/A	N/A	Voluntary Contribution: National World War II Veterans Memorial Fund
12/31/02	17053.45 23645	N/A	N/A	Credit: Sales and Use taxes Paid in the LA Revitalization Zone
12/31/02[1]	17053.46 23646	N/A	N/A	Credit: Hiring in the Local Agency Military Base Recovery Area
12/31/02[1]	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 Species Preservation Program

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

Fallen Hero Survivor Benefit Fairness Act Of 2001
(P.L. 107-15)

Section	Section Title
2	EXTENSION OF PRESENT LAW TREATMENT OF SURVIVOR ANNUITIES WITH RESPECT TO CERTAIN PUBLIC SAFETY OFFICERS KILLED IN THE LINE OF DUTY

BACKGROUND

The Taxpayer Relief Act of 1997 (TRA of 1997) provided that an amount paid as a survivor annuity on account of the death of a public safety officer who is killed in the line of duty is excludable from income to the extent the survivor annuity is attributable to the officer's service as a law enforcement officer. The survivor annuity must be provided under a governmental plan to the surviving spouse (or former spouse) of the public safety officer or to a child of the officer. Public safety officers include law enforcement officers, firefighters, rescue squad or ambulance crew. The provision does not apply with respect to the death of a public safety officer if it is determined by the appropriate supervising authority that (1) the death was caused by the intentional misconduct of the officer or by the officer's intention to bring about the death, (2) the officer was voluntarily intoxicated at the time of death, (3) the officer was performing his or her duties in a grossly negligent manner at the time of death, or (4) the actions of the individual to whom payment is to be made were a substantial contributing factor to the death of the officer. The TRA of 1997 provision applies to amounts received in taxable years beginning after December 31, 1996, with respect to individuals dying after that date.

New Federal Law

The bill extends the present-law treatment of survivor annuities with respect to public safety officers killed in the line of duty with respect to individuals dying on or before December 31, 1996.

Effective Date

The provision is effective with respect to payments received after December 31, 2001.

California Law

California has conformed to the TRA of 1997 federal law changes as its relates to an amount paid as a survivor annuity on account of the death of a public safety officer. California has not conformed to the 2001 federal law change.

Impact on California Revenue

The revenue loss associated with this proposal is projected to be minor, less than $500,000 annually, beginning in 2002-03.

<u>Section</u>	<u>Section Title</u>
101	MARGINAL TAX RATE REDUCTION - INDIVIDUAL INCOME TAX RATE STRUCTURE

<u>Background</u>

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

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

Regular income tax liability

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

For 2001, the regular income tax rate schedules for individuals are shown in Table 1, below. The rate bracket breakpoints for married individuals filing separate returns are exactly one-half of the rate brackets for married individuals filing joint returns. A separate, compressed rate schedule applies to estates and trusts.

INDIVIDUAL REGULAR INCOME TAX RATES FOR 2001

Single individuals

Taxable income is over:	But not over:	Then regular income tax equals
$0	$27,050	15% of taxable income
$27,050	$65,550	$4,057.50, plus 28% of the amount over $27,050
$65,550	$136,750	$14,837.50, plus 31% of the amount over $65,550
$136,750	$297,350	$36,909.50, plus 36% of the amount over $136,750
Over $297,350		$94,725.50, plus 39.6% of the amount over $297,350

Heads of households

Taxable income is over:	But not over:	Then regular income tax equals
$0	$36,250	15% of taxable income
$36,250	$93,650	$5,437.50, plus 28% of the amount over $36,25
$93,650	$151,650	$21,509.50, plus 31% of the amount over $93,65
$151,650	$297,350	$39,489.50, plus 36% of the amount over $151,65

Over $297,350		$91,941.50, plus 39.6% of the amount over $297,350

Married individuals filing joint returns

Taxable income is over:	But not over:	Then regular income tax equals:
$0	$45,200	15% of taxable income
$45,200	$109,250	$6,780.00, plus 28% of the amount over $45,200
$109,250	$166,500	$24,714.50, plus 31% of the amount over $109,250
$166,500	$297,350	$42,461.50, plus 36% of the amount over $166,500
Over $297,350		$89,567.50, plus 39.6% of the amount over $297,350

New Federal Law (IRC. Sec. 1)

In general

The Act creates a new 10% regular income tax bracket for a portion of taxable income that is currently taxed at 15%, effective for taxable years beginning after December 31, 2000. The Act also reduces the other regular income tax rates, effective July 1, 2001. By 2006, the present-law regular income tax rates (28%, 31%, 36% and 39.6%) will be lowered to 25%, 28%, 33%, and 35%, respectively.

New low-rate bracket

The Act establishes a new 10% income tax rate bracket for a portion of taxable income that is currently taxed at 15%. The 10% rate bracket applies to the first $6,000 of taxable income for single individuals, $10,000 of taxable income for heads of households, and $12,000 for married couples filing joint returns. This $6,000 increases to $7,000 and this $12,000 increases to $14,000 for 2008 and thereafter.

The taxable income levels for the new low-rate bracket will be adjusted annually for inflation for taxable years beginning after December 31, 2008. The new low-rate bracket for joint returns and head of household returns will be rounded down to the nearest $50. The bracket for single individuals and married individuals filing separately will be one-half for joint returns (after adjustment of that bracket for inflation).

Rate reduction credit for 2001

The Act includes a rate reduction credit for 2001 to more immediately achieve one of the purposes behind the new bottom rate bracket for 2001. The Act utilizes this credit mechanism (and the issuance of checks described below) because it will deliver economic stimulus to the economy more rapidly than would implementation of a new 10% rate bracket, even if that were accompanied by an immediate implementation of new wage withholding tables. Accordingly, this rate reduction credit operates in lieu of the new 10% income tax rate bracket for 2001.

This credit is computed in the following manner. Taxpayers would be entitled to a credit in tax year 2001 of 5% (the difference between the 15% rate and the 10% rate) of the amount of income that would have been eligible for the new 10% rate. Taxpayers may not receive a credit in excess of their income tax liability (determined after nonrefundable credits).

Most taxpayers will receive this credit in the form of a check issued by the Department of the Treasury. The amount of the check would be computed in the same manner as the credit, except that it will be done on the basis of tax returns filed for 2000 (instead of 2001). The Department of the Treasury is to make every effort to issue all checks before October 1, 2001, to taxpayers who timely filed their 2000 tax returns. Taxpayers who filed late or pursuant to extensions will receive their checks later in the fall.

Taxpayers would reconcile the amount of the credit with the check they receive in the following manner. They would complete a worksheet calculating the amount of the credit based on their 2001 tax return. They would then subtract from the credit the amount of the check they received. For many taxpayers, these two amounts would be the same. If, however, the result is a positive number (because, for example, the taxpayer paid no tax in 2000 but is paying tax in 2001), the taxpayer may claim that amount as a credit against 2001-tax liability. If, however, the result is negative (because, for example, the taxpayer paid tax in 2000 but owes no tax for 2001), the taxpayer is not required to repay that amount to the Treasury. Otherwise, the checks have no effect on tax returns filed in 2001; the amount is not includible in gross income and it does not otherwise reduce the amount of withholding. In no event may the Department of the Treasury issue checks after December 31, 2001. This is designed to prevent errors by taxpayers who might claim the full amount of the credit on their 2001 tax returns and file those returns early in 2002; at the same time the Treasury check might be mailed to them. Payment of the credit (or the check) is treated, for all purposes of the Code, as a payment of tax. As such, the credit or the check is subject to the refund-offset provisions, such as those applicable to past-due child support under section 6402 of the Code.

In general, taxpayers eligible for the credit (and the check) are individuals other than estates or trusts, nonresident aliens, or dependents. The determination of this status for the relevant year is made on the basis of the information filed on the tax return.

In light of the large number of checks that are being issued, the issuance of checks will take several months. Accordingly, no interest will be paid with respect to these checks. The checks will be issued in the order of the last two digits of the taxpayer identification number (which is generally a taxpayer's social security number), from lowest to highest. Payment by check is the only mechanism for receiving the payment prior to filing the 2001 tax return; taxpayers may not file either amended returns or claims for tentative refunds for tax year 2000 to claim these amounts.

The IRS will send notices to taxpayers. The notices will inform taxpayers of the computation of their checks and the approximate date by which they can expect to receive their check. This information should decrease the number of telephone calls made by taxpayers to the IRS inquiring when their check will be issued.

Modification of 15% bracket

The 15% regular income tax bracket is modified to begin at the end of the new low-rate regular income tax bracket. The 15% regular income tax bracket ends at the same level as under present law. The Act also makes other changes to the 15% rate bracket. (Including marriage penalty relief discussed below.)

Reduction of other rates and consolidation of rate brackets

The present-law regular income tax rates of 28%, 31%, 36%, and 39.6% are phased down over six years to 25%, 28%, 33%, and 35%, effective after June 30, 2001. Accordingly, for taxable years beginning during 2001, the rate reduction will come in the form of a blended tax rate. The taxable income levels for the new rates in all taxable years are the same as the taxable income levels that apply under the present-law rates.

The below table shows the schedule of regular income tax rate reductions.

REGULAR INCOME TAX RATE REDUCTIONS

Calendar year	28% rate reduced to	31% rate reduced to	36% rate reduced to	39.6% rate reduced to:
2001-2003	27%	30%	35%	38.6%
2004-2005	26%	29%	34%	37.6%
2006 and later	25%	28%	33%	35%

Projected regular income tax rate schedules under the Act

The table below shows the projected individual regular income tax rate schedules when the rate reductions are fully phased in (i.e., for 2006). As under present law, the rate brackets for married taxpayers filing separate returns under the bill are one half the rate brackets for married individuals filing joint returns. In addition, appropriate adjustments are made to the separate, compressed rate schedule for estates and trusts.

INDIVIDUAL REGULAR INCOME TAX RATES FOR 2006 (PROJECTED)

Single individuals

If taxable income is:	But not over:	Then regular income tax equals:
$0	$6,000	10% of taxable income
$6,000	$30,950	$600, plus 15% of the amount over $6,000
$30,950	$74,950	$4,342.50, plus 25% of the amount over $30,950
$74,950	$156,300	$15,342.50, plus 28% of the amount over $74,950
$156,300	$339,850	$38,120.50, plus 33% of the amount over $156,300
Over $339,850		$98,692, plus 35% of the amount over $339,850

Heads of households

If taxable income is:	But not over:	Then regular income tax equals:
$0	$10,000	10% of taxable income
$10,000	$41,450	$1,000, plus 15% of the amount over $10,000
$41,450	$107,000	$5,717.50, plus 25% of the amount over $41,450

$107,000	$173,300	$22,105, plus 28% of the amount over $107,000
$173,300	$339,850	$40,669, plus 33% of the amount over $173,300
Over $339,850		$95,630.50, plus 35% of the amount over $339,850

Married individuals filing joint returns

If taxable income is:	But not over:	Then regular income tax equals:
$0	$12,000	10% of taxable income
$12,000	$57,850	$1,200, plus 15% of the amount over $12,000
$57,850	$124,900	$8,077.50, plus 25% of the amount over $57,850
$124,900	$190,300	$24,840, plus 28% of the amount over $124,900
$190,300	$339,850	$43,152, plus 33% of the amount over $190,300
Over $339,850		$92,503.50, plus 35% of the amount over $339,850

The end point of the 15% rate bracket for married individuals filing joint returns also reflects the phase-in of the increase in the size of the 15% bracket discussed under the marriage penalty relief below.

Revised wage withholding for 2001

The Secretary is to make appropriate revisions to the wage withholding tables to reflect the rate reduction that will be effective beginning July 1, 2001, as expeditiously as possible.

Effective Date

The provisions of this section generally apply to taxable years beginning after December 31, 2000. The reductions in the tax rates, other than the new 10% rate, are effective after June 30, 2001. The conforming amendments to certain withholding provisions under the bill are effective for amounts paid more than 60 days after June 7, 2001.

California Law

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

Impact on California Revenue

Not applicable.

Section	Section Title
102	INCREASE STARTING POINT FOR PHASE-OUT OF ITEMIZED DEDUCTIONS.

Background

Taxpayers may choose to claim either the basic standard deduction (and additional standard deductions, if applicable) or itemized deductions (subject to certain limitations) for certain expenses incurred during the taxable year. Among these deductible expenses are unreimbursed medical expenses, investment interest, casualty and theft losses, wagering losses, charitable contributions, qualified residence interest, state and local income and property taxes, unreimbursed employee business expenses, and certain other miscellaneous expenses

The total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) is reduced by 3% of the amount of the taxpayer's adjusted gross income in excess of $132,950 in 2001 ($66,475 for married couples filing separate returns). These amounts are adjusted annually for inflation. In computing this reduction of total itemized deductions, all present-law limitations applicable to such deductions (such as the separate floors) are first applied and, then, the otherwise allowable total amount of itemized deductions is reduced in accordance with this provision. Under this provision, the otherwise allowable itemized deductions may not be reduced by more than 80%.

New Federal Law (IRC. Sec. 68)

The Act repeals the overall limitation on itemized deductions for all taxpayers. The repeal is phased-in over five years, as follows. The otherwise applicable overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009.

The overall limitation is repealed for taxable years beginning after December 31, 2009.

Effective Date

The provision is effective for taxable years beginning after December 31, 2005.

California Law

California phases out itemized deductions using federal rules but has higher threshold amounts. For the 2001 year, California's AGI phase-out threshold for married filing joint taxpayers is $261,664(versus the federal amount of $132,950.) California law provides for the AGI threshold for adjusted annually for inflation. California has not conformed to the eventual repeal of the itemized deduction phase-out provision.

Impact on California Revenue

The start of the repeal of these currently phased-out provisions for certain higher income filers (i.e. itemized deductions and exemption allowances) does not begin until 2006 and is cast in yearly stages until fully repealed by 2010. This time period is well beyond the initial impact years provided above for all conformity estimates. More time is needed to develop meaningful conformity estimates for 2006 through 2010.

Section	Section Title
103	PHASE-OUT OF SPECIAL RULES FOR PERSONAL EXEMPTIONS.

Background

In order to determine taxable income, an individual reduces adjusted gross income by any personal exemptions, deductions, and either the applicable standard deduction or itemized deductions. Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2001, the amount deductible for each personal exemption is $2,900. This amount is adjusted annually for inflation. The deduction for personal exemptions is phased-out ratably for taxpayers with adjusted gross income over certain thresholds. The applicable thresholds for 2001 are $132,950 for single individuals, $199,450 for married individuals filing a joint return, $166,200 for heads of households, and $99,725 for married individuals filing separate returns. These thresholds are adjusted annually for inflation.

The total amount of exemptions that may be claimed by a taxpayer is reduced by 2% for each $2,500 (or portion thereof) by which the taxpayer's adjusted gross income exceeds the applicable threshold. The phase-out rate is 2% for each $1,250 for married taxpayers filing separate returns. Thus, the personal exemptions claimed are phased-out over a $122,500 range ($61,250 for married taxpayers filing separate returns), beginning at the applicable threshold. The size of these phase-out ranges ($122,500/$61,250) is not adjusted for inflation.

For 2001, the point at which a taxpayer's personal exemptions are completely phased-out is $255,450 for single individuals, $321,950 for married individuals filing a joint return, $288,700 for heads of households, and $160,975 for married individuals filing separate returns.

New Federal Law (IRC. Sec. 151(d))

The Act repeals the personal exemptions phase-out. The Act provides for a five-year phase-in of the repeal of the personal exemption phase-out. Under the five-year phase-in, the otherwise applicable personal exemption phase-out is reduced by one-third in taxable years beginning in 2006 and 2007, and is reduced by two-thirds in taxable years beginning in 2008 and 2009. The repeal is fully effective for taxable years beginning after December 31, 2009.

Effective Date

The provision is effective for taxable years beginning after December 31, 2005.

California Law

California does not allow a personal exemption deduction, but instead allows a personal exemption credit. This credit is phased out using federal rules but with different AGI threshold amounts. For the 2001 year, California's exemption credit and the AGI phase-out threshold for married filing joint taxpayers is $158 and $261,664, respectively. California has not conformed to the eventual repeal of the personal exemption phase-out.

Impact on California Revenue

The start of the repeal of these currently phased-out provisions for certain higher income filers (i.e. itemized deductions and exemption allowances) does not begin until 2006 and is cast in yearly stages until fully repealed by 2010. This time period is well beyond the initial impact years provided above for all conformity estimates. More time is needed to develop meaningful conformity estimates for 2006 through 2010.

Section	Section Title
201	INCREASE AND EXPAND THE CHILD TAX CREDIT.

Background

In general

An individual may claim a $500 tax credit for each qualifying child under the age of 17. In general, a qualifying child is an individual for whom the taxpayer can claim a dependency exemption and who is the taxpayer's son or daughter (or descendent of either), stepson or stepdaughter, or eligible foster child.

The child tax credit is phased-out for individuals with income over certain thresholds. Specifically, the otherwise allowable child tax credit is reduced by $50 for each $1,000 (or fraction thereof) of modified adjusted gross income over $75,000 for single individuals or heads of households, $110,000 for married individuals filing joint returns, and $55,000 for married individuals filing separate returns. Modified adjusted gross income is the taxpayer's total gross income plus certain amounts excluded from gross income (i.e., excluded income of U.S. citizens or residents living abroad (sec. 911); residents of Guam, American Samoa, and the Northern Mariana Islands (sec. 931); and residents of Puerto Rico (sec. 933)). The length of the phase-out range depends on the number of qualifying children. For example, the phase-out range for a single individual with one qualifying child is between $75,000 and $85,000 of modified adjusted gross income. The phase-out range for a single individual with two qualifying children is between $75,000 and $95,000.

The child tax credit is not adjusted annually for inflation.

Refundability

In general, the child tax credit is nonrefundable. However, for families with three or more qualifying children, the child tax credit is refundable up to the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit.

Alternative minimum tax liability

An individual's alternative minimum tax liability reduces the amount of the refundable earned income credit and, for taxable years beginning after December 31, 2001, the amount of the refundable child credit for families with three or more children. This is known as the alternative minimum tax offset of refundable credits.

Through 2001, an individual generally may reduce his or her tentative alternative minimum tax liability by nonrefundable personal tax credits (such as the $500 child tax credit and the adoption tax credit). For taxable years beginning after December 31, 2001, nonrefundable personal tax credits may not reduce an individual's income tax liability below his or her tentative alternative minimum tax.

<u>New Federal Law</u> (IRC. Sec. 24)

In general

The Act increases the child tax credit to $1,000, phased-in over ten years, effective for taxable years beginning after December 31, 2000. The following table shows the phase-in increase of the child tax credit.

Increase of the Child Tax Credit

Calendar year	Credit amount per child
2001-2004	$600
2005-2008	$700
2009	$800
2010 and later	$1,000

Refundability.

The Act makes the child credit refundable to the extent of 10% of the taxpayer's earned income in excess of $10,000 for calendar years 2001-2004. The percentage is increased to 15% for calendar years 2005 and thereafter. The $10,000 amount is indexed for inflation beginning in 2002. Families with three or more children are allowed a refundable credit for the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit (the present-law rule), if that amount is greater than the refundable credit based on the taxpayer's earned income in excess of $10,000. The Act also provides that the refundable portion of the child credit does not constitute income and shall not be treated as resources for purposes of determining eligibility or the amount or nature of benefits or assistance under any federal, state or local program financed with federal funds.

Alternative minimum tax

The Act provides that the refundable child tax credit will no longer be reduced by the amount of the alternative minimum tax. In addition, the Act allows the child tax credit to the extent of the full amount of the individual's regular income tax and alternative minimum tax.

Effective Date

The provision generally is effective for taxable years beginning after December 31, 2000. The provision relating to allowing the child tax credit against alternative minimum tax is effective for taxable years beginning after December 31, 2001.

California Law

California does not have a young child tax credit. Instead, California allows a nonrefundable augmented dependent exemption credit. For the 2001 year, the dependent exemption credit for California is $247.

Impact on California Revenue

Not applicable.

Section	Section Title
202	EXTENSION AND EXPANSION OF ADOPTION TAX BENEFITS.

Background

Tax credit

In general

A tax credit is allowed for qualified adoption expenses paid or incurred by a taxpayer. The maximum credit is $5,000 per eligible child ($6,000 for a special needs child). An eligible child is an individual (1) who has not attained age 18 or (2) is physically or mentally incapable of caring for himself or herself. A special needs child is an eligible child who is a citizen or resident of the United States who a state has determined: (1) cannot or should not be returned to the home of the birth parents; and (2) has a specific factor or condition (such as the child's ethnic background, age, or membership in a minority or sibling group, or the presence of factors such as medical conditions, or physical, mental, or emotional handicaps) because of which the child cannot be placed with adoptive parents without adoption assistance.

Qualified adoption expenses are reasonable and necessary adoption fees, court costs, attorneys fees, and other expenses that are: (1) directly related to, and the principal purpose of which is for, the legal adoption of an eligible child by the taxpayer; (2) not incurred in violation of state or federal law, or in carrying out any surrogate parenting arrangement; (3) not for the adoption of the child of the taxpayer's spouse; and (4) not reimbursed (e.g., by an employer). Qualified adoption expenses may be incurred in one or more taxable years, but the credit may not exceed $5,000 per adoption ($6,000 for a special needs child). The adoption credit is phased out ratably for taxpayers with modified adjusted gross income between $75,000 and $115,000. Modified adjusted gross income is the sum of the taxpayer's adjusted gross income plus amounts excluded from income under Code sections 911, 931, and 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands; and residents of Puerto Rico, respectively). The adoption credit for special needs children is permanent. The adoption credit with respect to other children does not apply to expenses paid or incurred after December 31, 2001.

Alternative minimum tax

Through 2001, the adoption credit generally reduces the individual's regular income tax and alternative minimum tax. For taxable years beginning after December 31, 2001, the otherwise allowable adoption credit is allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit.

Exclusion from income

A maximum $5,000 exclusion from the gross income of an employee is allowed for qualified adoption expenses paid or reimbursed by an employer under an adoption assistance program. The maximum excludible amount is $6,000 for special needs adoptions. The exclusion is phased out ratably for taxpayers with modified adjusted gross income between $75,000 and $115,000. Modified adjusted gross income is the sum of the taxpayer's adjusted gross income plus amounts excluded from income under Code sections 911, 931, and 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands; and residents of Puerto Rico, respectively). For purposes of this exclusion, modified adjusted gross income also includes all employer payments and reimbursements for adoption expenses whether or not they are taxable to the employee. The exclusion does not apply for purposes of payroll taxes. Adoption expenses paid or reimbursed by the employer under an adoption assistance program are not eligible for the adoption credit. A taxpayer may be eligible for the adoption credit (with respect to qualified adoption expenses he or she incurs) and also for the exclusion (with respect to different qualified adoption expenses paid or reimbursed by his or her employer). The exclusion from income does not apply to amounts paid or expenses incurred after December 31, 2001.

<u>New Federal Law</u> (IRC. Sec. 137)

Tax credit

The Act permanently extends the adoption credit for children other than special needs children. The maximum credit is increased to $10,000 per eligible child, including special needs children. The Act provides for the credit in the year a special needs adoption is finalized regardless of whether the taxpayer has qualified adoption expenses. No credit is allowed with respect to the adoption of a special needs child if the adoption is not finalized. The beginning point of the income phase-out range is increased to $150,000 of modified adjusted gross income. Therefore, the adoption credit is phased-out for taxpayers with modified adjusted gross income of $190,000 or more. Finally, the adoption credit is allowed against the alternative minimum tax permanently.

Exclusion from income

The Act permanently extends the exclusion from income for employer-provided adoption assistance. The maximum exclusion is increased to $10,000 per eligible child, including special needs children. The Act provides the $10,000 exclusion in the case of a special needs adoption regardless of whether the taxpayer has qualified adoption expenses. The beginning point of the income phase-out range is increased to $150,000 of modified adjusted gross income. Therefore, the exclusion is not available to taxpayers with modified adjusted gross income of $190,000 or more.

Effective Date

Generally, the provision is effective for taxable years beginning after December 31, 2001. Qualified expenses paid or incurred in taxable years beginning on or before December 31, 2001, remain subject to the present-law dollar limits. The provisions that extend the tax credit and exclusion from income for special needs adoptions regardless of whether the taxpayer has qualified adoption expenses are effective for taxable years beginning after December 31, 2002.

California Law

California has it own adoption credit. For taxable years beginning on or after January 1, 1994, California allows a credit equal to 50% of the cost of adopting a minor child who is an American citizen and is in the custody of a California public agency or a political subdivision of California. The credit is to be claimed in the taxable year in which the decree or order of adoption is entered although qualifying costs paid or incurred in prior years can qualify for the credit.

Costs eligible for the credit include:

- fees for required services of either the Department of Social Services or a licensed adoption agency;
- travel and related expenses for the adoptive family that are directly related to the adoption process; and
- medical fees and expenses that are not reimbursed by insurance and are directly related to the adoption process.

The maximum allowable credit cannot exceed $2,500 per minor child; however, credit amounts exceeding the net tax may be carried over to succeeding taxable years until exhausted.

California's credit cannot reduce regular tax below tentative minimum tax for alternative minimum tax purposes.

California is fully conformed to the federal rules for excluding a maximum of $5,000 from an employee's income for employer-provided adoption assistance. This exclusion from income does not apply to amounts paid or expenses incurred after December 31, 2001.

Impact on California Revenue

Conformity revenue losses are estimated as follows:

Estimated Revenue Impact*			
Enactment Assumed By April 1, 2002			
Generally Effective for Tax Years Beginning after 12/31/01			
Fiscal Years			
(In Millions)			
	2002-3	2003-4	2004-5
Adoption Credit	-$12	-$24	-$27

* Estimates are net of the current state law credit.

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

Estimates are net of the current state credit and were based on available state data on existing levels and costs of adoptions by type, i.e., public, private, independent, inter-county. The significant increase for 2003-4 is due to the initial impact of prior year carryover credits applied.

Section	Section Title
204	EXPANSION OF DEPENDENT CARE TAX CREDIT.

Background

Dependent care credit

A taxpayer who maintains a household that includes one or more qualifying individuals may claim a nonrefundable credit against income tax liability for up to 30% of a limited amount of employment-related expenses. Eligible employment-related expenses are limited to $2,400 if there is one qualifying individual or $4,800 if there are two or more qualifying individuals. Thus, the maximum credit is $720 if there is one qualifying individual and $1,440 if there are two or more qualifying individuals. The applicable dollar limit ($2,400/$4,800) of otherwise eligible employment-related expenses is reduced by any amount excluded from income under an employer-provided dependent care assistance program. For example, a taxpayer with one qualifying individual who has $2,400 of otherwise eligible employment-related expenses but who excludes $1,000 of dependent care assistance must reduce the dollar limit of eligible employment-related expenses for the dependent care tax credit by the amount of the exclusion to $1,400 ($2,400-$1,000 = $1,400).

A qualifying individual is (1) a dependent of the taxpayer under the age of 13 for whom the taxpayer is eligible to claim a dependency exemption, (2) a dependent of the taxpayer who is physically or mentally incapable of caring for himself or herself, or (3) the spouse of the taxpayer; if the spouse is physically or mentally incapable of caring for himself or herself.

The 30% credit rate is reduced, but not below 20%, by 1 percentage point for each $2,000 (or fraction thereof) of adjusted gross income above $10,000. The credit is not available to married taxpayers unless they file a joint return.

Exclusion for employer-provided dependent care

Amounts paid or incurred by an employer for dependent care assistance provided to an employee generally are excluded from the employee's gross income and wages if the assistance is furnished under a program meeting certain requirements. These requirements include that the program be described in writing, satisfy certain nondiscrimination rules, and provide for notification to all eligible employees. Dependent care assistance expenses eligible for the exclusion are defined the same as employment-related expenses with respect to a qualifying individual under the dependent care tax credit.

The dependent care exclusion is limited to $5,000 per year, except that a married taxpayer filing a separate return may exclude only $2,500. Dependent care expenses excluded from income are not eligible for the dependent care tax credit (sec. 21(c)).

New Federal Law (IRC. Sec. 21)

The Act increases the maximum amount of eligible employment-related expenses from $2,400 to $3,000, if there is one qualifying individual (from $4,800 to $6,000, if there are two or more qualifying individuals). The Act also increases the maximum credit from 30% to 35%. Thus, the maximum credit is $1,050, if there is one qualifying individual and $2,100, if there are two or more qualifying individuals. Finally, the Act modifies the phase-down of the credit. The 35% credit rate is reduced, but not below 20%, by 1 percentage point for each $2,000 (or fraction thereof) of adjusted gross income above $15,000. Therefore, the credit percentage is reduced to 20% for taxpayers with adjusted gross income over $43,000.

Effective Date

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

California Law

California, under the PITL, allows a refundable credit based on a percentage of the taxpayer's federal household and dependent care credit.

The percentages are:

If state adjusted gross income is:	Credit percentage
$40,000 or less	63%
Over $40,000 but not over $70,000	53%
Over $70,000 but not over $100,000	42%
Over $100,000	0%

The credit is limited to those taxpayers who maintain a household within the state. R&TC Section 17052.6

Adjustments made by FTB to the amount claimed by a taxpayer under the refundable child and dependent care credit may be treated by FTB as a math error correction, but the taxpayer is allowed the right to protest and appeal FTB's adjustment.

Impact on California Revenue

Conformity revenue losses are estimated as follows:

Estimated Revenue Impact*			
Enactment Assumed By April 1, 2002			
Effective for Tax Years Beginning after 12/31/02			
Fiscal Years			
(In Millions)			
	2002-3	2003-4	2004-5
Dependent Care Tax Credit	-$10	-$87	-$87

*Current California law provides for a refundable dependent care credit. Conforming to federal law, the credit would no longer be refundable and the credit rate, eligible expenses, and start of the AGI phase-out would all increase.

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

Revenue losses are net of the current state refundable credit. Estimates were developed from a special simulation model using prior year state and federal tax data for this credit and adjusted to include higher income levels.

Section	Section Title
205	TAX CREDIT FOR EMPLOYER-PROVIDED CHILD CARE FACILITIES.

Background

Present federal law does not provide a tax credit to employers for supporting child care or childcare resource and referral services. An employer, however, may be able to deduct such expenses as ordinary and necessary business expenses. Alternatively, the employer may be required to capitalize the expenses and claim depreciation deductions over time.

New Federal Law (IRC. Sec. 45D)

Under the Act, taxpayers receive a tax credit equal to 25% of qualified expenses for employee childcare and 10% of qualified expenses for childcare resource and referral services. The maximum total credit that may be claimed by a taxpayer cannot exceed $150,000 per taxable year. Qualified childcare expenses include costs paid or incurred:

(1) To acquire, construct, rehabilitate or expand property that is to be used as part of the taxpayer's qualified childcare facility, (In addition, a depreciation deduction (or amortization in lieu of depreciation) must be allowable with respect to the property and the property must not be part of the principal residence of the taxpayer or any employee of the taxpayer.)
(2) For the operation of the taxpayer's qualified child care facility, including the costs of training and certain compensation for employees of the child care facility, and scholarship programs; or
(3) Under a contract with a qualified childcare facility to provide child care services to employees of the taxpayer.

To be a qualified child care facility, the principal use of the facility must be for child care (unless it is the principal residence of the taxpayer), and the facility must meet all applicable state and local laws and regulations, including any licensing laws. A facility is not treated as a qualified childcare facility with respect to a taxpayer unless:

(1) It has open enrollment to the employees of the taxpayer;
(2) Use of the facility (or eligibility to use such facility) does not discriminate in favor of highly compensated employees of the taxpayer (within the meaning of section 414(q); and
(3) At least 30% of the children enrolled in the center are dependents of the taxpayer's employees, if the facility is at the principal trade or business of the taxpayer.

Qualified childcare resource and referral expenses are amounts paid or incurred under a contract to provide child care resource and referral services to the employees of the taxpayer. Qualified child care services and qualified child care resource and referral expenditures must be provided (or be eligible for use) in a way that does not discriminate in favor of highly compensated employees of the taxpayer (within the meaning of section 414(q)).

Any amounts for which the taxpayer may otherwise claim a tax deduction are reduced by the amount of these credits. Similarly, if the credits are taken for expenses of acquiring, constructing, rehabilitating, or expanding a facility, the taxpayer's basis in the facility is reduced by the amount of the credits.

Credits taken for the expenses of acquiring, constructing, rehabilitating, or expanding a qualified facility are subject to recapture for the first ten years after the qualified child care facility is placed in service. The amount of recapture is reduced as a percentage of the applicable credit over the ten-year recapture period. Recapture takes effect if the taxpayer either ceases operation of the qualified childcare facility or transfers its interest in the qualified childcare facility without securing an agreement to assume recapture liability for the transferee. Other rules apply.

Effective Date

The provision is effective for taxable years beginning after December 31, 2001.

California Law

California has similar credits as follows:

Employer/Commercial Landlord Child Care Centers (R&TC 17052.17 and 23617)

Allows a credit for 30% of either or both of (1) start-up expenses of establishing a child care program, or constructing a child care facility in California and (2) contributions to California child care information and referral services. Commercial lessors who establish child care centers for the employees of their commercial tenants qualify for this credit. The credit is limited to $50,000 in any taxable or income year. Deductible start-up expenses must be reduced by the amount of the credit. If constructing a facility, the basis must be reduced by the amount to the credit. If the credit exceeds the tax, the excess may be carried over.

Employer Child Care Plans (R&TC Sec. 17052.18 and 23617.5)

Allows a credit for 30% of the cost of an employer for contributions to qualified care plans on behalf of dependents (under age 12) of the employer's California employees. The credit is limited to $360 per child per year. The term "contributions" excludes employer reimbursements to employees for the employee's qualified expenses and, effective for taxable years beginning on or after January 1, 2001, employer contributions pursuant to a salary reduction arrangement. The employer must reduce its deductible expense by the amount of the credit. If the credit exceeds the tax, the excess may be carried over.

Impact on California Revenue

Conformity revenue losses are estimated as follows:

Estimated Revenue Impact			
Enactment Assumed By April 1, 2002			
Effective for Tax Years Beginning after 12/31/01			
Fiscal Years			
(In Millions)			
	2002-3	2003-4	2003-4
Employer Child Care Credit	Minor Loss	-$5	-$6

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

Estimates reflect order of magnitude impacts by substituting federal law for state law and allowing for additional federal incentives.

Additional revenue losses under federal conformity largely reflect credits that would be claimed for employer contributions made through salary reduction agreements.

Section	Section Title
301	STANDARD DEDUCTION MARRIAGE PENALTY RELIEF.

Background

Marriage penalty

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

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

Basic standard deduction

Taxpayers who do not itemize deductions may choose the basic standard deduction (and additional standard deductions, if applicable), which is subtracted from adjusted gross income ("AGI") in arriving at taxable income. Additional standard deductions are allowed with respect to any individual who is elderly (age 65 or over) or blind. The size of the basic standard deduction varies according to filing status and is adjusted annually for inflation. For 2001, the basic standard deduction amount for single filers is 60% of the basic standard deduction amount for married couples filing joint returns. Thus, two unmarried individuals have standard deductions whose sum exceeds the standard deduction for a married couple filing a joint return.

New Federal Law (IRC. Sec. 63)

The Act increases the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return. The basic standard deduction for a married taxpayer filing separately will continue to equal one-half of the basic standard deduction for a married couple filing jointly; thus, the basic standard deduction for unmarried individuals filing a single return and for married couples filing separately will be the same.

The increase in the standard deduction is phased-in over five years beginning in 2005 and would be fully phased-in for 2009 and thereafter. The table below shows the standard deduction for married couples filing a joint return as a percentage of the standard deduction for single individuals during the phase-in period.

Phase-In of Increase of Standard Deduction for Married Couples Filing Joint Returns

Calendar Year	Standard Deduction for Joint Returns as Percentage of Standard Deduction for Single Returns
2005	174%
2006	184%
2007	187%
2008	190%
2009 and later	200%

Effective Date

The provision is effective for taxable years beginning after December 31, 2004.

California Law

California tax rates, exemptions, deductions, phase outs and etc. do not contain a "marriage penalty."

Impact on California Revenue

Not applicable.

Section	Section Title
302	EXPANSION OF THE 15% RATE BRACKET FOR MARRIED COUPLES FILING JOINT RETURNS.

Background

In general

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

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

Regular income tax liability

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

In general, the bracket breakpoints for single individuals are approximately 60% of the rate bracket breakpoints for married couples filing joint returns. The rate bracket breakpoint for the 39.6% marginal tax rate is the same for single individuals and married couples filing joint returns. The rate bracket breakpoints for married individuals filing separate returns are exactly one-half of the rate brackets for married individuals filing joint returns. A separate, compressed rate schedule applies to estates and trusts.

New Federal Law (IRC. Sec. 1)

The Act increases the size of the 15% regular income tax rate bracket for a married couple filing a joint return to twice the size of the corresponding rate bracket for an unmarried individual filing a single return. The increase is phased-in over four years, beginning in 2005. Therefore, this provision is fully effective (i.e., the size of the 15% regular income tax rate bracket for a married couple filing a joint return would be twice the size of the 15% regular income tax rate bracket for an unmarried individual filing a single return) for taxable years beginning after December 31, 2007. The phase is as follows:

Increase in Size of 15% Rate Bracket for Married Couples Filing a Joint Return

Taxable year	Endpoint of 15% rate bracket for married couple filing joint return as percentage of end point of 15% rate bracket for unmarried individuals
2005	180%
2006	187%
2007	193%
2008 and thereafter	200%

Effective Date

The provision is effective for taxable years beginning after December 31, 2004.

California Law

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

Impact on California Revenue

Not applicable.

Section	Section Title
303	MARRIAGE PENALTY RELIEF AND SIMPLIFICATION RELATING TO THE EARNED INCOME CREDIT.

Background

In general

Eligible low-income workers are able to claim a refundable earned income credit. The amount of the credit an eligible taxpayer may claim depends upon the taxpayer's income and whether the taxpayer has one, more than one, or no qualifying children.

The earned income credit is not available to married individuals who file separate returns. No earned income credit is allowed if the taxpayer has disqualified income in excess of $2,450 (for 2001) for the taxable year. Disqualified income is the sum of: (1) interest and dividends includible in gross income for the taxable year; (2) tax-exempt income received or accrued in the taxable year; (3) net income from rents and royalties for the taxable year not derived in the ordinary course of business; (4) capital gain net income for the taxpayer year; and (5) net passive income for the taxable year. In addition, no earned income credit is allowed if an eligible individual is the qualifying child of another taxpayer.

Definition of qualifying child and tie-breaker rules

To claim the earned income credit, a taxpayer must either (1) have a qualifying child or (2) meet the requirements for childless adults. A qualifying child must meet a relationship test, an age test, and a residence test. First, the qualifying child must be the taxpayer's child, stepchild, adopted child, grandchild, or foster child. Second, the child must be under age 19 (or under age 24 if a full-time student) or permanently and totally disabled regardless of age. Third, the child must live with the taxpayer in the United States for more than half the year (a full year for foster children).

An individual satisfies the relationship test under the earned income credit if the individual is the taxpayer's: (1) son or daughter or a descendant of either; (2) stepson or stepdaughter; or (3) eligible foster child. An eligible foster child is an individual (1) who is a brother, sister, stepbrother, or stepsister of the taxpayer (or a descendant of any such relative), or who is placed with the taxpayer by an authorized placement agency, and (2) who the taxpayer cares for as her or his own child. A married child of the taxpayer is not treated as meeting the relationship test unless the taxpayer is entitled to a dependency exemption with respect to the married child (e.g., the support test is satisfied) or would be entitled to the exemption if the taxpayer had not waived the exemption to the noncustodial parent. A child who is legally adopted or placed with the taxpayer for adoption by an authorized adoption agency is treated as the taxpayer's own child.

If a child otherwise qualifies with respect to more than one person, the child is treated as a qualifying child only of the person with the highest modified adjusted gross income. “Modified adjusted gross income” means adjusted gross income determined without regard to certain losses and increased by certain amounts not includible in gross income. The losses disregarded are: (1) net capital losses (up to $3,000); (2) net losses from estates and trusts; (3) net losses from nonbusiness rents and royalties; (4) 75% of the net losses from businesses, computed separately with respect to sole proprietorships (other than farming), farming sole proprietorships, and other businesses. The amounts added to adjusted gross income to arrive at modified adjusted gross income include: (1) tax-exempt interest; and (2) nontaxable distributions from pensions, annuities, and individual retirement plans (but not nontaxable rollover distributions or trustee-to-trustee transfers).

Definition of earned income

To claim the earned income credit, the taxpayer must have earned income. Earned income consists of wages, salaries, other employee compensation, and net earnings from self-employment. Employee compensation includes anything of value received by the taxpayer from the employer in return for services of the employee, including nontaxable earned income. Nontaxable forms of compensation treated as earned income include the following: (1) elective deferrals under a cash or deferred arrangement or section 403(b) annuity (sec. 402(g)); (2) employer contributions for nontaxable fringe benefits, including contributions for accident and health insurance (sec. 106), dependent care (sec. 129), adoption assistance (sec. 137), educational assistance (sec. 127), and miscellaneous fringe benefits (sec. 132); (3) salary reduction contributions under a cafeteria plan (sec. 125); (4) meals and lodging provided for the convenience of the employer (sec. 119), and (5) housing allowance or rental value of a parsonage for the clergy (sec. 107). Some of these items are not required to be reported on the Wage and Tax Statement (Form W 2).

Calculation of the credit

The maximum earned income credit is phased in as an individual's earned income increases. The credit phases out for individuals with earned income (or if greater, modified adjusted gross income) over certain levels. In the case of a married individual who files a joint return, the earned income credit both for the phase-in and phase-out is calculated based on the couples' combined income.

The credit is determined by multiplying the credit rate by the taxpayer's earned income up to a specified earned income amount. The maximum amount of the credit is the product of the credit rate and the earned income amount. The maximum credit amount applies to taxpayers with (1) earnings at or above the earned income amount and (2) modified adjusted gross income (or earnings, if greater) at or below the phase-out threshold level.

For taxpayers with modified adjusted gross income (or earned income, if greater) in excess of the phase-out threshold, the credit amount is reduced by the phase-out rate multiplied by the amount of earned income (or modified adjusted gross income, if greater) in excess of the phase-out threshold. In other words, the credit amount is reduced, falling to $0 at the "breakeven" income level, the point where a specified percentage of "excess" income above the phase-out threshold offsets exactly the maximum amount of the credit. The earned income amount and the phase-out threshold are adjusted annually for inflation. The table below shows the earned income credit parameters for taxable year 2001.

EARNED INCOME CREDIT PARAMETERS (2001)

	Two or more qualifying children	One qualifying child	No qualifying children.
Credit rate (%)	40.00%	34.00%	7.65%
Earned income amount	$10,020	$7,140	$4,760
Maximum credit	$4,008	$2,428	$364
Phase-out begins	$13,090	$13,090	$5,950
Phase-out rate	21.06%	15.98%	7.65%
Phase-out ends	$32,121	$28,281	$10,710

An individual's alternative minimum tax liability reduces the amount of the refundable earned income credit.

<u>New Federal Law</u> (IRC. Sec. 32)

For married taxpayers who file a joint return, the Act increases the beginning and ending of the earned income phase-out amount as follows: by $1,000 in the case of taxable years beginning in 2002, 2003, and 2004; by $2,000 in the case of taxable years beginning in 2005, 2006, and 2007; and by $3,000 in the case of taxable years beginning after 2007. The $3,000 amount is to be adjusted annually for inflation after 2008.

The Act simplifies the definition of earned income by excluding nontaxable employee compensation from the definition of earned income for earned income credit purposes. Thus, under the Act, earned income includes wages, salaries, tips, and other employee compensation, if includible in gross income for the taxable year, plus net earnings from self-employment.

The Act repeals the present-law provision that reduces the earned income credit by the amount of an individual's alternative minimum tax.

The Act simplifies the calculation of the earned income credit by replacing modified adjusted gross income with adjusted gross income.

The Act provides that the relationship test is met if the individual is the taxpayer's son, daughter, stepson, stepdaughter, or a descendant of any such individuals. A brother, sister, stepbrother, stepsister, or a descendant of such individuals, also qualifies if the taxpayer cares for such individual as his or her own child. A foster child satisfies the relationship test as well. A foster child is defined as an individual who is placed with the taxpayer by an authorized placement agency and who the taxpayer cares for as his or her own child. In order to be a qualifying child, in all cases the child must have the same principal place of abode as the taxpayer for over one-half of the taxable year.

The Act changes the present-law tie-breaking rule. If an individual would be a qualifying child with respect to more than one taxpayer, and more than one taxpayer claims the earned income credit with respect to that child, then the following tie-breaking rules apply. First, if one of the individuals claiming the child is the child's parent (or parents who file a joint return), then the child is considered the qualifying child of the parent (or parents). Second, if both parents claim the child and the parents do not file a joint return together, then the child is considered a qualifying child first of the parent with whom the child resided for the longest period of time during the year, and second of the parent with the highest adjusted gross income. Finally, if none of the taxpayers claiming the child as a qualifying child is the child's parent, the child is considered a qualifying child with respect to the taxpayer with the highest adjusted gross income.

The Act authorizes the IRS, beginning in 2004, to use math error authority to deny the earned income credit if the Federal Case Registry of Child Support Orders indicates that the taxpayer is the noncustodial parent of the child with respect to whom the credit is claimed.

It is the intent of Congress that by September 2002, the Department of the Treasury, in consultation with the National Taxpayer Advocate, deliver to the Senate Committee on Finance and the House Committee on Ways and Means a study of the Federal Case Registry database. The study is to cover (1) the accuracy and timeliness of the data in the Federal Case Registry, (2) the efficacy of using math error authority in this instance in reducing costs due to erroneous or fraudulent claims, and (3) the implications of using math error authority in this instance, given the findings on the accuracy and timeliness of the data.

Congress realizes that the expansion of the earned income credit may create a financial hardship on U.S. possessions with mirror codes and that further study of such effects is necessary.

Effective Date

The provision generally is effective for taxable years beginning after December 31, 2001. The amendment to authorize the IRS to use math error authority if the Federal Case Registry of Child Support Orders indicates the taxpayer is the noncustodial parent is effective beginning in 2004.

California Law

California does not have an earned income credit.

Impact on California Revenue

Not applicable.

Section	Section Title
401	MODIFICATIONS TO EDUCATION IRAs.

Background

In general

Section 530 of the Code provides tax-exempt status to education individual retirement accounts ("education IRAs"), meaning certain trusts or custodial accounts which are created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of a designated beneficiary. Contributions to education IRAs may be made only in cash. Special estate and gift tax rules apply to contributions made to and distributions made from education IRAs.

Annual contributions to education IRAs may not exceed $500 per beneficiary (except in cases involving certain tax-free rollovers, as described below) and may not be made after the designated beneficiary reaches age 18. Specially, IRC Section 530 states that an education IRA is a trust, which among other things cannot accept contributions that would result in aggregate contributions for the taxable year to exceed $500.

Phase-out of contribution limit

The $500 annual contribution limit for education IRAs is generally phased-out ratably for contributors with modified adjusted gross income (between $95,000 and $110,000). The phase-out range for married taxpayers filing a joint return is $150,000 to $160,000 of modified adjusted gross income. Individuals with modified adjusted gross income above the phase-out range are not allowed to make contributions to an education IRA established on behalf of any individual.

Treatment of distributions

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

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

The earnings portion of a distribution from an education IRA that is includible in income is also subject to an additional 10% tax. The 10% additional tax does not apply if a distribution is made on account of the death or disability of the designated beneficiary, or on account of a scholarship received by the designated beneficiary. The additional 10% tax also does not apply to the distribution of any contribution to an education IRA made during the taxable year if such distribution is made on or before the date that a return is required to be filed (including extensions of time) by the beneficiary for the taxable year during which the contribution was made (or, if the beneficiary is not required to file such a return, April 15th of the year following the taxable year during which the contribution was made).

Present law allows tax-free transfers or rollovers of account balances from one education IRA benefiting one beneficiary to another education IRA benefiting another beneficiary (as well as redesignations of the named beneficiary), provided that the new beneficiary is a member of the family of the old beneficiary and is under age 30.

Any balance remaining in an education IRA is deemed to be distributed within 30 days after the date that the beneficiary reaches age 30 (or, if earlier, within 30 days of the date that the beneficiary dies).

Qualified higher education expenses

The term ”qualified higher education expenses” includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible education institution, regardless of whether the beneficiary is enrolled at an eligible educational institution on a full-time, half time, or less than half-time basis. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses. In addition, qualified higher education expenses include amounts paid or incurred to purchase tuition credits (or to make contributions to an account) under a qualified state tuition program, as defined in section 529, for the benefit of the beneficiary of the education IRA. Moreover, qualified higher education expenses include, within limits, room and board expenses for any academic period during which the beneficiary is at least a half-time student. Room and board expenses that may be treated as qualified higher education expenses are limited to the minimum room and board allowance applicable to the student in calculating costs of attendance for federal financial aid programs under section 472 of the Higher Education Act of 1965, as in effect on the date of enactment of the Small Business Job Protection Act of 1996 (August 20, 1996). Thus, room and board expenses cannot exceed the following amounts: (1) for a student living at home with parents or guardians, $1,500 per academic year; (2) for a student living in housing owned or operated by the eligible education institution, the institution's “normal” room and board charge; and (3) for all other students, $2,500 per academic year.

Qualified higher education expenses generally include only out-of-pocket expenses. Such qualified higher education expenses do not include expenses covered by educational assistance for the benefit of the beneficiary that is excludable from gross income. Thus, total qualified higher education expenses are reduced by scholarship or fellowship grants excludable from gross income under present-law section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance that is excludable from the employee's gross income under section 127.

Present law also provides that if any qualified higher education expenses are taken into account in determining the amount of the exclusion for a distribution from an education IRA, then no deduction (e.g., for trade or business expenses), exclusion (e.g., for interest on education savings bonds) or credit is allowed with respect to such expenses.

Eligible educational institutions are defined by reference to section 481 of the Higher Education Act of 1965. Such institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, a graduate-level or professional degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible institutions. The institution must be eligible to participate in Department of Education student aid programs.

Time for making contributions

Contributions to an education IRA for a taxable year are taken into account in the taxable year in which they are made.

Coordination with HOPE and Lifetime Learning credits

If an exclusion from gross income is allowed for distributions from an education IRA with respect to an individual, then neither the HOPE nor Lifetime Learning credit may be claimed in the same taxable year with respect to the same individual. However, an individual may elect to waive the exclusion with respect to distributions from an education IRA. If such a waiver is made, then the HOPE or Lifetime Learning credit may be claimed with respect to the individual for the taxable year.

Coordination with qualified tuition programs

An excise tax is imposed on contributions to an education IRA for a year if contributions are made by anyone to a qualified state tuition program on behalf of the same beneficiary in the same year. The excise tax is equal to 6% of the contributions to the education IRA. The excise tax is imposed each year after the contribution is made, unless the contributions are withdrawn.

<u>New Federal Law</u> (IRC. Sec. 530)

Annual contribution

The Act increases the annual limit on contributions to education IRAs from $500 to $2,000. Thus, aggregate contributions that may be made by all contributors to one (or more) education IRAs established on behalf of any particular beneficiary is limited to $2,000 for each year.

Qualified education expenses

The Act expands the definition of qualified education expenses that may be paid tax-free from an education IRA to include "qualified elementary and secondary school expenses," meaning expenses for (1) tuition, fees, academic tutoring, special need services, books, supplies, and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under state law, (2) room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the beneficiary, and (3) the purchase of any computer technology or equipment (as defined in sec. 170(e)(6)(F)(i)) or Internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in school. Computer software primarily involving sports, games, or hobbies is not considered a qualified elementary and secondary school expense unless the software is predominantly educational in nature.

Phase-out of contribution limit

The Act increases the phase-out range for married taxpayers filing a joint return so that it is twice the range for single taxpayers. Thus, the phase-out range for married taxpayers filing a joint return is $190,000 to $220,000 of modified adjusted gross income.

Special needs beneficiaries

The Act provides that the rule prohibiting contributions to an education IRA after the beneficiary attains 18 does not apply in the case of a special needs beneficiary (as defined by Treasury Department regulations). In addition, a deemed distribution of any balance in an education IRA does not occur when a special needs beneficiary reaches age 30. Finally, the age 30 limitation does not apply in the case of a rollover contribution for the benefit of a special needs beneficiary or a change in beneficiaries to a special needs beneficiary. Treasury regulations are to define a special needs beneficiary to include an individual who because of a physical, mental, or emotional condition (including learning disability) requires additional time to complete his or her education.

Contributions by persons other than individuals

The Act clarifies that corporations and other entities (including tax-exempt organizations) are permitted to make contributions to education IRAs, regardless of the income of the corporation or entity during the year of the contribution.

Contributions permitted until April 15

Under the Act, individual contributors to education IRAs are deemed to have made a contribution on the last day of the preceding taxable year if the contribution is made on account of such taxable year and is made not later than the time prescribed by law for filing the individual's federal income tax return for such taxable year (not including extensions). Thus, individual contributors generally may make contributions for a year until April 15 of the following year.

Qualified room and board expenses

The Act modifies the definition of room and board expenses considered to be qualified higher education expenses. This modification is described with the provisions relating to qualified tuition programs, below.

Coordination with HOPE and Lifetime Learning credits

The Act allows a taxpayer to claim a HOPE credit or Lifetime Learning credit for a taxable year and to exclude from gross income amounts distributed (both the contributions and the earnings portions) from an education IRA on behalf of the same student as long as the distribution is not used for the same educational expenses for which a credit was claimed.

Coordination with qualified tuition programs

The Act repeals the excise tax on contributions made by any person to an education IRA on behalf of a beneficiary during any taxable year in which any contributions are made by anyone to a qualified state tuition program on behalf of the same beneficiary. If distributions from education IRAs and qualified tuition programs exceed the beneficiary's qualified higher education expenses for the year (after reduction by amounts used in claiming the HOPE or Lifetime Learning credit), the beneficiary is required to allocate the expenses between the distributions to determine the amount includible in income.

Effective Date

The provisions modifying education IRAs are effective for taxable years beginning after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to the definition of education IRAs. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Conforming to federal provisions for increasing contribution limits to Education IRAs would result in baseline revenue losses each year. Revenue losses (characterized as baseline) will result automatically due to the non-reporting of the inside build-up of earnings for taxpayers taking advantage of the new federal limits. The latter issue will require audit adjustments to taxpayer self-reporting. Total baseline revenue losses for affected provisions are provided in the footnote to the Conformity Summary Table.

Baseline revenue losses were based on projections of the number of Education IRAs established each year and assumed levels of annual contributions. A projected annual rate of return of 8% and an average marginal tax rate of 8% were applied to contributions. Contributions made during each year were assumed received at mid-year.

Section	Section Title
402	PRIVATE PREPAID TUITION PROGRAMS; EXCLUSION FROM GROSS INCOME OF EDUCATION DISTRIBUTIONS FROM QUALIFIED TUITION PROGRAMS.

Background

Law prior to the Act

Section 529 of the Code provides tax-exempt status to “qualified state tuition programs,” meaning certain programs established and maintained by a state (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account (a “savings account plan”). The term “qualified higher education expenses” generally has the same meaning as does the term for purposes of education IRAs (as described above) and, thus, includes expenses for tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible educational institution, as well as certain room and board expenses for any period during which the student is at least a half-time student. An “eligible education institution” is defined the same for purposes of education IRAs (described above) and qualified state tuition programs.

No amount is included in the gross income of a contributor to, or a beneficiary of, a qualified state tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary are included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent receives a refund) are included in the contributor's gross income to the extent such amounts exceed contributions made on behalf of the beneficiary. Distributions from qualified state tuition programs are treated as representing a pro-rata share of the contributions and earnings in the account.

A qualified state tuition program is required to provide that purchases or contributions only be made in cash. Contributors and beneficiaries are not allowed to direct the investment of contributions to the program (or earnings thereon). The program is required to maintain a separate accounting for each designated beneficiary. A specified individual must be designated as the beneficiary at the commencement of participation in a qualified state tuition program (i.e., when contributions are first made to purchase an interest in such a program), unless interests in such a program are purchased by a state or local government or a tax-exempt charity described in section 501(c)(3) as part of a scholarship program operated by such government or charity under which beneficiaries to be named in the future will receive such interests as scholarships.

Special estate and gift tax rules apply to contributions made to and distributions made from qualified state tuition programs.

A transfer of credits (or other amounts) from one account benefiting one designated beneficiary to another account benefiting a different beneficiary is considered a distribution (as is a change in the designated beneficiary of an interest in a qualified state tuition program), unless the beneficiaries are members of the same family. For this purpose, the term "member of the family” means: (1) the spouse of the beneficiary; (2) a son or daughter of the beneficiary or a descendent of either; (3) a stepson or stepdaughter of the beneficiary; (4) a brother, sister, stepbrother or stepsister of the beneficiary; (5) the father or mother of the beneficiary or an ancestor of either; (6) a stepfather or stepmother of the beneficiary; (7) a son or daughter of a brother or sister of the beneficiary; (8) a brother or sister of the father or mother of the beneficiary; (9) a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the beneficiary; or (10) the spouse of any person described in (2)-(9). Earnings on an account may be refunded to a contributor or beneficiary, but the state or instrumentality must impose a more than de minimis monetary penalty unless the refund is (1) used for qualified higher education expenses of the beneficiary, (2) made on account of the death or disability of the beneficiary, (3) made on account of a scholarship received by the beneficiary, or (4) a rollover distribution.

To the extent that a distribution from a qualified state tuition program is used to pay for qualified tuition and related expenses (as defined in sec. 25A(f)(1)), the beneficiary (or another taxpayer claiming the beneficiary as a dependent) may claim the HOPE credit or Lifetime Learning credit with respect to such tuition and related expenses (assuming that the other requirements for claiming the HOPE credit or Lifetime Learning credit are satisfied and the modified AGI phase-out for those credits does not apply).

<u>New Federal Law</u> (IRC. Sec. 529)

Qualified tuition program

The Act expands the definition of "qualified tuition program" to include certain prepaid tuition programs established and maintained by one or more eligible educational institutions (which may be private institutions) that satisfy the requirements under section 529 (other than the present-law state sponsorship rule). In the case of a qualified tuition program maintained by one or more private eligible educational institutions, persons are able to purchase tuition credits or certificates on behalf of a designated beneficiary (as set forth in sec. 529(b)(1)(A)(i)), but would not be able to make contributions to a savings account plan (as described in sec. 529(b)(1)(A)(ii)). Except to the extent provided in regulations, a tuition program maintained by a private institution is not treated as qualified unless it has received a ruling or determination from the IRS that the program satisfies applicable requirements.

The Act provides that, in order for a tuition program of a private eligible education institution to be a qualified tuition program, assets of the program must be held in a trust created or organized in the United States for the exclusive benefit of designated beneficiaries that complies with the requirements under section 408(a)(2) and (5). Under these rules, the trustee must be a bank or other person who demonstrates that it will administer the trust in accordance with applicable requirements and the assets of the trust may not be commingled with other property except in a common trust fund or common investment fund.
The Act repeals the present-law rule that a qualified state tuition program must impose a more than *de minimis* monetary penalty on any refund of earnings not used for qualified higher education expenses of the beneficiary (except in certain circumstances). Instead, the Act imposes an additional 10% tax on the amount of a distribution from a qualified tuition plan that is includible in gross income (like the additional tax that applies to such distributions from education IRAs). The same exceptions that apply to the 10% additional tax with respect to education IRAs apply.

A special rule applies because the exclusion for earnings on distributions used for qualified higher education expenses does not apply to qualified tuition programs of private institutions until 2004. Under the special rule, the additional 10% tax does not apply to any payment in a taxable year beginning before January 1, 2004, which is includible in gross income but used for qualified higher education expenses. Thus, for example, the earnings portion of a distribution from a qualified tuition program of a private institution that is made in 2003 and that is used for qualified higher education expenses is not subject to the additional tax, even though the earnings portion is includible in gross income. Conforming the penalty to the education IRA provisions will make it easier for taxpayers to allocate expenses between the various education tax incentives. For example, under the Act, a taxpayer who receives distributions from an education IRA and a qualified tuition program in the same year is required to allocate qualified expenses in order to determine the amount excludable from income. Other interactions between the various provisions also arise under the Act. For example, a taxpayer may need to know the amount excludable from income due to a distribution from a qualified tuition program in order to determine the amount of expenses eligible for the tuition deduction. It is expected that the Secretary will exercise the existing authority under sections 529(d) and 530(h) to require appropriate reporting, e.g., the amount of distributions and the earnings portions of distributions (taxable and nontaxable), to facilitate the provisions of the Act.

Exclusion from gross income

Under the Act, an exclusion from gross income is provided for distributions made in taxable years beginning after December 31, 2001, from qualified state tuition programs to the extent that the distribution is used to pay for qualified higher education expenses. This exclusion from gross income is extended to distributions from qualified tuition programs established and maintained by an entity other than a state (or agency or instrumentality thereof) for distributions made in taxable years after December 31, 2003.

Qualified higher education expenses

The Act provides that, for purposes of the exclusion for distributions from qualified tuition plans, the maximum room and board allowance is the amount applicable to the student in calculating costs of attendance for federal financial aid programs under section 472 of the Higher Education Act of 1965, as in effect on June 7, 2001, or, in the case of a student living in housing owned or operated by an eligible educational institution, the actual amount charged the student by the educational institution for room and board. This definition also applies to distributions from education IRAs.

The Act modifies the definition of qualified higher education expenses to include expenses of a special needs beneficiary that are necessary in connection with his or her enrollment or attendance at the eligible education institution. This definition also applies to distributions from education IRAs. In addition, a special needs beneficiary would be defined as under the provisions relating to education IRAs, described above.

Coordination with HOPE and Lifetime Learning credits

The Act allows a taxpayer to claim a HOPE credit or Lifetime Learning credit for a taxable year and to exclude from gross income amounts distributed (both the principal and the earnings portions) from a qualified tuition program on behalf of the same student as long as the distribution is not used for the same expenses for which a credit was claimed.

Rollovers for benefit of same beneficiary

The Act provides that a transfer of credits (or other amounts) from one qualified tuition program for the benefit of a designated beneficiary to another qualified tuition program for the benefit of the same beneficiary is not considered a distribution. This rollover treatment does not apply to more than one transfer within any 12-month period with respect to the same beneficiary. The intent of this provision is to allow, for example, transfers between a prepaid tuition program and a savings program maintained by the same state and between a state plan and a private prepaid tuition program.

Member of family

The Act provides that, for purposes of tax-free rollovers and changes of designated beneficiaries, a "member of the family" includes first cousins of the original beneficiary.

Effective Date

The provisions are effective for taxable years beginning after December 31, 2001, except that the exclusion from gross income for certain distributions from a qualified tuition program established and maintained by an entity other than a state (or agency or instrumentality thereof) is effective for taxable years beginning after December 31, 2003.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to qualified tuition programs. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Conforming to this federal provision would result in the following revenue losses.

[$ In Millions]		
2002-03	2003-04	2004-05
Minor loss	-$1.0	-$1.0

Minor loss is less than $500,000. Estimates were based on a proration of federal projections developed for the Economic Growth & Tax Relief Reconciliation Act of 2001.

Section	Section Title
411	EXCLUSION FOR EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE.

Background

Educational expenses paid by an employer for its employees are generally deductible by the employer. Employer-paid educational expenses are excludable from the gross income and wages of an employee if provided under a section 127 educational assistance plan or if the expenses qualify as a working condition fringe benefit under section 132. Section 127 provides an exclusion of $5,250 annually for employer-provided educational assistance. The federal exclusion does not apply to graduate courses beginning after June 30, 1996. The federal exclusion for employer-provided educational assistance for undergraduate courses expires with respect to courses beginning after December 31, 2001.

In order for the exclusion to apply, certain requirements must be satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer. The educational assistance program must not discriminate in favor of highly compensated employees. In addition, not more than 5% of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance plan can be provided for the class of individuals consisting of more than 5% owners of the employer (and their spouses and dependents). Educational expenses that do not qualify for the section 127 exclusion may be excludable from income as a working condition fringe benefit. These rules also apply in the event that section 127 expires.

In general, education qualifies as a working condition fringe benefit if the employee could have deducted the education expenses under section 162 if the employee paid for the education. In general, education expenses are deductible by an individual under section 162 if the education (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, applicable law or regulations imposed as a condition of continued employment. However, education expenses are generally not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses, along with other miscellaneous expenses, exceed 2% of the taxpayer's AGI. An individual's total deductions may also be reduced by the overall limitation on itemized deductions under section 68. These limitations do not apply in determining whether an item is excludable from income as a working condition fringe benefit.

New Federal Law (IRC. Sec. 127)

The Act extends the exclusion for employer-provided educational assistance to graduate education and makes the exclusion (as applied to both undergraduate and graduate education) permanent.

Effective Date

The provision is effective with respect to courses beginning after December 31, 2001.

California Law

California's exclusion for employer-provided educational assistance is contained in stand-alone language that parallels federal except that the California exclusion is permanent and applies to graduate courses. The maximum amount of the exclusion is $5,250. Therefore, the Economic Growth & Tax Relief Reconciliation Act of 2001 conformed to current California law.

Impact on California Revenue

Not applicable. The exclusion for employer provided educational benefits does not sunset under current state law.

Section	Section Title
412	MODIFICATIONS TO STUDENT LOAN INTEREST DEDUCTION.

Background

Certain individuals may claim an above-the-line deduction for interest paid on qualified education loans, subject to a maximum annual deduction limit. The deduction is allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. Required payments of interest generally do not include voluntary payments, such as interest payments made during a period of loan forbearance. Months during which interest payments are not required because the qualified education loan is in deferral or forbearance do not count against the 60-month period. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.

A qualified education loan generally is defined as any indebtedness incurred solely to pay for certain costs of attendance (including room and board) of a student (who may be the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred) who is enrolled in a degree program on at least a half-time basis at (1) an accredited post-secondary educational institution defined by reference to section 481 of the Higher Education Act of 1965, or (2) an institution conducting an internship or residency program leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.

The maximum allowable annual deduction is $2,500. The deduction is phased-out ratably for single taxpayers with modified adjusted gross income between $40,000 and $55,000 and for married taxpayers filing joint returns with modified adjusted gross income between $60,000 and $75,000. The income ranges will be adjusted for inflation after 2002.

New Federal Law (IRC. Sec. 221)

The Act increases the income phase-out ranges for eligibility for the student loan interest deduction to $50,000 to $65,000 for single taxpayers and to $100,000 to $130,000 for married taxpayers filing joint returns. These income phase-out ranges are adjusted annually for inflation after 2002.

The Act repeals both the limit on the number of months during which interest paid on a qualified education loan is deductible and the restriction that voluntary payments of interest are not deductible.

Effective Date

The provision is effective for interest paid on qualified education loans after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to the deduction of student interest. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Conformity revenue losses are estimated as follows:

Estimated Revenue Impact Enactment Assumed By April 1, 2002 Effective for Tax Years Beginning after 12/31/01 Fiscal Years (In Millions)			
	2002-3	2003-4	2004-5
Student Loan Interest Deduction	-$10	-$9	-$10

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

The revenue impact of this proposal would depend upon the number of new individuals who qualify to deduct interest paid on qualified higher education loans and the associated amount of interest claimed. New individuals qualifying to deduct this interest expense would include those paying qualified interest expense for more than 60 months and those who failed to meet the former AGI limitations but meet the new federal limitations.

Revenue estimates above were based on federal projections for this provision in HR 1836.

Section	Section Title
413	ELIMINATE TAX ON AWARDS UNDER THE NATIONAL HEALTH SERVICE CORPS SCHOLARSHIP PROGRAM AND THE F. EDWARD HEBERT ARMED FORCES HEALTH PROFESSIONS SCHOLARSHIP AND FINANCIAL ASSISTANCE PROGRAM.

Background

Section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by section 117 does not extend to scholarship amounts covering regular living expenses, such as room and board. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for certain education provided to employees (and their spouses and dependents) of certain educational organizations. The exclusion for qualified scholarships and qualified tuition reductions does not apply to any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship or tuition reduction.

The National Health Service Corps Scholarship Program (the “NHSC Scholarship Program”) and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program (the “Armed Forces Scholarship Program”) provide education awards to participants on the condition that the participants provide certain services. In the case of the NHSC Program, the recipient of the scholarship is obligated to provide medical services in a geographic area (or to an underserved population group or designated facility) identified by the Public Health Service as having a shortage of health care professionals. In the case of the Armed Forces Scholarship Program, the recipient of the scholarship is obligated to serve a certain number of years in the military at an armed forces medical facility. Because the recipients are required to perform services in exchange for the education awards, the awards used to pay higher education expenses are taxable income to the recipient.

New Federal Law (IRC. Sec. 117)

The Act provides that amounts received by an individual under the NHSC Scholarship Program or the Armed Forces Scholarship Program are eligible for tax-free treatment as qualified scholarships under section 117, without regard to any service obligation by the recipient. As with other qualified scholarships under section 117, the tax-free treatment does not apply to amounts received by students for regular living expenses, including room and board.

Effective Date

The provision is effective for education awards received after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to exclusions of scholarship income. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Based on federal loss projections for this provision ($1M per year), state income tax revenue losses are projected to be insignificant.

Section	Section Title
421-422	TAX BENEFITS FOR CERTAIN TYPES OF BONDS FOR EDUCATIONAL FACILITIES AND ACTIVITIES.

Background

Tax-exempt bonds

In general

Interest on debt (hereinafter referred to as “state or local government bonds”) incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (sec. 103).

Like other activities carried out or paid for by States and local governments, the construction, renovation, and operation of public schools is an activity eligible for financing with the proceeds of tax-exempt bonds. Interest on this debt is included in calculating the “adjusted current earnings” preference of the corporate alternative minimum tax. Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue Act. These bonds are called “private activity bonds.” The term “private person” includes the federal Government and all other individuals and entities other than States or local governments. Interest on private activity bonds (other than qualified 501(c)(3) bonds) is a preference item in calculating the alternative minimum tax.

Private activities eligible for financing with tax-exempt private activity bonds

Present law includes several exceptions permitting States or local governments to act as conduits providing tax-exempt financing for private activities. Both capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3) of the Code--including elementary, secondary, and post-secondary schools--may be financed with tax-exempt private activity bonds ("qualified 501(c)(3) bonds").

States or local governments may issue tax-exempt "exempt-facility bonds" to finance property for certain private businesses. Business facilities eligible for this financing include transportation (airports, ports, local mass commuting, and high speed intercity rail facilities); privately owned and/or privately operated public works facilities (sewage, solid waste disposal, local district heating or cooling, and hazardous waste disposal facilities); privately-owned and/or operated low-income rental housing; and certain private facilities for the local furnishing of electricity or gas. A further provision allows tax-exempt financing for "environmental enhancements of hydro-electric generating facilities." Tax-exempt financing also is authorized for capital expenditures for small manufacturing facilities and land and equipment for first-time farmers ("qualified small-issue bonds"), local redevelopment activities ("qualified redevelopment bonds"), and eligible empowerment zone and enterprise community businesses. Tax-exempt private activity bonds also may be issued to finance limited non-business purposes: certain student loans and mortgage loans for owner-occupied housing ("qualified mortgage bonds" and "qualified veterans' mortgage bonds").

Private activity tax-exempt bonds may not be issued to finance schools for private, for-profit businesses.

In most cases, the aggregate volume of private activity tax-exempt bonds is restricted by annual aggregate volume limits imposed on bonds issued by issuers within each state. These annual volume limits are equal to $62.50 per resident of the state, or $187.5 million if greater. The volume limits are scheduled to increase to the greater of $75 per resident of the state or $225 million in calendar year 2002. After 2002, the volume limits will be indexed annually for inflation.

Arbitrage restrictions on tax-exempt bonds

The federal income tax does not apply to the income of States and local governments that is derived from the exercise of an essential governmental function. To prevent these tax-exempt entities from issuing more federally subsidized tax-exempt bonds than is necessary for the activity being financed or from issuing such bonds earlier than needed for the purpose of the borrowing, the Code includes arbitrage restrictions limiting the ability to profit from investment of tax-exempt bond proceeds. In general, arbitrage profits may be earned only during specified periods (e.g., defined "temporary periods" before funds are needed for the purpose of the borrowing) or on specified types of investments (e.g., "reasonably required reserve or replacement funds"). Subject to limited exceptions, profits that are earned during these periods or on such investments must be rebated to the federal government.

Present law includes three exceptions to the arbitrage rebate requirements applicable to education-related bonds. First, issuers of all types of tax-exempt bonds are not required to rebate arbitrage profits if all of the proceeds of the bonds are spent for the purpose of the borrowing within six months after issuance. In the case of governmental bonds (including bonds to finance public schools), the six-month expenditure exception is treated as satisfied if at least 95% of the proceeds is spent within six months and the remaining 5% is spent within 12 months after the bonds are issued.

Second, in the case of bonds to finance certain construction activities, including school construction and renovation, the six-month period is extended to 24 months. Arbitrage profits earned on construction proceeds are not required to be rebated if all such proceeds (other than certain retainage amounts) are spent by the end of the 24-month period and prescribed intermediate spending percentages are satisfied. Issuers qualifying for this "construction bond" exception may elect to be subject to a fixed penalty payment regime in lieu of rebate if they fail to satisfy the spending requirements.

Third, governmental bonds issued by "small" governments are not subject to the rebate requirement. Small governments are defined as general purpose governmental units that issue no more than $5 million of tax-exempt governmental bonds in a calendar year. The $5 million limit is increased to $10 million if at least $5 million of the bonds are used to finance public schools.

Qualified zone academy bonds

As an alternative to traditional tax-exempt bonds, States and local governments are given the authority to issue "qualified zone academy bonds." Under present law, a total of $400 million of qualified zone academy bonds may be issued in each of 1998 through 2001. The $400 million aggregate bond authority is allocated each year to the States according to their respective populations of individuals below the poverty line. Each state, in turn, allocates the credit to qualified zone academies within such state. A state may carry over any unused allocation for up to two years (three years for authority arising before 2000).

Certain financial institutions (i.e., banks, insurance companies, and corporations actively engaged in the business of lending money) that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate multiplied by the face amount of the bond. An eligible financial institution holding a qualified zone academy bond on the credit allowance date (i.e., each one-year anniversary of the issuance of the bond) is entitled to a credit. The credit amount is includible in gross income (as if it were a taxable interest payment on the bond), and the credit may be claimed against regular income tax and alternative minimum tax liability. The Treasury Department sets the credit rate daily at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The maximum term of the bonds also is determined by the Treasury Department, so that the present value of the obligation to repay the bond is 50% of the face value of the bond. Present value is determined using as a discount rate the average annual interest rate of tax-exempt obligations with a term of 10 years or more issued during the month.

"Qualified zone academy bonds" are defined as bonds issued by a state or local government, provided that: (1) at least 95% of the proceeds is used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a "qualified zone academy" and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10% of the bond proceeds.

A school is a “qualified zone academy” if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in a designated empowerment zone or a designated enterprise community, or (b) it is reasonably expected that at least 35% of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

New Federal Law (IRC. Sec. 142, 146 & 148)

The Act increases the amount of governmental bonds that may be issued by governments qualifying for the “small governmental unit” arbitrage rebate exception from $5 million to $10 million. Thus, these governmental units may issue up to $15 million of governmental bonds in a calendar year provided that at least $10 million of the bonds are used to finance public school construction expenditures.

Allow issuance of tax-exempt private activity bonds for public school facilities.

The private activities for which tax-exempt bonds may be issued are expanded by the Act to include elementary and secondary public school facilities that are owned by private, for-profit corporations pursuant to public-private partnership agreements with a state or local educational agency. The term school facility includes school buildings and functionally related and subordinate land (including stadiums or other athletic facilities primarily used for school events) and depreciable personal property used in the school facility. The school facilities for which these bonds are issued must be operated by a public educational agency as part of a system of public schools.

A public-private partnership agreement is defined as an arrangement pursuant to which the for-profit corporate party constructs, rehabilitates, refurbishes or equips a school facility for a public school agency (typically pursuant to a lease arrangement). The agreement must provide that, at the end of the contract term, ownership of the bond-financed property is transferred to the public school agency party to the agreement for no additional consideration.

Issuance of these bonds is subject to a separate annual per-state private activity bond volume limit equal to $10 per resident ($5 million, if greater) in lieu of the present-law state private activity bond volume limits. As with the present-law state private activity bond volume limits, States can decide how to allocate the bond authority to state and local government agencies. Bond authority that is unused in the year in which it arises may be carried forward for up to three years for public school projects under rules similar to the carry forward rules of the present-law private activity bond volume limits.

Effective Date

The provisions are effective for bonds issued after December 31, 2001.

California Law

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. The Personal Income Tax Law (PITL) specifically does not conform to federal law regarding private activity bonds and provides that the determination of whether a bond is issued by this state or a local government in this state is to be made without regard to the source of payment or the security for that bond (public or private), and whether or not public improvements are financed. Federal law, other than the IRC, prohibits state taxation of interest on federal bonds, if the interest on state obligations is exempt from tax.

Under the Bank and Corporation Tax Law (B&CTL), taxpayers subject to the corporate franchise tax must report as income all interest received. However, interest received from federal obligations and California obligations or obligations of its political subdivision generally are excluded from income subject to the corporation income tax.

Impact on California Revenue

Based on the very low impact of federal estimates, the state revenue loss under conformity would be negligible annually.

Section	Section Title
431	DEDUCTION FOR QUALIFIED HIGHER EDUCATION EXPENSES.

Background

Deduction for education expenses

Under present law, an individual taxpayer generally may not deduct the education and training expenses of the taxpayer or the taxpayer's dependents. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment (Treas. Reg. sec. 1.162 5). Education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses meet the above-described criteria for deductibility under section 162 and only to the extent that the expenses, along with other miscellaneous deductions, exceed 2% of the taxpayer's adjusted gross income.

HOPE and Lifetime Learning credits

HOPE credit

Under present law, individual taxpayers are allowed to claim a nonrefundable credit, the “HOPE” credit, against federal income taxes of up to $1,500 per student per year for qualified tuition and related expenses paid for the first two years of the student's post secondary education in a degree or certificate program. The HOPE credit rate is 100% on the first $1,000 of qualified tuition and related expenses, and 50% on the next $1,000 of qualified tuition and related expenses. Thus, an eligible student who incurs $1,000 of qualified tuition and related expenses is eligible (subject to the AGI phase-out) for a $1,000 HOPE credit. If an eligible student incurs $2,000 of qualified tuition and related expenses, then he or she is eligible for a $1,500 HOPE credit. The HOPE credit may not be claimed against a taxpayer's alternative minimum tax liability. The qualified tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. The HOPE credit is available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education before the beginning of the second taxable year. The HOPE credit that a taxpayer may otherwise claim is phased-out ratably for taxpayers with modified AGI between $40,000 and $50,000 ($80,000 and $100,000 for joint returns). For taxable years beginning after 2001, the $1,500 maximum HOPE credit amount and the AGI phase-out ranges are indexed for inflation.

The HOPE credit is available for “qualified tuition and related expenses,” which include tuition and fees required to be paid to an eligible educational institution as a condition of enrollment or attendance of an eligible student at the institution. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living, or family expenses are not eligible for the credit. The expenses of education involving sports, games, or hobbies are not qualified tuition and related expenses unless this education is part of the student's degree program.

Qualified tuition and related expenses generally include only out-of-pocket expenses. Qualified tuition and related expenses do not include expenses covered by employer-provided educational assistance and scholarships that are not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and related expenses are reduced by any scholarship or fellowship grants excludable from gross income under section 117 and any other tax free educational benefits received by the student (or the taxpayer claiming the credit) during the taxable year.

Lifetime Learning credit

Individual taxpayers are allowed to claim a nonrefundable credit, the Lifetime Learning credit, against federal income taxes equal to 20% of qualified tuition and related expenses incurred during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or any dependents. For expenses paid after June 30, 1998, and prior to January 1, 2003, up to $5,000 of qualified tuition and related expenses per taxpayer return are eligible for the Lifetime Learning credit (i.e., the maximum credit per taxpayer return is $1,000). For expenses paid after December 31, 2002, up to $10,000 of qualified tuition and related expenses per taxpayer return will be eligible for the Lifetime Learning credit (i.e., the maximum credit per taxpayer return will be $2,000).

In contrast to the HOPE credit, a taxpayer may claim the Lifetime Learning credit for an unlimited number of taxable years. Also in contrast to the HOPE credit, the maximum amount of the Lifetime Learning credit that may be claimed on a taxpayer's return will not vary based on the number of students in the taxpayer's family--that is, the HOPE credit is computed on a per student basis, while the Lifetime Learning credit is computed on a family wide basis. The Lifetime Learning credit amount that a taxpayer may otherwise claim is phased-out ratably for taxpayers with modified AGI between $40,000 and $50,000 ($80,000 and $100,000 for joint returns).

New Federal Law (IRC. Sec. 222)

The Act permits taxpayers an above-the-line deduction for qualified higher education expenses paid by the taxpayer during a taxable year. Qualified higher education expenses are defined in the same manner as for purposes of the HOPE credit.

In 2002 and 2003, taxpayers with adjusted gross income that does not exceed $65,000 ($130,000 in the case of married couples filing joint returns) are entitled to a maximum deduction of $3,000 per year. Taxpayers with adjusted gross income above these thresholds would not be entitled to a deduction. In 2004 and 2005, taxpayers with adjusted gross income that does not exceed $65,000 ($130,000 in the case of married taxpayers filing joint returns) are entitled to a maximum deduction of $4,000 and taxpayers with adjusted gross income that does not exceed $80,000 ($160,000 in the case of married taxpayers filing joint returns) are entitled to a maximum deduction of $2,000. The provision contains ordering rules for use in determining adjusted gross income for purposes of the deduction.

Taxpayers are not eligible to claim the deduction and a HOPE or Lifetime Learning Credit in the same year with respect to the same student. A taxpayer may not claim a deduction for amounts taken into account in determining the amount excludable due to a distribution (i.e., the earnings and contribution portion of a distribution) from an education IRA or the amount of interest excludable with respect to education savings bonds. A taxpayer may not claim a deduction for the amount of a distribution from a qualified tuition plan that is excludable from income; however, a taxpayer may claim a deduction for the amount of a distribution from a qualified tuition plan that is not attributable to earnings. Thus, for example, if a taxpayer receives a distribution of $100 from a qualified tuition plan that is used for tuition, $10 of which represents earnings, the taxpayer would be entitled to claim the deduction with respect to the $90 representing a return of contributions. On the other hand, if the distribution were from an education IRA, the $90 would not be eligible for the deduction.

Effective Date

The provision is effective for payments made in taxable years beginning after December 31, 2001, and before January 1, 2006.

California Law

California has no similar deduction provision. Nor does California have credits similar to the HOPE or Lifetime Learning credits.

Impact on California Revenue

Economic Growth & Tax Relief Act of 2001
(P.L. 107-16)

Conformity revenue losses are estimated as follows:

Estimated Revenue Impact*			
Enactment Assumed By April 1, 2002			
Effective for Tax Years Beginning after 12/31/01			
Fiscal Years			
(In Millions)			
	2002-3	2003-4	2004-5
Higher Education Expenses Deduction	-$73	-$71	-$88

* 2004 is the first year that taxpayers with AGI over $65,000 ($130,000 for married filing joint) but below $80,000 ($160,000 for married filing joint) may claim a deduction for qualified expenses in an amount not exceeding $2,000. Additionally, the deduction for taxpayers with lower AGI increases in 2004 from $3,000 to $4,000.

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

The revenue estimates above were not based on federal projections. Federal projections include the impact of the HOPE and Lifetime Learning credits on the higher education deduction and California does not conform to these credits.

The California revenue estimates are based upon the number of students attending an eligible educational institution, the corresponding amount of qualified tuition and related expenses, and the ability of taxpayers within the specified AGI limits to apply the qualified deductions. Eligible educational institutions include community colleges, California State Universities, University of California colleges, private universities, and private career colleges. A three-percent growth-rate was applied to all enrollments based on available information. The percent of projected applied deductions in each year was computed based on information regarding demographic factors for each institutional classification and information on returns filed according to AGI ranges. The projections include a behavioral incentive effect of 2.5 percent for each year beginning after 2002.

Information for this estimate was obtained from various sources including the California Postsecondary Education Commission, the CSU and UC Systems, the Association of Independent California Colleges and Universities, the California Department of Education, and the Accrediting Council for Independent Colleges and Schools.

Section	Section Title
501-542	PHASEOUT AND REPEAL OF ESTATE AND GENERATION-SKIPPING TRANSFER TAXES; INCREASE IN GIFT TAX UNIFIED CREDIT EFFECTIVE EXEMPTION.

Background

Estate and gift tax rules

In general

Under present law, a gift tax is imposed on lifetime transfers and an estate tax is imposed on transfers at death. The gift tax and the estate tax are unified so that a single graduated rate schedule applies to cumulative taxable transfers made by a taxpayer during his or her lifetime and at death. The unified estate and gift tax rates begin at 18% on the first $10,000 of cumulative taxable transfers and reach 55% on cumulative taxable transfers over $3 million. In addition, a 5% surtax is imposed on cumulative taxable transfers between $10 million and $17,184,000, which has the effect of phasing out the benefit of the graduated rates. Thus, these estates are subject to a top marginal rate of 60%. Estates over $17,184,000 are subject to a flat rate of 55% on all amounts exceeding the unified credit effective exemption amount, as the benefit of the graduated rates has been phased out.

Gift tax annual exclusion

Donors of lifetime gifts are provided an annual exclusion of $10,000 (indexed for inflation occurring after 1997; the inflation-adjusted amount for 2001 remains at $10,000) of transfers of present interests in property to any one donee during the taxable year. If the non-donor spouse consents to split the gift with the donor spouse, then the annual exclusion is $20,000. Unlimited transfers between spouses are permitted without imposition of a gift tax.

Unified credit

A unified credit is available with respect to taxable transfers by gift and at death. The unified credit amount effectively exempts from tax transfers totaling $675,000 in 2001, $700,000 in 2002 and 2003, $850,000 in 2004, $950,000 in 2005, and $1 million in 2006 and thereafter. The benefit of the unified credit applies at the lowest estate and gift tax rates. For example, in 2001, the unified credit applies between the 18% and 37% estate and gift tax rates. Thus, in 2001, taxable transfers, after application of the unified credit, are effectively subject to estate and gift tax rates beginning at 37%.

Transfers to a surviving spouse

In general. --A 100% marital deduction generally is permitted for the value of property transferred between spouses. In addition, transfers of a "qualified terminable interest" also are eligible for the marital deduction. A "qualified terminable interest" is property: (1) which passes from the decedent, (2) in which the surviving spouse has a "qualifying income interest for life," and (3) to which an election under these rules applies. A "qualifying income interest for life" exists if: (1) the surviving spouse is entitled to all the income from the property (payable annually or at more frequent intervals) or the right to use property during the spouse's life, and (2) no person has the power to appoint any part of the property to any person other than the surviving spouse.

Transfers to surviving spouses who are not U.S. citizens. --A marital deduction generally is denied for property passing to a surviving spouse who is not a citizen of the United States. A marital deduction is permitted, however, for property passing to a qualified domestic trust of which the noncitizen surviving spouse is a beneficiary. A qualified domestic trust is a trust that has as its trustee at least one U.S. citizen or U.S. corporation. No corpus may be distributed from a qualified domestic trust unless the U.S. trustee has the right to withhold any estate tax imposed on the distribution. There is an estate tax imposed on (1) any distribution from a qualified domestic trust before the date of the death of the noncitizen surviving spouse and (2) the value of the property remaining in a qualified domestic trust on the date of death of the noncitizen surviving spouse. The tax is computed as an additional estate tax on the estate of the first spouse to die.

Expenses, indebtedness, and taxes.

An estate tax deduction is allowed for funeral expenses and administration expenses of an estate. An estate tax deduction also is allowed for claims against the estate and unpaid mortgages on, or any indebtedness in respect of, property for which the value of the decedent's interest therein, undiminished by the debt, is included in the value of the gross estate. If the total amount of claims and debts against the estate exceeds the value of the property to which the claims relate, an estate tax deduction for the excess is allowed, provided such excess is paid before the due date of the estate tax return. A deduction for claims against the estate generally is permitted only if the claim is allowable by the law of the jurisdiction under which the estate is being administered. A deduction also is allowed for the full-unpaid amount of any mortgage upon, or of any other indebtedness in respect of, any property included in the gross estate (including interest which has accrued thereon to the date of the decedent's death), provided that the full value of the underlying property is included in the decedent's gross estate.

Basis of property received

In general. --Gain or loss, if any, on the disposition of the property is measured by the taxpayer's amount realized (e.g., gross proceeds received) on the disposition, less the taxpayer's basis in such property. Basis generally represents a taxpayer's investment in property with certain adjustments required after acquisition. For example, basis is increased by the cost of capital improvements made to the property and decreased by depreciation deductions taken with respect to the property.

Property received from a donor of a lifetime gift takes a carryover basis. “Carryover basis” means that the basis in the hands of the donee is the same as it was in the hands of the donor. The basis of property transferred by lifetime gift also is increased, but not above fair market value, by any gift tax paid by the donor. The basis of a lifetime gift, however, generally cannot exceed the property's fair market value on the date of the gift. If the basis of the property is greater than the fair market value of the property on the date of gift, then, for purposes of determining loss, the basis is the property's fair market value on the date of gift.

Property passing from a decedent's estate generally takes a stepped-up basis. “Stepped-up basis” for estate tax purposes means that the basis of property passing from a decedent's estate generally is the fair market value on the date of the decedent's death (or, if the alternate valuation date is elected, the earlier of six months after the decedent's death or the date the property is sold or distributed by the estate). This step up (or step down) in basis eliminates the recognition of income on any appreciation of the property that occurred prior to the decedent's death, and has the effect of eliminating the tax benefit from any unrealized loss.

Special rule for community property. --In community property states, a surviving spouse's one-half share of community property held by the decedent and the surviving spouse (under the community property laws of any state, U.S. possession, or foreign country) generally is treated as having passed from the decedent, and thus is eligible for stepped-up basis. This rule applies if at least one-half of the whole of the community interest is includible in the decedent's gross estate.

Special rules for interests in certain foreign entities. --Stepped-up basis treatment generally is denied to certain interests in foreign entities. Under present law, stock or securities in a foreign personal holding company take a carryover basis. Stock in a foreign investment company takes a stepped up basis reduced by the decedent's ratable share of the company's accumulated earnings and profits. In addition, stock in a passive foreign investment company (including those for which a mark-to-market election has been made) generally takes a carryover basis, except that a passive foreign investment company for which a decedent shareholder had made a qualified electing fund election is allowed a stepped-up basis. Stock owned by a decedent in a domestic international sales corporation (or former domestic international sales corporation) takes a stepped-up basis reduced by the amount (if any) which would have been included in gross income under section 995(c) as a dividend if the decedent had lived and sold the stock at its fair market value on the estate tax valuation date (i.e., generally the date of the decedent's death unless an alternate valuation date is elected).

Provisions affecting small and family-owned businesses and farms

Special-use valuation. --An executor can elect to value for estate tax purposes certain “qualified real property” used in farming or another qualifying closely-held trade or business at its current-use value, rather than its fair market value. The maximum reduction in value for such real property is $750,000 (adjusted for inflation occurring after 1997; the inflation-adjusted amount for 2001 is $800,000). Real property generally can qualify for special-use valuation if at least 50% of the adjusted value of the decedent's gross estate consists of a farm or closely-held business assets in the decedent's estate (including both real and personal property) and at least 25% of the adjusted value of the gross estate consists of farm or closely-held business property. In addition, the property must be used in a qualified use (e.g., farming) by the decedent or a member of the decedent's family for five of the eight years before the decedent's death.

If, after a special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years of the decedent's death, an additional estate tax is imposed in order to recapture the entire estate-tax benefit of the special-use valuation.

Family-owned business deduction. --An estate is permitted to deduct the adjusted value of a qualified-family owned business interest of the decedent, up to $675,000. A qualified family-owned business interest is defined as any interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if the decedent's family owns at least 50% of the trade or business, two families own 70%, or three families own 90%, as long as the decedent's family owns at least 30% of the trade or business. An interest in a trade or business does not qualify if any interest in the business (or a related entity) was publicly traded at any time within three years of the decedent's death. An interest in a trade or business also does not qualify if more than 35% of the adjusted ordinary gross income of the business for the year of the decedent's death was personal holding company income. In the case of a trade or business that owns an interest in another trade or business (i.e., “tiered entities”), special look-through rules apply. The value of a trade or business qualifying as a family-owned business interest is reduced to the extent the business holds passive assets or excess cash or marketable securities.

The qualified family-owned business deduction and the unified credit effective exemption amount are coordinated. If the maximum deduction amount of $675,000 is elected, then the unified credit effective exemption amount is $625,000, for a total of $1.3 million. If the qualified family-owned business deduction is less than $675,000, then the unified credit effective exemption amount is equal to $625,000, increased by the difference between $675,000 and the amount of the qualified family-owned business deduction. However, the unified credit effective exemption amount cannot be increased above such amount in effect for the taxable year.

To qualify for the family-owned business exclusion, the decedent (or a member of the decedent's family) must have owned and materially participated in the trade or business for at least five of the eight years preceding the decedent's date of death. In addition, at least one qualified heir (or member of the qualified heir's family) is required to materially participate in the trade or business for at least 10 years following the decedent's death.

The qualified family-owned business rules provide a graduated recapture based on the number of years after the decedent's death in which the disqualifying event occurred. Under the provision, if the disqualifying event occurred within six years of the decedent's death, then 100% of the tax is recaptured. The remaining percentage of recapture based on the year after the decedent's death in which a disqualifying event occurs is as follows: the disqualifying event occurs during the seventh year after the decedent's death, 80%; during the eighth year after the decedent's death, 60%; during the ninth year after the decedent's death, 40%; and during the tenth year after the decedent's death, 20%. For purposes of the qualified family-owned business deduction, the contribution of a qualified conservation easement is not considered a disposition that would trigger recapture of estate tax. In general, there is no requirement that the qualified heir (or members of his or her family) continue to hold or participate in the trade or business more than 10 years after the decedent's death. However, the 10-year recapture period can be extended for a period of up to two years if the qualified heir does not begin to use the property for a period of up to two years after the decedent's death. An estate can claim the benefits of both the qualified family-owned business deduction and special-use valuation. For purposes of determining whether the value of the trade or business exceeds 50% of the decedent's gross estate, then the property's special-use value is used if the estate claimed special-use valuation.

State death tax credit

A credit is allowed against the federal estate tax for any estate, inheritance, legacy, or succession taxes actually paid to any state or the District of Columbia with respect to any property included in the decedent's gross estate. The maximum amount of credit allowable for state death taxes is determined under a graduated rate table, the top rate of which is 16%, based on the size of the decedent's adjusted taxable estate. Most States impose a “pick-up” or “soak-up” estate tax, which serves to impose a state tax equal to the maximum federal credit allowed.

Estate and gift taxation of nonresident noncitizens

Nonresident noncitizens are subject to gift tax with respect to certain transfers by gift of U.S.-situated property. Such property includes real estate and tangible property located within the United States. Nonresident noncitizens generally are not subject to U.S. gift tax on the transfer of intangibles, such as stock or securities, regardless of where such property is situated.

Estates of nonresident noncitizens generally are taxed at the same estate tax rates applicable to U.S. citizens, but the taxable estate includes only property situated within the United States that is owned by the decedent at death. This includes the value at death of all property, real or personal, tangible or intangible, situated in the United States. Special rules apply which treat certain property as being situated within and without the United States for these purposes. Unless modified by a treaty, a nonresident who is not a U.S. citizen generally is allowed a unified credit of $13,000, which effectively exempts $60,000 in assets from estate tax.

Generation-skipping transfer tax

A generation-skipping transfer tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a “skip person” (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the generation-skipping transfer tax include direct skips, taxable terminations, and taxable distributions. The generation-skipping transfer tax is imposed at a flat rate of 55% (i.e., the top estate and gift tax rate) on cumulative generation-skipping transfers in excess of $1 million (indexed for inflation occurring after 1997; the inflation-adjusted amount for 2001 is $1,060,000).

Selected income tax provisions

Transfers to certain foreign trusts and estates

A transfer (during life or at death) by a U.S. person to a foreign trust or estate generally is treated as a sale or exchange of the property for an amount equal to the fair market value of the transferred property. The amount of gain that must be recognized by the transferor is equal to the excess of the fair market value of the property transferred over the adjusted basis (for purposes of determining gain) of such property in the hands of the transferor.

Net operating loss and capital loss carryovers

Under present law, a capital loss and net operating loss from business operations sustained by a decedent during his last taxable year are deductible only on the final return filed in his or her behalf. Such losses are not deductible by his or her estate.

Transfers of property in satisfaction of a pecuniary bequest

Under present law, gain or loss is recognized on the transfer of property in satisfaction of a pecuniary bequest (i.e., a bequest of a specific dollar amount) to the extent that the fair market value of the property at the time of the transfer exceeds the basis of the property, which generally is the basis stepped up to fair market value on the date of the decedent's death.

Income tax exclusion for the gain on the sale of a principal residence

A taxpayer generally can exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. The exclusion is allowed each time a taxpayer sells or exchanges a principal residence that meets the eligibility requirements, but generally no more frequently than once every two years. To be eligible, a taxpayer must have owned the residence and occupied it as a principal residence for at least two of the five years prior to the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or other unforeseen circumstances is able to exclude the fraction of the $250,000 ($500,000 if married filing a joint return) equal to the fraction of two years that these requirements are met.

Excise tax on non-exempt trusts

Under present law, non-exempt split-interest trusts are subject to certain restrictions that are applicable to private foundations if an income, estate, or gift tax charitable deduction was allowed with respect to the trust. A non-exempt split-interest trust subject to these rules would be prohibited from engaging in self-dealing, retaining any excess business holdings, and from making certain investments or taxable expenditures. Failure to comply with these restrictions would subject the trust to certain excise taxes imposed on private foundations, which include excise taxes on self-dealing, excess business holdings, investments which jeopardize charitable purposes, and certain taxable expenditures.

<u>New Federal Law</u> (IRC. Secs. 121, 684, 1014, 1022, 1040, 1221, 2001 2058, 2210, 2501, 2502, 2503, 2505, 2511, 2601 2664, 2663, 4947, 6018, 6019, 6716, & 7701)

Overview

Under the Act, the estate, gift, and generation-skipping transfer taxes are reduced between 2002 and 2009, and the estate and generation-skipping transfer taxes are repealed in 2010.

Phaseout and repeal of estate and generation-skipping transfer taxes

In general

Under the Act, in 2002, the 5% surtax (which phases out the benefit of the graduated rates) and the rates in excess of 50% are repealed. In addition, in 2002, the unified credit effective exemption amount (for both estate and gift tax purposes) is increased to $1 million. In 2003, the estate and gift tax rates in excess of 49% are repealed. In 2004, the estate and gift tax rates in excess of 48% are repealed, and the unified credit effective exemption amount for estate tax purposes is increased to $1.5 million. (The unified credit effective exemption amount for gift tax purposes remains at $1 million as increased in 2002.) In addition, in 2004, the family-owned business deduction is repealed. In 2005, the estate and gift tax rates in excess of 47% are repealed. In 2006, the estate and gift tax rates in excess of 46% are repealed, and the unified credit effective exemption amount for estate tax purposes is increased to $2 million. In 2007, the estate and gift tax rates in excess of 45% are repealed. In 2009, the unified credit effective exemption amount is increased to $3.5 million. In 2010, the estate and generation-skipping transfer taxes are repealed.

From 2002 through 2009, the estate and gift tax rates and unified credit effective exemption amount for estate tax purposes are as follows:

Calendar year	Estate and GST tax death time transfer exemption	Highest estate and gift tax rates
2002	$1 million	50%
2003	$1 million	49%
2004	$1.5 million	48%
2005	$1.5 million	47%
2006	$2 million	46%
2007	$2 million	45%
2008	$2 million	45%
2009	$3.5 million	45%
2010	N/A (taxes repealed)	top individual rate under the Act (gift tax only)

The generation-skipping transfer tax exemption for a given year (prior to repeal) is equal to the unified credit effective exemption amount for estate tax purposes. In addition, as under present law, the generation-skipping transfer tax rate for a given year will be the highest estate and gift tax rate in effect for such year.

Repeal of estate and generation-skipping transfer taxes; modifications to gift tax

In 2010, the estate and generation-skipping transfer taxes are repealed. Also beginning in 2010, the top gift tax rate will be the top individual income tax rate as provided under the bill, and, except as provided in regulations, a transfer to trust will be treated as a taxable gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under the grantor trust provisions of the Code.

Reduction in state death tax credit; deduction for state death taxes paid

Under the Act, from 2002 through 2004, the state death tax credit allowable under present law is reduced as follows: in 2002, the state death tax credit is reduced by 25% (from present law amounts); in 2003, the state death tax credit is reduced by 50% (from present law amounts); and in 2004, the state death tax credit is reduced by 75% (from present law amounts). In 2005, the state death tax credit is repealed, after which there will be a deduction for death taxes (e.g., any estate, inheritance, legacy, or succession taxes) actually paid to any state or the District of Columbia, in respect of property included in the gross estate of the decedent. Such state taxes must have been paid and claimed before the later of: (1) four years after the filing of the estate tax return; or (2) (a) 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final, (b) the expiration of the period of extension to pay estate taxes over time under section 6166, or (c) the expiration of the period of limitations in which to file a claim for refund or 60 days after a decision of a court in which such refund suit has become final.

Basis of property acquired from a decedent

In general

Beginning in 2010, after the estate, gift, and generation-skipping transfer taxes have been repealed, the present-law rules providing for a fair market value basis for property acquired from a decedent are repealed. Instead, a modified carryover basis regime generally takes effect. Recipients of property transferred at the decedent's death will receive a basis equal the lesser of the adjusted basis of the decedent or the fair market value of the property on the date of the decedent's death.

The modified carryover basis rules apply to property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, property passing from the decedent to the extent such property passed without consideration, and certain other property to which the present law rules apply.

Property acquired from a decedent is treated as if the property had been acquired by gift. Thus, the character of gain on the sale of property received from a decedent's estate is carried over to the heir. For example, real estate that has been depreciated and would be subject to recapture if sold by the decedent will be subject to recapture if sold by the heir.

Property to which the modified carryover basis rules apply

The modified carryover basis rules apply to property acquired from the decedent. Property acquired from the decedent is (1) property acquired by bequest, devise, or inheritance, (2) property acquired by the decedent's estate from the decedent, (3) property transferred by the decedent during his or her lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust, (4) property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change to the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust, (5) property passing from the decedent by reason of the decedent's death to the extent such property passed without consideration (e.g., property held as joint tenants with right of survivorship or as tenants by the entireties), and (6) the surviving spouse's one-half share of certain community property held by the decedent and the surviving spouse as community property.

Basis increase for certain property

Amount of basis increase. --The Act allows an executor to increase (i.e., step up) the basis in assets owned by the decedent and acquired by the beneficiaries at death. Under this rule, each decedent's estate generally is permitted to increase (i.e., step up) the basis of assets transferred by up to a total of $1.3 million. The $1.3 million is increased by the amount of unused capital losses, net operating losses, and certain “built-in” losses of the decedent. In addition, an additional $3 million can increase the basis of property transferred to a surviving spouse. Thus, the basis of property transferred to surviving spouses can be increased by a total of $4.3 million. Nonresidents who are not U.S. citizens will be allowed to increase the basis of property by up to $60,000. The $60,000, $1.3 million, and $3 million amounts are adjusted annually for inflation occurring after 2009.

Property eligible for basis increase. --In general, the basis of property may be increased above the decedent's adjusted basis in that property only if the property is owned, or is treated as owned, by the decedent at the time of the decedent's death. In the case of property held as joint tenants or tenants by the entireties with the surviving spouse, one-half of the property is treated having been owned by the decedent and is thus eligible for the basis increase. In the case of property held jointly with a person other than the surviving spouse, the portion of the property attributable to the decedent's consideration furnished is treated as having been owned by the decedent and will be eligible for a basis increase. The decedent also is treated as the owner of property (which will be eligible for a basis increase) if the property was transferred by the decedent during his lifetime to a revocable trust that pays all of its income during the decedent's life to the decedent or at the direction of the decedent. The decedent also is treated as having owned the surviving spouse's one-half share of community property (which will be eligible for a basis increase) if at least one-half of the property was owned by, and acquired from, the decedent. The decedent shall not, however, be treated as owning any property solely by reason of holding a power of appointment with respect to such property.

Property not eligible for a basis increase includes: (1) property that was acquired by the decedent by gift (other than from his or her spouse) during the three-year period ending on the date of the decedent's death; (2) property that constitutes a right to receive income in respect of a decedent; (3) stock or securities of a foreign personal holding company; (4) stock of a domestic international sales corporation (or former domestic international sales corporation); (5) stock of a foreign investment company; and (6) stock of a passive foreign investment company (except for which a decedent shareholder had made a qualified electing fund election).

Rules applicable to basis increase. --Basis increase will be allocable on an asset-by-asset basis (e.g., basis increase can be allocated to a share of stock or a block of stock). However, in no case can the basis of an asset be adjusted above its fair market value. If the amount of basis increase is less than the fair market value of assets whose bases are eligible to be increased under these rules, the executor will determine which assets and to what extent each asset receives a basis increase

These rules regarding the determination of basis of property acquired from a decedent after repeal of the estate tax will be in effect beginning in 2010 (i.e., when the estate tax is repealed)

Reporting requirements

Lifetime gifts

A donor is required to provide to recipients of property by gift the information relating to the property (e.g., the fair market value and basis of property) that was reported on the donor's gift tax return with respect to such property.

Transfers at death

For transfers at death of non-cash assets in excess of $1.3 million and for appreciated property the value of which exceeds $25,000 received by a decedent within three years of death, the executor of the estate (or the trustee of a revocable trust) would report to the IRS:

- The name and taxpayer identification number of the recipient of the property,
- An accurate description of the property,
- The adjusted basis of the property in the hands of the decedent and its fair market value at the time of death,
- The decedent's holding period for the property,
- Sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income,
- The amount of basis increase allocated to the property, and
- Any other information as the Treasury Secretary may prescribe.

Penalties for failure to comply with the reporting requirements

Any donor required to provide to recipients of property by gift the information relating to the property that was reported on the donor's gift tax return (e.g., the fair market value and basis of property) with respect to such property who fails to do so is liable for a penalty of $50 for each failure to report such information to a donee.

Any person required to report to the IRS transfers at death of non-cash assets in excess of $1.3 million in value who fails to do so is liable for a penalty of $10,000 for the failure to report such information. Any person required to report to the IRS the receipt by a decedent of appreciated property valued in excess of $25,000 within three years of death who fails to do so is liable for a penalty of $500 for the failure to report such information to the IRS. There also is a penalty of $50 for each failure to report such information to a beneficiary. No penalty is imposed with respect to any failure that is due to reasonable cause. If any failure to report to the IRS or a beneficiary under the Act is due to intentional disregard of the rules, then the penalty is 5% of the fair market value of the property for which reporting was required, determined at the date of the decedent's death (for property passing at death) or determined at the time of gift (for a lifetime gift).

Certain tax benefits extending past the date for repeal of the estate tax

There will continue to be (1) the additional estate tax for those with a retained development right with respect to property for which a conservation easement was claimed, (2) the additional estate tax imposed under the special-use valuation rules, (3) the additional tax imposed under the qualified family-owned business deduction rules, and (4) acceleration of tax under the installment payment of estate tax provisions.

In addition, under the Act, there will continue to be an estate tax imposed on (1) any distribution prior to January 1, 2021, from a qualified domestic trust before the date of the death of the noncitizen surviving spouse and (2) the value of the property remaining in a qualified domestic trust on the date of death of the noncitizen surviving spouse if such surviving spouse dies before January 1, 2010.

Transfers to foreign trusts, estates, and nonresidents who are not U.S. citizens

The present-law rule providing that transfers by a U.S. person to a foreign trust or estate generally is treated as a sale or exchange is expanded. Under the Act, beginning in 2010, only a transfer by a U.S. person's estate (i.e., by a U.S. person at death) to a nonresident who is not a U.S. citizen is treated as a sale or exchange of the property for an amount equal to the fair market value of the transferred property. The amount of gain that must be recognized by the transferor is equal to the excess of the fair market value of the property transferred over the adjusted basis of such property in the hands of the transferor.

Transfers of property in satisfaction of a pecuniary bequest

Under the Act, gain or loss on the transfer of property in satisfaction of a pecuniary bequest is recognized only to the extent that the fair market value of the property at the time of the transfer exceeds the fair market value of the property on the date of the decedent's death (not the property's carryover basis).

Transfer of property subject to a liability

The Act clarifies that gain is not recognized at the time of death when the estate or heir acquires from the decedent property subject to a liability that is greater than the decedent's basis in the property. Similarly, the estate recognizes no gain on the distribution of such property to a beneficiary of the estate by reason of the liability.

Income tax exclusion for the gain on the sale of a principal residence

The income tax exclusion of up to $250,000 of gain on the sale of a principal residence is extended to estates and heirs. Under the Act, if the decedent's estate or an heir sells the decedent's principal residence, $250,000 of gain can be excluded on the sale of the residence, provided the decedent used the property as a principal residence for two or more years during the five-year period prior to the sale. In addition, if an heir occupies the property as a principal residence, the decedent's period of ownership and occupancy of the property as a principal residence can be added to the heir's subsequent ownership and occupancy in determining whether the property was owned and occupied for two years as a principal residence.

Additionally, the income tax exclusion for the gain on the sale of a principal residence applies to property sold by a trust that was a qualified revocable trust under section 645 of the Code immediately prior to the decedent's death. The decedent's period of occupancy of the property as a principal residence can be added to an heir's subsequent ownership and occupancy in determining whether the property was owned and occupied for two years as a principal residence, regardless of whether the residence was owned by such trust during the decedent's occupancy.

Excise tax on nonexempt trusts

Under the bill, split-interest trusts are subject to certain restrictions that are applicable to private foundations if an income tax charitable deduction, including an income tax charitable deduction by an estate or trust, was allowed with respect to transfers to the trust.

<u>Effective Date</u>

The estate and gift rate reductions, increases in the estate tax unified credit exemption equivalent amounts and generation-skipping transfer tax exemption amount, and reductions in and repeal of the state death tax credit are phased-in over time, beginning with estates of decedents dying and gifts and generation-skipping transfers after December 31, 2001. The repeal of the qualified family-owned business deduction is effective for estates of decedents dying after December 31, 2003.

The estate and generation-skipping transfer taxes are repealed, and the carryover basis regime takes effect for estates of decedents dying and generation-skipping transfers after December 31, 2009. The provisions relating to recognition of gain on transfers by the estate of a U.S. person (i.e., at death) to nonresidents who are not U.S. citizens is effective for transfers made after December 31, 2009.

The top gift tax rate will be the top individual income tax rate as provided in the bill, and transfers to trusts generally will be treated as a taxable gift unless the trust is treated as wholly owned by the donor or the donor's spouse, effective for gifts made after December 31, 2009.

An estate tax on distributions made from a qualified domestic trust before the date of the death of the surviving spouse will no longer apply for distributions made after December 31, 2020. An estate tax on the value of property remaining in a qualified domestic trust on the date of death of the surviving spouse will no longer apply after December 31, 2009.

California Law

California does not impose a gift tax; the California estate tax is a "pick-up" tax; that is, the state estate tax is equal to the maximum credit for a state death tax on the federal estate tax return for that particular decedent's estate. This "pick-up" tax is administered by the State Controller's Office.

California does conform to the federal rules, prior to the Economic Growth & Tax Relief Reconciliation Act of 2001, regarding the basis of property received from a decedent. Generally, if the property received from a decedent that was subject to estate tax, the basis of the property in the hands of the legatees is its FMV on the date of death (DOD) or 6 months later (the alternate valuation date).

Impact on California Revenue

Any revenue impact created by the change in carryover basis at death would not occur until 2011. The changes to carryover basis are effective with respect to decedents dying after December 31, 2009. Any income tax impact would occur from the disposition of affected assets received after December 31, 2009. The Joint Committee on Taxation projects the first year revenue loss in 2011 to be negligible.

Section	Section Title
551	EXPAND ESTATE TAX RULE FOR CONSERVATION EASEMENTS.

Background

In general

An executor can elect to exclude from the taxable estate 40% of the value of any land subject to a qualified conservation easement, up to a maximum exclusion of $100,000 in 1998, $200,000 in 1999, $300,000 in 2000, $400,000 in 2001, and $500,000 in 2002 and thereafter (sec. 2031(c)). The exclusion percentage is reduced by 2 percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30% of the value of the land (determined without regard to the value of such easement and reduced by the value of any retained development right). A qualified conservation easement is one that meets the following requirements:

(1) the land is located within 25 miles of a metropolitan area (as defined by the Office of Management and Budget) or a national park or wilderness area, or within 10 miles of an Urban National Forest (as designated by the Forest Service of the U.S. Department of Agriculture); (2) the land has been owned by the decedent or a member of the decedent's family at all times during the three-year period ending on the date of the decedent's death; and (3) a qualified conservation contribution (within the meaning of sec. 170(h)) of a qualified real property interest (as generally defined in sec. 170(h)(2)(C)) was granted by the decedent or a member of his or her family. For purposes of the provision, preservation of a historically important land area or a certified historic structure does not qualify as a conservation purpose.
In order to qualify for the exclusion, a qualifying easement must have been granted by the decedent, a member of the decedent's family, the executor of the decedent's estate, or the trustee of a trust holding the land, no later than the date of the election. To the extent that the value of such land is excluded from the taxable estate, the basis of such land acquired at death is a carryover basis (i.e., the basis is not stepped-up to its fair market value at death). Property financed with acquisition indebtedness is eligible for this provision only to the extent of the net equity in the property.

Retained development rights

The exclusion for land subject to a conservation easement does not apply to any development right retained by the donor in the conveyance of the conservation easement. An example of such a development right would be the right to extract minerals from the land. If such development rights exist, then the value of the conservation easement must be reduced by the value of any retained development right. If the donor or holders of the development rights agree in writing to extinguish the development rights in the land, then the development rights need not reduce the value of the easement. In such case, those persons with an interest in the land must execute the agreement no later than the earlier of (1) two years after the date of the decedent's death or (2) the date of the sale of such land subject to the conservation easement. If such agreement is not entered into within this time, then those with an interest in the land are personally liable for an additional tax, which is the amount of tax which would have been due on the retained development rights subject to the termination agreement.

New Federal Law (Sec. 2031)

The Act expands availability of qualified conservation easements by eliminating the requirement that the land be located within a certain distance from a metropolitan area, national park, wilderness area, or Urban National Forest. Thus, under the Act, a qualified conservation easement may be claimed with respect to any land that is located in the United States or its possessions. The Act also clarifies that the date for determining easement compliance is the date on which the donation was made.

Effective Date

The provisions are effective for estates of decedents dying after December 31, 2000.

California Law

California does not impose a gift tax; the California estate tax is a "pick-up" tax, that is, the state estate tax is equal to the maximum credit for a state death tax on the federal estate tax return for that particular decedent's estate. This "pick-up" tax is administered by the State Controller's Office.

Impact on California Revenue

Defer to the Controller's Office.

Section	Section Title
561	DEEMED ALLOCATION OF THE GENERATION-SKIPPING TRANSFER TAX EXEMPTION TO LIFETIME TRANSFERS TO TRUSTS THAT ARE NOT DIRECT SKIPS.

Background

A generation-skipping transfer tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the generation-skipping transfer tax include direct skips, taxable terminations, and taxable distributions. An exemption of $1 million (indexed beginning in 1999; the inflation-adjusted amount for 2001 is $1,060,000) is provided for each person making generation-skipping transfers. The exemption can be allocated by a transferor (or his or her executor) to transferred property.

A direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person. A skip person may be a natural person or certain trusts. All persons assigned to the second or more remote generation below the transferor are skip persons (e.g., grandchildren and great-grandchildren). Trusts are skip persons if (1) all interests in the trust are held by skip persons, or (2) no person holds an interest in the trust and at no time after the transfer may a distribution (including distributions and terminations) be made to a non-skip person.

A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip).

The tax rate on generation-skipping transfers is a flat rate of tax equal to the maximum estate and gift tax rate in effect at the time of the transfer (55% under present law) multiplied by the "inclusion ratio." The inclusion ratio with respect to any property transferred in a generation-skipping transfer indicates the amount of "generation-skipping transfer tax exemption" allocated to a trust. The allocation of generation-skipping transfer tax exemption reduces the 55% tax rate on a generation-skipping transfer.

If an individual makes a direct skip during his or her lifetime, any unused generation-skipping transfer tax exemption is automatically allocated to a direct skip to the extent necessary to make the inclusion ratio for such property equal to zero. An individual can elect out of the automatic allocation for lifetime direct skips.

For lifetime transfers made to a trust that are not direct skips, the transferor must allocate generation-skipping transfer tax exemption--the allocation is not automatic. If generation-skipping transfer tax exemption is allocated on a timely-filed gift tax return, then the portion of the trust which is exempt from generation-skipping transfer tax is based on the value of the property at the time of the transfer. If, however, the allocation is not made on a timely-filed gift tax return, then the portion of the trust which is exempt from generation-skipping transfer tax is based on the value of the property at the time the allocation of generation-skipping transfer tax exemption was made.

Treas. Reg. sec. 26.2632 1(d) further provides that any unused generation-skipping transfer tax exemption, which has not been allocated to transfers made during an individual's life, is automatically allocated on the due date for filing the decedent's estate tax return. Unused generation-skipping transfer tax exemption is allocated pro rata on the basis of the value of the property as finally determined for estate tax purposes, first to direct skips treated as occurring at the transferor's death. The balance, if any, of unused generation-skipping transfer tax exemption is allocated pro rata, on the basis of the estate tax value of the nonexempt portion of the trust property (or in the case of trusts that are not included in the gross estate, on the basis of the date of death value of the trust) to trusts with respect to which a taxable termination may occur or from which a taxable distribution may be made.

New Federal Law (Sec. 2632)

Under the Act, the generation-skipping transfer tax exemption will be automatically allocated to transfers made during life that are “indirect skips.” An indirect skip is any transfer of property (that is not a direct skip) subject to the gift tax that is made to a generation-skipping transfer trust.

A generation-skipping transfer trust is defined as a trust that could have a generation-skipping transfer with respect to the transferor (e.g., a taxable termination or taxable distribution), unless:

- The trust instrument provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons (a) before the date that the individual attains age 46, (b) on or before one or more dates specified in the trust instrument that will occur before the date that such individual attains age 46, or (c) upon the occurrence of an event that, in accordance with regulations prescribed by the Treasury Secretary, may reasonably be expected to occur before the date that such individual attains age 46;
- The trust instrument provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons and who are living on the date of death of another person identified in the instrument (by name or by class) who is more than 10 years older than such individuals;
- The trust instrument provides that, if one or more individuals who are non-skip persons die on or before a date or event described in clause (1) or (2), more than 25% of the trust corpus either must be distributed to the estate or estates of one or more of such individuals or is subject to a general power of appointment exercisable by one or more of such individuals;
- The trust is a trust any portion of which would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer;
- The trust is a charitable lead annuity trust or a charitable remainder annuity trust or a charitable unitrust; or

- The trust is a trust with respect to which a deduction was allowed under section 2522 for the amount of an interest in the form of the right to receive annual payments of a fixed percentage of the net fair market value of the trust property (determined yearly) and which is required to pay principal to a non-skip person if such person is alive when the yearly payments for which the deduction was allowed terminate.

If any individual makes an indirect skip during the individual's lifetime, then any unused portion of such individual's generation-skipping transfer tax exemption is allocated to the property transferred to the extent necessary to produce the lowest possible inclusion ratio for such property.

An individual can elect not to have the automatic allocation rules apply to an indirect skip, and such elections will be deemed timely if filed on a timely-filed gift tax return for the calendar year in which the transfer was made or deemed to have been made or on such later date or dates as may be prescribed by the Treasury Secretary. An individual can elect not to have the automatic allocation rules apply to any or all transfers made by such individual to a particular trust and can elect to treat any trust as a generation-skipping transfer trust with respect to any or all transfers made by the individual to such trust, and such election can be made on a timely-filed gift tax return for the calendar year for which the election is to become effective.

Effective Date

The provision applies to transfers subject to estate or gift tax made after December 31, 2000, and to estate tax inclusion periods ending after December 31, 2000.

California Law

California does not impose a gift tax; the California estate tax is a "pick-up" tax, that is, the state tax is equal to the maximum credit for a state death tax on the federal estate tax return for that particular decedent's estate. This "pick-up" tax is administered by the State Controller's Office.

Impact on California Revenue

Defer to the Controller’s Office.

Section	Section Title
561	RETROACTIVE ALLOCATION OF THE GENERATION-SKIPPING TRANSFER TAX EXEMPTION.

Background

A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip). If a transferor allocates generation-skipping transfer tax exemption to a trust prior to the taxable termination or taxable distribution, generation-skipping transfer tax may be avoided.

A transferor likely will not allocate generation-skipping transfer tax exemption to a trust that the transferor expects will benefit only non-skip persons. However, if a taxable termination occurs because, for example, the transferor's child unexpectedly dies such that the trust terminates in favor of the transferor's grandchild, and generation-skipping transfer tax exemption had not been allocated to the trust, then generation-skipping transfer tax would be due even if the transferor had unused generation-skipping transfer tax exemption.

New Federal Law (Sec. 2632)

The Act provides that generation-skipping transfer tax exemption can be allocated retroactively when there is an unnatural order of death. If a lineal descendant of the transferor predeceases the transferor, then the transferor can allocate any unused generation-skipping transfer exemption to any previous transfer or transfers to the trust on a chronological basis. The provision allows a transferor to retroactively allocate generation-skipping transfer exemption to a trust where a beneficiary (a) is a non-skip person, (b) is a lineal descendant of the transferor's grandparent or a grandparent of the transferor's spouse, (c) is a generation younger than the generation of the transferor, and (d) dies before the transferor. Exemption is allocated under this rule retroactively, and the applicable fraction and inclusion ratio would be determined based on the value of the property on the date that the property was transferred to trust.

Effective Date

The provision applies to deaths of non-skip persons occurring after December 31, 2000.

California Law

California does not impose a gift tax; the California estate tax is a "pick-up" tax, that is, the state tax is equal to the maximum credit for a state death tax on the federal estate tax return for that particular decedent's estate. This "pick-up" tax is administered by the State Controller's Office.

Impact on California Revenue

Defer to the Controller’s Office.

Section	Section Title
562	SEVERING OF TRUSTS HOLDING PROPERTY HAVING AN INCLUSION RATIO OF GREATER THAN ZERO.

Background

A generation-skipping transfer tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a “skip person” (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the generation-skipping transfer tax include direct skips, taxable terminations, and taxable distributions. An exemption of $1 million (indexed beginning in 1999; the inflation-adjusted amount for 2001 is $1,060,000) is provided for each person making generation-skipping transfers. The exemption can be allocated by a transferor (or his or her executor) to transferred property.

If the value of transferred property exceeds the amount of the generation-skipping transfer tax exemption allocated to that property, then the generation-skipping transfer tax generally is determined by multiplying a flat tax rate equal to the highest estate tax rate (which is currently 55%) by the “inclusion ratio” and the value of the taxable property at the time of the taxable event. The “inclusion ratio” is the number one minus the “applicable fraction.” The applicable fraction is a fraction calculated by dividing the amount of the generation-skipping transfer tax exemption allocated to the property by the value of the property.

Under Treas. Reg.26.2654 1(b), a trust may be severed into two or more trusts (e.g., one with an inclusion ratio of zero and one with an inclusion ratio of one) only if (1) the trust is severed according to a direction in the governing instrument or (2) the trust is severed pursuant to the trustee's discretionary powers, but only if certain other conditions are satisfied (e.g., the severance occurs or a reformation proceeding begins before the estate tax return is due). Under current Treasury regulations, however, a trustee cannot establish inclusion ratios of zero and one by severing a trust that is subject to the generation-skipping transfer tax after the trust has been created.

New Federal Law (Sec. 2642)

The Act provides that a trust can be severed in a “qualified severance.” A qualified severance is defined as the division of a single trust and the creation of two or more trusts if (1) the single trust was divided on a fractional basis, and (2) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust. If a trust has an inclusion ratio of greater than zero and less than one, a severance is a qualified severance only if the single trust is divided into two trusts, one of which receives a fractional share of the total value of all trust assets equal to the applicable fraction of the single trust immediately before the severance. In such case, the trust receiving such fractional share shall have an inclusion ratio of zero and the other trust shall have an inclusion ratio of one. Under the provision, a trustee may elect to sever a trust in a qualified severance at any time.

Effective Date

The provision is effective for severances of trusts occurring after December 31, 2000.

California Law

California does not impose a gift tax; the California estate tax is a "pick-up" tax, that is, the state tax is equal to the maximum credit for a state death tax on the federal estate tax return for that particular decedent's estate. This "pick-up" tax is administered by the State Controller's Office.

Impact on California Revenue

Defer to the Controller's Office.

Section	Section Title
563	MODIFICATION OF CERTAIN VALUATION RULES.

Background

Under present law, the inclusion ratio is determined using gift tax values for allocations of generation-skipping transfer tax exemption made on timely filed gift tax returns. The inclusion ratio generally is determined using estate tax values for allocations of generation-skipping transfer tax exemption made to transfers at death. Treas. Reg. 26.2642 5(b) provides that, with respect to taxable terminations and taxable distributions, the inclusion ratio becomes final on the later of the period of assessment with respect to the first transfer using the inclusion ratio or the period for assessing the estate tax with respect to the transferor's estate.

New Federal Law (Sec. 2462)

The Act provides that in connection with timely and automatic allocations of generation-skipping transfer tax exemption, the value of the property for purposes of determining the inclusion ratio shall be its finally determined gift tax value or estate tax value depending on the circumstances of the transfer. In the case of a generation-skipping transfer tax exemption allocation deemed to be made at the conclusion of an estate tax inclusion period, the value for purposes of determining the inclusion ratio shall be its value at that time.

Effective Date

The provision is effective for transfers subject to estate or gift tax made after December 31, 2000

California Law

California does not impose a gift tax; the California estate tax is a "pick-up" tax, that is, the state tax is equal to the maximum credit for a state death tax on the federal estate tax return for that particular decedent's estate. This "pick-up" tax is administered by the State Controller's Office.

Impact on California Revenue

Defer to the Controller's Office.

Section	Section Title
564	RELIEF FROM LATE ELECTIONS.

Background

Under present law, an election to allocate generation-skipping transfer tax exemption to a specific transfer may be made at any time up to the time for filing the transferor's estate tax return. If an allocation is made on a gift tax return filed timely with respect to the transfer to trust, then the value on the date of transfer to the trust is used for determining generation-skipping transfer tax exemption allocation. However, if the allocation relating to a specific transfer is not made on a timely-filed gift tax return, then the value on the date of allocation must be used. There is no statutory provision allowing relief for an inadvertent failure to make an election on a timely-filed gift tax return to allocate generation-skipping transfer tax exemption.

New Federal Law (Sec. 2462)

The Act provides that the Treasury Secretary is authorized and directed to grant extensions of time to make the election to allocate generation-skipping transfer tax exemption and to grant exceptions to the time requirement, without regard to whether any period of limitations has expired. If such relief is granted, then the gift tax or estate tax value of the transfer to trust would be used for determining generation-skipping transfer tax exemption allocation.

In determining whether to grant relief for late elections, the Treasury Secretary is directed to consider all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Treasury Secretary deems relevant. For purposes of determining whether to grant relief, the time for making the allocation (or election) is treated as if not expressly prescribed by statute.

Effective Date

The provision applies to requests pending on, or filed after, December 31, 2000. No inference is intended with respect to the availability of relief from late elections prior to the effective date of the provision

California Law

California does not impose a gift tax; the California estate tax is a "pick-up" tax, that is, the state tax is equal to the maximum credit for a state death tax on the federal estate tax return for that particular decedent's estate. This "pick-up" tax is administered by the State Controller's Office.

Impact on California Revenue

Defer to the Controller's Office.

Section	Section Title
564	SUBSTANTIAL COMPLIANCE.

Background

Under present law, there is no statutory rule that provides that substantial compliance with the statutory and regulatory requirements for allocating generation-skipping transfer tax exemption will suffice to establish that generation-skipping transfer tax exemption was allocated to a particular transfer or trust.

New Federal Law (Sec. 2642)

The Act provides that substantial compliance with the statutory and regulatory requirements for allocating generation-skipping transfer tax exemption will suffice to establish that generation-skipping transfer tax exemption was allocated to a particular transfer or a particular trust. If a taxpayer demonstrates substantial compliance, then so much of the transferor's unused generation-skipping transfer tax exemption will be allocated to the extent it produces the lowest possible inclusion ratio. In determining whether there has been substantial compliance, all relevant circumstances will be considered, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Treasury Secretary deems appropriate.

Effective Date

The provision applies to transfers subject to estate or gift tax made after December 31, 2000. No inference is intended with respect to the availability of a rule of substantial compliance prior to the effective date of the provision.

California Law

California does not impose a gift tax; the California estate tax is a "pick-up" tax, that is, the state tax is equal to the maximum credit for a state death tax on the federal estate tax return for that particular decedent's estate. This "pick-up" tax is administered by the State Controller's Office.

Impact on California Revenue

Defer to the Controller's Office.

Section	Section Title
571-572	EXPAND AND MODIFY AVAILABILITY OF INSTALLMENT PAYMENT OF ESTATE TAX FOR CLOSELY-HELD BUSINESSES.

Background

Under present law, the estate tax generally is due within nine months of a decedent's death. However, an executor generally may elect to pay estate tax attributable to an interest in a closely held business in two or more installments (but no more than 10). An estate is eligible for payment of estate tax in installments if the value of the decedent's interest in a closely-held business exceeds 35% of the decedent's adjusted gross estate (i.e., the gross estate less certain deductions). If the election is made, the estate may defer payment of principal and pay only interest for the first five years, followed by up to 10 annual installments of principal and interest. This provision effectively extends the time for paying estate tax by 14 years from the original due date of the estate tax. A special 2% interest rate applies to the amount of deferred estate tax attributable to the first $1 million (adjusted annually for inflation occurring after 1998; the inflation-adjusted amount for 2001 is $1,060,000) in taxable value of a closely held business. The interest rate applicable to the amount of estate tax attributable to the taxable value of the closely-held business in excess of $1 million is equal to 45% of the rate applicable to underpayments of tax under section 6621 (i.e., 45% of the federal short-term rate plus 3 percentage points). Interest paid on deferred estate taxes is not deductible for estate or income tax purposes.

For purposes of these rules, an interest in a closely-held business is: (1) an interest as a proprietor in a sole proprietorship, (2) an interest as a partner in a partnership carrying on a trade or business if 20% or more of the total capital interest of such partnership is included in the decedent's gross estate or the partnership had 15 or fewer partners, and (3) stock in a corporation carrying on a trade or business if 20% or more of the value of the voting stock of the corporation is included in the decedent's gross estate or such corporation had 15 or fewer shareholders. The decedent may own the interest directly or, in certain cases, ownership may be indirect, through a holding company. If ownership is through a holding company, the stock must be non-readily tradable. If stock in a holding company is treated as business company stock for purposes of the installment payment provisions, the five-year deferral for principal and the 2% interest rate do not apply. The value of any interest in a closely-held business does not include the value of that portion of such interest attributable to passive assets held by such business.

New Federal Law (Sec. 6166)

The Act expands the definition of a closely-held business for purposes of installment payment of estate tax. The bill increases from 15 to 45 the number of partners in a partnership and shareholders in a corporation that is considered a closely-held business in which a decedent held an interest, and thus will qualify the estate for installment payment of estate tax.

The Act expands availability of the installment payment provisions by providing that an estate of a decedent with an interest in a qualifying lending and financing business is eligible for installment payment of the estate tax. The bill also provides that an estate with an interest in a qualifying lending and financing business that claims installment payment of estate tax must make installment payments of estate tax (which will include both principal and interest) relating to the interest in a qualifying lending and financing business over five years. No inference is intended as to whether one or more of the specified activities of a qualified lending and financing business would be a trade or business eligible for installment payment of estate tax under present law.

The Act also clarifies that the installment payment provisions require that only the stock of holding companies, not that of operating subsidiaries, must be non-readily tradable in order to qualify for installment payment of the estate tax. The Act also provides that an estate with a qualifying property interest held through holding companies that claims installment payment of estate tax must make all installment payments of estate tax (which will include both principal and interest) relating to a qualifying property interest held through holding companies over five years.

Effective Date

The provision is effective for decedents dying after December 31, 2001.

California Law

California does not impose a gift tax; the California estate tax is a "pick-up" tax, that is, the state tax is equal to the maximum credit for a state death tax on the federal estate tax return for that particular decedent's estate. This "pick-up" tax is administered by the State Controller's Office.

Impact on California Revenue

Defer to the Controller's Office.

Section	Section Title
601-603	INDIVIDUAL RETIREMENT ARRANGEMENTS.

Background

There are two general types of individual retirement arrangements ("IRAs") under present law: traditional IRAs, to which both deductible and nondeductible contributions may be made, and Roth IRAs. The federal income tax rules regarding each type of IRA (and IRA contribution) differ.

Traditional IRAs

Under present law, an individual may make deductible contributions to an IRA up to the lesser of $2,000 or the individual's compensation if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. In the case of a married couple, deductible IRA contributions of up to $2,000 can be made for each spouse (including, for example, a homemaker who does not work outside the home), if the combined compensation of both spouses is at least equal to the contributed amount. If the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the $2,000 deduction limit is phased out for taxpayers with adjusted gross income ("AGI") over certain levels for the taxable year.

The AGI phase-out limits for taxpayers who are active participants in employer-sponsored plans are as follows.

Single Taxpayers

Taxable years beginning in:	Phase-out range
2001	$33,000 43,000
2002	34,000 44,000
2003	40,000 50,000
2004	45,000 55,000
2005 and thereafter	50,000 60,000

Joint Returns

Taxable years beginning in:	Phase-out range
2001	$53,000 63,000
2002	54,000 64,000
2003	60,000 70,000
2004	65,000 75,000
2005	70,000 80,000
2006	75,000 85,000
2007 and thereafter	80,000 100,000

The AGI phase-out range for married taxpayers filing a separate return is $0 to $10,000.

If the individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the $2,000 deduction limit is phased out for taxpayers with AGI between $150,000 and $160,000.

To the extent an individual cannot or does not make deductible contributions to an IRA or contributions to a Roth IRA, the individual may make nondeductible contributions to a traditional IRA.

Amounts held in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Includible amounts withdrawn prior to attainment of age 59 1/2 are subject to an additional 10% early withdrawal tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, is used to pay medical expenses in excess of 7.5% of AGI, is used to purchase health insurance of an unemployed individual, is used for education expenses, or is used for first-time homebuyer expenses of up to $10,000.

Roth IRAs

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that may be made to a Roth IRA is the lesser of $2,000 or the individual's compensation for the year. The contribution limit is reduced to the extent an individual makes contributions to any other IRA for the same taxable year. As under the rules relating to IRAs generally, a contribution of up to $2,000 for each spouse may be made to a Roth IRA provided the combined compensation of the spouses is at least equal to the contributed amount. The maximum annual contribution that can be made to a Roth IRA is phased out for single individuals with AGI between $95,000 and $110,000 and for joint filers with AGI between $150,000 and $160,000.

Taxpayers with modified AGI of $100,000 or less generally may convert a traditional IRA into a Roth IRA. The amount converted is includible in income as if a withdrawal had been made, except that the 10% early withdrawal tax does not apply and, if the conversion occurred in 1998, the income inclusion may be spread ratably over four years. Married taxpayers who file separate returns cannot convert a traditional IRA into a Roth IRA.

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, or subject to the additional 10% tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) which is made after attainment of age 59 1/2, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings, and subject to the 10% early withdrawal tax (unless an exception applies). The same exceptions to the early withdrawal tax that apply to IRAs apply to Roth IRAs. Early distribution of converted amounts may also accelerate income inclusion of converted amounts that are taxable under the four-year rule applicable to 1998 conversions.

<u>New Federal Law</u> (Sec. 219, 408, & 408A)

Increase in annual contribution limits

The Act increases the maximum annual dollar contribution limit for IRA contributions from $2,000 to $3,000 for 2002 through 2004, $4,000 for 2005 through 2007, and $5,000 for 2008. After 2008, the limit is adjusted annually for inflation in $500 increments.

Additional catch-up contributions

The Act provides that individuals who have attained age 50 may make additional catch-up IRA contributions. The otherwise maximum contribution limit (before application of the AGI phase-out limits) for an individual who has attained age 50 before the end of the taxable year is increased by $500 for 2002 through 2005, and $1,000 for 2006 and thereafter.

Deemed IRAs under employer plans

The Act provides that, if an eligible retirement plan permits employees to make voluntary employee contributions to a separate account or annuity that (1) is established under the plan, and (2) meets the requirements applicable to either traditional IRAs or Roth IRAs, then the separate account or annuity is deemed a traditional IRA or a Roth IRA, as applicable, for all purposes of the Code. For example, the reporting requirements applicable to IRAs apply. The deemed IRA, and contributions thereto, are not subject to the Code rules pertaining to the eligible retirement plan. In addition, the deemed IRA, and contributions thereto, are not taken into account in applying such rules to any other contributions under the plan. The deemed IRA, and contributions thereto, are subject to the exclusive benefit and fiduciary rules of ERISA to the extent otherwise applicable to the plan, and are not subject to the ERISA reporting and disclosure, participation, vesting, funding, and enforcement requirements applicable to the eligible retirement plan. An eligible retirement plan is a qualified plan (sec. 401(a)), tax-sheltered annuity (sec. 403(b)), or a governmental section 457 plan.

The Act does not specify the treatment of deemed IRAs for purposes other than the Code and ERISA.

Effective Date

The provisions are generally effective for taxable years beginning after December 31, 2001. The provision relating to deemed IRAs under employer plans is effective for plan years beginning after December 31, 2002.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to IRAs. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Conforming to federal provisions for modifying IRA contribution limits and IRA catch-up contributions would result in the following revenue losses.

[$ In Millions]			
Provision	2002-03	2003-04	2004-05
Increase maximum contribution limit for traditional and Roth IRAs	-$8	-$8	-$12
Increase maximum contribution limit for traditional and Roth IRAs for individuals age 50 or older	-$1	-$1	-$1
Total	-$9	-$9	-$13

Estimates were based on a proration of federal projections developed for the Economic Growth & Tax Relief Reconciliation Act of 2001. Prorated federal estimates were further analyzed to determine separate impacts for conformity and baseline losses. Revenue losses (characterized as baseline) will result automatically due to federal ERISA provisions and/or the non-reporting of the inside build-up of earnings for taxpayers taking advantage of the new federal limits. The latter issue will require audit adjustments to taxpayer self-reporting. Total baseline revenue losses for affected provisions are provided in the footnote to the Conformity Summary Table.

Section	Section Title
611	PENSION PROVISIONS - INCREASE IN BENEFIT AND CONTRIBUTION LIMITS.

Background

In general

Present law imposes limits on contributions and benefits under qualified plans (sec. 415), the amount of compensation that may be taken into account under a plan for determining benefits (sec. 401(a)(17)), the amount of elective deferrals that an individual may make to a salary reduction plan or tax sheltered annuity (sec. 402(g)), and deferrals under an eligible deferred compensation plan of a tax-exempt organization or a state or local government (sec. 457).

Limitations on contributions and benefits

Under present law, the limits on contributions and benefits under qualified plans are based on the type of plan. Under a defined contribution plan, the qualification rules limit the annual additions to the plan with respect to each plan participant to the lesser of (1) 25% of compensation or (2) $35,000 (for 2001). Annual additions are the sum of employer contributions, employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer. The

$35,000 limit is indexed for cost-of-living adjustments in $5,000 increments. Under a defined benefit plan, the maximum annual benefit payable at retirement is generally the lesser of (1) 100% of average compensation, or (2) $140,000 (for 2001). The dollar limit is adjusted for cost-of-living increases in $5,000 increments. Under present law, in general, the dollar limit on annual benefits is reduced if benefits under the plan begin before the social security retirement age (currently, age 65) and increased if benefits begin after social security retirement age.

Compensation limitation

Under present law, the annual compensation of each participant that may be taken into account for purposes of determining contributions and benefits under a plan, applying the deduction rules, and for nondiscrimination testing purposes is limited to $170,000 (for 2001). The compensation limit is indexed for cost-of-living adjustments in $10,000 increments.

In general, contributions to qualified plans and IRAs are based on compensation. For a self-employed individual, compensation generally means net earnings subject to self-employment taxes ("SECA taxes"). Members of certain religious faiths may elect to be exempt from SECA taxes on religious grounds. Because the net earnings of such individuals are not subject to SECA taxes, these individuals are considered to have no compensation on which to base contributions to a retirement plan. Under an exception to this rule, net earnings of such individuals are treated as compensation for purposes of making contributions to an IRA.

Elective deferral limitations

Under present law, under certain salary reduction arrangements, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals.

The maximum annual amount of elective deferrals that an individual may make to a qualified cash or deferred arrangement (a "section 401(k) plan"), a tax-sheltered annuity ("section 403(b) annuity") or a salary reduction simplified employee pension plan ("SEP") is $10,500 (for 2001). The maximum annual amount of elective deferrals that an individual may make to a SIMPLE plan is $6,500 (for 2001). These limits are indexed for inflation in $500 increments.

Section 457 plans

The maximum annual deferral under a deferred compensation plan of a state or local government or a tax-exempt organization (a "section 457 plan") is the lesser of (1) $8,500 (for 2001) or (2) 33 1/3% of compensation. The $8,500 dollar limit is increased for inflation in $500 increments. Under a special catch-up rule, the section 457 plan may provide that, for one or more of the participant's last three years before retirement, the otherwise applicable limit is increased to the lesser of (1) $15,000 or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.

Economic Growth & Tax Relief Act of 2001
(P.L. 107-16)

<u>New Federal Law</u> (Sec. 401(a)(17), 401(c)(2), 402(g), 408(p), 415 & 457)

Limits on contributions and benefits

The Act increases the $35,000 limit on annual additions to a defined contribution plan to $40,000. This amount is indexed in $1,000 increments. The Act increases the $140,000 annual benefit limit under a defined benefit plan to $160,000. The dollar limit is reduced for benefit commencement before age 62 and increased for benefit commencement after age 65. In adopting rules regarding the application of the increase in the defined benefit plan limits under the Act, it is intended that the Secretary will apply rules similar to those adopted in Notice 99-44 regarding benefit increases due to the repeal of the combined plan limit under former section 415(e). Thus, for example, a defined benefit plan could provide for benefit increases to reflect the provisions of the Act for a current or former employee who has commenced benefits under the plan prior to the effective date of the bill if the employee or former employee has an accrued benefit under the plan (other than an accrued benefit resulting from a benefit increase solely as a result of the increases in the section 415 limits under the bill). As under the notice, the maximum amount of permitted increase is generally the amount that could have been provided had the provisions of the Act been in effect at the time of the commencement of benefit. In no case may benefits reflect increases that could not be paid prior to the effective date because of the limits in effect under present law. In addition, in no case may plan amendments providing increased benefits under the relevant provision of the Act are effective prior to the effective date of the Act. Another provision of the Act modifies the defined benefit pension plan limits for multiemployer plans.

Compensation limitation

The Act increases the limit on compensation that may be taken into account under a plan to $200,000. This amount is indexed in $5,000 increments. The Act also amends the definition of compensation for purposes of all qualified plans and IRAs (including SIMPLE arrangements) to include an individual's net earnings that would be subject to SECA taxes but for the fact that the individual is covered by a religious exemption.

Elective deferral limitations

The Act increases the dollar limit on annual elective deferrals under section 401(k) plans, section 403(b) annuities and salary reduction SEPs to $11,000 in 2002. In 2003 and thereafter, the limits are increased in $1,000 annual increments until the limits reach $15,000 in 2006, with indexing in $500 increments thereafter. The Act increases the maximum annual elective deferrals that may be made to a SIMPLE plan to $7,000 in 2002. In 2003 and thereafter, the SIMPLE plan deferral limit is increased in $1,000 annual increments until the limit reaches $10,000 in 2005. Beginning after 2005, the $10,000 dollar limit is indexed in $500 increments.

Section 457 plans

The Act increases the dollar limit on deferrals under a section 457 plan to conform to the elective deferral limitation. Thus, the limit is $11,000 in 2002, and is increased in $1,000 annual increments thereafter until the limit reaches $15,000 in 2006. The limit is indexed thereafter in $500 increments. The limit is twice the otherwise applicable dollar limit in the three years prior to retirement

Effective Date

The provisions are generally effective for years beginning after December 31, 2001. The provisions relating to defined benefit plans are effective for years ending after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to contribution limits of pensions. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Conforming to federal provisions for increasing contribution and benefit limits would result in the following revenue losses.

[$ In Millions]			
Provision	2002-03	2003-04	2004-05
Increase limitation on exclusion for elective deferrals	-$2	-$10	-$16
Increase limitation on SIMPLE elective contributions	-$1	-$1	-$2
Increase defined benefit dollar limit to $160,000	-----------------baseline loss-----------------		
Lower early retirement age to 62; lower normal retirement age to 65	---------negligible revenue effect----------		
Increase annual addition limitation for defined contribution plans to $40,000 with indexing	-$1	-$1	-$1
Increase qualified plan compensation limit to $200,000 with indexing and expand availability of qualified plans to certain self-employed	-$5	-$4	-$5
Increase limits on deferrals under deferred compensation plans of State and local government and tax exempt organizations	-$3	-$3	-$3
Total	-$12	-$19	-$27

Estimates were based on a proration of federal projections developed for the Economic Growth & Tax Relief Reconciliation Act of 2001. Prorated federal estimates were further analyzed to determine separate impacts for conformity and baseline losses. Revenue losses (characterized as baseline) will result automatically due to federal ERISA provisions and/or the non-reporting of the inside build-up of earnings for taxpayers taking advantage of the new federal limits. The latter issue will require audit adjustments to taxpayer self-reporting. Total baseline revenue losses for affected provisions are provided in the footnote to the Conformity Summary Table.

Section	Section Title
612	PENSION PLAN - PLAN LOANS FOR S CORPORATION SHAREHOLDERS, PARTNERS, AND SOLE PROPRIETORS.

Background

The IRC prohibits certain transactions ("prohibited transactions") between a qualified plan and a disqualified person in order to prevent persons with a close relationship to the qualified plan from using that relationship to the detriment of plan participants and beneficiaries. Certain types of transactions are exempted from the prohibited transaction rules, including loans from the plan-to-plan participants, if certain requirements are satisfied. In addition, the Secretary of Labor can grant an administrative exemption from the prohibited transaction rules if the Secretary finds the exemption is administratively feasible, in the interest of the plan and plan participants and beneficiaries, and protective of the rights of participants and beneficiaries of the plan. Pursuant to this exemption process, the Secretary of Labor grants exemptions both with respect to specific transactions and classes of transactions.

The statutory exemptions to the prohibited transaction rules do not apply to certain transactions in which the plan makes a loan to an owner-employee. Certain transactions involving a plan and S corporation shareholders are permitted. Loans to participants other than owner-employees are permitted if loans are available to all participants on a reasonably equivalent basis, are not made available to highly compensated employees in an amount greater than made available to other employees, are made in accordance with specific provisions in the plan, bear a reasonable rate of interest, and are adequately secured. In addition, the Code places limits on the amount of loans and repayment terms.

For purposes of the prohibited transaction rules, an owner-employee means (1) a sole proprietor, (2) a partner who owns more than 10% of either the capital interest or the profits interest in the partnership, (3) an employee or officer of a Subchapter S corporation who owns more than 5% of the outstanding stock of the corporation, and (4) the owner of an individual retirement arrangement ("IRA"). The term owner-employee also includes certain family members of an owner-employee and certain corporations owned by an owner-employee.

Under the Internal Revenue Code, a two-tier excise tax is imposed on disqualified persons who engage in a prohibited transaction. The first level tax is equal to 15% of the amount involved in the transaction. The second level tax is imposed if the prohibited transaction is not corrected within a certain period, and is equal to 100% of the amount involved.

New Federal Law (Sec. 4975)

The Act generally eliminates the special present-law rules relating to plan loans made to an owner-employee (other than the owner of an IRA). Thus, the general statutory exemption applies to such transactions. Present law continues to apply with respect to IRAs.

Congress intends that the Secretary of the Treasury and the Secretary of Labor will waive any penalty or excise tax in situations where a loan made prior to the effective date of the provision was exempt when initially made (treating any refinancing as a new loan) and the loan would have been exempt throughout the period of the loan if the provision had been in effect during the period of the loan.

Effective Date

The provision is effective with respect to years beginning after December 31, 2001

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to loans from pension plans, except that California law does not impose any excise tax on prohibited transactions. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Not applicable.

Section	Section Title
613	PENSION PLAN - MODIFICATION OF TOP-HEAVY RULES.

Background

In general

Under present law, additional qualification requirements apply to plans that primarily benefit an employer's key employees (“top-heavy plans”). These additional requirements provide (1) more rapid vesting for plan participants who are non-key employees and (2) minimum nonintegrated employer contributions or benefits for plan participants who are non-key employees.

Definition of top-heavy plan

A defined benefit plan is a top-heavy plan if more than 60% of the cumulative accrued benefits under the plan are for key employees. A defined contribution plan is top heavy if the sum of the account balances of key employees is more than 60% of the total account balances under the plan. For each plan year, the determination of top-heavy status generally is made as of the last day of the preceding plan year ("the determination date").

For purposes of determining whether a plan is a top-heavy plan, benefits derived both from employer and employee contributions, including employee elective contributions, are taken into account. In addition, the accrued benefit of a participant in a defined benefit plan and the account balance of a participant in a defined contribution plan includes any amount distributed within the five-year period ending on the determination date.

An individual's accrued benefit or account balance is not taken into account in determining whether a plan is top-heavy if the individual has not performed services for the employer during the five-year period ending on the determination date.

In some cases, two or more plans of a single employer must be aggregated for purposes of determining whether the group of plans is top-heavy. The following plans must be aggregated: (1) plans which cover a key employee (including collectively bargained plans); and (2) any plan upon which a plan covering a key employee depends for purposes of satisfying the Code's nondiscrimination rules. The employer may be required to include terminated plans in the required aggregation group. In some circumstances, an employer may elect to aggregate plans for purposes of determining whether they are top heavy.

SIMPLE plans are not subject to the top-heavy rules.

Definition of key employee

A key employee is an employee who, during the plan year that ends on the determination date or any of the four preceding plan years, is (1) an officer earning over one-half of the defined benefit plan dollar limitation of section 415 ($70,000 for 2001), (2) a 5% owner of the employer, (3) a 1% owner of the employer earning over $150,000, or (4) one of the 10 employees earning more than the defined contribution plan dollar limit ($35,000 for 2001) with the largest ownership interests in the employer. A family ownership attribution rule applies to the determination of 1% owner status, 5% owner status, and largest ownership interest. Under this attribution rule, an individual is treated as owning stock owned by the individual's spouse, children, grandchildren, or parents.

Minimum benefit for non-key employees

A minimum benefit generally must be provided to all non-key employees in a top-heavy plan. In general, a top-heavy defined benefit plan must provide a minimum benefit equal to the lesser of (1) 2% of compensation multiplied by the employee's years of service, or (2) 20% of compensation. A top-heavy defined contribution plan must provide a minimum annual contribution equal to the lesser of (1) 3% of compensation, or (2) the percentage of compensation at which contributions were made for key employees (including employee elective contributions made by key employees and employer matching contributions).

For purposes of the minimum benefit rules, only benefits derived from employer contributions (other than amounts employees have elected to defer) to the plan are taken into account, and an employee's social security benefits are disregarded (i.e., the minimum benefit is nonintegrated). Employer matching contributions may be used to satisfy the minimum contribution requirement; however, in such a case the contributions are not treated as matching contributions for purposes of applying the special nondiscrimination requirements applicable to employee elective contributions and matching contributions under sections 401(k) and (m). Thus, such contributions would have to meet the general nondiscrimination test of section 401(a)(4).

Top-heavy vesting

Benefits under a top-heavy plan must vest at least as rapidly as under one of the following schedules: (1) three-year cliff vesting, which provides for 100% vesting after three years of service; and (2) two-six year graduated vesting, which provides for 20% vesting after two years of service, and 20% more each year thereafter so that a participant is fully vested after six years of service.

Benefits under a plan that is not top heavy must vest at least as rapidly as under one of the following schedules:

(1) five-year cliff vesting; and
(2) three-seven year graded vesting, which provides for 20% vesting after three years and 20% more each year thereafter so that a participant is fully vested after seven years of service.

Qualified cash or deferred arrangements

Under a qualified cash or deferred arrangement (a “section 401(k) plan”), an employee may elect to have the employer make payments as contributions to a qualified plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. A special nondiscrimination test applies to elective deferrals under cash or deferred arrangements, which compares the elective deferrals of highly compensated employees with elective deferrals of nonhighly compensated employees. (This test is called the actual deferral percentage test or the “ADP” test). Employer matching contributions under qualified defined contribution plans are also subject to a similar nondiscrimination test. (This test is called the actual contribution percentage test or the “ACP” test.)

Under a design-based safe harbor, a cash or deferred arrangement is deemed to satisfy the ADP test if the plan satisfies one of two contribution requirements and satisfies a notice requirement. A plan satisfies the contribution requirement under the safe harbor rule for qualified cash or deferred arrangements if the employer either (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least three percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement without regard to the permitted disparity rules (sec. 401(1)). A plan satisfies the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to (a) 100% of the employee's elective deferrals up to 3% of compensation and (b) 50% of the employee's elective deferrals from 3% to 5% of compensation; and (2), the rate of match with respect to any elective contribution for highly compensated employees is not greater than the rate of match for nonhighly compensated employees. Matching contributions that satisfy the design-based safe harbor for cash or deferred arrangements are deemed to satisfy the ACP test. Certain additional matching contributions are also deemed to satisfy the ACP test.

New Federal Law (Sec. 416)

Definition of top-heavy plan

The Act provides that a plan consisting of a cash-or-deferred arrangement that satisfies the design-based safe harbor for such plans and matching contributions that satisfy the safe harbor rule for such contributions is not a top-heavy plan. Matching or nonelective contributions provided under such a plan may be taken into account in satisfying the minimum contribution requirements applicable to top-heavy plans. This provision is not intended to preclude the use of nonelective contributions that are used to satisfy the safe harbor rules from being used to satisfy other qualified retirement plan nondiscrimination rules, including those involving cross-testing.

In determining whether a plan is top-heavy, distributions during the year ending on the date the top-heavy determination is being made are taken into account. The present-law five-year rule applies with respect to in-service distributions. Similarly, the Act provides that an individual's accrued benefit or account balance is not taken into account if the individual has not performed services for the employer during the one-year period ending on the date the top-heavy determination is being made.

Definition of key employee

The Act: (1) provides that an employee is not considered a key employee by reason of officer status unless the employee was (a) an officer with compensation in excess of $130,000 (adjusted for inflation in $5,000 increments), (b) a 5% owner, or (c) a 1% owner with compensation in excess of $150,000, and (2) repeals the top-10 owner key employee category. The present-law limits on the number of officers treated as key employees under (1) continue to apply. The Act repeals the four-year lookback rule for determining key employee status and provides that an employee is a key employee only if he or she is a key employee during the preceding plan year.

An employee is considered a key employee if, during the prior year, the employee was (1) an officer with compensation in excess of $130,000 (adjusted for inflation in $5,000 increments), (2) a 5% owner, or (3) a 1% owner with compensation in excess of $150,000. The present-law limits on the number of officers treated as key employees under (1) continue to apply.

Under the Act, the family ownership attribution rule continues to apply in determining whether an individual is a 5% owner of the employer for purposes of the top-heavy rules.

Minimum benefit for non-key employees

Under the Act, matching contributions are taken into account in determining whether the minimum benefit requirement has been satisfied. Thus, this provision overrides the provision in Treasury regulations that, if matching contributions are used to satisfy the minimum benefit requirement, then they are not treated as matching contributions for purposes of the section 401(m) nondiscrimination rules.

The Act provides that, in determining the minimum benefit required under a defined benefit plan, a year of service does not include any year in which no key employee or former key employee benefits under the plan (as determined under sec. 410).

Effective Date

The Act is effective for years beginning after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to top heavy rules for pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Conforming to federal provisions that modify top-heavy rules would result in minor revenue losses annually of less than $500,000. Estimates were based on a proration of federal projections developed for the Economic Growth & Tax Relief Reconciliation Act of 2001.

Section	Section Title
614	PENSION PLAN - ELECTIVE DEFERRALS NOT TAKEN INTO ACCOUNT FOR PURPOSES OF DEDUCTION LIMITS.

Background

Employer contributions to one or more qualified retirement plans are deductible subject to certain limits. In general, the deduction limit depends on the kind of plan.

In the case of a defined benefit pension plan or a money purchase pension plan, the employer generally may deduct the amount necessary to satisfy the minimum funding cost of the plan for the year. If a defined benefit pension plan has more than 100 participants, the maximum amount deductible is at least equal to the plan's unfunded current liabilities.

In the case of a profit-sharing or stock bonus plan, the employer generally may deduct an amount equal to 15% of compensation of the employees covered by the plan for the year.

If an employer sponsors both a defined benefit pension plan and a defined contribution plan that covers some of the same employees (or a money purchase pension plan and another kind of defined contribution plan), the total deduction for all plans for a plan year generally is limited to the greater of (1) 25% of compensation or (2) the contribution necessary to meet the minimum funding requirements of the defined benefit pension plan for the year (or the amount of the plan's unfunded current liabilities, in the case of a plan with more than 100 participants).

For purposes of the deduction limits, employee elective deferral contributions to a section 401(k) plan are treated as employer contributions and, thus, are subject to the generally applicable deduction limits.

Subject to certain exceptions, nondeductible contributions are subject to a 10% excise tax.

New Federal Law (Sec. 404)

Under the Act, elective deferral contributions are not subject to the deduction limits, and the application of a deduction limitation to any other employer contribution to a qualified retirement plan does not take into account elective deferral contributions.

Effective Date

The provision is effective for years beginning after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to deferrals for pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Conforming to this federal provision would result in the following revenue losses.

[$ In Millions]		
2002-03	2003-04	2004-05
-$4	-$3	-$3

Estimates were based on a proration of federal projections developed for the Economic Growth & Tax Relief Reconciliation Act of 2001. Prorated federal estimates were further analyzed to determine separate impacts for conformity and baseline losses. Revenue losses (characterized as baseline) will result automatically due to federal ERISA provisions and/or the non-reporting of the inside build-up of earnings for taxpayers taking advantage of the new federal limits. The latter issue will require audit adjustments to taxpayer self-reporting. Total baseline revenue losses for affected provisions are provided in the footnote to the Conformity Summary Table.

Section	Section Title
615	PENSION PLAN - REPEAL OF COORDINATION REQUIREMENTS FOR DEFERRED COMPENSATION PLANS OF STATE AND LOCAL GOVERNMENTS AND TAX-EXEMPT ORGANIZATIONS.

Background

Compensation deferred under an eligible deferred compensation plan of a tax-exempt or state and local government employer (a “section 457 plan”) is not includible in gross income until paid or made available. In general, the maximum permitted annual deferral under such a plan is the lesser of (1) $8,500 (in 2001) or (2) 33 1/3% of compensation. The $8,500 limit is increased for inflation in $500 increments. Under a special catch-up rule, a section 457 plan may provide that, for one or more of the participant's last three years before retirement, the otherwise applicable limit is increased to the lesser of (1) $15,000 or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.

The $8,500 limit (as modified under the catch-up rule), applies to all deferrals under all section 457 plans in which the individual participates. In addition, in applying the $8,500 limit, contributions under a tax-sheltered annuity (“section 403(b) annuity”), elective deferrals under a qualified cash or deferred arrangement (“section 401(k) plan”), salary reduction contributions under a simplified employee pension plan (“SEP”), and contributions under a SIMPLE plan are taken into account. Further, the amount deferred under a section 457 plan is taken into account in applying a special catch-up rule for section 403(b) annuities.

New Federal Law (Sec. 457)

The Act repeals the rules coordinating the section 457 dollar limit with contributions under other types of plans. (The limits on deferrals under a section 457 plan are modified under other provisions of the Act.)

Effective Date

The Act is effective for years beginning after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Conforming to this federal provision would result in the following revenue losses.

[$ In Millions]		
2002-03	2003-04	2004-05
-$1	-$1	-$1

Estimates were based on a proration of federal projections developed for the Economic Growth & Tax Relief Reconciliation Act of 2001.

Section	Section Title
621	PENSION PLAN - ELIMINATE IRS USER FEES FOR CERTAIN DETERMINATION LETTER REQUESTS REGARDING EMPLOYER PLANS.

Background

An employer that maintains a retirement plan for the benefit of its employees may request from the IRS a determination as to whether the form of the plan satisfies the requirements applicable to tax-qualified plans (sec. 401(a)). In order to obtain from the IRS a determination letter on the qualified status of the plan, the employer must pay a user fee. The Secretary determines the user fee applicable for various types of requests, subject to statutory minimum requirements for average fees based on the category of the request. The user fee may range from $125 to $1,250, depending upon the scope of the request and the type and format of the plan. Authorization for the user fees was originally enacted in section 10511 of the Revenue Act of 1987 (Pub. L. No. 100-203, December 22, 1987). The authorization was extended through September 30, 2003, by Public Law Number 104-117.

Present law provides that plans that do not meet the qualification requirements will be treated as meeting such requirements if appropriate retroactive plan amendments are made during the remedial amendment period. In general, the remedial amendment period ends on the due date for the employer's tax return (including extensions) for the taxable year in which the event giving rise to the disqualifying provision occurred (e.g., a plan amendment or a change in the law). The Secretary may provide for general extensions of the remedial amendment period or for extensions in certain cases. For example, the remedial amendment period with respect to amendments relating to the qualification requirements affected by the General Agreements on Tariffs and Trade, the Uniformed Services Employment and Reemployment Rights Act of 1994, the Small Business Job Protection Act of 1996, the Taxpayer Relief Act of 1997, and the Internal Revenue Service Restructuring and Reform Act of 1998 generally ends the last day of the first plan year beginning on or after January 1, 2001.

New Federal Law

A eligible employer is not required to pay a user fee for a determination letter request with respect to the qualified status of a retirement plan that the employer maintains if the request is made before the later of (1) the last day of the fifth plan year of the plan or (2) the end of any applicable remedial amendment period with respect to the plan that begins before the end of the fifth plan year of the plan. In addition, determination letter requests for which user fees are not required under the Act are not taken into account in determining average user fees. The Act applies only to requests by employers for determination letters concerning the qualified retirement plans they maintain. Therefore, a sponsor of a prototype plan is required to pay a user fee for a request for a notification letter, opinion letter, or similar ruling. A small employer that adopts a prototype plan, however, is not required to pay a user fee for a determination letter request with respect to the employer's plan.

An employer is eligible under the Act if the employer has no more than 100 employees and has at least one nonhighly compensated employee who is participating in the plan.

Effective date—

The provision is effective for determination letter requests made after December 31, 2001.

California Law

California law does not charge user fees on pension plans.

Impact on California Revenue

Not applicable.

Section	Section Title
616	PENSION PLAN - DEDUCTION LIMITS.

Background

Employer contributions to one or more qualified retirement plans are deductible subject to certain limits. In general, the deduction limit depends on the kind of plan. Subject to certain exceptions, nondeductible contributions are subject to a 10% excise tax.

In the case of a defined benefit pension plan or a money purchase pension plan, the employer generally may deduct the amount necessary to satisfy the minimum funding cost of the plan for the year. If a defined benefit pension plan has more than 100 participants, the maximum amount deductible is at least equal to the plan's unfunded current liabilities.

In some cases, the amount of deductible contributions is limited by compensation. In the case of a profit-sharing or stock bonus plan, the employer generally may deduct an amount equal to 15% of compensation of the employees covered by the plan for the year.

If an employer sponsors both a defined benefit pension plan and a defined contribution plan that covers some of the same employees (or a money purchase pension plan and another kind of defined contribution plan), the total deduction for all plans for a plan year generally is limited to the greater of (1) 25% of compensation or (2) the contribution necessary to meet the minimum funding requirements of the defined benefit pension plan for the year (or the amount of the plan's unfunded current liabilities, in the case of a plan with more than 100 participants).

In the case of an employee stock ownership plan ("ESOP"), principal payments on a loan used to acquire qualifying employer securities are deductible up to 25% of compensation.

For purposes of the deduction limits, employee elective deferral contributions to a qualified cash or deferred arrangement ("section 401(k) plan") are treated as employer contributions and, thus, are subject to the generally applicable deduction limits.

For purposes of the deduction limits, compensation means the compensation otherwise paid or accrued during the taxable year to the beneficiaries under the plan, and the beneficiaries under a profit-sharing or stock bonus plan are the employees who benefit under the plan with respect to the employer's contribution. An employee who is eligible to make elective deferrals under a section 401(k) plan is treated as benefiting under the arrangement even if the employee elects not to defer.

For purposes of the deduction rules, compensation generally includes only taxable compensation, and thus does not include salary reduction amounts, such as elective deferrals under a section 401(k) plan or a tax-sheltered annuity ("section 403(b) annuity"), elective contributions under a deferred compensation plan of a tax-exempt organization or a state or local government ("section 457 plan"), and salary reduction contributions under a section 125 cafeteria plan. For purposes of the contribution limits under section 415, compensation does include such salary reduction amounts.

<u>New Federal Law</u> (Sec. 404)

Under the Act, the definition of compensation for purposes of the deduction rules includes salary reduction amounts treated as compensation under section 415. In addition, the annual limitation on the amount of deductible contributions to a profit-sharing or stock bonus plan is increased from 15% to 25% of compensation of the employees covered by the plan for the year. Also, except to the extent provided in regulations, a money purchase pension plan is treated like a profit-sharing or stock bonus plan for purposes of the deduction rules.

<u>Effective Date</u>

The provision is effective for years beginning after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to deduction limits for pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Conforming to the federal provision increasing deduction limits would result in the following revenue losses.

[$ In Millions]		
2002-03	2003-04	2004-05
-$1	-$1	-$1

Estimates were based on a proration of federal projections developed for the Economic Growth & Tax Relief Reconciliation Act of 2001.

Section	Section Title
617	PENSION PLAN - OPTION TO TREAT ELECTIVE DEFERRALS AS AFTER-TAX CONTRIBUTIONS

Background

A qualified cash or deferred arrangement ("section 401(k) plan") or a tax-sheltered annuity ("section 403(b) annuity") may permit a participant to elect to have the employer make payments as contributions to the plan or to the participant directly in cash. Contributions made to the plan at the election of a participant are elective deferrals. Elective deferrals must be nonforfeitable and are subject to an annual dollar limitation (sec. 402(g)) and distribution restrictions. In addition, elective deferrals under a section 401(k) plan are subject to special nondiscrimination rules. Elective deferrals (and earnings attributable thereto) are not includible in a participant's gross income until distributed from the plan.

Elective deferrals for a taxable year that exceed the annual dollar limitation ("excess deferrals") are includible in gross income for the taxable year. If an employee makes elective deferrals under a plan (or plans) of a single employer that exceed the annual dollar limitation ("excess deferrals"), then the plan may provide for the distribution of the excess deferrals, with earnings thereon. If the excess deferrals are made to more than one plan of unrelated employers, then the plan may permit the individual to allocate excess deferrals among the various plans, no later than March 1 (April 15 under the applicable regulations) following the end of the taxable year. If excess deferrals are distributed not later than April 15 following the end of the taxable year, along with earnings attributable to the excess deferrals, then the excess deferrals are not again includible in income when distributed. The earnings are includible in income in the year distributed. If excess deferrals (and income thereon) are not distributed by the applicable April 15, then the excess deferrals (and income thereon) are includible in income when received by the participant. Thus, excess deferrals that are not distributed by the applicable April 15th are taxable both in the taxable year when the deferral was made and in the year the participant receives a distribution of the excess deferral.

Individuals with adjusted gross income below certain levels generally may make nondeductible contributions to a Roth IRA and may convert a deductible or nondeductible IRA into a Roth IRA. Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, nor subject to the additional 10% tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) is made after attainment of age 59 1/2, is made on account of death or disability, or is a qualified special purpose distribution (i.e., for first-time homebuyer expenses of up to $10,000). A distribution from a Roth IRA that is not a qualified distribution is includible in income to the extent attributable to earnings, and is subject to the 10% tax on early withdrawals (unless an exception applies). Early distributions of converted amounts may also accelerate income inclusion of converted amounts that are taxable under the four-year rule applicable to 1998 conversions.

<u>New Federal Law</u> (Sec. 402A)

A section 401(k) plan or a section 403(b) annuity is permitted to include a “designated Roth contribution“ that permits a participant to elect to have all or a portion of the participant's elective deferrals under the plan treated as designated Roth contributions. Designated Roth contributions are elective deferrals that the participant designates (at such time and in such manner as the Secretary may prescribe) as not excludable from the participant's gross income. It is intended that the Secretary will generally not permit retroactive designations of elective deferrals as designated Roth contributions.

The annual dollar limitation on a participant's designated Roth contributions is the section 402(g) annual limitation on elective deferrals, reduced by the participant's elective deferrals that the participant does not designate as designated Roth contributions. Designated Roth contributions are treated as any other elective deferral for purposes of nonforfeitability requirements and distribution restrictions. Similarly, designated Roth contributions to a section 403(b) annuity are treated the same as other salary reduction contributions to the annuity (except that designated Roth contributions are includible in income).

Under a section 401(k) plan, designated Roth contributions also are treated as any other elective deferral for purposes of the special nondiscrimination requirements. It is intended that the Secretary provide ordering rules regarding the return of excess contributions under the special nondiscrimination rules (pursuant to sec. 401(k)(8)) in the event a participant makes both regular elective deferrals and designated Roth contributions. It is intended that such rules will generally permit a plan to allow participants to designate which contributions are returned first or to permit the plan to specify which contributions are returned first. It is also intended that the Secretary will provide ordering rules to determine the extent to which a distribution consists of excess Roth contributions.

The plan is required to establish a separate account, and maintain separate record keeping, for a participant's designated Roth contributions (and earnings allocable thereto). A qualified distribution from a participant's designated Roth contributions account is not includible in the participant's gross income. A qualified distribution is a distribution that is made after the end of a specified nonexclusion period and that is (1) made on or after the date on which the participant attains age 59 1/2, (2) made to a beneficiary (or to the estate of the participant) on or after the death of the participant, or (3) attributable to the participant's being disabled. A qualified special purpose distribution, as defined under the rules relating to Roth IRAs, does not qualify as a tax-free distribution from a designated Roth contributions account. The nonexclusion period is the five-year-taxable period beginning with the earlier of (1) the first taxable year for which the participant made a designated Roth contribution to any designated Roth contribution account established for the participant under the plan, or (2) if the participant has made a rollover contribution to the designated Roth contribution account that is the source of the distribution from a designated Roth contribution account established for the participant under another plan, the first taxable year for which the participant made a designated Roth contribution to the previously established account.

A distribution from a designated Roth contributions account that is a corrective distribution of an elective deferral (and income allocable thereto) that exceeds the section 402(g) annual limit on elective deferrals or a corrective distribution of an excess contribution under the special nondiscrimination rules (pursuant to sec. 401(k)(8) (and income allocable thereto) is not a qualified distribution. In addition, the treatment of excess designated Roth contributions is similar to the treatment of excess deferrals attributable to non-designated Roth contributions. If excess designated Roth contributions (including earnings thereon) are distributed no later than the April 15th following the taxable year, then the designated Roth contribution is not includible in gross income as a result of the distribution, because such contributions are includible in gross income when made. Earnings on such excess designated Roth contributions are treated the same as earnings on excess deferrals distributed no later than April 15th, i.e., they are includible in income when distributed. If excess designated Roth contributions are not distributed no later than the applicable April 15th, then such contributions (and earnings thereon) are taxable when distributed. Thus, as is the case with excess elective deferrals that are not distributed by the applicable April 15th, the contributions are includible in income in the year when made and again when distributed from the plan. Earnings on such contributions are taxable when received.

A participant is permitted to roll over a distribution from a designated Roth contributions account only to another designated plus contributions account or a Roth IRA of the participant.

The Secretary of the Treasury is directed to require the plan administrator of each section 401(k) plan or section 403(b) annuity that permits participants to make designated Roth contributions to make such returns and reports regarding designated Roth contributions to the Secretary, plan participants and beneficiaries, and other persons that the Secretary may designate.

<u>Effective Date</u>

The provision is effective for taxable years beginning after December 31, 2005.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

This proposal would be effective for years beginning after December 31, 2005. The conformity revenue gain for the 2006 tax year would be on the order of $5 million.

Section	Section Title
618	PENSION PLAN - NONREFUNDABLE CREDIT TO CERTAIN INDIVIDUALS FOR ELECTIVE DEFERRALS AND IRA CONTRIBUTIONS.

Background

Present law provides favorable tax treatment for a variety of retirement savings vehicles, including employer-sponsored retirement plans and individual retirement arrangements ("IRAs").

Several different types of tax-favored employer-sponsored retirement plans exist, such as section 401(a) qualified plans (including plans with a section 401(k) qualified cash-or-deferred arrangement), section 403(a) qualified annuity plans, section 403(b) annuities, section 408(k) simplified employee pensions ("SEPs"), section 408(p) SIMPLE retirement accounts, and section 457(b) eligible deferred compensation plans. In general, an employer and, in certain cases, employees, contribute to the plan. Taxation of the contributions and earnings thereon is generally deferred until benefits are distributed from the plan to participants or their beneficiaries. In the case of after-tax employee contributions, only earnings are taxed upon withdrawal. Contributions and benefits under tax-favored employer-sponsored retirement plans are subject to specific limitations.

Coverage and nondiscrimination rules also generally apply to tax-favored employer-sponsored retirement plans to ensure that plans do not disproportionately cover higher-paid employees and that benefits provided to moderate- and lower-paid employees are generally proportional to those provided to higher-paid employees.

IRAs include both traditional IRAs and Roth IRAs. In general, an individual makes contributions to an IRA, and investment earnings on those contributions accumulate on a tax-deferred basis. Total annual IRA contributions per individual are limited to $2,000 (or the compensation of the individual or the individual's spouse, if smaller). Contributions to a traditional IRA may be deducted from gross income if an individual's adjusted gross income ("AGI") is below certain levels or the individual is not an active participant in certain employer-sponsored retirement plans. Contributions to a Roth IRA are not deductible from gross income, regardless of adjusted gross income. A distribution from a traditional

IRA is includible in the individual's gross income except to the extent of individual contributions made on a nondeductible basis. A qualified distribution from a Roth IRA is excludable from gross income.

Taxable distributions made from employer retirement plans and IRAs before the employee or individual has reached age 59 1/2 are subject to a 10% additional tax, unless an exception applies.

New Federal Law (Sec. 25B)

The Act provides a temporary nonrefundable tax credit for contributions made by eligible taxpayers to a qualified plan. The maximum annual contribution eligible for the credit is $2,000. The credit rate depends on the adjusted gross income ("AGI") of the taxpayer. Only joint returns with AGI of $50,000 or less, head of household returns of $37,500 or less, and single returns of $25,000 or less are eligible for the credit. The AGI limits applicable to single taxpayers apply to married taxpayers filing separate returns. The credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit offsets minimum tax liability as well as regular tax liability. The credit is available to individuals who are 18 or over, other than individuals who are full-time students or claimed as a dependent on another taxpayer's return.

The credit is available with respect to elective contributions to a section 401(k) plan, section 403(b) annuity, or eligible deferred compensation arrangement of a state or local government (a "sec. 457 plan"), SIMPLE, or SEP, contributions to a traditional or Roth IRA, and voluntary after-tax employee contributions to a qualified retirement plan. The present-law rules governing such contributions continue to apply.

The amount of any contribution eligible for the credit is reduced by taxable distributions received by the taxpayer and his or her spouse from any savings arrangement described above or any other qualified retirement plan during the taxable year for which the credit is claimed, the two taxable years prior to the year the credit is claimed, and during the period after the end of the taxable year and prior to the due date for filing the taxpayer's return for the year. In the case of a distribution from a Roth IRA, this rule applies to any such distributions, whether or not taxable.

The credit rates based on AGI are as follows.

Joint filers	Heads of households	All other filers	Credit rate
$0-$30,000	$0-$22,500	$0-$15,000	50%
$30,000-$32,500	$22,500-$24,375	$15,000-$16,250	20%
$32,500-$50,000	$24,375-$37,500	$16,250-$25,000	10%
Over $50,000	Over $37,500	Over $25,000	0%

The Act directs the Secretary of the Treasury to report annually to the Senate Finance Committee and the House Committee on Ways and Means regarding the number of individuals who claim the credit.

Effective Date

The provision is effective for taxable years beginning after December 31, 2001, and before January 1, 2007.

California Law

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
620	PENSION PLAN - SMALL BUSINESS TAX CREDIT FOR NEW RETIREMENT PLAN EXPENSES.

Background

The costs incurred by an employer related to the establishment and maintenance of a retirement plan (e.g., payroll system changes, investment vehicle set-up fees, consulting fees) generally are deductible by the employer as ordinary and necessary expenses in carrying on a trade or business.

New Federal Law (Sec. 45E)

The Act provides a nonrefundable income tax credit for 50% of the administrative and retirement-education expenses for any small business that adopts a new qualified defined benefit or defined contribution plan (including a section 401(k) plan), SIMPLE plan, or simplified employee pension ("SEP"). The credit applies to 50% of the first $1,000 in administrative and retirement-education expenses for the plan for each of the first three years of the plan.

The credit is available to an employer that did not employ, in the preceding year, more than 100 employees with compensation in excess of $5,000. In order for an employer to be eligible for the credit, the plan must cover at least one nonhighly compensated employee. In addition, if the credit is for the cost of a payroll deduction IRA arrangement, the arrangement must be made available to all employees of the employer who have worked with the employer for at least three months.

The credit is a general business credit. The 50% of qualifying expenses that are effectively offset by the tax credit are not deductible; the other 50% of the qualifying expenses (and other expenses) are deductible to the extent permitted under present law.

Effective Date

The Act is effective with respect to costs paid or incurred in taxable years beginning after December 31, 2001, with respect to plans established after such date.

California Law

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
622	PENSION PLAN - CERTAIN NONRESIDENT ALIENS EXCLUDED IN APPLYING MINIMUM COVERAGE REQUIREMENTS.

Background

Under the minimum coverage requirements (sec. 410(b)), a qualified plan must benefit a minimum number of the employer's nonhighly compensated employees. In applying the minimum coverage requirements, employees who are nonresident aliens are disregarded if they have no earned income from sources within the United States ("U.S. source income").

Generally, compensation for services performed in the United States is treated as U.S. source income. Under a special rule, compensation is not treated as U.S. source income if the compensation is paid for labor or services performed by a nonresident alien in connection with the individual's temporary presence in the United States as a regular member of the crew of a foreign vessel engaged in transportation between the United States and a foreign country or a possession of the United States. However, this special rule does not apply for purposes of qualified retirement plans (including the minimum coverage and nondiscrimination requirements applicable to such plans), employer-provided group-term life insurance, or employer-provided accident and health plans. As a result, such compensation is treated as U.S. source income for purposes of such plans, including the application of the qualified retirement plan minimum coverage and nondiscrimination requirements. As a result, such nonresident aliens must be taken into account in determining whether the plan satisfies the minimum coverage requirements.

New Federal Law (Secs. 410(b)(3) & 861(a)(3))

Under the Act, the special rule relating to compensation paid for labor or services performed by a nonresident alien in connection with the individual's temporary presence in the United States as a regular member of the crew of a foreign vessel engaged in transportation between the United States and a foreign country or a possession of the United States compensation is extended in order to apply for purposes of qualified retirement plans, employer-provided group-term life insurance, and employer-provided accident and health plans. Therefore, such compensation is not treated as U.S. source income for any purpose under such plans, including the application of the qualified retirement plan minimum coverage and nondiscrimination requirements.

Effective Date

The provision is effective with respect to plan years beginning after December 31, 2001.

California Law

In general, California law taxes California residents on income from all sources. Nonresidents of California are subject to tax on all income derived from sources within this state. The state does not conform to any federal nonresident alien rules, since it has unique rules relating to nonresidents of California.

Impact on California Revenue

Not applicable.

Section	Section Title
631	PENSION PLAN - ENHANCING FAIRNESS FOR WOMEN - ADDITIONAL SALARY REDUCTION CATCH-UP CONTRIBUTIONS.

Background

Elective deferral limitations

Under present law, under certain salary reduction arrangements, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. The maximum annual amount of elective deferrals that an individual may make to a qualified cash or deferred arrangement (a “401(k) plan”), a tax-sheltered annuity (“section 403(b) annuity”) or a salary reduction simplified employee pension plan (“SEP”) is $10,500 (for 2001). The maximum annual amount of elective deferrals that an individual may make to a SIMPLE plan is $6,500 (for 2001). These limits are indexed for inflation in $500 increments.

Section 457 plans

The maximum annual deferral under a deferred compensation plan of a state or local government or a tax-exempt organization (a “section 457 plan”) is the lesser of (1) $8,500 (for 2001) or (2) 33 1/3% of compensation. The $8,500 dollar limit is increased for inflation in $500 increments. Under a special catch-up rule, the section 457 plan may provide that, for one or more of the participant's last three years before retirement, the otherwise applicable limit is increased to the lesser of (1) $15,000 or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.

New Federal Law (Sec. 414)

The Act provides that the otherwise applicable dollar limit on elective deferrals under a section 401(k) plan, section 403(b) annuity, SEP, or SIMPLE, or deferrals under a section 457 plan is increased for individuals who have attained age 50 by the end of the year. Another provision of the Act increases the dollar limit on elective deferrals under such arrangements. The catch-up contribution provision does not apply to after-tax employee contributions. Additional contributions may be made by an individual who has attained age 50 before the end of the plan year and with respect to whom no other elective deferrals may otherwise be made to the plan for the year because of the application of any limitation of the Code (e.g., the annual limit on elective deferrals) or of the plan. Under the Act, the additional amount of elective contributions that may be made by an eligible individual participating in such a plan is the lesser of (1) the applicable dollar amount or (2) the participant's compensation for the year reduced by any other elective deferrals of the participant for the year. In the case of a section 457 plan, this catch-up rule does not apply during the participant's last three years before retirement (in those years, the regularly applicable dollar limit is doubled). The applicable dollar amount under a section 401(k) plan, section 403(b) annuity, SEP, or section 457 plan is $1,000 for 2002, $2,000 for 2003, $3,000 for 2004, $4,000 for 2005, and $5,000 for 2006 and thereafter. The applicable dollar amount under a SIMPLE is $500 for 2002, $1,000 for 2003, $1,500 for 2004, $2,000 for 2005, and $2,500 for 2006 and thereafter. The $5,000 and $2,500 amounts are adjusted for inflation in $500 increments in 2007 and thereafter. In the case of a section 457 plan, this catch-up rule does not apply during the participant's last three years before retirement (in those years, the regularly applicable dollar limit is doubled).

Catch-up contributions made under the Act are not subject to any other contribution limits and are not taken into account in applying other contribution limits. In addition, such contributions are not subject to applicable nondiscrimination rules. However, a plan fails to meet the applicable nondiscrimination requirements under section 401(a)(4) with respect to benefits, rights, and features unless the plan allows all eligible individuals participating in the plan to make the same election with respect to catch-up contributions. For purposes of this rule, all plans of related employers are treated as a single plan.

An employer is permitted to make matching contributions with respect to catch-up contributions. Any such matching contributions are subject to the normally applicable rules.

The following examples illustrate the application of the Act, after the catch-up is fully phased-in.

Example 1: Employee A is a highly compensated employee who is over 50 and who participates in a section 401(k) plan sponsored by A's employer. The maximum annual deferral limit (without regard to the provision) is $15,000. After application of the special nondiscrimination rules applicable to section 401(k) plans, the maximum elective deferral A may make for the year is $8,000. Under the provision, A is able to make additional catch-up salary reduction contributions of $5,000.

Example 2: Employee B, who is over 50, is a participant in a section 401(k) plan. B's compensation for the year is $30,000. The maximum annual deferral limit (without regard to the provision) is $15,000. Under the terms of the plan, the maximum permitted deferral is 10% of compensation or, in B's case, $3,000. Under the provision, B can contribute up to $8,000 for the year ($3,000 under the normal operation of the plan, and an additional $5,000 under the provision).

Effective Date

The provision is effective for taxable years beginning after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Conformity revenue losses are estimated as follows:

Enactment Assumed By April 1, 2002 [$ In Millions]		
2002-03	2003-04	2004-05
-$10	-$7	-$5

Estimates were based on a proration of federal projections developed for the Economic Growth & Tax Relief Reconciliation Act of 2001. Prorated federal estimates were further analyzed to determine separate impacts for conformity and baseline losses. Revenue losses (characterized as baseline) will result automatically due to federal ERISA provisions and/or the non-reporting of the inside build-up of earnings for taxpayers taking advantage of the new federal limits. The latter issue will require audit adjustments to taxpayer self-reporting. Total baseline revenue losses for affected provisions are provided in the footnote to the Conformity Summary Table.

Section	Section Title
632	PENSION PLAN - ENHANCING FAIRNESS FOR WOMAN - EQUITABLE TREATMENT FOR CONTRIBUTIONS OF EMPLOYEES TO DEFINED CONTRIBUTION PLANS

Background

Present law imposes limits on the contributions that may be made to tax-favored retirement plans.

Defined contribution plans

In the case of a tax-qualified defined contribution plan, the limit on annual additions that can be made to the plan on behalf of an employee is the lesser $35,000 (for 2001) or 25% of the employee's compensation (sec. 415(c)). Annual additions include employer contributions, including contributions made at the election of the employee (i.e., employee elective deferrals), after-tax employee contributions, and any forfeitures allocated to the employee. For this purpose, compensation means taxable compensation of the employee, plus elective deferrals, and similar salary reduction contributions. A separate limit applies to benefits under a defined benefit plan.

For years before January 1, 2000, an overall limit applied if an employee was a participant in both a defined contribution plan and a defined benefit plan of the same employer.

Tax-sheltered annuities

In the case of a tax-sheltered annuity (a “section 403(b) annuity”), the annual contribution generally cannot exceed the lesser of the exclusion allowance or the section 415(c) defined contribution limit. The exclusion allowance for a year is equal to 20% of the employee's includible compensation, multiplied by the employee's years of service, minus excludable contributions for prior years under qualified plans, tax-sheltered annuities or section 457 plans of the employer.

In addition to this general rule, employees of nonprofit educational institutions, hospitals, home health service agencies, health and welfare service agencies, and churches may elect application of one of several special rules that increase the amount of the otherwise permitted contributions. The election of a special rule is irrevocable; an employee may not elect to have more than one special rule apply.

Under one special rule, in the year the employee separates from service, the employee may elect to contribute up to the exclusion allowance, without regard to the 25% of compensation limit under section 415. Under this rule, the exclusion allowance is determined by taking into account no more than 10 years of service.

Under a second special rule, the employee may contribute up to the lesser of: (1) the exclusion allowance; (2) 25% of the participant's includible compensation; or (3) $15,000.

Under a third special rule, the employee may elect to contribute up to the section 415(c) limit, without regard to the exclusion allowance. If this option is elected, then contributions to other plans of the employer are also taken into account in applying the limit.

For purposes of determining the contribution limits applicable to section 403(b) annuities, includible compensation means the amount of compensation received from the employer for the most recent period which may be counted as a year of service under the exclusion allowance. In addition, includible compensation includes elective deferrals and similar salary reduction amounts.

Treasury regulations include provisions regarding application of the exclusion allowance in cases where the employee participates in a section 403(b) annuity and a defined benefit plan. The Taxpayer Relief Act of 1997 directed the Secretary of the Treasury to revise these regulations, effective for years beginning after December 31, 1999, to reflect the repeal of the overall limit on contributions and benefits.

Section 457 plans

Compensation deferred under an eligible deferred compensation plan of a tax-exempt or state and local governmental employer (a “section 457 plan”) is not includible in gross income until paid or made available. In general, the maximum permitted annual deferral under such a plan is the lesser of (1) $8,500 (in 2001) or (2) 33 1/3% of compensation. The $8,500 limit is increased for inflation in $500 increments.

New Federal Law (Secs. 403(b), 415, & 457)

Increase in defined contribution plan limit

The Act increases the 25% of compensation limitation on annual additions under a defined contribution plan to 100%. Another provision of the Act increases the defined contribution plan dollar limit. The Act preserves the present-law deduction rules for money purchase pension plans. Thus, for purposes of such rules, the limitation on the amount the employer generally may deduct is an amount equal to 25% of compensation of the employees covered by the plan for the year.

It is intended that the Secretary of the Treasury will use the Secretary's existing authority to address situations where qualified nonelective contributions are targeted to certain participants with lower compensation in order to increase the average deferral percentage of nonhighly compensated employees.

For taxable years beginning after December 31, 1999, a plan may disregard the requirement that contributions to a defined benefit plan be treated as previously excluded amounts for purposes of the exclusion allowance.

Conforming limits on tax-sheltered annuities

The Act repeals the exclusion allowance applicable to contributions to tax-sheltered annuities. Thus, such annuities are subject to the limits applicable to tax-qualified plans.

The Act also directs the Secretary of the Treasury to revise the regulations relating to the exclusion allowance under section 403(b)(2) to render void the requirement that contributions to a defined benefit plan be treated as previously excluded amounts for purposes of the exclusion allowance. For taxable years beginning after December 31, 1999, the regulatory provisions regarding the exclusion allowance are to be applied as if the requirement that contributions to a defined benefit plan be treated as previously excluded amounts for purposes of the exclusion allowance were void.

Section 457 plans

The Act increases the 33 1/3% of compensation limitation on deferrals under a section 457 plan to 100% of compensation.

Effective Date

The provision generally is effective for years beginning after December 31, 2001. The provision regarding the regulations under section 403(b)(2) is effective on June 7, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Conformity revenue losses are estimated as follows:

Enactment Assumed By April 1, 2002 [$ In Millions]		
2002-03	2003-04	2004-05
-$4	-$3	-$3

Estimates were based on a proration of federal projections developed for the Economic Growth & Tax Relief Reconciliation Act of 2001. Prorated federal estimates were further analyzed to determine separate impacts for conformity and baseline losses. Revenue losses (characterized as baseline) will result automatically due to federal ERISA provisions and/or the non-reporting of the inside build-up of earnings for taxpayers taking advantage of the new federal limits. The latter issue will require audit adjustments to taxpayer self-reporting. Total baseline revenue losses for affected provisions are provided in the footnote to the Conformity Summary Table.

Section	Section Title
633	PENSION PLAN - ENHANCING FAIRNESS FOR WOMAN - FASTER VESTING OF EMPLOYER MATCHING CONTRIBUTIONS.

Background

Under present law, a plan is not a qualified plan unless a participant's employer-provided benefit vests at least as rapidly as under one of two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100% of the participant's accrued benefit derived from employer contributions upon the completion of five years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to at least 20% of the participant's accrued benefit derived from employer contributions after three years of service, 40% after four years of service, 60% after five years of service, 80% after six years of service, and 100% after seven years of service. The minimum vesting requirements are also contained in Title I of ERISA.

New Federal Law (Sec. 411)

The Act applies faster vesting schedules to employer matching contributions. Under the Act, employer matching contributions are required to vest at least as rapidly as under one of the following two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100% of employer matching contributions upon the completion of three years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to 20% of employer matching contributions for each year of service beginning with the participant's second year of service and ending with 100% after six years of service.

Effective Date

The provision is effective for contributions for plan years beginning after December 31, 2001, with a delayed effective date for plans maintained pursuant to a collective bargaining agreement. The provision does not apply to any employee until the employee has an hour of service after the effective date. In applying the new vesting schedule, service before the effective date is taken into account.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Based on federal estimates of inconsequential revenue effects for this provision in the Economic Growth & Tax Relief Reconciliation Act of 2001, conforming to the provision would result in negligible revenue effects for state tax purposes.

Section	Section Title
634	PENSION PLAN - ENHANCING FAIRNESS FOR WOMAN. MODIFICATIONS TO MINIMUM DISTRIBUTION RULES

Background

In general

Minimum distribution rules apply to all types of tax-favored retirement vehicles, including qualified plans, individual retirement arrangements (“IRAs”), tax-sheltered annuities (“section 403(b) annuities”), and eligible deferred compensation plans of tax-exempt and state and local government employers (“section 457 plans”). In general, under these rules, distribution of minimum benefits must begin no later than the required beginning date. Minimum distribution rules also apply to benefits payable with respect to a plan participant who has died. Failure to comply with the minimum distribution rules results in an excise tax imposed on the individual plan participant equal to 50% of the required minimum distribution not distributed for the year. The excise tax may be waived if the individual establishes to the satisfaction of the Commissioner that the shortfall in the amount distributed was due to reasonable error and reasonable steps are being taken to remedy the shortfall. Under certain circumstances following the death of a participant, the excise tax is automatically waived under proposed Treasury regulations.

Distributions prior to the death of the individual

In the case of distributions prior to the death of the plan participant, the minimum distribution rules are satisfied if either (1) the participant's entire interest in the plan is distributed by the required beginning date, or (2) the participant's interest in the plan is to be distributed (in accordance with regulations), beginning not later than the required beginning date, over a permissible period. The permissible periods are (1) the life of the participant, (2) the lives of the participant and a designated beneficiary, (3) the life expectancy of the participant, or (4) the joint life and last survivor expectancy of the participant and a designated beneficiary. In calculating minimum required distributions, life expectancies of the participant and the participant's spouse may be recomputed annually.

In the case of qualified plans, tax-sheltered annuities, and section 457 plans, the required beginning date is the April 1 of the calendar year following the later of (1) the calendar year in which the employee attains age 70½ or (2) the calendar year in which the employee retires. However, in the case of a 5% owner of the employer, distributions are required to begin no later than the April 1 of the calendar year following the year in which the 5% owner attains age 70½ If commencement of benefits is delayed beyond age 70½ from a defined benefit plan, then the accrued benefit of the employee must be actuarially increased to take into account the period after age 70½ in which the employee was not receiving benefits under the plan. State and local government plans and church plans are not required to actuarially increase benefits that begin after age 70½.

In the case of distributions from an IRA other than a Roth IRA, the required beginning date is the April 1 of the calendar year following the calendar year in which the IRA owner attains age 70½. The pre-death minimum distribution rules do not apply to Roth IRAs.

In general, under the proposed Treasury regulations, in order to satisfy the minimum distribution rules, annuity payments under a defined benefit plan must be paid in periodic payments made at intervals not longer than one year over a permissible period, and must be nonincreasing, or increase only as a result of the following: (1) cost-of-living adjustments; (2) cash refunds of employee contributions; (3) benefit increases under the plan; or (4) an adjustment due to death of the employee's beneficiary. In the case of a defined contribution plan, the minimum required distribution is determined by dividing the employee's benefit by an amount from the uniform table provided in the proposed regulations.

New Federal Law

The Act directs the Treasury to revise the life expectancy tables under the applicable regulations to reflect current life expectancy.

Effective Date

The provision is effective on June 7, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Based on federal estimates of inconsequential revenue effects for this provision in the Economic Growth & Tax Relief Reconciliation Act of 2001, conforming to the provision would result in negligible baseline revenue effects for state tax purposes.

Section	Section Title
635	PENSION PLAN - ENHANCING FAIRNESS FOR WOMAN - CLARIFICATION OF TAX TREATMENT OF DIVISION OF SECTION 457 PLAN BENEFITS UPON DIVORCE

Background

Under present law, benefits provided under a qualified retirement plan for a participant may not be assigned or alienated to creditors of the participant, except in very limited circumstances. One exception to the prohibition on assignment or alienation rule is a qualified domestic relations order ("QDRO"). A QDRO is a domestic relations order that creates or recognizes a right of an alternate payee to any plan benefit payable with respect to a participant, and that meets certain procedural requirements.

Under present law, a distribution from a governmental plan or a church plan is treated as made pursuant to a QDRO if it is made pursuant to a domestic relations order that creates or recognizes a right of an alternate payee to any plan benefit payable with respect to a participant. Such distributions are not required to meet the procedural requirements that apply with respect to distributions from qualified plans.

Under present law, amounts distributed from a qualified plan generally are taxable to the participant in the year of distribution. However, if amounts are distributed to the spouse (or former spouse) of the participant by reason of a QDRO, the benefits are taxable to the spouse (or former spouse). Amounts distributed pursuant to a QDRO to an alternate payee other than the spouse (or former spouse) are taxable to the plan participant.

Section 457 of the Internal Revenue Code provides rules for deferral of compensation by an individual participating in an eligible deferred compensation plan ("section 457 plan") of a tax-exempt or state and local government employer. The QDRO rules do not apply to section 457 plans.

New Federal Law (Secs. 414(p) & 457)

The Act applies the taxation rules for qualified plan distributions pursuant to a QDRO to distributions made pursuant to a domestic relations order from a section 457 plan. In addition, a section 457 plan does not violate the restrictions on distributions from such plans due to payments to an alternate payee under a QDRO. The special rule applicable to governmental plans and church plans apply for purposes of determining whether a distribution is pursuant to a QDRO.

Effective Date

The provision is effective for transfers, distributions, and payments made after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Based on federal estimates of inconsequential revenue effects for this provision in the Economic Growth & Tax Relief Reconciliation Act of 2001, conforming to the provision would result in negligible revenue effects for state tax purposes.

Section	Section Title
636	PENSION PLAN - ENHANCING FAIRNESS FOR WOMAN - PROVISIONS RELATING TO HARDSHIP WITHDRAWALS

Background

Elective deferrals under a qualified cash or deferred arrangement (a "section 401(k) plan") may not be distributable prior to the occurrence of one or more specified events. One event upon which distribution is permitted is the financial hardship of the employee. Applicable Treasury regulations provide that a distribution is made on account of hardship only if the distribution is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the heavy need.

The Treasury regulations provide a safe harbor under which a distribution may be deemed necessary to satisfy an immediate and heavy financial need. One requirement of this safe harbor is that the

employee be prohibited from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least 12 months after receipt of the hardship distribution.
Under present law, hardship withdrawals of elective deferrals from a qualified cash or deferred arrangement (or 403(b) annuity) are not eligible rollover distributions. Other types of hardship distributions, e.g., employer matching contributions distributed on account of hardship, are eligible rollover distributions. Different withholding rules apply to distributions that are eligible rollover distributions and to distributions that are not eligible rollover distributions. Eligible rollover distributions that are not directly rolled over are subject to withholding at a flat rate of 20%. Distributions that are not eligible rollover distributions are subject to elective withholding. Periodic distributions are subject to withholding as if the distribution were wages; nonperiodic distributions are subject to withholding at a rate of 10%. In either case, the individual may elect not to have withholding apply.

<u>New Federal Law</u> (Secs. 401(k) & 402)

The Secretary of the Treasury is directed to revise the applicable regulations to reduce from 12 months to six months the period during which an employee must be prohibited from making elective contributions and employee contributions in order for a distribution to be deemed necessary to satisfy an immediate and heavy financial need. The revised regulations are to be effective for years beginning after December 31, 2001.

In addition, any distribution made upon hardship of an employee is not an eligible rollover distribution. Thus, such distributions may not be rolled over, and are subject to the withholding rules applicable to distributions that are not eligible rollover distributions. The Act does not modify the rules under which hardship distributions may be made. For example, as under present law, hardship distributions of qualified employer matching contributions are only permitted under the rules applicable to elective deferrals.

The Act is intended to clarify that all assets distributed as a hardship withdrawal, including assets attributable to employee elective deferrals and those attributable to employer matching or nonelective contributions, are ineligible for rollover. This rule is intended to apply to all hardship distributions from any tax qualified plan, including those made pursuant to standards set forth in section 401(k)(2)(B)(i)(IV) (which are applicable to section 401(k) plans and section 403(b) annuities) and to those treated as hardship distributions under any profit-sharing plan (whether or not in accordance with the standards set forth in section 401(k)(2)(B)(i)(IV)). For this purpose, a distribution that could be made either under the hardship provisions of a plan or under other provisions of the plan (such as provisions permitting in-service withdrawal of assets attributable to employer matching or nonelective contributions after a fixed period of years) could be treated as made upon hardship of the employee if the plan treats it that way. For example, if a plan makes an in-service distribution that consists of assets attributable to both elective deferrals (in circumstances where those assets could be distributed only upon hardship) and employer matching or nonelective contributions (which could be distributed in nonhardship circumstances under the plan), the plan is permitted to treat the distribution in its entirety as made upon hardship of the employee.

<u>Effective Date</u>

The provision directing the Secretary to revise the rules relating to safe harbor hardship distributions is effective on June 7, 2001. The provision that hardship distributions are not eligible rollover distributions is effective for distributions made after December 31, 2001. The Secretary has the authority to issue transitional guidance with respect to the provision that hardship distributions are not eligible rollover distributions to provide sufficient time for plans to implement the new rule.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Based on federal estimates of inconsequential revenue effects for this provision in the Economic Growth & Tax Relief Reconciliation Act of 2001, conforming to the provision would result in negligible revenue effects for state tax purposes.

Section	Section Title
637	PENSION PLAN - ENHANCING FAIRNESS FOR WOMAN - PENSION COVERAGE FOR DOMESTIC AND SIMILAR WORKERS

Background

Under present law, within limits, employers may make deductible contributions to qualified retirement plans for employees. Subject to certain exceptions, a 10% excise tax applies to nondeductible contributions to such plans.

Employers of household workers may establish a pension plan for their employees. Contributions to such plans are not deductible because they are not made in connection with a trade or business of the employer.

New Federal Law (Sec. 4972(c)(6))

The 10% excise tax on nondeductible contributions does not apply to contributions to a SIMPLE plan or a SIMPLE IRA that are nondeductible solely because the contributions are not a trade or business expense under section 162 because they are not made in connection with a trade or business of the employer. Thus, for example, employers of household workers are able to make contributions to such plans without imposition of the excise tax. As under present law, the contributions are not deductible. The present-law rules applicable to such plans, e.g., contribution limits and nondiscrimination rules, continue to apply. The Act does not apply with respect to contributions on behalf of the individual and members of his or her family.

No inference is intended with respect to the application of the excise tax under present law to contributions that are not deductible because they are not made in connection with a trade or business of the employer.

As under present law, a plan covering domestic workers is not qualified unless the coverage rules are satisfied by aggregating all employees of family members taken into account under the attribution rules in section 414(c), but disregarding employees employed by a controlled group of corporations or a trade or business.

It is intended that the Act is restricted to contributions made by employers of household workers with respect to whom all applicable employment taxes have been and are being paid.

Effective Date

The provision is effective for taxable years beginning after December 31, 2001.

California Law

California law is in conformity, with minor modifications, with federal law as it read on January 1, 1998, as it relates to pension plans. California's early withdrawal on IRA distributions penalty is 2.5%, as opposed to the 10% federal rate. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Not applicable.

Section	Section Title
641-643 & 649	PENSION PLAN - ROLLOVERS OF RETIREMENT PLAN AND IRA DISTRIBUTIONS.

Background

Present law permits the rollover of funds from a tax-favored retirement plan to another tax-favored retirement plan. The rules that apply depend on the type of plan involved. Similarly, the rules regarding the tax treatment of amounts that are not rolled over depend on the type of plan involved.

Distributions from qualified plans

Under present law, an "eligible rollover distribution" from a tax-qualified employer-sponsored retirement plan may be rolled over tax free to a traditional individual retirement arrangement ("IRA") (All references to IRAs refer only to traditional IRAs. A "traditional" IRA refers to IRAs other than Roth

IRAs or SIMPLE) or another qualified plan). An eligible rollover distribution may either be rolled over by the distributee within 60 days of the date of the distribution or, as described below, directly rolled over by the distributing plan. An "eligible rollover distribution" means any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified plan, except the term does not include (1) any distribution which is one of a series of substantially equal periodic payments made (a) for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and the employee's designated beneficiary, or (b) for a specified period of 10 years or more, (2) any distribution to the extent such distribution is required under the minimum distribution rules, and (3) certain hardship distributions. The maximum amount that can be rolled over is the amount of the distribution includible in income, i.e., after-tax employee contributions cannot be rolled over. Qualified plans are not required to accept rollovers.

Distributions from tax-sheltered annuities

Eligible rollover distributions from a tax-sheltered annuity ("section 403(b) annuity") may be rolled over into an IRA or another section 403(b) annuity. Distributions from a section 403(b) annuity cannot be rolled over into a tax-qualified plan. Section 403(b) annuities are not required to accept rollovers.

IRA distributions

Distributions from a traditional IRA, other than minimum required distributions, can be rolled over into another IRA. In general, distributions from an IRA cannot be rolled over into a qualified plan or section 403(b) annuity. An exception to this rule applies in the case of so-called "conduit IRAs." Under the conduit IRA rule, amounts can be rolled from a qualified plan into an IRA and then subsequently rolled back to another qualified plan if the amounts in the IRA are attributable solely to rollovers from a qualified plan. Similarly, an amount may be rolled over from a section 403(b) annuity to an IRA and subsequently rolled back into a section 403(b) annuity if the amounts in the IRA are attributable solely to rollovers from a section 403(b) annuity.

Distributions from section 457 plans

A "section 457 plan" is an eligible deferred compensation plan of a state or local government or tax-exempt employer that meets certain requirements. In some cases, different rules apply under section 457 to governmental plans and plans of tax-exempt employers. For example, governmental section 457 plans are like qualified plans in that plan assets are required to be held in a trust for the exclusive benefit of plan participants and beneficiaries. In contrast, benefits under a section 457 plan of a tax-exempt employer are unfunded, like nonqualified deferred compensation plans of private employers.

Section 457 benefits can be transferred to another section 457 plan. Distributions from a section 457 plan cannot be rolled over to another section 457 plan, a qualified plan, a section 403(b) annuity, or an IRA.

Rollovers by surviving spouses

A surviving spouse that receives an eligible rollover distribution may roll over the distribution into an IRA, but not a qualified plan or section 403(b) annuity.

Direct rollovers and withholding requirements

Qualified plans and section 403(b) annuities are required to provide that a plan participant has the right to elect that an eligible rollover distribution be directly rolled over to another eligible retirement plan. If the plan participant does not elect the direct rollover option, then withholding is required on the distribution at a 20% rate. Distributions from qualified plans and section 403(b) annuities that are not eligible rollover distributions are subject to elective withholding. Periodic distributions are subject to withholding as if the distribution were wages; nonperiodic distributions are subject to withholding at a rate of 10%. In either case, the individual may elect not to have withholding apply.

Notice of eligible rollover distribution

The plan administrator of a qualified plan or a section 403(b) annuity is required to provide a written explanation of rollover rules to individuals who receive a distribution eligible for rollover. In general, the notice is to be provided within a reasonable period of time before making the distribution and is to include an explanation of (1) the provisions under which the individual may have the distribution directly rolled over to another eligible retirement plan, (2) the provision that requires withholding if the distribution is not directly rolled over, (3) the provision under which the distribution may be rolled over within 60 days of receipt, and (4) if applicable, certain other rules that may apply to the distribution. The Treasury Department has provided more specific guidance regarding timing and content of the notice.

Taxation of distributions

As is the case with the rollover rules, different rules regarding taxation of benefits apply to different types of tax-favored arrangements. In general, distributions from a qualified plan, section 403(b) annuity, or IRA are includible in income in the year received. In certain cases, distributions from qualified plans are eligible for capital gains treatment and averaging. These rules do not apply to distributions from another type of plan. Distributions from a qualified plan, IRA, and section 403(b) annuity generally are subject to an additional 10% early withdrawal tax if made before age 591/2. There are a number of exceptions to the early withdrawal tax. Some of the exceptions apply to all three types of plans, and others apply only to certain types of plans. For example, the 10% early withdrawal tax does not apply to IRA distributions for educational expenses, but does apply to similar distributions from qualified plans and section 403(b) annuities. Benefits under a section 457 plan are generally includible in income when paid or made available. The 10% early withdrawal tax does not apply to section 457 plans.

<u>New Federal Law</u> (Sec. 401, 402, 403(b), 408, 457, & 3405)

In general

The Act provides that eligible rollover distributions from qualified retirement plans, section 403(b) annuities, and governmental section 457 plans generally could be rolled over to any of such plans or arrangements. Hardship distributions from governmental section 457 plans would not be considered eligible rollover distributions.

Similarly, distributions from an IRA generally are permitted to be rolled over into a qualified plan, section 403(b) annuity, or governmental section 457 plan. The direct rollover and withholding rules are extended to distributions from a governmental section 457 plan, and such plans are required to provide the written notification regarding eligible rollover distributions. The elective withholding rules applicable to distributions from qualified plans and section 403(b) annuities that are not eligible rollover distributions are also extended to distributions from governmental section 457 plans. Thus, periodic distributions from governmental section 457 plans that are not eligible rollover distributions are subject to withholding as if the distribution were wages and nonperiodic distributions from such plans that are not eligible rollover distributions are subject to withholding at a 10% rate. In either case, the individual may elect not to have withholding apply. The rollover notice (with respect to all plans) is required to include a description of the provisions under which distributions from the plan to which the distribution is rolled over may be subject to restrictions and tax consequences different than those applicable to distributions from the distributing plan. Qualified plans, section 403(b) annuities, and section 457 plans would not be required to accept rollovers.

Some special rules apply in certain cases. A distribution from a qualified plan is not eligible for capital gains or averaging treatment if there was a rollover to the plan that would not have been permitted under present law. Thus, in order to preserve capital gains and averaging treatment for a qualified plan distribution that is rolled over; the rollover would have to be made to a “conduit IRA” as under present law, and then rolled back into a qualified plan. Amounts distributed from a section 457 plan are subject to the early withdrawal tax to the extent the distribution consists of amounts attributable to rollovers from another type of plan. Section 457 plans are required to separately account for such amounts.

Rollover of after-tax contributions

The Act provides that employee after-tax contributions may be rolled over into another qualified plan or a traditional IRA. In the case of a rollover from a qualified plan to another qualified plan, the rollover is permitted to be accomplished only through a direct rollover. In addition, a qualified plan is not permitted to accept rollovers of after-tax contributions unless the plan provides separate accounting for such contributions (and earnings thereon). After-tax contributions (including nondeductible contributions to an IRA) are not permitted to be rolled over from an IRA into a qualified plan, tax-sheltered annuity, or section 457 plan.

In the case of a distribution from a traditional IRA that is rolled over into an eligible rollover plan that is not an IRA, the distribution is attributed first to amounts other than after-tax contributions.

Expansion of spousal rollovers

The Act provides that surviving spouses may roll over distributions to a qualified plan, section 403(b) annuity, or governmental section 457 plan in which the surviving spouse participates.

Treasury regulations

The Secretary is directed to prescribe rules necessary to carry out the Act. Such rules may include, for example, reporting requirements and mechanisms to address mistakes relating to rollovers. It is anticipated that the IRS will develop forms to assist individuals who roll over after-tax contributions to an IRA in keeping track of such contributions. Such forms could, for example, expand Form 8606--Nondeductible IRAs, to include information regarding after-tax contributions.

Effective Date

The provision is effective for distributions made after December 31, 2001. It is intended that the Secretary will revise the safe harbor rollover notice that plans may use to satisfy the rollover requirements. No penalty is imposed on a plan for a failure to provide the information required under the Act with respect to any distribution made before the date that is 90 days after the date the Secretary issues a new safe harbor rollover notice, if the plan administrator makes a reasonable attempt to comply with such notice requirement. For example, the Act requires that the rollover notice include a description of the provisions under which distributions from the eligible retirement plan receiving the distribution may be subject to restrictions and tax consequences which are different from those applicable to distributions from the plan making the distribution. A plan is treated as making a reasonable good faith effort to comply with this requirement if the notice states that distributions from the plan to which the rollover is made may be subject to different restrictions and tax consequences than those that apply to distributions from the plan from which the rollover is made.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to rollovers of pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Based on the low level of federal estimates for this provision in the Economic Growth & Tax Relief Reconciliation Act of 2001, conforming to the provision would result in a minor loss in 2002-03 of less than $500,000, and negligible revenue losses annually in subsequent years of less than $250,000.

Section	Section Title
644	PENSION PLAN - WAIVER OF 60-DAY RULE.

Background

Under present law, amounts received from an IRA or qualified plan may be rolled over tax free if the rollover is made within 60 days of the date of the distribution. The Secretary does not have the authority to waive the 60-day requirement, except during military service in a combat zone or by reason of a Presidentially declared disaster. The Secretary has issued regulations postponing the 60-day rule in such cases.

New Federal Law (Secs. 402 & 408)

The Act provides that the Secretary may waive the 60-day rollover period if the failure to waive such requirement would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement. For example, the Secretary may issue guidance that includes objective standards for a waiver of the 60-day rollover period, such as waiving the rule due to military service in a combat zone or during a Presidentially declared disaster (both of which are provided for under present law), or for a period during which the participant has received payment in the form of a check, but has not cashed the check, or for errors committed by a financial institution, or in cases of inability to complete a rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country, or postal error.

Effective Date

The provision applies to distributions made after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to the 60-day rule for pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Based on federal estimates of inconsequential revenue effects for this provision in the Economic Growth & Tax Relief Reconciliation Act of 2001, conforming to the provision would result in negligible revenue effects for state tax purposes.

Section	Section Title
645	PENSION PLAN - TREATMENT OF FORMS OF DISTRIBUTION.

Background

An amendment of a qualified retirement plan may not decrease the accrued benefit of a plan participant. An amendment is treated as reducing an accrued benefit if, with respect to benefits accrued before the amendment is adopted, the amendment has the effect of either (1) eliminating or reducing an early retirement benefit or a retirement-type subsidy, or (2) except as provided by Treasury regulations, eliminating an optional form of benefit (sec. 411(d)(6)). A similar provision is contained in Title I of ERISA.

Under regulations recently issued by the Secretary, this prohibition against the elimination of an optional form of benefit does not apply in the case of (1) a defined contribution plan that offers a lump sum at the same time as the form being eliminated if the participant receives at least 90 days' advance notice of the elimination, or (2) a voluntary transfer between defined contribution plans, subject to the requirements that a transfer from a money purchase pension plan, an ESOP, or a section 401(k) plan must be to a plan of the same type and that the transfer be made in connection with certain corporate mergers, acquisitions, or similar transactions or changes in employment status

New Federal Law (Sec. 411(d)(6))

A defined contribution plan to which benefits are transferred will not be treated as reducing a participant's or beneficiary's accrued benefit even though it does not provide all of the forms of distribution previously available under the transferor plan if (1) the plan receives from another defined contribution plan a direct transfer of the participant's or beneficiary's benefit accrued under the transferor plan, or the plan results from a merger or other transaction that has the effect of a direct transfer (including consolidations of benefits attributable to different employers within a multiple employer plan), (2) the terms of both the transferor plan and the transferee plan authorize the transfer, (3) the transfer occurs pursuant to a voluntary election by the participant or beneficiary that is made after the participant or beneficiary received a notice describing the consequences of making the election, and (4) the transferee plan allows the participant or beneficiary to receive distribution of his or her benefit under the transferee plan in the form of a single sum distribution. The Act does not modify the rules relating to survivor annuities under section 417. Thus, as under present law, a plan that is a transferee of a plan subject to the joint and survivor rules is also subject to those rules.

Except to the extent provided by the Secretary of the Treasury in regulations, a defined contribution plan is not treated as reducing a participant's accrued benefit if (1) a plan amendment eliminates a form of distribution previously available under the plan, (2) a single sum distribution is available to the participant at the same time or times as the form of distribution eliminated by the amendment, and (3) the single sum distribution is based on the same or greater portion of the participant's accrued benefit as the form of distribution eliminated by the amendment.

Furthermore, the Act directs the Secretary of the Treasury to provide by regulations that the prohibitions against eliminating or reducing an early retirement benefit, a retirement-type subsidy, or an optional form of benefit do not apply to plan amendments that eliminate or reduce early retirement benefits, retirement-type subsidies, and optional forms of benefit that create significant burdens and complexities for a plan and its participants, but only if such an amendment does not adversely affect the rights of any participant in more than a de minimis manner.

It is intended that the factors to be considered in determining whether an amendment has more than a de minimis adverse effect on any participant will include (1) all of the participant's early retirement benefits, retirement-type subsidies, and optional forms of benefits that are reduced or eliminated by the amendment, (2) the extent to which early retirement benefits, retirement-type subsidies, and optional forms of benefit in effect with respect to a participant after the amendment effective date provide rights that are comparable to the rights that are reduced or eliminated by the plan amendment, (3) the number of years before the participant attains normal retirement age under the plan (or early retirement age, as applicable), (4) the size of the participant's benefit that is affected by the plan amendment, in relation to the amount of the participant's compensation, and (5) the number of years before the plan amendment is effective.

This provision does not affect the rules relating to involuntary cash outs (sec. 411(a)(11)) or survivor annuity requirements (sec. 417). Accordingly, if a participant is entitled to protections of the joint and survivor rules, those protections may not be eliminated. The intent of the provision authorizing regulations is solely to permit the elimination of early retirement benefits, retirement-type subsidies, or optional forms of benefit that have no more than a de minimis effect on any participant but create disproportionate burdens and complexities for a plan and its participants.

For example, assume the following. Employer A acquires employer B and merges B's defined benefit plan into A's defined benefit plan. The defined benefit plan maintained by B before the merger provides an early retirement subsidy for individuals age 55 with a specified number of years of service. E1 and E2 are employees of B and who transfer to A in connection with the merger. E1 is 25 years old and has compensation of $40,000. The present value of E1's early retirement subsidy under B's plan is $75. E2 is 50 years old and also has compensation of $40,000. The present value of E2's early retirement subsidy under B's plan is $10,000.

Assume that A's plan has an early retirement subsidy for individuals who have attained age 50 with a specified number of years of service, but the subsidy is not the same as under B's plan. Under A's plan, the present value of E2's early retirement subsidy is $9,850. Maintenance of both subsidies after the plan merger would create burdens for the plan and complexities for the plan and its participants.

Treasury regulations could permit E1's early retirement subsidy under B's plan to be eliminated entirely (i.e., even if A's plan did not have an early retirement subsidy). Taking into account all relevant factors, including the value of the benefit, E1's compensation, and the number of years until E1 would be eligible to receive the subsidy, the subsidy is de minimis. Treasury regulations could permit E2's early retirement subsidy under B's plan to be eliminated as to be replaced by the subsidy under A's plan, because the difference in the subsidies is de minimis. However, A's subsidy could not be entirely eliminated. The Secretary is directed to issue, not later than December 31, 2003, final regulations under section 411(d)(6), including regulations required under the Act.

Effective Date

The Act is effective for years beginning after December 31, 2001, except that the direction to the Secretary is effective on June 7, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Based on federal estimates of inconsequential revenue effects for this provision in the Economic Growth & Tax Relief Reconciliation Act of 2001, conforming to the provision would result in negligible revenue effects for state tax purposes.

Section	Section Title
646	PENSION PLAN - RATIONALIZATION OF RESTRICTIONS ON DISTRIBUTIONS

Background

Elective deferrals under a qualified cash or deferred arrangement ("section 401(k) plan"), tax-sheltered annuity ("section 403(b) annuity"), or an eligible deferred compensation plan of a tax-exempt organization or state or local government ("section 457 plan"), may not be distributable prior to the occurrence of one or more specified events. These permissible distributable events include "separation from service."

A separation from service occurs only upon a participant's death, retirement, resignation or discharge, and not when the employee continues on the same job for a different employer as a result of the liquidation, merger, consolidation or other similar corporate transaction. A severance from employment occurs when a participant ceases to be employed by the employer that maintains the plan. Under a so-called "same desk rule," a participant's severance from employment does not necessarily result in a separation from service.

In addition to separation from service and other events, a section 401(k) plan that is maintained by a corporation may permit distributions to certain employees who experience a severance from employment with the corporation that maintains the plan but do not experience a separation from service because the employees continue on the same job for a different employer as a result of a corporate transaction. If the corporation disposes of substantially all of the assets used by the corporation in a trade or business, a distributable event occurs with respect to the accounts of the employees who continue employment with the corporation that acquires the assets. If the corporation disposes of its interest in a subsidiary, a distributable event occurs with respect to the accounts of the employees who continue employment with the subsidiary. Under a recent IRS ruling, a person is generally deemed to have separated from service if that person is transferred to another employer in connection with a sale of less than substantially all the assets of a trade or business.

New Federal Law (Secs. 401(k), 403(b), & 457)

The Act modifies the distribution restrictions applicable to section 401(k) plans, section 403(b) annuities, and section 457 plans to provide that distribution may occur upon severance from employment rather than separation from service. In addition, the provisions for distribution from a section 401(k) plan based upon a corporation's disposition of its assets or a subsidiary are repealed; this special rule is no longer necessary under the Act.

It is intended that a plan may provide that certain specified types of severance from employment do not constitute distributable events. For example, a plan could provide that a severance from employment is not a distributable event if it would not have constituted a "separation from service" under the law in effect prior to a specified date. Also, if a plan describes distributable events by reference to section 401(k)(2), the plan may be amended to restrict distributable events to fewer than all events that constitute a severance from employment. Thus, for example, if a plan sponsor had employees who experienced a severance from employment in the past that the "same desk rule" prevented from being treated as a distributable event, the plan sponsor would have the option of providing in the plan that such severance from employment would, or would not, be treated as a distributable event under the plan.

It is also intended that, as under current law, if there is a transfer of plan assets and liabilities relating to any portion of an employee's benefit under a plan of the employee's former employer to a plan being maintained or created by the employee's new employer (other than a rollover or elective transfer), then that employee has not experienced a severance from employment with the employer maintaining the plan that covers the employee.

Effective Date

The provision is effective for distributions after December 31, 2001, regardless of when the severance of employment occurred.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Based on federal estimates of inconsequential revenue effects for this provision in the Economic Growth & Tax Relief Reconciliation Act of 2001, conforming to the provision would result in negligible revenue effects for state tax purposes.

Section	Section Title
647	PENSION PLAN - PURCHASE OF SERVICE CREDIT UNDER GOVERNMENTAL PENSION PLANS.

Background

A qualified retirement plan maintained by a state or local government employer may provide that a participant may make after-tax employee contributions in order to purchase permissive service credit, subject to certain limits (sec. 415). Permissive service credit means credit for a period of service recognized by the governmental plan only if the employee voluntarily contributes to the plan an amount (as determined by the plan) that does not exceed the amount necessary to fund the benefit attributable to the period of service and that is in addition to the regular employee contributions, if any, under the plan.

In the case of any repayment of contributions and earnings to a governmental plan with respect to an amount previously refunded upon a forfeiture of service credit under the plan (or another plan maintained by a state or local government employer within the same state), any such repayment is not taken into account for purposes of the section 415 limits on contributions and benefits. Also, service credit obtained as a result of such a repayment is not considered permissive service credit for purposes of the section 415 limits. A participant may not use a rollover or direct transfer of benefits from a tax-sheltered annuity ("section 403(b) annuity") or an eligible deferred compensation plan of a tax-exempt organization or a state or local government ("section 457 plan") to purchase permissive service credits or repay contributions and earnings with respect to a forfeiture of service credit.

New Federal Law (Secs. 403(b) & 457)

A participant in a state or local governmental plan is not required to include in gross income a direct trustee-to-trustee transfer to a governmental defined benefit plan from a section 403(b) annuity or a section 457 plan if the transferred amount is used (1) to purchase permissive service credits under the plan, or (2) to repay contributions and earnings with respect to an amount previously refunded under a forfeiture of service credit under the plan (or another plan maintained by a state or local government employer within the same state).

Effective Date

The provision is effective for transfers after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Based on federal estimates of inconsequential revenue effects for this provision in the Economic Growth & Tax Relief Reconciliation Act of 2001, conforming to the provision would result in negligible revenue effects for state tax purposes.

Section	Section Title
648	PENSION PLAN - EMPLOYERS MAY DISREGARD ROLLOVERS FOR PURPOSES OF CASH-OUT RULES

Background

If a qualified retirement plan participant ceases to be employed by the employer that maintains the plan, the plan may distribute the participant's nonforfeitable accrued benefit without the consent of the participant and, if applicable, the participant's spouse, if the present value of the benefit does not exceed $5,000. If such an involuntary distribution occurs and the participant subsequently returns to employment covered by the plan, then service taken into account in computing benefits payable under the plan after the return need not include service with respect to which a benefit was involuntarily distributed unless the employee repays the benefit.

Generally, a participant may roll over an involuntary distribution from a qualified plan to an IRA or to another qualified plan. Other Act provisions expand the kinds of plans to which benefits may be rolled over.

New Federal Law (Sec. 411(a)(11))

For purposes of the cash-out rule, a plan is permitted to provide that the present value of a participant's nonforfeitable accrued benefit is determined without regard to the portion of such benefit that is attributable to rollover contributions (and any earnings allocable thereto).

Effective Date

The provision is effective for distributions after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Based on federal estimates of inconsequential revenue effects for this provision in the Economic Growth & Tax Relief Reconciliation Act of 2001, conforming to the provision would result in negligible revenue effects for state tax purposes.

Section	Section Title
649	PENSION PLAN - MINIMUM DISTRIBUTION AND INCLUSION REQUIREMENTS FOR SECTION 457 PLANS.

Background

A “section 457 plan” is an eligible deferred compensation plan of a state or local government or tax-exempt employer that meets certain requirements. For example, amounts deferred under a section 457 plan cannot exceed certain limits. Amounts deferred under a section 457 plan are generally includible in income when paid or made available. Amounts deferred under a plan of deferred compensation of a state or local government or tax-exempt employer that does not meet the requirements of section 457 are includible in income when the amounts are not subject to a substantial risk of forfeiture, regardless of whether the amounts have been paid or made available. This rule of inclusion does not apply to amounts deferred under a tax-qualified retirement plan or similar plans.

Section 457 plans are subject to the minimum distribution rules applicable to tax-qualified pension plans. In addition, such plans are subject to additional minimum distribution rules (sec. 457(d)(2)(B)).

New Federal Law (Sec. 457)

The Act provides that amounts deferred under a section 457 plan of a state or local government are includible in income when paid. The Act also repeals the special minimum distribution rules applicable to section 457 plans. Thus, such plans are subject to the minimum distribution rules applicable to qualified plans.

Effective Date

The provision is effective for distributions after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Conformity revenue losses for this provision are included in estimates of other provisions.

Section	Section Title
651-652	PENSION PLAN - PHASE IN REPEAL OF 160% OF CURRENT LIABILITY FUNDING LIMIT; DEDUCTION FOR CONTRIBUTIONS TO FUND TERMINATION LIABILITY

Background

Under present law, defined benefit pension plans are subject to minimum funding requirements designed to ensure that pension plans have sufficient assets to pay benefits. A defined benefit pension plan is funded using one of a number of acceptable actuarial cost methods.

No contribution is required under the minimum funding rules in excess of the full funding limit. The full funding limit is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 160% of the plan's current liability, over (2) the value of the plan's assets (sec. 412(c)(7)). In general, current liability is all liabilities to plan participants and beneficiaries accrued to date, whereas the accrued liability full funding limit is based on projected benefits. The current liability full funding limit is scheduled to increase as follows: 165% for plan years beginning in 2003 and 2004, and 170% for plan years beginning in 2005 and thereafter. In no event is a plan's full funding limit less than 90% of the plan's current liability over the value of the plan's assets.

An employer sponsoring a defined benefit pension plan generally may deduct amounts contributed to satisfy the minimum funding standard for the plan year. Contributions in excess of the full funding limit generally are not deductible. Under a special rule, an employer that sponsors a defined benefit pension plan (other than a multiemployer plan) which has more than 100 participants for the plan year may deduct amounts contributed of up to 100% of the plan's unfunded current liability.

New Federal Law (Secs. 404(a)(1), 412(c)(7), & 4972(c))

Current liability full funding limit

The Act gradually increases and then repeals the current liability full funding limit. Under the Act, the current liability full funding limit is 165% of current liability for plan years beginning in 2002, and 170% for plan years beginning in 2003. The current liability full funding limit is repealed for plan years beginning in 2004 and thereafter. Thus, in 2004 and thereafter, the full funding limit is the excess, if any, of (1) the accrued liability under the plan (including normal cost), over (2) the value of the plan's assets.

Deduction for contributions to fund termination liability

The special rule allowing a deduction for unfunded current liability generally is extended to all defined benefit pension plans, i.e., the Act applies to multiemployer plans and plans with 100 or fewer participants. The special rule does not apply to plans not covered by the PBGC termination insurance program. The PBGC termination insurance program does not cover plans of professional service employers that have fewer than 25 participants. The Act also modifies the rule by providing that the deduction is for up to 100% of unfunded termination liability, determined as if the plan terminated at the end of the plan year. In the case of a plan with less than 100 participants for the plan year, termination liability does not include the liability attributable to benefit increases for highly compensated employees resulting from a plan amendment which was made or became effective, whichever is later, within the last two years. This rule to provide that the deduction is for up to 100% of unfunded termination liability is applicable only for a plan that terminates within the plan year.

Effective Date

The Act is effective for plan years beginning after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Conformity revenue losses are estimated as follows:

Enactment Assumed Before April 15, 2002 [$ In Millions]		
2002-03	2003-04	2004-05
-$1	-$1	-$1

Estimates were based on a proration of federal projections developed for the Economic Growth & Tax Relief Reconciliation Act of 2001.

Section	Section Title
653	PENSION PLAN - EXCISE TAX RELIEF FOR SOUND PENSION FUNDING

Background

Under present law, defined benefit pension plans are subject to minimum funding requirements designed to ensure that pension plans have sufficient assets to pay benefits. A defined benefit pension plan is funded using one of a number of acceptable actuarial cost methods.

No contribution is required under the minimum funding rules in excess of the full funding limit. The full funding limit is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 160% of the plan's current liability, over (2) the value of the plan's assets (sec. 412(c)(7)). In general, current liability is all liabilities to plan participants and beneficiaries accrued to date, whereas the accrued liability full funding limit is based on projected benefits. The current liability full funding limit is scheduled to increase as follows: 165% for plan years beginning in 2003 and 2004, and 170% for plan years beginning in 2005 and thereafter. In no event is a plan's full funding limit less than 90% of the plan's current liability over the value of the plan's assets.

An employer sponsoring a defined benefit pension plan generally may deduct amounts contributed to satisfy the minimum-funding standard for the plan year. Contributions in excess of the full funding limit generally are not deductible. Under a special rule, an employer that sponsors a defined benefit pension plan (other than a multiemployer plan) which has more than 100 participants for the plan year may deduct amounts contributed of up to 100% of the plan's unfunded current liability.

Present law also provides that contributions to defined contribution plans are deductible, subject to certain limitations.

Subject to certain exceptions, an employer that makes nondeductible contributions to a plan is subject to an excise tax equal to 10% of the amount of the nondeductible contributions for the year. The 10%

excise tax does not apply to contributions to certain terminating defined benefit plans. The 10% excise tax also does not apply to contributions of up to six% of compensation to a defined contribution plan for employer matching and employee elective deferrals.

New Federal Law (Sec. 4972)

In determining the amount of nondeductible contributions, the employer is permitted to elect not to take into account contributions to a defined benefit pension plan except to the extent they exceed the accrued liability full funding limit. Thus, if an employer elects, contributions in excess of the current liability full funding limit are not subject to the excise tax on nondeductible contributions. An employer making such an election for a year is not permitted to take advantage of the present-law exceptions for certain terminating plans and certain contributions to defined contribution plans. The Act applies to terminated plans as well as ongoing plans.

Effective Date

The Act is effective for years beginning after December 31, 2001.

California Law

California law does not provide for any type of excise tax on pension plans. California law does provide for a penalty tax for early withdrawals from pension plans and IRAs.

Impact on California Revenue

Not applicable.

Section	Section Title
659	PENSION PLAN - NOTICE OF SIGNIFICANT REDUCTION IN PLAN BENEFIT ACCRUALS.

Background

Section 204(h) of Title I of ERISA provides that a defined benefit pension plan or a money purchase pension plan may not be amended so as to provide for a significant reduction in the rate of future benefit accrual, unless, after adoption of the plan amendment and not less than 15 days before the effective date of the plan amendment, the plan administrator provides a written notice ("section 204(h) notice"), setting forth the plan amendment (or a summary of the amendment written in a manner calculated to be understood by the average plan participant) and its effective date. The plan administrator must provide the section 204(h) notice to each plan participant, each alternate payee under an applicable qualified domestic relations order ("QDRO"), and each employee organization representing participants in the plan. The applicable Treasury regulations provide, however, that a plan administrator need not provide the section 204(h) notice to any participant or alternate payee whose rate of future benefit accrual is reasonably expected not to be reduced by the amendment, nor to an employee organization that does not represent a participant to whom the section 204(h) notice must be provided. In addition, the regulations provide that the rate of future benefit accrual is determined without regard to optional forms of benefit, early retirement benefits, retirement-type subsidiaries, ancillary benefits, and certain other rights and features.

A covered amendment generally will not become effective with respect to any participants and alternate payees whose rate of future benefit accrual is reasonably expected to be reduced by the amendment but who do not receive a section 204(h) notice. An amendment will become effective with respect to all participants and alternate payees to whom the section 204(h) notice was required to be provided if the plan administrator (1) has made a good faith effort to comply with the section 204(h) notice requirements, (2) has provided a section 204(h) notice to each employee organization that represents any participant to whom a section 204(h) notice was required to be provided, (3) has failed to provide a section 204(h) notice to no more than a de minimis percentage of participants and alternate payees to whom a section 204(h) notice was required to be provided, and (4) promptly upon discovering the oversight, provides a section 204(h) notice to each omitted participant and alternate payee.

The Internal Revenue Code does not require any notice concerning a plan amendment that provides for a significant reduction in the rate of future benefit accrual.

<u>New Federal Law</u> (Sec. 4980F)

The Act adds to the Internal Revenue Code a requirement that the plan administrator of a defined benefit pension plan or a money purchase pension plan furnish a written notice concerning a plan amendment that provides for a significant reduction in the rate of future benefit accrual, including any elimination or reduction of an early retirement benefit or retirement-type subsidy. The plan administrator is required to provide in this notice, in a manner calculated to be understood by the average plan participant, sufficient information (as defined in Treasury regulations) to allow participants to understand the effect of the amendment.

The notice requirement does not apply to governmental plans or church plans with respect to which an election to have the qualified plan participation, vesting, and funding rules apply has not been made (sec. 410(d)). The Act authorizes the Secretary of the Treasury to provide a simplified notice requirement or an exemption from the notice requirement for plans with less than 100 participants and to allow any notice required under the Act to be provided by using new technologies. The Act also authorizes the Secretary to provide a simplified notice requirement or an exemption from the notice requirement if participants are given the option to choose between benefits under the new plan formula and the old plan formula. In such cases, the Act will have no effect on the fiduciary rules applicable to pension plans that may require appropriate disclosure to participants, even if no disclosure is required under the Act.

The plan administrator is required to provide this notice to each affected participant, each affected alternate payee, and each employee organization representing affected participants. For purposes of the Act, an affected participant or alternate payee is a participant or alternate payee whose rate of future benefit accrual may reasonably be expected to be significantly reduced by the plan amendment. Except to the extent provided by Treasury regulations, the plan administrator is required to provide the notice within a reasonable time before the effective date of the plan amendment. The Act permits a plan administrator to provide any notice required under the Act to a person designated in writing by the individual to whom it would otherwise be provided.

The Act imposes on a plan administrator that fails to comply with the notice requirement an excise tax equal to $100 per day per omitted participant and alternate payee. No excise tax is imposed during any period during which any person subject to liability for the tax did not know that the failure existed and exercised reasonable diligence to meet the notice requirement. In addition, no excise tax is imposed on any failure if any person subject to liability for the tax exercised reasonable diligence to meet the notice requirement and such person provides the required notice during the 30-day period beginning on the first date such person knew, or exercising reasonable diligence would have known, that the failure existed. Also, if the person subject to liability for the excise tax exercised reasonable diligence to meet the notice requirement, the total excise tax imposed during a taxable year of the employer will not exceed $500,000. Furthermore, in the case of a failure due to reasonable cause and not to willful neglect, the Secretary of the Treasury is authorized to waive the excise tax to the extent that the payment of the tax would be excessive relative to the failure involved.

It is intended under the Act that the Secretary issue the necessary regulations with respect to disclosure within 90 days of enactment. It is also intended that such guidance may be relatively detailed because of the need to provide for alternative disclosures rather than a single disclosure methodology that may not fit all situations, and the need to consider the complex actuarial calculations and assumptions involved in providing necessary disclosures. In addition, the Act directs the Secretary of the Treasury to prepare a report on the effects of conversions of traditional defined benefit plans to cash balance or hybrid formula plans. Such study is to examine the effect of such conversions on longer service participants, including the incidence and effects of “wear away” provisions under which participants earn no additional benefits for a period of time after the conversion. The Secretary is directed to submit such report, together with recommendations thereon, to the Committee on Ways and Means and the Committee on Education and the Workforce of the House of Representatives and the Committee on Finance and the Committee on Health, Education, Labor, and Pensions of the Senate as soon as practicable, but not later than 60 days after June 7, 2001.

The Act also modifies the present-law notice requirement contained in section 204(h) of Title I of ERISA to provide that an applicable pension plan may not be amended to provide for a significant reduction in the rate of future benefit accrual in the event of an egregious failure by the plan administrator to comply with a notice requirement similar to the notice requirement that the Act adds to the Internal Revenue Code. In addition, the Act expands the current ERISA notice requirement regarding significant reductions in normal retirement benefit accrual rates to early retirement benefits and retirement-type subsidies.

<u>Effective Date</u>

The provision is effective for plan amendments taking effect on or after June 7, 2001. The period for providing any notice required under the provision will not end before the last day of the three-month period following June 7, 2001. Prior to the issuance of Treasury regulations, a plan is treated as meeting the requirements of the Act if the plan makes a good faith effort to comply with such requirements. The notice requirement under the provision does not apply to any plan amendment taking effect on or after June 7, 2001 if, before April 25, 2001, notice is provided to participants and beneficiaries adversely affected by the plan amendment (or their representatives) that is reasonably expected to notify them of the nature and effective date of the plan amendment.

California Law

California law requires few reporting requirements on pension plans. California relies on the pension plans reporting to the federal government.

Impact on California Revenue

Not applicable.

Section	Section Title
654	PENSION PLAN - MODIFICATIONS TO SECTION 415 LIMITS FOR MULTIEMPLOYER PLANS.

Background

Under present law, limits apply to contributions and benefits under qualified plans (sec. 415). The limits on contributions and benefits under qualified plans are based on the type of plan. Under a defined benefit plan, the maximum annual benefit payable at retirement is generally the lesser of (1) 100% of average compensation for the highest three years, or (2) $140,000 (for 2001). The dollar limit is adjusted for cost-of-living increases in $5,000 increments. The dollar limit is reduced in the case of retirement before the social security retirement age and increases in the case of retirement after the social security retirement age

A special rule applies to governmental defined benefit plans. In the case of such plans, the defined benefit dollar limit is reduced in the case of retirement before age 62 and increased in the case of retirement after age 65. In addition, there is a floor on early retirement benefits. Pursuant to this floor, the minimum benefit payable at age 55 is $75,000.

In the case of a defined contribution plan, the limit on annual additions is the lesser of (1) 25% of compensation or (2) $35,000 (for 2001). Another provision of the Act increases this limit to 100% of compensation.

In applying the limits on contributions and benefits, plans of the same employer are aggregated. That is, all defined benefit plans of the same employer are treated as a single plan, and all defined contribution plans of the same employer are treated as a single plan. Under Treasury regulations, multiemployer plans are not aggregated with other multiemployer plans. However, if an employer maintains both a plan that is not a multiemployer plan and a multiemployer plan, the plan that is not a multiemployer plan is aggregated with the multiemployer plan to the extent that benefits provided under the multiemployer plan are provided with respect to a common participant.

New Federal Law (Sec. 415)

Under the Act, the 100% of compensation defined benefit plan limit does not apply to multiemployer plans. With respect to aggregation of multiemployer plans with other plans, the Act provides that multiemployer plans are not aggregated with single-employer defined benefit plans maintained by an employer contributing to the multiemployer plan for purposes of applying the 100% of compensation limit to such single-employer plan.

Effective Date

The provision is effective for years beginning after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Based on the low level of federal estimates for this provision in the Economic Growth & Tax Relief Reconciliation Act of 2001, conforming to the provision would result in negligible revenue losses annually of less than $250,000 for state tax purposes.

Section	Section Title
655	PENSION PLAN - INVESTMENT OF EMPLOYEE CONTRIBUTIONS IN 401(K) PLANS

Background

The Employee Retirement Income Security Act of 1974, as amended (“ERISA”) prohibits certain employee benefit plans from acquiring securities or real property of the employer who sponsors the plan if, after the acquisition, the fair market value of such securities and property exceeds 10% of the fair market value of plan assets. The 10% limitation does not apply to any “eligible individual account plans” that specifically authorize such investments. Generally, eligible individual account plans are defined contribution plans, including plans containing a cash or deferred arrangement (“401(k) plans”).

The term “eligible individual account plan” does not include the portion of a plan that consists of elective deferrals (and earnings on the elective deferrals) made under section 401(k) if elective deferrals equal to more than 1% of any employee's eligible compensation are required to be invested in employer securities and employer real property. Eligible compensation is compensation that is eligible to be deferred under the plan. The portion of the plan that consists of elective deferrals (and earnings thereon) is still treated as an individual account plan, and the 10% limitation does not apply, as long as elective deferrals (and earnings thereon) are not required to be invested in employer securities or employer real property. The rule excluding elective deferrals (and earnings thereon) from the definition of individual account plan does not apply if individual account plans are a small part of the employer's retirement plans. In particular, that rule does not apply to an individual account plan for a plan year if the value of the assets of all individual account plans maintained by the employer do not exceed 10% of the value of the assets of all pension plans maintained by the employer (determined as of the last day of the preceding plan year). Multiemployer plans are not taken into account in determining whether the value of the assets of all individual account plans maintained by the employer exceed 10% of the value of the assets of all pension plans maintained by the employer.

The rule excluding elective deferrals (and earnings thereon) from the definition of individual account plan does not apply to an employee stock ownership plan as defined in section 4975(e)(7) of the Internal Revenue Code.

The rule excluding elective deferrals (and earnings thereon) from the definition of individual account plan applies to elective deferrals for plan years beginning after December 31, 1998 (and earnings thereon). It does not apply with respect to earnings on elective deferrals for plan years beginning before January 1, 1999.

New Federal Law (Sec. 1524(b) of the Taxpayer Relief Act of 1997)

The Act modifies the effective date of the rule excluding certain elective deferrals (and earnings thereon) from the definition of individual account plan by providing that the rule does not apply to any elective deferral used to acquire an interest in the income or gain from employer securities or employer real property acquired (1) before January 1, 1999, or (2) after such date pursuant to a written contract which was binding on such date and at all times thereafter.

Effective Date

The provision is effective as if included in the section of the Taxpayer Relief Act of 1997 that contained the rule excluding certain elective deferrals (and earnings thereon).

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Not applicable.

Section	Section Title
656	PENSION PLAN - PROHIBITED ALLOCATIONS OF STOCK IN AN S CORPORATION ESOP.

Background

The Small Business Job Protection Act of 1996 allowed qualified retirement plan trusts described in section 401(a) to own stock in an S corporation. That Act treated the plan's share of the S corporation's income (and gain on the disposition of the stock) as includible in full in the trust's unrelated business taxable income ("UBTI").

The Tax Relief Act of 1997 repealed the provision treating items of income or loss of an S corporation as UBTI in the case of an employee stock ownership plan ("ESOP"). Thus, the income of an S corporation allocable to an ESOP is not subject to current taxation.

Present law provides a deferral of income on the sales of certain employer securities to an ESOP (sec. 1042). A 50% excise tax is imposed on certain prohibited allocations of securities acquired by an ESOP in a transaction to which section 1042 applies. In addition, such allocations are currently includible in the gross income of the individual receiving the prohibited allocation.

New Federal Law (Secs. 409 & 4979a)

In general

Under the Act, if there is a nonallocation year with respect to an ESOP maintained by an S corporation: (1) the amount allocated in a prohibited allocation to an individual who is a disqualified person is treated as distributed to such individual (i.e., the value of the prohibited allocation is includible in the gross income of the individual receiving the prohibited allocation); (2) an excise tax is imposed on the S corporation equal to 50% of the amount involved in a prohibited allocation; and (3) an excise tax is imposed on the S corporation with respect to any synthetic equity owned by a disqualified person. The plan is not disqualified merely because an excise tax is imposed under the provision.

It is intended that the Act will limit the establishment of ESOPs by S corporations to those that provide broad-based employee coverage and that benefit rank-and-file employees as well as highly compensated employees and historical owners.

Definition of nonallocation year

A nonallocation year means any plan year of an ESOP holding shares in an S corporation if, at any time during the plan year, disqualified persons own at least 50% of the number of outstanding shares of the S corporation.

A person is a disqualified person if the person is either (1) a member of a "deemed 20% shareholder group" or (2) a "deemed 10% shareholder." A person is a member of a "deemed 20% shareholder group" if the aggregate number of deemed-owned shares of the person and his or her family members is at least 20% of the number of deemed-owned shares of stock in the S corporation. A person is a deemed 10% shareholder if the person is not a member of a deemed 20% shareholder group and the number of the person's deemed-owned shares is at least 10% of the number of deemed-owned shares of stock of the corporation. A family member of a member of a “deemed 20% shareholder group” with deemed owned shares is also treated as a disqualified person.

In general, “deemed-owned shares” means: (1) stock allocated to the account of an individual under the ESOP, and (2) an individual's share of unallocated stock held by the ESOP. An individual's share of unallocated stock held by an ESOP is determined in the same manner as the most recent allocation of stock under the terms of the plan. For purposes of determining whether there is a nonallocation year, ownership of stock generally is attributed under the rules of section 318. These attribution rules also apply to stock treated as owned by reason of the ownership of synthetic equity, except that: (1) the family attribution rules are modified to include certain other family members, as described below, (2) option attribution does not apply (but instead special rules relating to synthetic equity described below apply), and (3) “deemed-owned shares” held by the ESOP are treated as held by the individual with respect to whom they are deemed owned.

Under the Act, family members of an individual include (1) the spouse of the individual, (2) an ancestor or lineal descendant of the individual or his or her spouse, (3) a sibling of the individual (or the individual's spouse) and any lineal descendant of the brother or sister, and (4) the spouse of any person described in (2) or (3).

The Act contains special rules applicable to synthetic equity interests. Except to the extent provided in regulations, the stock on which a synthetic equity interest is based are treated as outstanding stock of the S corporation and as deemed-owned shares of the person holding the synthetic equity interest if such treatment will result in the treatment of any person as a disqualified person or the treatment of any year as a nonallocation year. Thus, for example, disqualified persons for a year include those individuals who are disqualified persons under the general rule (i.e., treating only those shares held by the ESOP as deemed-owned shares) and those individuals who are disqualified individuals if synthetic equity interests are treated as deemed-owned shares.

“Synthetic equity” means any stock option, warrant, restricted stock, deferred issuance stock right, or similar interest that gives the holder the right to acquire or receive stock of the S corporation in the future. Except to the extent provided in regulations, synthetic equity also includes a stock appreciation right, phantom stock unit, or similar right to a future cash payment based on the value of such stock or appreciation in such value. The provisions relating to synthetic equity do not modify the rules relating to S corporations, e.g., the circumstances in which options or similar interests are treated as creating a second class of stock.

Ownership of synthetic equity is attributed in the same manner as stock is attributed under the Act (as described above). In addition, ownership of synthetic equity is attributed under the rules of section 318(a)(2) and (3) in the same manner as stock.

Definition of prohibited allocation

An ESOP of an S corporation is required to provide that no portion of the assets of the plan attributable to (or allocable in lieu of) S corporation stock may, during a nonallocation year, accrue (or be allocated directly or indirectly under any qualified plan of the S corporation) for the benefit of a disqualified person. A “prohibited allocation” refers to violations of this provision. A prohibited allocation occurs, for example, if income on S corporation stock held by an ESOP is allocated to the account of an individual who is a disqualified person.

Application of excise tax

In the case of a prohibited allocation, the S corporation is liable for an excise tax equal to 50% of the amount of the allocation. For example, if S corporation stock is allocated in a prohibited allocation, the excise tax is equal to 50% of the fair market value of such stock.

A special rule applies in the case of the first nonallocation year, regardless of whether there is a prohibited allocation. In that year, the excise tax also applies to the fair market value of the deemed-owned shares of any disqualified person held by the ESOP, even though those shares are not allocated to the disqualified person in that year. As mentioned above, the S corporation also is liable for an excise tax with respect to any synthetic equity interest owned by any disqualified person in a nonallocation year. The excise tax is 50% of the value of the shares on which synthetic equity is based.

Treasury regulations

The Treasury Department is given the authority to prescribe such regulations as may be necessary to carry out the purposes of the Act.

The Act authorizes the Secretary to determine, by regulation or other guidance of general applicability, that a nonallocation year occurs in any case in which the principal purpose of the ownership structure of an S corporation constitutes, in substance, an avoidance or evasion of the prohibited allocation rules. For example, this might apply if more than 10 independent businesses are combined in an S corporation owned by an ESOP in order to take advantage of the income tax treatment of S corporations owned by an ESOP.

Effective Date

The Act generally is effective with respect to plan years beginning after December 31, 2004. In the case of an ESOP established after March 14, 2001, or an ESOP established on or before such date if the employer maintaining the plan was not an S corporation on such date, the Act is effective with respect to plan years ending after March 14, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Based on the very low level of federal estimates for this provision in the Economic Growth & Tax Relief Reconciliation Act of 2001, conforming to the provision would result in negligible revenue gains in 2002-03 and 2003-04 of less than $250,000 each year, increasing to a minor gain in 2004-05 of less than $500,000.

<u>Section</u>	<u>Section Title</u>
657	PENSION PLAN - AUTOMATIC ROLLOVERS OF CERTAIN MANDATORY DISTRIBUTIONS.

Background

If a qualified retirement plan participant ceases to be employed by the employer that maintains the plan, the plan may distribute the participant's nonforfeitable accrued benefit without the consent of the participant and, if applicable, the participant's spouse, if the present value of the benefit does not exceed $5,000. If such an involuntary distribution occurs and the participant subsequently returns to employment covered by the plan, then service taken into account in computing benefits payable under the plan after the return need not include service with respect to which a benefit was involuntarily distributed unless the employee repays the benefit.

Generally, a participant may roll over an involuntary distribution from a qualified plan to an IRA or to another qualified plan. Before making a distribution that is eligible for rollover, a plan administrator must provide the participant with a written explanation of the ability to have the distribution rolled over directly to an IRA or another qualified plan and the related tax consequences.

New Federal Law (Sec. 404(c) of ERISA)

The Act makes a direct rollover the default option for involuntary distributions that exceed $1,000 and that are eligible rollover distributions from qualified retirement plans. The distribution must be rolled over automatically to a designated IRA, unless the participant affirmatively elects to have the distribution transferred to a different IRA or a qualified plan or to receive it directly.

The written explanation provided by the plan administrator is required to explain that an automatic direct rollover will be made unless the participant elects otherwise. The plan administrator is also required to notify the participant in writing (as part of the general written explanation or separately) that the distribution may be transferred without cost to another IRA.

The Act amends the fiduciary rules of ERISA so that, in the case of an automatic direct rollover, the participant is treated as exercising control over the assets in the IRA upon the earlier of (1) the rollover of any portion of the assets to another IRA, or (2) one year after the automatic rollover.

The Act directs the Secretary of Labor to issue safe harbors under which the designation of an institution and investment of funds in accordance with the Act are deemed to satisfy the requirements of section 404(a) of ERISA. In addition, the Act authorizes and directs the Secretary of the Treasury and the Secretary of Labor to give consideration to providing special relief with respect to the use of low-cost individual retirement plans for purposes of the provision and for other uses that promote the preservation of tax-qualified retirement assets for retirement income purposes. The Act directs the Secretary of Labor to adopt final regulations implementing the Act not later than three years after June 7, 2001

Effective Date

The provision applies to distributions that occur after the Department of Labor has adopted final regulations implementing the Act.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Based on the low level of federal estimates for this provision in the Economic Growth & Tax Relief Reconciliation Act of 2001, conforming to the provision would result in a negligible revenue loss beginning in 2003-04 of less than $250,000, increasing to a $1 million loss in 2004-05.

Section	Section Title
658	PENSION PLAN - CLARIFICATION OF TREATMENT OF CONTRIBUTIONS TO A MULTIEMPLOYER PLAN.

Background

Employer contributions to one or more qualified retirement plans are deductible subject to certain limits. In general, contributions are deductible for the taxable year of the employer in which the contributions are made. Under a special rule, an employer may be deemed to have made a contribution on the last day of the preceding taxable year if the contribution is on account of the preceding taxable year and is made not later than the time prescribed by law for filing the employer's income tax return for that taxable year (including extensions).

A change in method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. A material item is any item that involves the proper time for the inclusion of the item in income or taking of a deduction.

A change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability. Also, a change in method of accounting does not include adjustment of any item of income or deduction that does not involve the proper time for the inclusion of the item of income or the taking of a deduction. A change in method of accounting also does not include a change in treatment resulting from a change in underlying facts.

New Federal Law

The Act clarifies that a determination of whether contributions to multiemployer pension plans are on account of a prior year under section 404(a)(6) is not a method of accounting. Thus, any taxpayer that begins to deduct contributions to multiemployer plans as provided in section 404(a)(6) has not changed its method of accounting and is not subject to an adjustment under section 481. The Act is intended to respect, not disturb, the effect of the statute of limitations. The Act is not intended to permit, as of the end of the taxable year, aggregate deductions for contributions to a qualified plan in excess of the amounts actually contributed or deemed contributed to the plan by the taxpayer. The Secretary of the Treasury is authorized to promulgate regulations to clarify that, in the aggregate, no taxpayer will be permitted deductions in excess of amounts actually contributed to multiemployer plans, taking into account the provisions of section 404(a)(6).

No inference is intended regarding whether the determination of whether a contribution to a multiemployer pension plan on account of a prior year under section 404(a)(6) is a method of accounting prior to the effective date of the provision.

Effective Date

The Act is effective after June 7, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Conforming to federal provisions for clarifying the treatment of contributions to multiemployer plans would result in baseline revenue losses each year. Revenue losses (characterized as baseline) will result automatically due to federal ERISA provisions and/or the non-reporting of the inside build-up of earnings for taxpayers taking advantage of the new federal limits. The latter issue will require audit adjustments to taxpayer self-reporting. Total baseline revenue losses for affected provisions are provided in the footnote to the Conformity Summary Table.

Section	Section Title
661	PENSION PLAN - MODIFICATION OF TIMING OF PLAN VALUATIONS.

Background

Under present law, plan valuations are generally required annually for plans subject to the minimum funding rules. Under proposed Treasury regulations, except as provided by the Commissioner, the valuation must be as of a date within the plan year to which the valuation refers or within the month prior to the beginning of that year.

New Federal Law (Sec. 412)

The Act incorporates into the statute the proposed regulation regarding the date of valuations. The Act also provides, as an exception to this general rule, that the valuation date with respect to a plan year may be any date within the immediately preceding plan year if, as of such date, plan assets are not less than 100% of the plan's current liability. Information determined as of such date is required to be adjusted actuarially, in accordance with Treasury regulations, to reflect significant differences in plan participants. A change in funding method to take advantage of the exception to the general rule may not be made unless, as of such date, plan assets are not less than 125% of the plan's current liability. The Secretary is directed to automatically approve changes in funding method to use a prior year valuation date if the change is within the first three years that the plan is eligible to make the change.

Effective Date

The provision is effective for plan years beginning after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Based on federal estimates of inconsequential revenue effects for this provision in the Economic Growth & Tax Relief Reconciliation Act of 2001, conforming to the provision would result in negligible baseline revenue effects for state tax purposes.

Section	Section Title
662	PENSION PLAN - ESOP DIVIDENDS MAY BE REINVESTED WITHOUT LOSS OF DIVIDEND DEDUCTION

Background

An employer is entitled to deduct certain dividends paid in cash during the employer's taxable year with respect to stock of the employer that is held by an employee stock ownership plan ("ESOP"). The deduction is allowed with respect to dividends that, in accordance with plan provisions, are (1) paid in cash directly to the plan participants or their beneficiaries, (2) paid to the plan and subsequently distributed to the participants or beneficiaries in cash no later than 90 days after the close of the plan year in which the dividends are paid to the plan, or (3) used to make payments on loans (including payments of interest as well as principal) that were used to acquire the employer securities (whether or not allocated to participants) with respect to which the dividend is paid.

The Secretary may disallow the deduction for any ESOP dividend if he determines that the dividend constitutes, in substance, an evasion of taxation (sec. 404(k)(5)).

New Federal Law (Sec. 404)

In addition to the deductions permitted under present law for dividends paid with respect to employer securities that are held by an ESOP, an employer is entitled to deduct dividends that, at the election of plan participants or their beneficiaries, are (1) payable in cash directly to plan participants or beneficiaries, (2) paid to the plan and subsequently distributed to the participants or beneficiaries in cash no later than 90 days after the close of the plan year in which the dividends are paid to the plan, or (3) paid to the plan and reinvested in qualifying employer securities.

The Act permits the Secretary to disallow the deduction for any ESOP dividend if the Secretary determines that the dividend constitutes, in substance, the avoidance or evasion of taxation. This provision includes authority to disallow a deduction of unreasonable dividends.

For purposes of the section 404(k)(2)(A)(iii) reinvested dividends, a dividend paid on common stock that is primarily and regularly traded on an established securities market would be reasonable. In addition, for this purpose in the case of employers with no common stock (determined on a controlled group basis) that is primarily and regularly traded on an established securities market, the reasonableness of a dividend is determined by comparing the dividend rate on stock held by the ESOP with the dividend rate for common stock of comparable corporations whose stock is primarily and regularly traded on an established securities market. Whether a corporation is comparable is determined by comparing relevant corporate characteristics such as industry, corporate size, earnings, debt-equity structure and dividend history.

Effective Date

The Act is effective for taxable years beginning after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Conformity revenue losses are estimated as follows:

Enactment Assumed By April 1, 2002 [$ In Millions]		
2002-03	2003-04	2004-05
-$2	-$2	-$2

Estimates were based on a proration of federal projections developed for the Economic Growth & Tax Relief Reconciliation Act of 2001.

Section	Section Title
663	PENSION PLAN - REPEAL TRANSITION RULE RELATING TO CERTAIN HIGHLY COMPENSATED EMPLOYEES

Background

Under present law, for purposes of the rules relating to qualified plans, a highly compensated employee is generally defined as an employee, including self-employed individuals, who: (1) was a 5% owner of the employer at any time during the year or the preceding year or (2) either (a) had compensation for the preceding year in excess of $85,000 (for 2001) or (b) at the election of the employer, had compensation in excess of $85,000 for the preceding year and was in the top 20% of employees by compensation for such year.

Under a rule enacted in the Tax Reform Act of 1986, a special definition of highly compensated employee applies for purposes of the nondiscrimination rules relating to qualified cash or deferred arrangements ("section 401(k) plans") and matching contributions. This special definition applies to an employer incorporated on December 15, 1924, that meets certain specific requirements.

New Federal Law (Sec. 1114(c)(4) of the Tax Reform Act of 1986)

The Act repeals the special definition of highly compensated employee under the Tax Reform Act of 1986. Thus, the present-law definition applies.

Effective Date

The Act is effective for plan years beginning after December 31, 2001.

California Law

California law did not conform to the highly compensated employee rule enacted by the Tax Reform Act of 1986. Therefore, it is not necessary to repeal the special rule.

Impact on California Revenue

Based on the very low level of federal estimates for this provision in the Economic Growth & Tax Relief Reconciliation Act of 2001, conforming to the provision would result in negligible revenue losses annually of less than $250,000 for state tax purposes.

Section	Section Title
664	PENSION PLAN - EMPLOYEES OF TAX-EXEMPT ENTITIES.

Background

The Tax Reform Act of 1986 provided that nongovernmental tax-exempt employers were not permitted to maintain a qualified cash or deferred arrangement (“section 401(k) plan”). This prohibition was repealed, effective for years beginning after December 31, 1996, by the Small Business Job Protection Act of 1996.

Treasury regulations provide that, in applying the nondiscrimination rules to a section 401(k) plan (or a section 401(m) plan that is provided under the same general arrangement as the section 401(k) plan), the employer may treat as excludable those employees of a tax-exempt entity who could not participate in the arrangement due to the prohibition on maintenance of a section 401(k) plan by such entities. Such employees may be disregarded only if more than 95% of the employees who could participate in the section 401(k) plan benefit under the plan for the plan year.

Tax-exempt charitable organizations may maintain a tax-sheltered annuity (a “section 403(b) annuity”) that allows employees to make salary reduction contributions.

New Federal Law (Sec. 198)

The Treasury Department is directed to revise its regulations under section 410(b) to provide that employees of a tax-exempt charitable organization who are eligible to make salary reduction contributions under a section 403(b) annuity may be treated as excludable employees for purposes of testing a section 401(k) plan, or a section 401(m) plan that is provided under the same general arrangement as the section 401(k) plan of the employer if (1) no employee of such tax-exempt entity is eligible to participate in the section 401(k) or 401(m) plan and (2) at least 95% of the employees who are not employees of the charitable employer are eligible to participate in such section 401(k) plan or section 401(m) plan.

The revised regulations are to be effective for years beginning after December 31, 1996.

Effective Date

The Act is effective on June 7, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Based on federal estimates of inconsequential revenue effects for this provision in the Economic Growth & Tax Relief Reconciliation Act of 2001, conforming to the provision would result in negligible revenue effects for state tax purposes.

Section	Section Title
665	PENSION PLAN - TREATMENT OF EMPLOYER-PROVIDED RETIREMENT ADVICE.

Background

Under present law, certain employer-provided fringe benefits are excludable from gross income and wages for employment tax purposes. These excludable fringe benefits include working condition fringe benefits and de minimis fringes. In general, a working condition fringe benefit is any property or services provided by an employer to an employee to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction as a business expense. A de minimis fringe benefit is any property or services provided by the employer the value of which, after taking into account the frequency with which similar fringes are provided, is so small as to make accounting for it unreasonable or administratively impracticable. In addition, if certain requirements are satisfied, up to $5,250 annually of employer-provided educational assistance is excludable from gross income (sec. 127) and wages. This exclusion expires with respect to courses beginning after December 31, 2001. Education not excludable under section 127 may be excludable as a working condition fringe.

There is no specific exclusion under present law for employer-provided retirement planning services. However, such services may be excludable as employer-provided educational assistance or a fringe benefit.

New Federal Law (Sec. 132)

Qualified retirement planning services provided to an employee and his or her spouse by an employer maintaining a qualified plan is excludable from income and wages. The exclusion does not apply with respect to highly compensated employees unless the services are available on substantially the same terms to each member of the group of employees normally provided education and information regarding the employer's qualified plan. “Qualified retirement planning services” are retirement planning advice and information. The exclusion is not limited to information regarding the qualified plan, and, thus, for example, applies to advice and information regarding retirement income planning for an individual and his or her spouse and how the employer's plan fits into the individual's overall retirement income plan. On the other hand, the exclusion does not apply to services that may be related to retirement planning, such as tax preparation, accounting, legal or brokerage services.

It is intended that the Act will clarify the treatment of retirement advice provided in a nondiscriminatory manner. It is intended that the Secretary, in determining the application of the exclusion to highly compensated employees, may permit employers to take into consideration employee circumstances other than compensation and position in providing advice to classifications of employees. Thus, for example, the Secretary may permit employers to limit certain advice to individuals nearing retirement age under the plan.

Effective Date

The Act is effective with respect to years beginning after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Based on federal estimates of inconsequential revenue effects for this provision in the Economic Growth & Tax Relief Reconciliation Act of 2001, conforming to the provision would result in negligible revenue effects for state tax purposes.

Section	Section Title
666	PENSION PLAN - REPEAL OF THE MULTIPLE USE TEST.

Background

Elective deferrals under a qualified cash or deferred arrangement ("section 401(k) plan") are subject to a special annual nondiscrimination test ("ADP test"). The ADP test compares the actual deferral percentages ("ADPs") of the highly compensated employee group and the nonhighly compensated employee group. The ADP for each group generally is the average of the deferral percentages separately calculated for the employees in the group who are eligible to make elective deferrals for all or a portion of the relevant plan year. Each eligible employee's deferral percentage generally is the employee's elective deferrals for the year divided by the employee's compensation for the year.

The plan generally satisfies the ADP test if the ADP of the highly compensated employee group for the current plan year is either (1) not more than 125% of the ADP of the nonhighly compensated employee group for the prior plan year, or (2) not more than 200% of the ADP of the nonhighly compensated employee group for the prior plan year and not more than two percentage points greater than the ADP of the nonhighly compensated employee group for the prior plan year.

Employer matching contributions and after-tax employee contributions under a defined contribution plan also is subject to a special annual nondiscrimination test ("ACP test"). The ACP test compares the actual deferral percentages ("ACPs") of the highly compensated employee group and the nonhighly compensated employee group. The ACP for each group generally is the average of the contribution percentages separately calculated for the employees in the group who are eligible to make after-tax employee contributions or who are eligible for an allocation of matching contributions for all or a portion of the relevant plan year. Each eligible employee's contribution percentage generally is the employee's aggregate after-tax employee contributions and matching contributions for the year divided by the employee's compensation for the year.

The plan generally satisfies the ACP test if the ACP of the highly compensated employee group for the current plan year is either (1) not more than 125% of the ACP of the nonhighly compensated employee group for the prior plan year, or (2) not more than 200% of the ACP of the nonhighly compensated employee group for the prior plan year and not more than two percentage points greater than the ACP of the nonhighly compensated employee group for the prior plan year.

For any year in which (1) at least one highly compensated employee is eligible to participate in an employer's plan or plans that are subject to both the ADP test and the ACP test, (2) the plan subject to the ADP test satisfies the ADP test but the ADP of the highly compensated employee group exceeds 125% of the ADP of the nonhighly compensated employee group, and (3) the plan subject to the ACP test satisfies the ACP test but the ACP of the highly compensated employee group exceeds 125% of the ACP of the nonhighly compensated employee group, an additional special nondiscrimination test ("multiple use test") applies to the elective deferrals, employer matching contributions, and after-tax employee contributions. The plan or plans generally satisfy the multiple use test if the sum of the ADP and the ACP of the highly compensated employee group does not exceed the greater of (1) the sum of (A) 1.25 times the greater of the ADP or the ACP of the nonhighly compensated employee group, and (B) two percentage points plus (but not more than two times) the lesser of the ADP or the ACP of the nonhighly compensated employee group, or (2) the sum of (A) 1.25 times the lesser of the ADP or the ACP of the nonhighly compensated employee group, and (B) two percentage points plus (but not more than two times) the greater of the ADP or the ACP of the nonhighly compensated employee group.

New Federal Law (Sec. 401(m))

The Act repeals the multiple use test.

Effective Date

The Act is effective for years beginning after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the Economic Growth & Tax Relief Reconciliation Act of 2001.

Impact on California Revenue

Conformity revenue losses for this provision are included in estimates of other provisions.

Section	Section Title
691	TAX TREATMENT OF ELECTING ALASKA NATIVE SETTLEMENT TRUSTS.

Background

An Alaska Native Corporation ("ANC") may establish a Settlement Trust ("Trust") under section 39 of the Alaska Native Claims Settlement Act ("ANCSA") and transfer money or other property to such Trust for the benefit of beneficiaries who constitute all or a class of the shareholders of the ANC, to promote the health, education and welfare of the beneficiaries and preserve the heritage and culture of Alaska Natives. A settlement Trust is subject to certain limitations under ANCSA, including that it may not operate a business.

With certain exceptions, once an ANC has made a conveyance to a Trust, the assets conveyed shall not be subject to attachment, distraint, or sale or execution of judgment, except with respect to the lawful debts and obligations of the Trust.

The Internal Revenue Service ("IRS") has indicated that contributions to a Trust constitute distributions to the beneficiary-shareholders at the time of the contribution and are treated as dividends to the extent of earnings and profits as provided under section 301 of the Code. Also, a Trust and its beneficiaries are generally taxed subject to applicable trust rules.

Under general rules regarding the classification of entities, an entity that is taxed as a trust may not engage in business activity and must meet certain other requirements. Under certain circumstances, a trust can be treated as a "grantor" trust rather than being taxed as a trust; and its income can be taxed directly to the person or persons considered the owner of the trust.

New Federal Law (Secs. 1(e), 301, 641, 646, 651, 661, 6034A & 6039H)

The Act allows an election under which special rules will apply in determining the income tax treatment of an electing Trust and of its beneficiaries. An electing Trust will pay tax on its income at the lowest rate specified for ordinary income of an individual (or corresponding lower capital gains rate). The provision also specifies the treatment of distributions by an electing Trust to beneficiaries, the reporting requirements associated with such an election, and the consequences of disqualification for these benefits due to the allowance of certain impermissible dispositions of Trust interests, or of ANC stock. Under the provision, a Trust that makes the election remains subject to the generally applicable requirements for classification and taxation as a trust, in order to obtain the benefits of the provision.

Under the provision, a trust that is a Trust established by an Alaska Native Corporation under section 39 of ANCSA may make an election for its first taxable year ending after June 7, 2001, of the provision to be subject to the rules of the provision rather than otherwise applicable income tax rules. If the election is in effect, no amount will be included in the gross income of a beneficiary of such Trust by reason of a contribution to the Trust. If the ANC transfers appreciated property to the Trust, section 311(b) of the Code will apply to the ANC, as under present law, so that the ANC will recognize gain as if it had sold the property for fair market value. The Trust takes the property with a fair market value basis, pursuant to section 301(d) of the Code. In addition, ordinary income of the electing Trust, whether accumulated or distributed, will be taxed only to the Trust (and not to beneficiaries) at the lowest individual tax rate for ordinary income. Capital gains of the electing Trust will similarly be taxed to the Trust at the capital gains rate applicable to individuals subject to such lowest rate. These rates will apply, rather than the higher rates generally applicable to trusts or to higher tax bracket beneficiaries. The election is made on a one-time basis only. The benefits of the election will terminate, however, and other special rules will apply, if the electing Trust or the sponsoring ANC fail to satisfy the restrictions on transferability of Trust beneficial interests or of ANC stock.

The treatment to beneficiaries of amounts distributed by an electing Trust depends upon the amount of the distribution. Solely for purposes of determining what amount has been distributed and thus which treatment applies under these rules, the amount of any distribution of property is the fair market value of the property at the time of the distribution. Section 661 of the Code, which provides a deduction to the trust for certain distributions, does not apply to an electing Trust under the provision unless the election is terminated by disqualification. Similarly, the inclusion provisions of section 662 of the Code, relating to amounts to be included in income of beneficiaries, also do not apply to a qualified electing Trust.

Amounts distributed by an electing Trust during any taxable year are excludable from the gross income of the recipient beneficiary to the extent of (1) the taxable income of the Trust for the taxable year and all prior taxable years for which an election was in effect (decreased by any income tax paid by the Trust with respect to the income) plus (2) any amounts excluded from gross income of the Trust under section 103 for those periods. In the case of any such excludable distribution that involves a distribution of property other than cash, the basis of such property in the hands of the recipient beneficiary will generally be the adjusted basis of the property in the hands of the Trust, unless the Trust makes an election to pay tax, in which case the basis in the hands of the beneficiary would be the fair market value of the property. See Code sections 643(e) and 643(e)(3).

If distributions to beneficiaries exceed the excludable amounts described above, then such excess distributions are reported and taxed to beneficiaries as if distributed by the ANC in the year of the distribution by the electing Trust to the extent the ANC then has current or accumulated earnings and profits, and are treated as dividends to beneficiaries. The treatment of such amounts distributed by an electing Trust as a dividend applies even if all or any part of the contributions by an ANC to a Trust would not have been dividends at the time of the contribution under present law; for example, because the ANC had no current or accumulated earnings and profits, or because the contribution was made from Alaska Native Fund amounts that may not have been taxable.

The beneficiaries treat additional distributions in excess of the current or accumulated earnings and profits of the ANC as distributions by the Trust in excess of the distributable net income of the Trust for such year. Such distributions would not be taxable to the beneficiaries. In the case of any such nontaxable distribution that involves a distribution of property other than cash, the basis of such property in the hands of the recipient beneficiary will generally be the adjusted basis of the property in the hands of the Trust, unless the Trust makes an election to pay tax, in which case the basis in the hands of the beneficiary will be the fair market value of the property. See Code sections 643(e) and 643(e)(3).

The fiduciary of an electing Trust must report to the IRS, with the Trust tax return, the amount of distributions to each beneficiary, and the tax treatment to the beneficiary of such distributions under the provision (either as exempt from tax to the beneficiary, or as a distribution deemed made by the ANC). The electing Trust must also furnish such information to the ANC. In the case of distributions that are treated as if made by the ANC, the ANC must then report such amounts to the beneficiaries and must indicate whether they are dividends or not, in accordance with the earnings and profits of the ANC. The reporting thus required by an electing Trust will be in lieu of, and will satisfy, the reporting requirements of section 6034A (and such other reporting requirements as the Secretary of the Treasury may deem appropriate).

The earnings and profits of an ANC will not be reduced by the amount of its contributions to an electing Trust at the time of the contributions. However, the ANC earnings and profits will be reduced as and when distributions are thereafter made by the electing Trust that are taxed to beneficiaries under the provision as dividends from the ANC to the Trust beneficiaries.

If in any taxable year the beneficial interests in the electing Trust may be disposed of to a person in a manner that would not be permitted under ANCSA if the interests were Settlement Common Stock (generally, to a person other than an Alaska Native), then the special provisions applicable to electing Trusts, including the favorable ordinary income tax rate and corresponding lower capital gains tax rate, cease to apply as of the beginning of such taxable year. Under ANSCA, Settlement Common Stock is subject to restrictions on transferability, generally limiting transfers. However, if changes are made to permit transfers of stock that would not be permitted for Settlement Common Stock, then the Settlement Common Stock is cancelled and Replacement Common Stock is issued. See 43 U.S.C. 1602(p), 1606(h) and 1629c. The distributable net income of the Trust is increased up to the amount of current and accumulated earnings and profits of the ANC as of the end of that year, but such increase shall not exceed the fair market value of the assets of the Trust as of the date the beneficial interests of the Trust became disposable. To the extent the earnings and profits of the ANC increase distributable net income of the Trust under this provision, the ANC will have a corresponding adjustment reducing its earnings and profits. Thereafter, the Trust and its beneficiaries are generally subject to the rules of subchapter J and to the generally applicable trust income tax rates. Thus, the increase in distributable net income will result in the Trust being taxed at regular trust rates to the extent the recomputed distributable net income is not distributed to beneficiaries; and beneficiaries will be taxed to the extent there are distributions. Normal reporting rules applicable to trusts and their beneficiaries will apply. The basis of any property distributed to beneficiaries will also be determined under normal trust rules. The same rules apply if any stock of the ANC may be disposed of to a person in a manner that would not be permitted under ANCSA if the stock were Settlement Common Stock and the ANC makes a transfer to the Trust.

The restrictions on transfer of stock or beneficial interests under the provision are those that would apply to Settlement Common Stock under section 7(h) of ANSCA (whether or not the interest or stock in question is in fact Settlement Common Stock). To the extent section 7(h) of ANSCA permits certain transfers of Settlement Common stock on death or in other special circumstances, those are also permitted under the provision. Also, the mere transferability of ANC stock in a manner that would not be permitted for Settlement Common Stock (but without such transferability of any Trust interests) will not destroy the beneficial treatment of an existing electing Trust unless and until the ANC thereafter makes a transfer to the Trust.

The provision contains a special loss disallowance rule that reduces any loss that would otherwise be recognized by a shareholder upon the disposition of a share of stock of a sponsoring ANC by a "per share loss adjustment factor". This factor reflects the aggregate of all contributions to an electing Trust sponsored by such ANC made on or after the first day the trust is treated as an electing Trust, expressed on a per share basis and determined as of the day of each such contribution.

The special loss disallowance rule is intended to prevent the allowance of noneconomic losses if the ANC stock owned by beneficiaries ever becomes transferable in any type of transaction that could cause the recognition of taxable gain or loss, (including a redemption by the ANC) where the basis of the stock in the hands of the beneficiary (or in the hands of any transferee of a beneficiary) fails to reflect the allocable reduction in corporate value attributable to amounts transferred by the ANC into the Trust. Under the provision, the per share loss adjustment factor for stock of an ANC is the aggregate of all contributions to all electing Trusts sponsored by such ANC made on or after the first day each such Trust is treated as an electing Trust expressed on a per share basis and determined as of the day of each such contribution.

Under the provision, the surrender of an interest in an ANC or an electing Trust in order to accomplish the whole or partial redemption of the interest of a shareholder or beneficiary in such ANC or Trust, or to accomplish the whole or partial liquidation of such ANC or Trust, is deemed to be a transfer permitted by section 7(h) of ANSCA for purposes of the provision.

The Act clarifies the effect of the general sunset rule of the legislation on this provision. The general sunset is effective for taxable years beginning after December 31, 2010. For such taxable years, the tax consequences of any election previously made under this provision, and any right to make a future election, shall be terminated. Thus, for taxable years beginning after December 31, 2010, any electing Trust then in existence, its beneficiaries, and the sponsoring ANC shall be taxed under the provisions of law in effect immediately prior to the enactment of this provision.

Effective Date

The provision is effective for taxable years of Trusts, their beneficiaries, and sponsoring Alaska Native Corporations ending after June 7, 2001, and to contributions made to electing Trusts during such year and thereafter.

California Law

California law has not conformed to the federal treatment of ANCs; therefore this section is not applicable.

Impact on California Revenue

Not applicable.

Section	Section Title
701	INDIVIDUAL ALTERNATIVE MINIMUM TAX RELIEF.

Background

Present law imposes an alternative minimum tax ("AMT") on individuals to the extent that the tentative minimum tax exceeds the regular tax. An individual's tentative minimum tax generally is an amount equal to the sum of (1) 26% of the first $175,000 ($87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income ("AMTI") in excess of an exemption amount and (2) 28% of the remaining AMTI. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments.

The AMT exemption amounts are: (1) $45,000 in the case of married individuals filing a joint return and surviving spouses; (2) $33,750 in the case of other unmarried individuals; and (3) $22,500 in the case of married individuals filing a separate return, estates and trusts. The exemption amounts are phased out by an amount equal to 25% of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. The exemption amounts, the threshold phase-out amounts, and rate brackets are not indexed for inflation.

New Federal Law (Sec. 55)

The Act increases the AMT exemption amount for married couples filing a joint return and surviving spouses by $4,000. The AMT exemption amounts for other individuals (i.e., unmarried individuals and married individuals filing a separate return) are increased by $2,000.

Effective Date

The provision applies to taxable years beginning after December 31, 2000, and beginning before January 1, 2005.

California Law

California law generally conforms to the computation of AMT. However, California's AMT exemption amounts differ from the federal amounts. In 1998, California increased the AMT exemption amounts and indexed them for inflation. For 2001, the exemption amounts are $64,152 for married couples filing a joint return and surviving spouses and $48,117 for single filers.

Impact on California Revenue

Not applicable.

Section	Section Title
801 & 815	MODIFICATION TO CORPORATE ESTIMATED TAX REQUIREMENTS.

Background

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

New Federal Law

The Act changes corporate estimated tax payments due on September 17, 2001, 100% is now not due until October 1, 2001. With respect to corporate estimated tax payments due on September 15, 2004, 20% is not due until October 1, 2004.

Effective Date

The provision is effective on June 7, 2001.

California Law

California law mirrors prior federal law as it relates to due dates of estimated tax payments. California law has not been changed to reflect the 2001 federal change in due dates of estimated tax.

Impact on California Revenue

Not applicable.

Section	Section Title
802	AUTHORITY TO POSTPONE CERTAIN TAX-RELATED DEADLINES BY REASON OF PRESIDENTIALLY DECLARED DISASTER.

Background

The Secretary of the Treasury may specify that certain deadlines are postponed for a period of up to 90 days in the case of a taxpayer determined to be affected by a Presidentially declared disaster. The deadlines that may be postponed are the same as are postponed by reason of service in a combat zone. If the Secretary extends the period of time for filing income tax returns and for paying income tax, the Secretary must abate related interest for that same period of time.

New Federal Law (Sec. 7508A)

The Act expands the period of time with respect to which the Secretary may postpone certain deadlines from 90 days to 120 days.

Effective Date

The provision is effective on June 7, 2001.

California Law (R&TC 19109)

California is in conformity with federal law as it read on 1/1/98. California can extend deadlines up to 90 days. California has conformed to the federal change made in 1998, which provides for the abatement of interest for the period deadlines have been extended, but only with respect to individuals.

Impact on California Revenue

Based on federal estimates of annual losses (less than $1 million), the state income tax revenue impact would be insignificant.

Section	Section Title
803	INCOME TAX TREATMENT OF CERTAIN RESTITUTION PAYMENTS TO HOLOCAUST VICTIMS.

Background

Under the Code, gross income means, “income from whatever source derived” except for certain items specifically exempt or excluded by statute (sec. 61). There is no explicit statutory exception from gross income provided for amounts received by Holocaust victims or their heirs.

New Federal Law

The Act provides that excludable restitution payments made to an eligible individual (or the individual's heirs or estate) are: (1) excluded from gross income; and (2) not taken into account for any provision of the Code which takes into account excludable gross income in computing adjusted gross income (e.g., taxation of Social Security benefits).

The basis of any property received by an eligible individual (or the individual's heirs or estate) that is excluded under this provision is the fair market value of such property at the time of receipt by the eligible individual (or the individual's heirs or estate).

Eligible restitution payments are any payment or distribution made to an eligible individual (or the individual's heirs or estate) which: (1) is payable by reason of the individual's status as an eligible individual (including any amount payable by any foreign country, the United States, or any foreign or domestic entity or fund established by any such country or entity, any amount payable as a result of a final resolution of legal action, and any amount payable under a law providing for payments or restitution of property); (2) constitutes the direct or indirect return of, or compensation or reparation for, assets stolen or hidden, or otherwise lost to, the individual before, during, or immediately after World War II by reason of the individual's status as an eligible individual (including any proceeds of insurance under policies issued on eligible individuals by European insurance companies immediately before and during World War II); or (3) interest payable as part of any payment or distribution described in (1) or (2), above. Interest earned by enumerated escrow or settlement funds are also excluded from tax.

An eligible individual is a person who was persecuted for racial, religious, physical or mental disability or sexual orientation reasons by Nazi Germany, or any other Axis regime, or any other Nazi-controlled or Nazi-allied country.

Effective Date

The provision is effective for any amounts received on or after January 1, 2000. No inference is intended with respect to the income tax treatment of any amount received before January 1, 2000.

California Law

California excludes from income amounts received as reparation payments from the German Foundation known as Remembrance, Responsibility, and the Future, or any other source of humanitarian aid, to redress injustice done to persons required to perform slave or forced labor during World War II.

Impact on California Revenue

Neither the number of claims nor the amount of reparation payments from the German Foundation to the Holocaust survivors or their heirs living in this state is known at this time (deadline for claims is postponed to December 31, 2001).

Extrapolating the projected federal losses ($3 million per year), state income tax revenue losses would be on the order of $500,000 beginning with year 2002/03.

<u>Section</u> <u>Section Title</u>
809 ESTATE TAX RECAPTURE FROM CASH RENTS OF SPECIALLY VALUED PROPERTY.

<u>Background</u>

Under the special-use valuation rules of section 2032A, the executor may elect to value certain “qualified real property” used in farming or another qualifying trade or business at its current use rather than its highest and best use. If, after the special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years (15 years for individuals dying before 1982) of the decedent's death, an additional estate tax is imposed in order to “recapture” the benefit of the special-use valuation. Section 2032A is effective for estates of decedents dying after December 31, 1976.

Under prior law, some courts had held that cash rental of property for which special-use valuation was claimed was not a qualified use under the rules, because the heirs no longer bore the financial risk of working the property, thus triggering the additional estate tax. (See Martin v. Commissioner, 783 F.2d 81 (7th Cir. 1986) (cash lease to unrelated party not qualified use); Williamson v. Commissioner, 93 T.C. 242 (1989), aff'd. 974 F.2d 1525 (9th Cir. 1992) (cash lease to family member not a qualified use); Fisher v. Commissioner, T.C. Memo. 1993 139 (cash lease to family member not a qualified use); cf. Minter v. U.S., 19 F.3d 426 (8th Cir. 1994) (cash lease to family's farming corporation is qualified use); Estate of Gavin v. U.S., 103 F.3d 802 (8th Cir. 1997) (heir's option to pay cash rent or 50% crop share is qualified use)).

With respect to a decedent's surviving spouse, a special rule provides that the surviving spouse will not be treated as failing to use the property in a qualified use solely because the spouse rents the property to a member of the spouse's family on a net cash basis. Members of an individual's family include (1) the individual's spouse, (2) the individual's ancestors, (3) lineal descendants of the individual, of the individual's spouse, or of the individual's parents, and (4) the spouses of any such lineal descendants.

Section 504(c) of the Tax Reform Act of 1997 expanded the class of heirs eligible to lease property for which special-use valuation was claimed without causing the qualified use of such property to cease for purposes of imposition of the additional estate tax. Section 2032A(c)(7)(E) provides that the net cash lease of property (for which special-use valuation was claimed) by a lineal descendant of the decedent to a member of such lineal descendant's family does not cause the qualified use of the property to cease for purposes of imposition of the additional estate tax. The amendment made under the Tax Reform Act of 1997 applies to leases entered into after December 31, 1976.

In Technical Advice Memorandum 9843001, the IRS determined that the retroactive effective date in the changes made by the Tax Reform Act of 1997 did not constitute a waiver of the period of limitations otherwise applicable on a taxpayer's claim. Accordingly, the IRS determined that a taxpayer's claim for refund of recapture tax paid on account of the cessation of a qualified use was barred under the generally applicable statute of limitations on refund claims.

New Federal Law

The Act provides that, if on June 7, 2001, or at any time within one year after June 7, 2001, a claim for refund or credit of any overpayment of tax resulting from the application of net cash lease provisions for spouses and lineal descendants (Sec. 2032A(c)(7)(E)) is barred by operation of law or rule of law, then the refund or credit of such overpayment shall, nonetheless, be allowed if a claim therefore is filed before the date that is one year after June 7, 2001.

Effective Date

This provision is effective for refund claims filed prior to the date that is one year after June 7, 2001.

California Law

California does not impose a gift tax; the California estate tax is a "pick-up" tax, that is, the state tax is equal to the maximum credit for a state death tax on the federal estate tax return for that particular decedent's estate. This "pick-up" tax is administered by the State Controller's Office.

Impact on California Revenue

Defer to the Controller's Office.

Section	Section Title
901	SUNSET OF PROVISIONS OF ACT.

The Act provides that all provisions of, and amendments made by, the Economic Growth & Tax Relief Reconciliation Act of 2001 shall not apply: (1) to taxable, plan, or limitation years beginning after December 31, 2010; or (2) in the case of title V, to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010. The Act provides that the Code and the Employee Retirement Income Security Act of 1974 shall be applied and administered to such years, estates, gifts, and transfers after December 31, 2010, as if the provisions and amendments made by the Act had never been enacted.

California Law

Not applicable.

Impact on California Revenue

Not applicable.

Rename Education IRA to Coverdell Education Savings Account (P.L. 107-22)

Section	Section Title
1	RENAME EDUCATION IRA TO COVERDELL EDUCATION SAVINGS ACCOUNT.

New Federal Law

The Act renames education IRA's to Coverdell education savings account wherever it appears in the Internal Revenue Code.

California Law

Not applicable.

Impact on California Revenue

Not applicable.

EXHIBIT A

EXPIRING TAX PROVISIONS

Calif. Sunset*	Calif. Section	Federal Section	Fed. Sect.	Description and Comments
12/31/02	18704	N/A	N/A	Voluntary Contribution: National World War II Veterans Memorial Fund
12/31/02	17053.45 23645	N/A	N/A	Credit: Sales and Use taxes Paid in the LA Revitalization Zone
12/31/02[1]	17053.46 23646	N/A	N/A	Credit: Hiring in the Local Agency Military Base Recovery Area
12/31/02[1]	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
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
12/31/06	17052.17	N/A	N/A	Credit: Employer Child Care Facility

EXHIBIT A

EXPIRING TAX PROVISIONS

Calif. Sunset*	Calif. Section	Federal Section	Fed. Sect.	Description and Comments
	23638			
12/31/06	17052.18 23617.5	N/A	N/A	Credit: Employer Dependent Care Plan
01/01/06	17053.36 17053.37 23636 23637	N/A	N/A	Credit: Joint Strike Fighters Wage & Property
12/31/06	17053.57 23657	N/A	N/A	Credit: Community Development Financial Institution Deposits
12/31/06	17053.84 23684	N/A		Credit: Solar Energy
12/31/06	18840	N/A	N/A	Voluntary Contribution: Lupus Foundation
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.

  This table only extends out eight years.

1 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

Conformity Revenue Estimates for H.R. 1836, Economic Growth and Tax Relief Act of 2001
Effective Date – Years Beginning after 12/31/01 Unless Otherwise Noted
Assumed Enactment By April 1, 2002

	Provisions		**State Revenue Impact (in millions)**		
		Footnotes	**2002-3**	**2003-4**	**2004-5**
Act Section	*Conformity Items*				
101	Marginal Tax Rate Reductions	a/	-	-	-
102	Phase-in repeal of Pease cutback of itemized deductions	tyba 12/31/05	-	-	-
103	Phase-in repeal of personal exemption phase-out	tyba 12/31/05	-	-	-
201	Increase & other changes to the Child Tax Credit	b/	N/A	N/A	N/A
202	Adoption Credit	c/	-$12	-$24	-$27
204	Dependent Care Tax Credit	tyba 12/31/02 d/	-$10	-$87	-$87
205	Employer Child Care Credit	e/	Minor Loss	-$5	-$6
301-302	Marriage Tax Proposal		N/A	N/A	N/A
303	EIC Modification and Simplification		N/A	N/A	N/A
401	Education IRAs	l/m	Baseline Loss	Baseline Loss	Baseline Loss
402	Qualified Tuition Plans	l/	Minor Loss	-$1.0	-$1
411	Employer Provided Educational Benefits Extension	f/	N/A	N/A	N/A
412	Student Loan Interest		-$10	-$9	-$10
413	Eliminate tax on specific scholarship programs		Negl. Loss	Negl. Loss	Negl. Loss
421	Increase arbitrage rebate exception for governmental bonds used to finance qualified school construction		N/A	N/A	N/A
422	Issuance of tax-exempt private activity bonds for qualified education facilities		Negl. Loss	Negl. Loss	Negl. Loss
431	Qualified Higher Education Expenses Deduction	g/	-$73	-$71	-$88
501-581	Estate and Gift Tax Provisions (State Controller's Office)	h/	-	-	-
601	Modify IRA Contribution Limits	l/m	-$8	-$8	-$12
601	IRA Catch-up Contributions	l/m	-$1	-$1	-$1
602	Deemed IRAs under employee plans	pyba 12/31/02	-	Negl. Effect	Negl. Effect
611	Increase limitation on exclusion for elective deferrals	k/l/m	-$2	-$10	-$16
611	Increase limitation on SIMPLE elective contributions	l/	-$1	-$1	-$2
611	Increase defined benefit dollar limit to $160,000	k/l	Baseline Loss	Baseline Loss	Baseline Loss
611	Lower early retirement age to 62; lower normal retirement age to 65	k/l	Negl. Effect	Negl. Effect	Negl. Effect

611	Increase annual addition limitation for defined contribution plans to $40,000 with indexing	k/l	-$1	-$1	-$1
611	Increase qualified plan compensation limit to $200,000 with indexing and expand availability of qualified plans	k/l	-$5	-$4	-$5
611	Increase limits on deferrals under deferred compensation plans of State and local government and tax exempts.	l/m	-$3	-$3	-$3
612	Plan loans for S corporation owners, partners, and sole proprietors		N/A	N/A	N/A
613	Modify top-heavy rules	k/l	Minor Loss	Minor Loss	Minor Loss
614	Elective deferrals not taken into account for purposes of deduction limits	k/l/m	-$4	-$3	-$3
615	Repeal of coordination requirement for deferred compensation plans of State & Local governments & tax exempts	l/	-$1	-$1	-$1
616	Definition of compensation for purposes of deduction limits	k/	Negl. Loss	Negl. Loss	Negl. Loss
616	Increase stock bonus and profit sharing plan deduction limit from 15% to 25%	k/l	-$1	-$1	-$1
617	Option to treat elective deferrals as after-tax Roth contributions	yba 12/31/05	-	-	-
618	Nonrefundable credit to certain individuals for elective deferrals and IRA contributions (sunset 12/31/06)		N/A	N/A	N/A
619	Small business tax credit for new retirement plan expenses - first 3 years of the plan		N/A	N/A	N/A
620	Eliminate user fee for certain requests		N/A	N/A	N/A
621	Treatment of nonresident aliens engaged in international transportation services		N/A	N/A	N/A
631	Additional catch-up contributions for individuals age 50 or older	k/l/m	-$10	-$7	-$5
632	Equitable treatment for contributions of employees to defined contribution plans	k/l/m	-$4	-$3	-$3
633	Faster vesting of certain employer matching contributions	k/l	Negl. Loss	Negl. Loss	Negl. Loss
634	Simplify and update the minimum distribution rules by modifying post-death distribution rules		Negl. Baseline Loss	Negl. Baseline Loss	Negl. Baseline Loss
635	Clarify tax treatment of division of section 457 plan benefits upon divorce		Negl. Effect	Negl. Effect	Negl. Effect
636	Modify safe harbor relief for hardship withdrawals from 401(k) plans	k/	Negl. Effect	Negl. Effect	Negl. Effect
637	Waiver of tax on nondeductible contributions for domestic or similar workers		N/A	N/A	N/A
641	Rollovers allowed among government section 457 plans, section 403(b) plans, and qualified plans	k/l	Minor loss	Negl. Loss	Negl. Loss
642	Rollovers of IRAs to workplace retirement plans	k/l	Negl. Effect	Negl. Effect	Negl. Effect
643	Rollovers of after-tax retirement plan contributions	k/l	Negl. Effect	Negl. Effect	Negl. Effect
644	Waiver of 60-day rule		Negl. Effect	Negl. Effect	Negl. Effect
645	Treatment of forms of qualified plan distributions	k/l	Negl. Effect	Negl. Effect	Negl. Effect
646	Rationalization of restrictions on distributions	k/	Negl. Effect	Negl. Effect	Negl. Effect

647	Purchase of service credit in government defined benefit plans	k/l	Negl. Effect	Negl. Effect	Negl. Effect
648	Employers may disregard rollovers for cash-out amounts	k/l	Negl. Effect	Negl. Effect	Negl. Effect
649	Minimum distribution and inclusion requirements for section 457 plans	l/ In other provisions	-	-	-
651	Phase-in repeal of 160% of current liability funding limit; extent maximum deduction rule	k/l	-$1	-$1	-$1
653	Excise tax relief for sound pension funding		N/A	N/A	N/A
654	Repeal 100% compensation limit for multi-employer plans	k/l	Negl. Loss	Negl. Loss	Negl. Loss
654	Modify section 415 aggregation rules for multi-employer plans	k/l	Negl. Loss	Negl. Loss	Negl. Loss
655	Investment of employee contributions in 401(k) plans	i/	N/A	N/A	N/A
656	Prohibited allocations of stock in an ESOP S corporation	k/	Negl. Gain	Negl. Gain	Minor Gain
657	Automatic rollovers of certain mandatory distributions	k/ dma frap	-	Negl. Loss	-$1
658	Clarify treatment of contributions to multi-employer plans	yea DOE	Baseline Loss	Baseline Loss	Baseline Loss
659	Notice of significant reduction in plan benefit accruals		N/A	N/A	N/A
661	Modify timing of plan valuations	k/	Baseline Loss	Baseline Loss	Baseline Loss
662	ESOP dividends may be reinvested without loss of dividend deduction	k/	-$2	-$2	-$2
663	Repeal transition rule relating to certain highly compensated employees		Negl. Loss	Negl. Loss	Negl. Loss
664	Employees of tax-exempt entities	DOE	Negl. Effect	Negl. Effect	Negl. Effect
665	Treatment of employer-provided retirement advice		Negl. Effect	Negl. Effect	Negl. Effect
666	Repeal of multiple use test	In other provisions	-	-	-
671	Miscellaneous Provisions - Alaska Native Settlement Trusts		N/A	N/A	N/A
701	AMT Relief	j/	-	-	-
801	Change in Corporate Estimated Tax Requirements for 2001 thru 2004 (to achieve revenue targets only)		N/A	N/A	N/A
802	Expansion of Authority to Postpone Certain Tax Deadlines Due to Disaster		Minor Loss	Minor Loss	Minor Loss
803	Exclude from Gross Income certain payments made to Holocaust survivors or their heirs	aro/a 1/1/00	Minor Loss	Minor Loss	Minor Loss
	TOTALS		-$149	-$243	-$276

Estimates above exclude “baseline” revenue losses that would occur independently of state conformity legislation. See footnote “m”.

N/A = Not applicable.
Negligible = Loss or gain of less than $250,000

Minor = Loss or gain of less than $500,000

Refer to attached "Footnotes" legend.

Legend for "Footnotes" column:

aro/a - amounts received on or after

dma - distributions made after

DOE - date of enactment

frap - federal regulations are prescribed

pyba - plan years beginning after

tyba - taxable years beginning after

yba - years beginning after

yea - years ending after

a/ California has its own tax rate structure.

b/ California has not previously conformed to the federal Child Tax Credit. California's dependent exemption credit was $235 for 2000 and is indexed annually.

c/ Estimates are net of the current state credit.

d/ Current California law provides for a refundable dependent care credit. Conforming to federal law, the credit would no longer be refundable and the credit rate, eligible expenses, and start of the AGI phase-out would all increase.

e/ Estimates are net of current state law credits.

f/ The exclusion for employees does not sunset under current state law.

g/ Because of additional federal changes beginning in 2004, the state conformity impact increases to $88 million for 2004-5.

h/ Any revenue impact created by the change in carryover basis at death would not occur until 2011. The changes to carryover basis are effective with respect to decedents dying after December 31, 2009. Any income tax impact would occur from the disposition of affected assets received after December 31, 2009. The Joint Committee on Taxation projects the first year revenue loss in 2011 to be negligible.

i/ Considered a “baseline” issue for state purposes since it relates to ERISA provisions.

j/ Federal AMT relief was enacted in response to the marginal tax rate reductions. State AMT relief would be an issue in the event of a proposal to reduce state marginal tax rates.
k/ ERISA implications.
l/ Without conforming legislation, existing plans potentially could be disqualified.
m/ Baseline implication. Baseline revenue losses for educational IRA's and all pension issues total $40, $40, and $60 million for FY 2002-3, 2003-4, and 2004-5.

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