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# **SUMMARY OF FEDERAL INCOME TAX CHANGES ---- 2002**

## **Laws Affected:**

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

# **SUMMARY OF FEDERAL INCOME TAX CHANGES 2002**

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

Executive Summary

During 2002, the Internal Revenue Code and/or its application was changed by:

<u>PUBLIC LAW</u>	<u>TITLE</u>
107-147	Job Creation and Worker Assistance Act of 2002
107-181	Clergy Housing Allowance Clarification Act of 2002
107-210	Trade Act of 2002
107-276	An Act to Amend Section 527 of the IRC
107-330	Veterans Improvement Act of 2002
107-358	Holocaust Restitution Tax Fairness Act of 2002

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 2003.

<u>Calif. Sunset</u>	<u>Calif. Section</u>	<u>Federal Sunset</u>	<u>Fed. Sect.</u>	<u>Description and Comments</u>
06/30/03	19444	N/A	N/A	Administration: High Risk Collection Procedures
12/31/03 <sup>1</sup>	17053.49 23649	N/A	N/A	Credit: Manufacturers' Investment
12/31/03	17276.3 24416.3	172	N/A	Deduction: NOL Suspension
12/31/03	18785	N/A	N/A	Voluntary Contribution: D.A.R.E. California (Drug Abuse Resistance Education) Fund
12/31/03	18816	N/A	N/A	Voluntary Contribution: California Public School Library Protection Fund
12/31/03	18855	N/A	N/A	Voluntary Contribution: Emergency Food Assistance Program
12/31/03	19559	6103(i)	1/1/04	Administration: Terrorism Disclosure Procedures

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

# Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

<u>Section</u>	<u>Section Title</u>
101	Special Depreciation Allowance for Certain Property

## Background

### Depreciation Deductions

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system (MACRS). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from 3 to 25 years. The depreciation methods generally applicable to tangible personal property are the 200% and 150% declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

Section 280F limits the annual depreciation deductions with respect to passenger automobiles to specified dollar amounts, indexed for inflation.

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

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment generally may elect to deduct up to \$24,000 (for taxable years beginning in 2001 or 2002) of the cost of qualifying property placed in service for the taxable year (sec. 179). This amount is increased to \$25,000 for taxable years beginning in 2003 and thereafter. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.

### New Federal Law (Sec. 168)

The provision allows an additional first-year depreciation deduction equal to 30% of the adjusted basis of qualified property. The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service.<sup>1</sup> The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, the provision provides that there would be no adjustment to the allowable amount of depreciation for purposes of computing a

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<sup>1</sup> The additional first-year depreciation deduction is subject to the general rules regarding whether an item is deductible under section 162 or subject to capitalization under section 263 or section 263A.



## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

taxpayer's alternative minimum taxable income with respect to property to which the provision applies. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

In order for property to qualify for the additional first-year depreciation deduction it must meet all of the following requirements. First, the property must be property to which the general rules of MACRS<sup>2</sup> apply with (1) an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) computer software other than computer software covered by section 197, or (4) qualified leasehold improvement property<sup>3</sup>. Second, the original use<sup>4</sup> of the property must commence with the taxpayer on or after September 11, 2001. Third, the taxpayer must purchase the property within the applicable time period. Finally, the property must be placed in service before January 1, 2005. An extension of the place in service date of one year (i.e., January 1, 2006) is provided for certain property with a recovery period of ten years or longer and certain transportation property.<sup>5</sup> Transportation

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<sup>2</sup> A special rule precludes the additional first-year depreciation deduction for property that is required to be depreciated under the alternative depreciation system of MACRS.

<sup>3</sup> Qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease either by the lessee (or sublessee) of that portion of the building, or by the lessor of that portion of the building. That portion of the building is to be occupied exclusively by the lessee (or any sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service.

Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building.

For purposes of the provision, a binding commitment to enter into a lease would be treated as a lease, and the parties to the commitment would be treated as lessor and lessee. A lease between related persons would not be considered a lease for this purpose.

Finally, New York Liberty Zone qualified leasehold improvement property is not eligible for the additional first year depreciation deduction.

<sup>4</sup> The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. It is intended that, when evaluating whether property qualifies as "original use," the factors used to determine whether property qualified as "new section 38 property" for purposes of the investment tax credit would apply. See Treasury Regulation 1.48-2. Thus, it is intended that additional capital expenditures incurred to recondition or rebuild acquired property (or owned property) would satisfy the "original use" requirement. However, the cost of reconditioned or rebuilt property acquired by the taxpayer would not satisfy the "original use" requirement. For example, if on February 1, 2002, a taxpayer buys from X for \$20,000 a machine that has been previously used by X. Prior to September 11, 2004, the taxpayer makes an expenditure on the property of \$5,000 of the type that must be capitalized. Regardless of whether the \$5,000 is added to the basis of such property or is capitalized as a separate asset, such amount would be treated as satisfying the "original use" requirement and would be qualified property (assuming all other conditions are met). No part of the \$20,000 purchase price would qualify for the additional first year depreciation

<sup>5</sup> In order for property to qualify for the extended placed in service date, the property is

## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

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

The applicable time period for acquired property is (1) after September 10, 2001 and before September 11, 2004, and no binding written contract for the acquisition is in effect before September 11, 2001 or (2) pursuant to a binding written contract which was entered into after September 10, 2001, and before September 11, 2004. With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after September 10, 2001, and before September 11, 2004. Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer. For property eligible for the extended placed in service date, a special rule limits the amount of costs eligible for the additional first year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred before September 11, 2004 ("progress expenditures") shall be eligible for the additional first year depreciation.<sup>6</sup>

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

The following examples illustrate the operation of the provision.

EXAMPLE 1. -- Assume that on March 1, 2002, a calendar year taxpayer acquires and places in service qualified property that costs \$1 million. Under the provision, the taxpayer is allowed an additional first-year depreciation deduction of \$300,000. The remaining \$700,000 of adjusted basis is recovered in 2002 and subsequent years pursuant to the depreciation rules of present law.

EXAMPLE 2. -- Assume that on March 1, 2002, a calendar year taxpayer acquires and places in service qualified property that costs \$50,000. In addition, assume that the property qualifies for the expensing election under section 179. Under the provision, the taxpayer is first allowed a \$24,000 deduction under section 179. The taxpayer then is allowed an additional first year depreciation deduction of \$7,800 based on \$26,000 (\$50,000 original cost less the section 179 deduction of \$24,000) of adjusted basis. Finally, the remaining adjusted basis of \$18,200 (\$26,000 adjusted basis less \$7,800 additional first-year depreciation) is to

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required to have a production period exceeding two years or an estimated production period exceeding one year and a cost exceeding \$1 million.

<sup>6</sup> For purposes of determining the amount of eligible progress expenditures, it is intended that rules similar to sec. 46(d)(3) as in effect prior to the Tax Reform Act of 1986 shall apply.

## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

be recovered in 2002 and subsequent years pursuant to the depreciation rules of present law.

### Effective Date

The provision applies to property placed in service after September 10, 2001.

### California Law

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

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

Under the Corporation Tax Law (CTL), California law does not conform to the federal law MACRS depreciation and the section 179 expensing provision. The CTL permits an "additional first-year depreciation" of 20% of the cost (up to a maximum of \$10,000 per year) of qualifying property. Thus, a maximum expense deduction of \$2,000 per year is allowed. Property qualifying for the "additional first-year depreciation" is similar to property qualifying under section 179. Prior to the enactment of the present day section 179 deduction, "additional first-year depreciation" was the federal rule.

California has not conformed to the federal additional depreciation of 30% enacted by the Job Creation Act of 2002.

### Impact on California Revenue

Estimate Revenue Impact for 30% Bonus Depreciation For Expenditures After September 10, 2001 and Before September 10, 2004		
2003-04	2004-05	2005-06
-\$400	-\$195	-\$70

Revenue estimates were based on federal projections.

# Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

<u>Section</u>	<u>Section Title</u>
102	Five-Year Carryback of Net Operating Losses

## Background

A net operating loss (NOL) is, generally, the amount by which a taxpayer's allowable deductions exceed the taxpayer's gross income. A carryback of an NOL generally results in the refund of Federal income tax for the carryback year. A carryforward of an NOL reduces Federal income tax for the carryforward year.

In general, an NOL may be carried back two years and carried forward 20 years to offset taxable income in such years. Different rules apply with respect to NOLs arising in certain circumstances. For example, a three-year carryback applies with respect to NOLs (1) arising from casualty or theft losses of individuals, or (2) attributable to Presidentially declared disasters for taxpayers engaged in a farming business or a small business. A five-year carryback period applies to NOLs from a farming loss (regardless of whether the loss was incurred in a Presidentially declared disaster area). Special rules also apply to real estate investment trusts (no carryback), specified liability losses (10-year carryback), and excess interest losses (no carryback to any year preceding a corporate equity reduction transaction). The alternative minimum tax rules provide that a taxpayer's NOL deduction cannot reduce the taxpayer's alternative minimum taxable income ("AMTI") by more than 90% of the AMTI.

## New Federal Law (Secs. 56 & 172)

The provision temporarily extends the general NOL carryback period to five years (from two years) for NOLs arising in taxable years ending in 2001 and 2002.<sup>7</sup> In addition, the five-year carryback period applies to NOLs from these years that qualify under present law for a three-year carryback period (i.e., NOLs arising from casualty or theft losses of individuals or attributable to certain Presidentially declared disaster areas).

A taxpayer can elect to forgo the five-year carryback period. The election to forgo the five-year carryback period is made in the manner prescribed by the Secretary of the Treasury and must be made by the due date of the return (including extensions) for the year of the loss. The election is irrevocable. If a taxpayer elects to forgo the five-year carryback period, then the losses are subject to the rules that otherwise would apply under section 172 absent the provision.

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<sup>7</sup> The provision does not affect the terms and conditions that the Internal Revenue Service may impose on a taxpayer seeking approval for a change in its annual accounting period. *See e.g.*, Rev. Proc. 2000-11, 2000-1 C.B. 309, sec. 5.06 ("If the corporation (or consolidated group) has a NOL (or consolidated NOL) in the short period required to effect the change, the NOL may not be carried back but must be carried over in accordance with the provisions of sec. 172 beginning with the first taxable year after the short period. However, the short period NOL (or consolidated NOL) is carried back or carried over in accordance with sec. 172 if it is either: (a) \$50,000 or less, or (b) results from a short period of 9 months or longer and is less than the NOL (or the consolidated NOL) for a full 12-month period beginning with the first day of the short period.")

## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

The provision also allows an NOL deduction attributable to NOL carrybacks arising in taxable years ending in 2001 and 2002, as well as NOL carryforwards to these taxable years, to offset 100% of a taxpayer's AMTI.

### Effective Date

The 5-year carryback provision is effective for net operating losses generated in taxable years ending after December 31, 2000.

The provision allowing the use of NOL carrybacks and carryforwards to offset 100% of AMTI is effective for taxable years ending before January 1, 2003.

### California Law

California conforms to the federal computation of NOLs with certain exceptions and modifications. California law does not permit NOL carrybacks of any kind. The NOL deduction may also be limited depending on the year the NOL was generated or the type of NOL. Following are the different types of NOLs and their carryover percentages and periods:

Type of NOL	NOL % Allowed to be Carried Over	Carryover Period
General NOL	60% (2002 - 2003)* 100% (2004 - on)	10 Years
New Business: Year 1 Year 2 Year 3	100% 100% 100%	10 Years
Eligible Small Business	100%	10 Years
Specified Disaster Loss	100% 50%	10Years 10 Years
Economic Development Areas	100%	15 Years

\* Note: AB 2065 (Stats. 2002, Ch. 488) suspends the NOL deduction for the 2002 and 2003 taxable years. AB 2065 also extends the carryover period for the number of years an NOL was suspended.

Current California law permits only 90% of AMTI to be offset by an NOL.

### Impact on California Revenue

The NOL carryback is not applicable. The NOL offsetting 100% of AMTI is only being allowed at the federal level for a year that the NOL is suspended for California purposes.

# Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

Additionally, California does not normally conform to federal law changes that would generate amended returns. Therefore, the NOL offsetting 100% of AMTI is also not applicable.

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<u>Section</u>	<u>Section Title</u>
209	Special Reed Act Transfer in Fiscal Year 2002

## Background

When three federal accounts in the Unemployment Trust Fund (UTF) reach their statutory limits at the end of a federal fiscal year, any excess funds are transferred to the individual state accounts in the UTF. These transfers are called "Reed Act" distributions. States can use this funding for payment of cash benefits and administering their unemployment compensation and employment services programs. The Balanced Budget Act of 1997 limited Reed Act transfers to states to \$100 million after each of fiscal years 1999, 2000, and 2001 and limited these funds' use to paying administrative expenses of unemployment compensation laws.

If the Secretary finds that a state is not eligible to receive Reed Act transfers at the beginning of a fiscal year, the amount available for transfer to the state instead is transferred to the federal unemployment account. If the state becomes eligible during the following one-year period, the amount which was available for transfer will be transferred from the federal unemployment account to the state's account. If the state does not become eligible within one year, the amount remains in the federal unemployment account for other uses. If any state has borrowed from the federal unemployment account, any amount that would be transferred is retained and credited against any balance due to the state.

## New Federal Law

The \$100 million limit on distributions from excess federal funds available at the end of fiscal year 2001 is repealed. The provision also repeals the limitation on the use of funds applied to the \$100 million special distribution under the Balanced Budget Act of 1997. This limitation applied only to special distributions at the end of fiscal years 1999, 2000, and 2001, and with the repeal of the underlying special distribution provision is no longer relevant.

The Secretary of the Treasury will transfer excess federal UTF balances as of the close of fiscal year 2001 into the account of each state in the UTF. Total transfers will be capped at no more than \$8 billion.

At the option of the state, amounts transferred to state accounts may be used for the payment of cash benefits to individuals with respect to unemployment, including regular

## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

unemployment compensation or additions to regular benefits. States also may use these funds to support payment of benefits to individuals not otherwise eligible for regular unemployment compensation benefits under the laws of the state, such as individuals seeking only part-time work or those eligible only under an alternative base period.

Other than for cash benefits, states may use amounts transferred to their accounts in the administration of their public employment laws and public employment offices, including for the provision of employment services needed to help individuals return to work.

### Effective Date

Transfers under this provision shall be made within 10 days following March 9, 2002.

### California Law

Unemployment benefits are administered by the Employment Development Department (EDD).

### Impact on California Revenue

Defer to EDD.

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<u>Section</u>	<u>Section Title</u>
301	Expansion of Work Opportunity Tax Credit Targeted Categories to Include Certain Employees in New York City

### Background

#### In General

The work opportunity tax credit ("WOTC") is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The credit equals 40% (25% for employment of less than 400 hours) of qualified wages. Generally, qualified wages are wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. The maximum credit per employee is \$2,400 (40% of the first \$6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is \$1,200 (40% of the first \$3,000 of qualified first-year wages).

## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

For purposes of the credit, wages are generally defined as under the Federal Unemployment Tax Act, without regard to the dollar cap.

### Targeted Groups Eligible for the Credit

The eight targeted groups are: (1) families eligible to receive benefits under the Temporary Assistance for Needy Families (“TANF”) Program; (2) high-risk youth; (3) qualified ex-felons; (4) vocational rehabilitation referrals; (5) qualified summer youth employees; (6) qualified veterans; (7) families receiving food stamps; and (8) persons receiving certain Supplemental Security Income (“SSI”) benefits.

The employer’s deduction for wages is reduced by the amount of the credit.

### Expiration Date

The credit is effective for wages paid or incurred to a qualified individual who began work for an employer before January 1, 2002.

### New Federal Law (Sec. 1400L(a))

The Act creates a new targeted group for the WOTC and extends WOTC only for this purpose.<sup>8</sup> Generally, the new targeted group is individuals who perform substantially all their services in the recovery zone for a business located on or south of Canal street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan, New York, New York (the “New York Liberty Zone”). The new targeted group also includes individuals who perform substantially all their services in New York City for a business that relocated from the New York Liberty Zone elsewhere within New York City due to the physical destruction or damage of their workplaces within the New York Liberty Zone by the September 11, 2001 terrorist attack. It is anticipated that only otherwise qualified businesses that relocate due to significant physical damage will be eligible for the credit.

Generally qualified wages for purposes of this targeted group are wages paid or incurred for work performed in the New York Liberty Zone after December 31, 2001 and before January 1, 2004 by such qualified individuals. Also, in the case of otherwise qualified businesses that relocated due to the destruction or damage of their workplaces by the September 11, 2001 terrorist attack, the credit can be claimed for work performed outside of the zone but within New York City subject to the dates specified above. Other rules like the minimum employment periods (sec. 51(i)(3)) of the WOTC apply.

Unlike the other targeted categories, the credit for the new targeted group is available for wages paid to both new hires and existing employees. For each qualified business that

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<sup>8</sup> A separate provision of this bill includes a general 2-year extension of WOTC.



## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

relocated from the New York Liberty Zone elsewhere within New York City due to the physical destruction or damage of their workplaces within the New York Liberty Zone, the number of that employer's employees whose wages are eligible under the new targeted category may not exceed the number of its employees in the New York Liberty Zone on September 11, 2001. Other qualified businesses (e.g., businesses that operate in the New York Liberty Zone both on and after Sept. 11, 2001 and businesses that move into the New York Liberty Zone after September 11, 2001) would not be subject to that limitation.

No credit for this new category of workers is allowed if the otherwise qualifying employer on average employed more than 200 employees during the taxable year in question.

Unlike the other targeted categories, members of this targeted group will not require certification for their wages to qualify for the credit.

For the new category, the maximum credit is \$2,400 (40% of \$6,000 of qualified wages) per qualified employee in each taxable year.

The portion of each employer's WOTC credit attributable to the new targeted group is allowed against the alternative minimum tax.

### Effective Date

The provision is effective in taxable years ending after December 31, 2001 (for wages paid or incurred to qualified individuals for work after December 31, 2001 and before January 1, 2004).

### California Law

California does not conform to this federal credit.

### Impact on California Revenue

Not applicable.

# Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

<u>Section</u>	<u>Section Title</u>
301	Special Depreciation Allowance for Certain Property

## Background

### Depreciation Deductions

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from 3 to 25 years. The depreciation methods generally applicable to tangible personal property are the 200% and 150% declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized. In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment generally may elect to deduct up to \$24,000 (for taxable years beginning in 2001 or 2002) of the cost of qualifying property placed in service for the taxable year (sec. 179). For taxable years beginning in 2003 and thereafter, the amount deductible under section 179 is increased to \$25,000.

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

### New Federal Law (Sec. 1400L(b))

The provision allows an additional first-year depreciation deduction equal to 30% of the adjusted basis of qualified New York Liberty Zone ("Liberty Zone") property. The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, the provision provides that there would be no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

In order for property to qualify for the additional first-year depreciation deduction it must meet all of the following requirements. First, the property must be property to which the general

## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

rules of MACRS<sup>9</sup> apply with (1) an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) certain nonresidential real property and residential rental property, or (4) computer software other than computer software covered by section 197. A special rule precludes the additional first year depreciation under this provision for (1) qualified New York Liberty Zone leasehold improvement property<sup>10</sup> and, (2) property eligible for the additional first year depreciation under section 168(k) (i.e., property is eligible for only one 30% additional first year depreciation). Second, substantially all of the use of such property must be in the Liberty Zone. Third, the original use<sup>11</sup> of the property in the Liberty Zone must commence with the taxpayer on or after September 11, 2001.<sup>12</sup> Finally, the property must be acquired by purchase<sup>13</sup> by the taxpayer (1) after September 10, 2001 and placed in service on or before December 31, 2006. For qualifying nonresidential real property and residential rental property, the property must be placed in service on or before December 31, 2009 in lieu of December 31, 2006. Property will not qualify if a binding written contract for the acquisition of such property is in effect before September 11, 2001.

Nonresidential real property and residential rental property are eligible for the additional first-year depreciation only to the extent such property rehabilitates real property damaged, or replaces real property destroyed or condemned as a result of the terrorist attacks of September 11, 2001. Property shall be treated as replacing destroyed property if, as part of an integrated plan, such property replaces real property which is included in a continuous area which includes real property destroyed or condemned. For purposes of this provision, it is intended that real property destroyed (or condemned) only include circumstances in which an entire building or structure was destroyed (or condemned) as a result of the terrorist attacks. Otherwise, such property is considered damaged real property. For example, if certain structural components (e.g., walls, floors, or plumbing fixtures) of a building are damaged or destroyed as a result of the terrorist attacks but the building is not destroyed (or condemned), then only costs related to replacing the damaged or destroyed components qualifies for the provision.

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<sup>9</sup> A special rule precludes the additional first-year depreciation deduction for property that is required to be depreciated under the alternative depreciation system of MACRS.

<sup>10</sup> Qualified New York Liberty Zone leasehold improvement property is defined in another provision of the bill. Leasehold improvements that do not satisfy the requirements to be treated as “qualified New York Liberty Zone leasehold improvement property” are eligible for the 30% additional first-year depreciation deduction (assuming all other conditions are met).

<sup>11</sup> Thus, used property may constitute qualified property so long as it has not previously been used within the Liberty Zone. In addition, it is intended that additional capital expenditures incurred to recondition or rebuild property the original use of which in the Liberty Zone began with the taxpayer would satisfy the “original use” requirement. See Treasury Regulation 1.48-2, Example 5.

<sup>12</sup> A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property would be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback.

<sup>13</sup> For purposes of this provision, purchase is defined under section 179(d).

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Property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer qualifies if the taxpayer begins the manufacture, construction, or production of the property after September 10, 2001, and the property is placed in service on or before December 31, 2006<sup>14</sup> (and all other requirements are met). Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.

The Liberty Zone means the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York, New York.

The following examples illustrate the operation of the provision.

EXAMPLE 1. -- Assume that on March 1, 2002, a calendar year taxpayer acquires and places in service qualified property in the Liberty Zone that costs \$1 million. Under the provision, the taxpayer is allowed an additional first-year depreciation deduction of \$300,000. The remaining \$700,000 of adjusted basis is recovered in 2002 and subsequent years pursuant to the depreciation rules of present law.

EXAMPLE 2. -- Assume that on March 1, 2002, a calendar year taxpayer acquires and places in service qualified property in the Liberty Zone that costs \$100,000. In addition, assume that the property qualifies for the expensing election under section 179. Under the provision, the taxpayer is first allowed a \$59,000 deduction under section 179.<sup>15</sup> The taxpayer then is allowed an additional first-year depreciation deduction of \$12,300 based on \$41,000 (\$100,000 original cost less the section 179 deduction of \$59,000) of adjusted basis. Finally, the remaining adjusted basis of \$28,700 (\$41,000 adjusted basis less \$12,300 additional first-year depreciation) is to be recovered in 2002 and subsequent years pursuant to the depreciation rules of present law.

### California Law

Under the PITL, California law is currently in full conformity with federal law as of January 1, 2001, as it relates to MACRS and the section 179 deduction.

Under current California law, S corporations (and their shareholders) are allowed to use MACRS and a section 179 deduction under the PITL. For income years beginning on or after January 1, 2002, an S corporation may elect to expense up to \$24,000 in the computation of

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<sup>14</sup> December 31, 2009 with respect to nonresidential real property and residential rental property.

<sup>15</sup> Section 301 provides that property in the Liberty Zone is eligible for an additional \$35,000 of expensing under section 179.

## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

the S corporation's measured tax (presently the S corporation tax rate for non-financial corporations is 1.5%.)

Under the Corporation Tax Law (CTL), California law does not conform to the federal law MACRS depreciation and the section 179 expensing provision. The CTL permits an "additional first-year depreciation" of 20% of the cost (up to a maximum of \$10,000 per year) of qualifying property. Thus, a maximum expense deduction of \$2,000 per year is allowed. Property qualifying for the "additional first-year depreciation" is similar to property qualifying under section 179. Prior to the enactment of the present day section 179 deduction, "additional first-year depreciation" was the federal rule.

California law has not conformed to any depreciation changes made by the Job Creation Act of 2002.

### Impact on California Revenue

Conforming to the federal provisions for all of the tax incentives included in the New York City Liberty Zone would have an insignificant impact on state revenues.

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<u>Section</u>	<u>Section Title</u>
301	Authorize Issuance of Tax-Exempt Private Activity Bonds for Rebuilding the Portion of New York City Damaged in the September 11, 2001, Terrorist Attack

### Background

Rules Governing Issuance Of Tax-Exempt Bonds.

In General.

Interest on debt 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). 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.

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

## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

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 (“qualified 501(c)(3) bonds”) may be financed with tax-exempt 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”). Purchasers of houses financed with qualified mortgage bonds must be first-time homebuyers satisfying prescribed income limits, the purchase prices of the houses is limited, the amount by which interest rates charged to homebuyers may exceed the interest paid by issuers is restricted, and a recapture provision applies to target the benefit to purchasers having longer-term need for the subsidy provided by the bonds. Qualified veterans' mortgage bonds are not subject to these limitations, but these bonds may only be issued by five States and may only be used to finance mortgage loans to veterans who served on active duty before January 1, 1977.

With the exception of qualified 501(c)(3) bonds, private activity bonds may not be issued to finance working capital requirements of private businesses.

In most cases, the aggregate volume of tax-exempt private activity bonds that may be issued in a State is restricted by annual volume limits. 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

## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

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. Governmental bonds are subject to less restrictive arbitrage rules than most private activity bonds.

### Miscellaneous Additional Restrictions On Tax-Exempt Bonds.

Several additional restrictions apply to the issuance of tax-exempt bonds. First, private activity bonds (other than qualified 501(c)(3) bonds) may not be advance refunded. Governmental bonds and qualified 501(c)(3) bonds may be advance refunded one time. An advance refunding occurs when the refunded bonds are not retired within 90 days of issuance of the refunding bonds.

Issuance of private activity bonds is subject to restrictions on use of proceeds for the acquisition of land and existing property, use of proceeds to finance certain specified facilities, (e.g., airplanes, skyboxes, other luxury boxes, health club facilities, gambling facilities, and liquor stores) and use of proceeds to pay costs of issuance (e.g., bond counsel and underwriter fees). Additionally, the term of the bonds generally may not exceed 120% of the economic life of the property being financed and certain public approval requirements (similar to requirements that typically apply under State law to issuance of governmental debt) apply under Federal law to issuance of private activity bonds. Present law precludes substantial users of property financed with private activity bonds from owning the bonds to prevent their deducting tax-exempt interest paid to themselves. Finally, owners of most private-activity-bond-financed property are subject to special “change-in-use” penalties if the use of the bond-financed property changes to a use that is not eligible for tax-exempt financing while the bonds are outstanding.

### New Federal Law (Sec. 1400L(c))

#### In General

The provision authorizes issuance during calendar years 2002, 2003, and 2004 of an aggregate amount of \$8 billion of tax-exempt private activity bonds to finance the construction and rehabilitation of nonresidential real property<sup>16</sup> and residential rental real property<sup>17</sup> in a

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<sup>16</sup> No more than \$800 million of the authorized bond amount may be used to finance property used for retail sales of tangible property (e.g., department stores, restaurants, etc.) and functionally related and subordinate property. The term nonresidential real property includes structural components of such property if the taxpayer treats such components as part of the real property structure for all Federal income tax purposes (e.g., cost recovery). The \$800 million limit is divided equally between the Mayor and the Governor.

<sup>17</sup> No more than \$1.6 billion of the authorized bond amount may be used to finance residential rental property. The \$1.6 billion limit is divided equally between the Mayor and the Governor.

## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

newly designated "Liberty Zone" (the "Zone") of New York City.<sup>18</sup> Property eligible for financing with these bonds includes buildings and their structural components, fixed tenant improvements,<sup>19</sup> and public utility property (e.g., gas, water, electric and telecommunication lines). All business addresses located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan are considered to be located within the New York Recovery Zone. Issuance of bonds authorized under the provision is limited to projects approved by the Mayor of New York City or the Governor of New York State, each of whom may designate up to \$4 billion of the bonds authorized under the Act.

If the Mayor or the Governor determines that it is not feasible to use all of the authorized bond proceeds which he is authorized to designate for property located in the Zone, up to \$1 billion of bond proceeds may be designated by each to be used for the acquisition, construction, and rehabilitation of commercial real property (including fixed tenant improvements) located outside the Zone and within New York City. Bond-financed property located outside the Zone must meet the additional requirements that the project have at least 100,000 square feet of usable office or other commercial space in a single building or multiple adjacent buildings.

Subject to the following exceptions and modifications, issuance of these tax-exempt bonds is subject to the general rules applicable to issuance of exempt-facility private activity bonds:

- (1) Issuance of the bonds is not subject to the aggregate annual State private activity bond volume limits (sec. 146);
- (2) The restriction on acquisition of existing property is applied using a minimum requirement of 50% of the cost of acquiring the building being devoted to rehabilitation (sec. 147(d));
- (3) The special arbitrage expenditure rules for certain construction bond proceeds apply to available construction proceeds of the bonds (sec. 148(f)(4)(C));
- (4) The tenant targeting rules applicable to exempt-facility bonds for residential rental property (and the corresponding change in use penalties for violation of those rules) do not apply to such property financed with the bonds (secs. 142(d) and 150(b)(2));
- (5) Repayments of bond-financed loans may not be used to make additional loans, but rather must be used to retire outstanding bonds (with the first such retirement occurring 10 years after issuance of the bonds); and
- (6) Interest on the bonds is not a preference item for purposes of the alternative minimum tax preference for private activity bond interest (sec. 57(a)(5)).

### Effective Date

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<sup>18</sup> Current refundings of outstanding bonds issued under the provision do not count against the \$8 billion volume limit to the extent that the principal amount of the refunding bonds does not exceed the outstanding principal amount of the bonds being refunded. The bonds may not be advance refunded.

<sup>19</sup> Fixtures and equipment that could be removed from the designated zone for use elsewhere are not eligible for financing with these bonds.



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The provision is effective for bonds issued after March 9, 2002 and before January 1, 2005.

## California Law

The PITL specifically does not conform to federal law regarding private activity bonds. The California Constitution provides an exemption from income taxation for all interest from bonds issued by this state or a local government of this state. Federal law, other than the IRC, prohibits state taxation of interest on federal bonds if the interest on state obligations is exempt from tax. Taxpayers subject to the corporate franchise tax must include in the measure of franchise tax all interest received including interest on governmental obligations that is exempt from income tax. Interest received from federal obligations and California obligations or its political subdivisions is excluded from income subject to the corporation and personal income tax.

## Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
301	Allow One Additional Advance Refunding for Certain Previously Refunded Bonds for Facilities Located in New York City

## Background

Interest on bonds issued 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). 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. Present law includes several exceptions permitting States or local governments to act as conduits providing tax-exempt financing for private activities. One such exception is the provision of financing for activities of charitable organizations described in section 501(c)(3) of the Code (“qualified 501(c)(3) bonds”).

A refunding bond is used to redeem a prior bond issuance. The Code contains different rules for “current” as opposed to “advance” refunding bonds. Tax-exempt bonds may be refunded currently an indefinite number of times. A current refunding occurs when the refunded debt is

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redeemed within 90 days of issuance of the refunding bonds. Governmental bonds and qualified 501(c)(3) bonds also may be advance refunded one time (sec. 149(d)). An advance refunding occurs when the refunded debt is not redeemed within 90 days after the refunding bonds are issued. Rather, proceeds of the refunding bonds are invested in an escrow account and held until a future date when the refunded debt may be redeemed under the terms of the refunded bonds.

### New Federal Law (Sec. 1400L(d))

The Act permits certain bonds for facilities located in New York City to be advance refunded one additional time. These bonds include only bonds for which all present-law advance refunding authority was exhausted before September 12, 2001, and with respect to which the advance refunding bonds authorized under present law were outstanding on September 11, 2001. Further, to be eligible for the additional advance refunding, at least 90% of the refunded bonds must have been used to finance facilities located in New York City,<sup>20</sup> and the bonds must be --

- (1) Governmental general obligation bonds of New York City;
- (2) Governmental bonds issued by the Metropolitan Transportation Authority of the State of New York;
- (3) Governmental bonds issued by the New York Municipal Water Finance Authority; or
- (4) Qualified 501(c)(3) bonds issued by or on behalf of New York State or New York City to finance hospital facilities (as defined in section 145(c).

The maximum amount of advance refunding bonds that may be issued pursuant to this provision is \$9 billion. Eligible advance refunding bonds must be designated as such by the Mayor of New York City or the Governor of New York State. Up to \$4.5 billion of bonds may be designated by each of these officials. Advance refunding bonds issued under the provision must satisfy all requirements of section 148 and 149(d) except for the limit on the number of advance refundings allowed under section 149(d).

### Effective Date

The provision is effective on March 9, 2002, and before January 1, 2005.

### 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. Federal law, other than the

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<sup>20</sup> This requirement is 95% in the case of eligible qualified 501(c)(3) bonds.

## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

IRC, prohibits state taxation of interest on federal bonds if the interest on state obligations is exempt from tax. Taxpayers subject to the corporate franchise tax must include in the measure of franchise tax all interest received including interest on governmental obligations that is exempt from income tax. Interest received from federal obligations and California obligations of its political subdivisions is excluded from income subject to the corporation and personal income tax.

California law does not conform to the federal advance refunding provisions of the IRC. Additionally, if California was conformed to the federal advance refunding provisions, this Job Creation Act Provision would still not apply because the Act provision only affects New York bonds. California law does not exempt from income taxation the interest from bonds issued by state or local governments other than California.

### Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
301	Increase in Expensing Treatment for Business Property Used in the New York Liberty Zone

### Background

Present law provides that, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to \$24,000 (for taxable years beginning in 2001 or 2002) of the cost of qualifying property placed in service for the taxable year (sec. 179). This amount is increased to \$25,000 of the cost of qualified property placed in service for taxable years beginning in 2003 and thereafter. The \$24,000 (\$25,000 for taxable years beginning in 2003 and thereafter) amount is phased-out (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000.

Additional section 179 incentives are provided with respect to a qualified zone property used by a business in an empowerment zone (sec. 1397A). Such a business may elect to deduct an additional \$20,000 of the cost of qualified zone property placed in service in year 2001. The \$20,000 amount is increased to \$35,000 for taxable years beginning in 2002 and thereafter. In addition, the phase-out range is applied by taking into account only 50% of the cost of qualified zone property that is section 179 property.

## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

### New Federal Law (Sec. 1400L)

The provision increases the amount a taxpayer can deduct under section 179 for qualifying property used in the New York Liberty Zone.<sup>21</sup> Specifically, the provision increases the maximum dollar amount that may be deducted under section 179 by the lesser of (1) \$35,000 or (2) the cost of qualifying property placed in service during the taxable year. This amount is in addition to the amount otherwise deductible under section 179.

Qualifying property means section 179 property purchased and placed in service by the taxpayer after September 10, 2001 and before January 1, 2007, where (1) substantially all of its use is in the New York Liberty Zone in the active conduct of a trade or business by the taxpayer in the zone, and (2) the original use of which in the New York Liberty Zone commences with the taxpayer after September 10, 2001.

As under present law with respect to empowerment zones, the phase-out range for the section 179 deduction attributable to New York Liberty Zone property is applied by taking into account only 50% of the cost of New York Liberty Zone property that is section 179 property. Also, no general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

### Effective Date

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

### California Law

The PITL conforms to federal law, as of January 1, 2001, as to the section 179 deduction. S corporations (and their shareholders may also take a section 179 deduction (under the PITL). California law has not conformed to the increased amounts allowed for property placed in service in the New York Liberty Zone.

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<sup>21</sup> The "New York Liberty Zone" means the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York, New York.

## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

Under the CTL, California law does not conform to the federal law MACRS depreciation and the section 179 expensing provision. The CTL permits an “additional first-year depreciation” of 20% of the cost (up to a maximum of \$10,000 per year) of qualifying property. Thus, a maximum expense deduction of \$2,000 per year is allowed. Property qualifying for the “additional first-year depreciation” is similar to property qualifying under section 179. Prior to the enactment of the present day section 179 deduction, “additional first-year depreciation” was the federal rule.

### Impact on California Revenue

Conforming to the federal provisions for all of the tax incentives included in the New York City Liberty Zone would have an insignificant impact on state revenues.

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<u>Section</u>	<u>Section Title</u>
301	Extension of Replacement Period for Certain Property Involuntarily Converted in the New York Liberty Zone

### Background

A taxpayer may elect not to recognize gain with respect to property that is involuntarily converted if the taxpayer acquires within an applicable period (the “replacement period”) property similar or related in service or use (sec. 1033). If the taxpayer does not replace the converted property with property similar or related in service or use, then gain generally is recognized. If the taxpayer elects to apply the rules of section 1033, gain on the converted property is recognized only to the extent that the amount realized on the conversion exceeds the cost of the replacement property. In general, the replacement period begins with the date of the disposition of the converted property and ends two years after the close of the first taxable year in which any part of the gain upon conversion is realized. The replacement period is extended to three years if the converted property is real property held for the productive use in a trade or business or for investment.

Special rules apply for property converted in a Presidentially declared disaster. With respect to a principal residence that is converted in a Presidentially declared disaster, no gain is recognized by reason of the receipt of insurance proceeds for unscheduled personal property that was part of the contents of such residence. In addition, the replacement period for the replacement of such a principal residence is extended to four years after the close of the first taxable year in which any part of the gain upon conversion is realized. With respect to investment or business property that is converted in a Presidentially declared disaster, any tangible property acquired and held for productive use in a business is treated as similar or related in service or use to the converted property.

# Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

## New Federal Law (Sec. 1400L)

The provision extends the replacement period to five years for a taxpayer to purchase property to replace property that was involuntarily converted within the New York Liberty Zone<sup>22</sup> as a result of the terrorist attacks that occurred on September 11, 2001. However, the five-year period is available only if substantially all of the use of the replacement property is in New York City. In all other cases, the present-law replacement period rules continue to apply.

## Effective Date

The provision is effective for involuntary conversions in the New York Liberty Zone occurring on or after September 11, 2001, as a consequence of the terrorist attacks on such date.

## California Law

California is in conformity to federal law as of January 1, 2001, as it relates to involuntary conversions. California law has not conformed to the changes made to the IRC by the Job Creation and Worker Assistance Act of 2002.

## Impact on California Revenue

Conforming to the federal provisions for all of the tax incentives included in the New York City Liberty Zone would have an insignificant impact on state revenues.

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<u>Section</u>	<u>Section Title</u>
301	Treatment of Qualified Leasehold Improvement Property

## Background

### Depreciation of leasehold improvements

Depreciation allowances for property used in a trade or business generally are determined under the modified Accelerated Cost Recovery System (MACRS) of section 168. Depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease (sec. 168(i)(8)). This rule applies regardless whether the lessor or lessee places the leasehold improvements in service. If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement is

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<sup>22</sup> The "New York Liberty Zone" has the same definition throughout this bill

## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service (secs. 168(b)(3), (c)(1), (d)(2), and (i)(6)).<sup>23</sup>

### Treatment of dispositions of leasehold improvements

A lessor of leased property that disposes of a leasehold improvement which was made by the lessor for the lessee of the property may take the adjusted basis of the improvement into account for purposes of determining gain or loss if the improvement is irrevocably disposed of or abandoned by the lessor at the termination of the lease.<sup>24</sup> This rule conforms the treatment of lessors and lessees with respect to leasehold improvements disposed of at the end of a term of lease. For purposes of applying this rule, it is expected that a lessor must be able to separately account for the adjusted basis of the leasehold improvement that is irrevocably disposed of or abandoned. This rule does not apply to the extent section 280B applies to the demolition of a structure, a portion of which may include leasehold improvements.<sup>25</sup>

### New Federal Law (Sec. 1400L)

The provision provides that 5-year property for purposes of the depreciation rules of section 168 includes qualified New York Liberty Zone leasehold improvement property (“qualified NYLZ leasehold improvement property”). The term qualified NYLZ leasehold improvement property means property defined in section 168(e)(6)<sup>26</sup> that is placed in service after September 10, 2001 and before January 1, 2007 (and not subject to a binding contract on September 10, 2001) in the New York Liberty Zone. The straight-line method is required to be used with respect to qualified NYLZ leasehold improvement property. A 9-year period is specified as the class life of qualified NYLZ leasehold improvement property for purposes of the alternative depreciation system.

### California Law

The PITL is in conformity with federal law as of January 1, 2001, as it relates to leasehold improvements and their treatment for depreciation purposes. The PITL has not conformed to the 2002 federal change. The CTL does not conform to the federal depreciation rules.

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<sup>23</sup> If the improvement is characterized as tangible personal property, ACRS or MACRS depreciation is calculated using the shorter recovery periods and accelerated methods applicable to such property. The determination of whether certain improvements are characterized as tangible personal property or as nonresidential real property often depends on whether or not the improvements constitute a “structural component” of a building (as defined by Treas. Reg. sec. 1.48-1(e)(1)). See, for example, *Metro National Corp.*, 52 TCM 1440 (1987); *King Radio Corp.*, 486 F.2d 1091 (10th Cir., 1973); *Mallinckrodt, Inc.*, 778 F.2d 402 (8th Cir., 1985) (with respect various leasehold improvements).

<sup>24</sup> The conference report describing this provision mistakenly states that the provision applies to improvements that are irrevocably disposed of or abandoned by the *lessee* (rather than the *lessor*) at the termination of the lease.

<sup>25</sup> Under present law, section 280B denies a deduction for any loss sustained on the demolition of any structure.

<sup>26</sup> Section 168(e)(6) regarding qualified leasehold improvement property is added by section 205 of the bill.

# Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

## Impact on California Revenue

Conforming to the federal provisions for all of the tax incentives included in the New York City Liberty Zone would have an insignificant impact on state revenues.

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<u>Section</u>	<u>Section Title</u>
401	Allowance of Electronic Forms 1099

## Background

Many provisions in the Code require entities to file information returns with the IRS and to provide copies to taxpayers. For example, employers are required to provide information with respect to wages paid to employees, and entities (such as banks and credit unions) that pay interest to individuals are also required to provide information with respect to those payments. In general, the copies of the information returns that are provided to taxpayers are provided on paper via the U.S. mail.

Temporary regulations allow Form W-2 to be furnished electronically on a voluntary basis. Under Temp. Treas. Reg. §31.6051-1T(j), a recipient must have affirmatively consented to receive the statement electronically and must not have withdrawn that consent before the statement is furnished. A similar rule cannot be implemented administratively with respect to some information returns, because the Code requires that the copies furnished to individuals must be furnished either in person or in a statement sent by first-class mail in a specified format.

IRS Form 5498 is used to report contributions to an Archer MSA, an Individual Retirement Account, or a Coverdell education savings account. In addition, distributions from these accounts are reported on IRS Form 1099. Under present law, the Secretary has the authority to issue rules under which Forms 5498 and 1099 related to these accounts may be provided electronically.

## New Federal Law

The provision removes the statutory impediment to providing copies of specified information returns to taxpayers electronically. Accordingly, these copies may be furnished electronically to a recipient who has consented to this; the copies may be furnished in a manner similar to the one permitted with respect to Form W-2 or in another manner provided by the Secretary.



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## Effective Date

The provision is effective on March 9, 2002.

## California Law

California law generally reflects federal information reporting requirements. California participates in the IRS Combined Federal/State Information Filing Program and otherwise generally “piggy-backs” on federal information reporting requirements. California law does provide that the same information filed with the IRS may also be required to be filed with the FTB upon request. In the case of the FTB requesting the information from the payor, the payor is required to provide a statement to the payee containing the same information provided to the FTB.

## Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
402	Discharge of Indebtedness of an S Corporation

## Background

In general, an S corporation is not subject to the corporate income tax on its items of income and loss. Instead, an S corporation passes through its items of income and loss to its shareholders. Each shareholder takes into account separately his or her pro rata share of these items on their individual income tax returns. To prevent double taxation of these items, each shareholder’s basis in the stock of the S corporation is increased by the amount included in income (including tax-exempt income) and is decreased by the amount of any losses (including nondeductible losses) taken into account. A shareholder may deduct losses only to the extent of a shareholder’s basis in his or her stock in the S corporation plus the shareholder’s adjusted basis in any indebtedness of the corporation to the shareholder. Any loss that is disallowed by reason of lack of basis is “suspended” at the corporate level and is carried forward and allowed in any subsequent year in which the shareholder has adequate basis in the stock or debt.

In general, gross income includes income from the discharge of indebtedness. However, income from the discharge of indebtedness of a taxpayer in a bankruptcy case or when the taxpayer is insolvent (to the extent of the insolvency) is excluded from income. The taxpayer

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is required to reduce tax attributes, such as net operating losses, certain carryovers, and basis in assets, to the extent of the excluded income.

In the case of an S corporation, the eligibility for the exclusion and the attribute reduction are applied at the corporate level. For this purpose, a shareholder's suspended loss is treated as a tax attribute that is reduced. Thus, if the S corporation is in bankruptcy or is insolvent, any income from the discharge of indebtedness by a creditor of the S corporation is excluded from the corporation's income, and the S corporation reduces its tax attributes (including any suspended losses).

To illustrate these rules, assume that a sole shareholder of an S corporation has zero basis in its stock of the corporation. The S corporation borrows \$100 from a third party and loses the entire \$100. Because the shareholder has no basis in its stock, the \$100 loss is "suspended" at the corporate level. If the \$100 debt is forgiven when the corporation is in bankruptcy or is insolvent, the \$100 income from the discharge of indebtedness is excluded from income, and the \$100 "suspended" loss should be eliminated in order to achieve a tax result that is consistent with the economics of the transactions in that the shareholder has no economic gain or loss from these transactions.

Notwithstanding the economics of the overall transaction, the United States Supreme Court ruled in the case of *Gitlitz v. Commissioner* (531 U.S. 206 (2001)) that, under present law, income from the discharge of indebtedness of an S corporation that is excluded from income is treated as an item of income which increases the basis of a shareholder's stock in the S corporation and allows the suspended corporate loss to pass thru to a shareholder. Thus, under the decision, an S corporation shareholder is allowed to deduct a loss for tax purposes that it did not economically incur.

### New Federal Law (Sec. 108)

The provision provides that income from the discharge of indebtedness of an S corporation that is excluded from the S corporation's income is not taken into account as an item of income by any shareholder and thus does not increase the basis of any shareholder's stock in the corporation. In effect, the Act reverses the result in *Gitlitz*.

### Effective Date

The provision generally applies to discharges of indebtedness after October 11, 2001. The provision does not apply to any discharge of indebtedness before March 1, 2002, pursuant to a plan of reorganization filed with a bankruptcy court on or before October 11, 2001.

### California Law

California is in conformity with federal law as it relates to the computation of basis in S corporations as of January 1, 2001. California law has also conformed to the 2002 federal

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change that effectively reversed the *Gitlitz* decision (discussed above). The effective date of the state's conformity is for discharges of indebtedness occurring after December 31, 2002, in taxable years ending after that date. The change does not apply to discharges of indebtedness occurring before March 1, 2002, pursuant to a plan of reorganization filed with a bankruptcy court on or before October 11, 2001.

### Impact on California Revenue

Conformed in AB 1122 (Stats. 2002, Ch. 35).

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<u>Section</u>	<u>Section Title</u>
403	Limitation on Use of Non-Accrual Experience Method of Accounting

### Background

An accrual method taxpayer generally must recognize income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. An accrual method taxpayer may deduct the amount of any receivable that was previously included in income that becomes worthless during the year.

Accrual method taxpayers are not required to include in income amounts to be received for the performance of services which, on the basis of experience, will not be collected (the "non-accrual experience method"). The availability of this method is conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount charged.

Generally, a cash method taxpayer is not required to include an amount in income until received. A taxpayer generally may not use the cash method if purchase, production, or sale of merchandise is an income producing factor. Such taxpayers generally are required to keep inventories and use an accrual method of accounting. In addition, corporations (and partnerships with corporate partners) generally may not use the cash method of accounting if their average annual gross receipts years exceed \$5 million. An exception to this \$5 million rule is provided for qualified personal service corporations. A qualified personal service corporation is a corporation (1) substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting and (2) substantially all of the stock of which is owned by current or former employees performing such services, their estates or heirs. Qualified personal service corporations are allowed to use the cash method without regard to whether their average annual gross receipts exceed \$5 million.

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### New Federal Law (Sec. 448)

Under the provision, the non-accrual experience method of accounting is available only for amounts to be received for the performance of qualified services and for services provided by certain small businesses. Amounts to be received for all other services are subject to the general rule regarding inclusion in income. Qualified services are services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting. As under present law, the availability of this method is conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount charged.

Under a special rule, the non-accrual experience method of accounting continues to be available for the performance of non-qualified services if the average annual gross receipts (as defined in sec. 448(c)) of the taxpayer (or any predecessor) does not exceed \$5 million. The rules of paragraph (2) and (3) of section 448(c) (i.e., the rules regarding the aggregation of related taxpayers, taxpayers not in existence for the entire three year period, short taxable years, definition of gross receipts, and treatment of predecessors) apply for purposes of determining the average annual gross receipts test.

The provision requires that the Secretary of the Treasury prescribe regulations to permit a taxpayer to use alternative computations or formulas if such alternative computations or formulas accurately reflect, based on experience, the amount of its year-end receivables that will not be collected. It is anticipated that the Secretary of the Treasury will consider providing safe harbors in such regulations that may be relied upon by taxpayers. In addition, the provision also provides that the Secretary of the Treasury permit taxpayers to adopt, or request consent of the Secretary of the Treasury to change to, an alternative computation or formula that clearly reflects the taxpayer's experience. The provision requires the Secretary of Treasury to approve a request provided that the alternative computation or formula clearly reflects the taxpayer's experience.

### Effective Date

The provision is effective for taxable years ending after March 9, 2002. Any change in the taxpayer's method of accounting required as a result of the limitation on the use of the non-accrual experience method is treated as a voluntary change initiated by the taxpayer with the consent of the Secretary of the Treasury. Any resultant section 481(a) adjustment is to be taken into account over a period not to exceed the lesser of the number of years the taxpayer has used the non-accrual experience method of accounting or four years under principles consistent with those in Rev. Proc. 99-49 (1999-2 C.B. 725).

### California Law

California is in conformity with federal law as of January 1, 2001, as it relates to the use of accrual method of accounting. California law has not conformed to the changes made to the IRC by the Job Creation and Worker Assistance Act of 2002.

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### Impact on California Revenue

The following state conformity estimates are based on federal projections for this provision:

Estimated Revenue Impact Effective for Taxable Years Ending After March 6, 2002 (\$ in Millions)			
	2003-04	2004-05	2005-06
Limitation of Non-Accrual Experience Method Accounting	\$3.5	\$1	minor

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<u>Section</u>	<u>Section Title</u>
404	Expansion of the Exclusion from Income for Qualified Foster Care Payments

### Background

If certain requirements are satisfied, an exclusion from gross income is provided for qualified foster care payments paid to a foster care provider by either (1) a State or local government; or (2) a tax-exempt placement agency. Qualified foster care payments are amounts paid for caring for a qualified foster care individual in the foster care provider's home and difficulty of care payments.<sup>27</sup> A qualified foster care individual is an individual living in a foster care family home in which the individual was placed by: (1) an agency of the State or local government (regardless of the individual's age at the time of placement); or (2) a tax-exempt placement agency licensed by the State or local government (if such individual was under the age of 19 at the time of placement).

### New Federal Law (Sec. 131)

The Act makes two modifications to the present-law exclusion for qualified foster care payments. First, the Act expands the definition of qualified foster care payments to include payments by any placement agency that is licensed or certified by a State or local government, or an entity designated by a State or local government to make payments to providers of foster care. Second, the Act expands the definition of a qualified foster care

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<sup>27</sup> A difficulty of care payment is a payment designated by the person making such payment as compensation for providing the additional care of a qualified foster care individual in the home of the foster care provider which is required by reason of a physical, mental, or emotional handicap of such individual and with respect to which the State has determined that there is a need for additional compensation

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individual by including foster care individuals placed by a qualified foster care placement agency (regardless of the individual's age at the time of placement).

### Effective Date

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

### California Law

California is in conformity with federal law as of January 1, 2001, as it relates to the exclusion from gross income of certain foster care payments. California law has not conformed to the changes made to the IRC by the Job Creation and Worker Assistance Act of 2002.

### Impact on California Revenue

Estimated Revenue Impact for Exclusion from Income for Qualified Foster Care Payments			
Fiscal Years			
(In Millions)			
Provision	2003-04	2004-05	2005-06
Exclusion of Foster Care payment	-\$5	-\$3	-\$3

Estimates for this proposal are based on original federal projections.

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<u>Section</u>	<u>Section Title</u>
405	Interest Rate Used in Determining Additional Required Contributions to Defined Benefit Plans and PBGC Variable Rate Premiums

### Background

In general.

ERISA and the Code impose both minimum and maximum funding requirements with respect to defined benefit pension plans. The minimum funding requirements are designed to provide at least a certain level of benefit security by requiring the employer to make certain minimum contributions to the plan. The amount of contributions required for a plan year is generally the amount needed to fund benefits earned during that year plus that year's portion of other

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liabilities that are amortized over a period of years, such as benefits resulting from a grant of past service credit.

Additional contributions for underfunded plans.

Additional contributions are required under a special funding rule if a single-employer defined benefit pension plan is underfunded. Under the special rule, a plan is considered underfunded for a plan year if the value of the plan assets is less than 90% of the plan's current liability.<sup>28</sup> The value of plan assets as a percentage of current liability is the plan's "funded current liability percentage." If a plan is underfunded, the amount of additional required contributions is based on certain elements, including whether the plan has an unfunded liability related to benefits accrued before 1988 or 1995 or to changes in the mortality table used to determine contributions, and whether the plan provides for unpredictable contingent event benefits (that is, benefits that depend on contingencies that are not reliably and reasonably predictable, such as facility shutdowns or reductions in workforce). However, the amount of additional contributions cannot exceed the amount needed to increase the plan's funded current liability percentage to 100%.

Required interest rate.

In general, a plan's current liability means all liabilities to employees and their beneficiaries under the plan. The interest rate used to determine a plan's current liability must be within a permissible range of the weighted average of the interest rates on 30-year Treasury securities for the four-year period ending on the last day before the plan year begins. The permissible range is from 90% to 105%. As a result of debt reduction, the Department of the Treasury does not currently issue 30-year Treasury securities.

Timing of plan contributions.

In general, plan contributions required to satisfy the funding rules must be made within 8- 1/2 months after the end of the plan year. If the contribution is made by such due date, the contribution is treated as if it were made on the last day of the plan year.

In the case of a plan with a funded current liability percentage of less than 100% for the preceding plan year, estimated contributions for the current plan year must be made in quarterly installments during the current plan year. The amount of each required installment is 25% of the lesser of (1) 90% of the amount required to be contributed for the current plan year or (2) 100% of the amount required to be contributed for the preceding plan year. No additional quarterly contributions are due once the plan's funded current liability percentage for the plan year reaches 100%.

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<sup>28</sup> Under an alternative test, a plan is not considered underfunded if (1) the value of the plan assets is at least 80% of current liability and (2) the value of the plan assets was at least 90% of current liability for each of the two immediately preceding years or each of the second and third immediately preceding years

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### PBGC premiums.

Because benefits under a defined benefit pension plan may be funded over a period of years, plan assets may not be sufficient to provide the benefits owed under the plan to employees and their beneficiaries if the plan terminates before all benefits are paid. In order to protect employees and their beneficiaries, the Pension Benefit Guaranty Corporation ("PBGC") generally insures the benefits owed under defined benefit pension plans. Employers pay premiums to the PBGC for this insurance coverage.

In the case of an underfunded plan, additional PBGC premiums are required based on the amount of unfunded vested benefits. These premiums are referred to as "variable rate premiums." In determining the amount of unfunded vested benefits, the interest rate used is 85% of the interest rate on 30-year Treasury securities for the month preceding the month in which the plan year begins.

### New Federal Law (Sec. 412 and ERISA Secs. 302 and 4006)

#### Additional contributions.

The provision expands the permissible range of the statutory interest rate used in calculating a plan's current liability for purposes of applying the additional contribution requirements for plan years beginning after December 31, 2001, and before January 1, 2004. Under the provision, the permissible range is from 90% to 120% for these years. Use of a higher interest rate under the expanded range will affect the plan's current liability, which may in turn affect the need to make additional contributions and the amount of any additional contributions.

Because the quarterly contributions requirements are based on current liability for the preceding plan year, the provision also provides special rules for applying these requirements for plans years beginning in 2002 (when the expanded range first applies) and 2004 (when the expanded range no longer applies). In each of those years ("present year"), current liability for the preceding year is redetermined, using the permissible range applicable to the present year. This redetermined current liability will be used for purposes of the plan's funded current liability percentage for the preceding year, which may affect the need to make quarterly contributions and for purposes of determining the amount of any quarterly contributions in the present year, which is based in part on the preceding year.

#### PBGC variable rate premiums.

Under the provision, the interest rate used in determining the amount of unfunded vested benefits for variable rate premium purposes is increased to 100% of the interest rate on 30-year Treasury securities for the month preceding the month in which the plan year begins.



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## Effective Date

The provision is effective with respect to plan contributions and PBGC variable rate premiums for plan years beginning after December 31, 2001, and before January 1, 2004.

## California Law

With exceptions, California law conforms to changes in federal law related to pension and retirement plans. California is conformed to the changes in federal law related to pension and retirement plans made by the Job Creation and Worker Assistance Act of 2002.

## Impact on California Revenue

Conformed in AB 1122 (Stats. 2002, Ch. 35). The baseline revenue gain for state tax purposes is projected at \$50 million gain for 2001-02, \$125 million gain for 2002-03 and \$10 million gain for 2003-04.

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<u>Section</u>	<u>Section Title</u>
406	Deduction for Classroom Materials

## Background

In general, ordinary and necessary business expenses are deductible (sec. 162). However, unreimbursed employee business expenses are deductible only as an itemized deduction and only to the extent that the individual's total miscellaneous deductions (including employee business expenses) exceed 2% of adjusted gross income.

An individual's otherwise allowable itemized deductions may be further limited by the overall limitation on itemized deductions, which reduces itemized deductions for taxpayers with adjusted gross income in excess of \$137,300 (for 2002).<sup>29</sup> In addition, miscellaneous itemized deductions are not allowable under the alternative minimum tax.

## New Federal Law (Sec. 62)

The Act provides an above-the-line deduction for up to \$250 annually of expenses paid or incurred by an eligible educator for books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the

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<sup>29</sup> The effect of this overall limitation is phased down beginning in 2006, and is repealed for 2010.

## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

eligible educator in the classroom. To be eligible for this deduction, the expenses must be otherwise deductible under 162 as a trade or business expense.

An eligible educator is a kindergarten through grade 12 teacher, instructor, counselor, or principal in a school for at least 900 hours during a school year. A school means any school which provides elementary education or secondary education, as determined under State law.

### Effective Date

The provision is effective for taxable years beginning after December 31, 2001, and before January 1, 2004.

### California Law

California law is generally in conformity with federal law as it relates to ordinary and necessary business expenses. California law has not conformed to the changes made to the IRC regarding above-the-line deduction of classroom room supplies by the Job Creation and Worker Assistance Act of 2002. Under current California law, qualified classroom room supplies provided by an educator would be deductible only as an itemized deduction subject to the 2% floor on miscellaneous itemized deductions.

### Impact on California Revenue

Estimated Revenue Impact for Deduction for Classroom Materials			
Fiscal Years			
(In Millions)			
Provision	2003-04	2004-05	2005-06
Deduction for Classroom Materials	-\$10	-	-

Estimates for this proposal are based on original federal projections in the Estimated Revenue Effects of the "Job Creation and Worker Assistance Act of 2002".

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<u>Section</u>	<u>Section Title</u>
401-418	TAX TECHNICAL CORRECTIONS

## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

Except as otherwise provided, the technical corrections contained in the Job Creation and Worker Assistance Act Of 2002, generally are effective as if included in the originally enacted related legislation.

### Amendments to the Economic Growth and Tax Relief Reconciliation Act of 2001

Child tax credit.--The provision clarifies that for taxable years beginning in 2001, the portion of the child credit that is refundable is determined by referring in Code section 24(d)(1)(B) to "the aggregate amount of credits allowed by this subpart." This would retain prior law that was inadvertently changed by the Act.

Transition rule for adoption tax credit.--Under prior law, the maximum amount of adoption expenses which could be taken into account in computing the adoption tax credit for any child was \$5,000 (\$6,000 in the case of special needs adoptions). Under prior and present law, the credit generally is allowed in the taxable year following the taxable year the expenses are paid or incurred where expenses are paid or incurred before the taxable year the adoption becomes final. The Act increased the maximum amount of expenses to \$10,000 for taxable years beginning after 2001, but did not include a provision describing the dollar limit for amounts paid or incurred during taxable years beginning before January 1, 2002, for adoptions that do not become final in those years. The provision clarifies that amount of expenses paid or incurred during taxable years beginning before January 1, 2002, which are taken into account in determining a credit allowed in a taxable year beginning after December 31, 2001, are subject to the \$5,000 (or \$6,000) dollar cap in effect immediately prior to the enactment of the Act.

Dollar amount of credit for special needs adoptions.--The provision clarifies that, for special needs adoptions that become final in taxable years beginning after 2002, the adoption expenses taken into account shall be increased by the excess (if any) of \$10,000 over the aggregate adoption expenses for the taxable year the adoption becomes final and all prior taxable years.

Employer-provided adoption assistance exclusion with respect to special needs adoptions.--The provision clarifies that, for taxable years beginning after 2002, the amount of adoption expenses taken into account in determining the exclusion for employer-provided adoption assistance in the case of a special needs adoption is increased by the excess (if any) of \$10,000 over the aggregate qualified adoption expenses with respect to the adoption for the taxable year the adoption becomes final and all prior taxable years.

Credit for employer expenses for child care assistance.--The provision clarifies that recapture tax with respect to this credit is treated like recapture taxes with respect to other credits under chapter 1 of the Code. Thus, it would not be treated as a tax for purposes of determining the amounts of other credits or determining the amount of alternative minimum tax.

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Elimination of marriage penalty in standard deduction.--The provision provides rules that were inadvertently omitted providing for separate returns and rounding rules for the standard deduction for the transition period years.

Education IRAs; non-application of 10% additional tax with respect to amounts for which HOPE credit is claimed.--Under the law prior to the Act, taxpayers could not claim the HOPE (or Lifetime learning) credit in the same year that they claimed an exclusion from income from an education IRA. Taxpayers were permitted to waive the exclusion in order to claim the HOPE (or Lifetime learning) credit. For taxpayers electing the waiver, earnings from amounts withdrawn from education IRAs and attributable to education expenses for which a HOPE (or Lifetime learning) credit was claimed were includable in income, but the additional 10% tax was not applied. Under the Act, taxpayers are permitted to claim the education IRA exclusion and claim a HOPE (or Lifetime learning) credit in the same year, provided they do not claim both with respect to the same educational expenses. The election to waive the education IRA exclusion was thus unnecessary, and was dropped. However, a reference to the election was retained (sec. 530(d)(4)(b)(iv)). The reference to the election was intended to preserve the rule relating to the non-application of the 10% additional tax for education IRA earnings that are includable in income solely because the HOPE (or Lifetime learning) credit is claimed for those expenses. The provision clarifies the present-law rules to reflect this result.

The provision prevents the 10% additional tax from applying to a distribution from an education IRA (or qualified tuition program) that is used to pay qualified higher education expenses, but the taxpayer elects to claim a HOPE or Lifetime Learning credit in lieu of the exclusion under section 530 or 529. Thus, the income distributed from the education IRA (or qualified tuition program) would be subject to income tax, but not to the 10% additional tax.

Transfers in trust.--The provision clarifies that the effect of section 511(e) of the Act (effective for gifts made after 2009) is to treat certain transfers in trust as transfers of property by gift. The result of the clarification is that the gift tax annual exclusion and the marital and charitable deductions may apply to such transfers. Under the provision as clarified, certain amounts transferred in trust will be treated as transfers of property by gift, despite the fact that such transfers would be regarded as incomplete gifts or would not be treated as transferred under the law applicable to gifts made prior to 2010. For example, if in 2010 an individual transfers property in trust to pay the income to one person for life, remainder to such persons and in such portions as the settlor may decide, then the entire value of the property will be treated as being transferred by gift under the provision, even though the transfer of the remainder interest in the trust would not be treated as a completed gift under current Treas. Reg. sec. 25.2511-2(c). Similarly, if in 2010 an individual transfers property in trust to pay the income to one person for life, and makes no transfer of a remainder interest, the entire value of the property will be treated as being transferred by gift under the provision.

Recovery of taxes claimed as credit (State death tax credit).--The provision eliminates as deadwood a reference to the State death tax credit.

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### Pension-Related Amendments to the Economic Growth and Tax Relief Reconciliation Act of 2001

Individual Retirement Arrangements (“IRAs”).-- Under the Act, a qualified employer plan may provide for voluntary employee contributions to a separate account that is deemed to be an IRA. The provision clarifies that, for purposes of deemed IRAs, the term “qualified employer plan” includes the following types of plans maintained by a governmental employer: a qualified retirement plan under section 401(a), a qualified annuity plan under section 403(a), a tax-sheltered annuity plan under section 403(b), and an eligible deferred compensation plan under section 457(b). The provision also clarifies that the Employee Retirement Income Security Act (“ERISA”) is intended to apply to a deemed IRA in a manner similar to a simplified employee pension (“SEP”).

Increase in benefit and contribution limits.--Under the Act, the benefit and contribution limits that apply to qualified retirement plans are increased. These increases are generally effective for years beginning after December 31, 2001, but the increase in the limit on benefits under a defined benefit plan is effective for years ending after December 31, 2001. In the case of some plans that incorporate the benefit limits by reference and that use a plan year other than the calendar year, the increased benefit limits became effective under the plan automatically, causing unintended benefit increases. The provision permits an employer to amend such a plan by June 30, 2002, to reduce benefits to the level that applied before enactment of the Act without violating the anticutback rules that generally apply to plan amendments.

In connection with the increases in the benefit and contribution limits under the Act, a new base period applies in indexing the 2002 dollar amounts for future cost-of-living adjustments. The same indexing method applies to the dollar amounts used to determine eligibility to participate in a SEP and to determine the proper period for distributions from an employee stock ownership plan (“ESOP”). The provision changes these dollar amounts to the 2002 indexed amounts so that future indexing will operate properly.

Modification of top-heavy rules.--Under the Act, in determining whether a plan is top-heavy, distributions made because of separation from service, death, or disability are taken into account for one year after distribution. Other distributions are taken into account for five years. The Act also permits distributions from a section 401(k) plan, a tax-sheltered annuity plan, or an eligible deferred compensation plan to be made when the participant has a severance from employment (rather than separation from service). The provision clarifies that distributions made after severance from employment (rather than separation from service) are taken into account for only one year in determining top-heavy status.

Elective deferrals not taken into account for deduction limits.--The provision clarifies that elective deferrals to a SEP are not subject to the deduction limits and are not taken into account in applying the limits to other SEP contributions. The provision also clarifies that the combined deduction limit of 25% of compensation for qualified defined benefit and defined

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contribution plans does not apply if the only amounts contributed to the defined contribution plan are elective deferrals.

Deduction limits.--Under present law, contributions to a SEP are included in an employee's income to the extent they exceed the lesser of 15% of compensation or \$40,000 (for 2002), subject to a reduction in some cases. Under prior law, the annual limitation on the amount of deductible contributions to a SEP was 15% of compensation. Under the Act, the annual limitation on the amount of deductible contributions that can be made to a SEP is increased from 15% of compensation to 25% of compensation. The provision makes a conforming change to the rule that limits the amount of SEP contributions that may be made for a particular employee. Under the provision, contributions are included in an employee's income to the extent they exceed the lesser of 25% of compensation or \$40,000 (for 2002), subject to a reduction in some cases.

Under present law, the Secretary of the Treasury has the authority to require an employer who makes contributions to a SEP to provide simplified reports with respect to such contributions. Consistent with present law and the provision, such reports could appropriately include information as to compliance with the requirements that apply to SEPs, including the contribution limits.

Nonrefundable credit for certain individuals for elective deferrals and IRA contributions.--The provision clarifies that the amount of contributions taken into account in determining the credit for elective deferrals and IRA contributions is reduced by the amount of a distribution from a qualified retirement plan, an eligible deferred compensation plan, or a traditional IRA that is includible in income or that consists of after-tax contributions. The provision retains the rule that distributions that are rolled over to another retirement plan do not affect the credit.

Small business tax credit for new retirement plan expenses.--The provision clarifies that the small business tax credit for new retirement plan expenses applies in the case of a plan first effective after December 31, 2001, even if adopted on or before that date.

Additional salary reduction catch-up contributions.--Under the Act, an individual aged 50 or over may make additional elective deferrals ("catch-up contributions") to certain retirement plans, up to a specified limit. A plan may not permit catch-up deferrals in excess of this limit. The provision clarifies that, for this purpose, the limit applies to all qualified retirement plans, tax-sheltered annuity plans, SEPs and SIMPLE plans maintained by the same employer on an aggregated basis, as if all plans were a single plan. The limit applies also to all eligible deferred compensation plans of a government employer on an aggregated basis.

Under the Act, catch-up contributions up to the specified limit are excluded from an individual's income. The provision also clarifies that the total amount that an individual may exclude from income as catch-up contributions for a year cannot exceed the catch-up contribution limit for that year (and for that type of plan), without regard to whether the individual made catch-up contributions under plans maintained by more than one employer.

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The provision clarifies that an individual who will attain age 50 by the end of the taxable year is an eligible participant as of the beginning of the taxable year rather than only at the attainment of age 50. The provision also clarifies that a participant in an eligible deferred compensation plan of a government employer may make catch-up contributions in an amount equal to the greater of the amount permitted under the new catch-up rule and the amount permitted under the special catch-up rule for eligible deferred compensation plans.

The provision revises the lists of requirements that do not apply to catch-up contributions to reflect other statutory amendments made by the Act and to reflect the fact that catch-up contributions can be made only to a qualified defined contribution plan, not to a qualified defined benefit plan. The provision also clarifies that the special nondiscrimination rule for mergers and acquisitions applies for purposes of the nondiscrimination requirement applicable to catch-up contributions.

Equitable treatment for contributions of employees to defined contribution plans.-- Under prior law, the limits on contributions to a tax-sheltered annuity plan applied at the time contributions became vested. Under the Act, tax-sheltered annuity plans are generally subject to the same contribution limits as qualified defined contribution plans, but certain special rules were retained.

The provision clarifies that the limits apply to contributions to a tax-sheltered annuity plan in the year the contributions are made without regard to when the contributions become vested. The provision also clarifies that contributions may be made for an employee for up to five years after retirement, based on includible compensation for the last year of service before retirement. The provision also restores special rules for ministers and lay employees of churches and for foreign missionaries that were inadvertently eliminated.

Under the Act, amounts deferred under an eligible deferred compensation plan are generally subject to the same contribution limits as qualified defined contribution plans. The provision conforms the definition of compensation used in applying the limits to an eligible deferred compensation plan to the definition used for defined contribution plans.

Rollovers of retirement plan and IRA distributions.--Under prior law and under the Act, a qualified retirement plan must provide for the rollover of certain distributions directly to a qualified defined contribution plan, a qualified annuity plan, a tax-sheltered annuity plan, a governmental eligible deferred compensation plan, or a traditional IRA, if the participant elects a direct rollover. The provision clarifies that a qualified retirement plan must provide for the direct rollover of after-tax contributions only to a qualified defined contribution plan or a traditional IRA. The provision also clarifies that, if a distribution includes both pretax and after-tax amounts, the portion of the distribution that is rolled over is treated as consisting first of pretax amounts.

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Employers may disregard rollovers for purposes of cash-out amounts.-- Under prior and present law, if a participant in a qualified retirement plan ceases to be employed with the employer maintaining 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. Under the Act, a plan may provide that the present value of the benefit is determined without regard to the portion of the benefit that is attributable to rollover contributions (and any earnings allocable thereto) for purposes of determining whether the participant must consent to the cash-out of the benefit. The provision clarifies that rollover amounts may be disregarded also in determining whether a spouse must consent to the cash-out of the benefit.

Notice of significant reduction in plan benefit accruals.-- Under the Act, notice must be provided to participants if a defined benefit plan is amended to provide for a significant reduction in the future rate of benefit accrual, including any elimination or reduction of an early retirement benefit or retirement-type subsidy. The provision clarifies that the notice requirement applies to a defined benefit plan only if the plan is qualified. The provision further clarifies that, in the case of an amendment that eliminates an early retirement benefit or retirement-type subsidy, notice is required only if the early retirement benefit or retirement-type subsidy is significant. The provision also eliminates inconsistencies in the statutory language.

Modification of timing of plan valuations.--Under the Act, a plan valuation may be made as of any date in the immediately preceding plan year if, as of such date, plan assets are not less than 100% of the plan's current liability. Under the Act, a change in funding method to use a valuation date in the prior year generally may not be made unless, as of such date, plan assets are not less than 125% of the plan's current liability. The provision conforms the statutory language to Congressional intent as reflected in the Statement of Managers.

ESOP dividends may be reinvested without loss of dividend deduction.--Under prior and present law, a deduction is permitted for a dividend paid with respect to employer stock held in an ESOP if the dividend is (1) paid in cash directly to participants or (2) paid to the plan and subsequently distributed to the participants in cash no later than 90 days after the close of the plan year in which the dividend is paid to the plan. The deduction is allowable for the taxable year of the corporation in which the dividend is paid or distributed to the participants.

Under the Act, in addition to the deductions permitted under present law, a deduction is permitted for a dividend paid with respect to employer stock that, at the election of the participants, is payable in cash directly to participants or paid to the plan and subsequently distributed to the participants in cash no later than 90 days after the close of the plan year in which the dividend is paid to the plan, or paid to the plan and reinvested in qualifying employer securities. Under the provision, the deduction for dividends that are reinvested in qualifying employer securities at the election of participants is allowable for the taxable year in which the later of the reinvestment or the election occurs. The provision also clarifies that a



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dividend that is reinvested in qualifying employer securities at the participant's election must be nonforfeitable.

### California Law

California has specifically conformed to the pension-related technical amendments to the Economic Growth and Tax Relief Reconciliation Act of 2001 made by the Job Creation and Worker Assistance Act of 2002 in AB 1122 (Stats. 2002, Ch. 35). California law does not contain a child or HOPE tax credit, a marriage penalty or a gift tax. California law contains its own separate adoption and employer childcare assistance credits. The Office of the Controller administers the California estate tax.

### Impact on California Revenue

Conforming to these federal provisions would have negligible impact on state revenues. Estimates for this proposal are based on original federal projections in the Estimated Revenue Effects of the "Job Creation and Worker Assistance Act of 2002".

Amendments to the Community Renewal Tax Relief Act of 2000.

Phaseout of \$25,000 amount for certain rental real estate under passive loss rules.-- Present law provides for a phaseout of the \$25,000 amount allowed in the case of certain deductions and certain credits with respect to rental real estate activities, for taxpayers with adjusted gross income exceeding \$100,000. The phaseout rule does not apply, or applies separately, in the case of the rehabilitation credit, the low-income housing credit, and the commercial revitalization deduction. The provision clarifies the operation of the ordering rules to reflect the exceptions and separate phaseout rules for these items.

Treatment of missing children.--Present law provides that in the case of a dependent child of the taxpayer that is kidnapped, the taxpayer may continue to treat the child as a dependent for purposes of the dependency exemption, child credit, surviving spouse filing status, and head of household filing status. A similar rule applies under the earned income credit. The provision clarifies that, if a taxpayer met the household maintenance requirement of the surviving spouse filing status or the head of household filing status, respectively, with respect to his or her dependent child immediately before the kidnapping, then the taxpayer would be deemed to continue to meet that requirement for purposes of the filing status rule of section 2 of the Code until the child would have reached age 18 or is determined to be dead.

Basis of property in an exchange by a corporation involving assumption of liabilities.--The provision clarifies that the basis reduction rule of section 358(h) of the Code gives rise to a basis reduction in the amount of any liability that is assumed by another party as part of the exchange in which the property (whose basis exceeds its fair market value) is received, so long as the other requirements under section 358(h) apply.

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Tax treatment of securities futures contracts.--The provision clarifies that the termination of a securities contract is treated in a manner similar to a sale or exchange of a securities futures contract for purposes of determining the character of any gain or loss from a termination of a securities futures contract. Under the provision, any gain or loss from the termination of a securities futures contract (other than a dealer securities futures contract) is treated as gain or loss from the sale or exchange of property that has the same character as the property to which the contract relates has (or would have) in the hands of the taxpayer.

The provision also clarifies that losses from the sale, exchange, or termination of a securities futures contract (other than a dealer securities futures contract) to sell generally are treated in the same manner as losses from the closing of a short sale for purposes of applying the wash sale rules. Thus, the wash sale rules apply to any loss from the sale, exchange, or termination of a securities futures contract (other than dealer securities futures contract) if, within a period beginning 30 days before the date of such sale, exchange, or termination and ending 30 days after such date: (1) stock that is substantially identical to the stock to which the contract relates is sold; (2) a short sale of substantially identical stock is entered into; or (3) another securities futures contract to sell substantially identical stock is entered into.

The provision clarifies that a securities futures contract to sell generally is treated in a manner similar to a short sale for purposes of the special holding period rules in section 1233. Thus, subsections (b) and (d) of section 1233 may apply to characterize certain capital gains as short-term capital gain and certain capital losses as long-term capital loss, and to determine holding periods where certain securities futures contracts to sell are entered into while holding the substantially identical stock.

### California Law

California is conformed to the underlying law on which the above technical amendments were made. California has not yet conformed to the technical amendments.

### Impact on California Revenue

Conforming to these federal provisions would have negligible impact on state revenues. Estimates for this proposal are based on original federal projections in the Estimated Revenue Effects of the "Job Creation and Worker Assistance Act of 2002".

Amendment to the Tax Relief Extension Act of 1999.

Taxable REIT subsidiaries - 100% tax on improperly allocated amounts.--The provision clarifies that redetermined rents, to which the excise tax applies, are the excess of the amount treated by the REIT as rents from real property under Code section 856(d) over the amount that would be so treated after reduction under Code section 482 to clearly reflect

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income as a result of services furnished or rendered by a taxable REIT subsidiary of the REIT to a tenant of the REIT. Similarly, redetermined deductions are the excess of the amount treated by the taxable REIT subsidiary as other deductions over the amount that would be so treated after reduction under Code section 482.

### California Law

California is generally conformed federal law related to REITs, with exceptions. One exception is that California law does not impose any excise taxes on REITS. Therefore, the above technical amendment does not apply to California.

### Impact on California Revenue

Not applicable.

Amendments to the Taxpayer Relief Act of 1997.

Election to recognize gain on assets held on January 1, 2001; treatment of gain on sale of principal residence.--The provision clarifies that the gain to which the mark-to-market election applies is included in gross income. Thus, the exclusion of gain on the sale of a principal residence under Code section 121 would not apply with respect to an asset for which the election to mark to market is made. The provision is consistent with the holding of Rev. Rul. 2001-57.

Election to recognize gain on assets held on January 1, 2001; treatment of disposition of interest in passive activity.--The provision clarifies that the election to mark to market an interest in a passive activity does not result in the deduction of suspended losses by reason of section 469(g)(1)(A). Any gain taken into account by reason of an election with respect to any interest in a passive activity is taken into account in determining the passive activity loss for the taxable year (as defined in section 469(d)(1)). Section 469(g)(1)(A) may apply to a subsequent disposition of the interest in the activity by the taxpayer.

### California Law

California is conformed to the underlying law on which the above technical amendments were made. California has not yet conformed to the technical amendments made to the Taxpayer Relief Act of 1997.

### Impact on California Revenue

Conforming to these federal provisions would have negligible impact on state revenues. Estimates for this proposal are based on original federal projections in the Estimated Revenue Effects of the "Job Creation and Worker Assistance Act of 2002".

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Amendment to the Balanced Budget Act of 1997.

Medicare+Choice MSA.--The provision conforms the treatment of the additional tax on Medicare+Choice MSAs distributions not used for qualified medical expenses if a minimum balance is not maintained to the treatment of the additional tax on Archer MSA distributions not used for qualified medical expenses, for purposes of determining whether certain taxes are included within regular tax liability under Code section 26(b).

## California Law

California is conformed to the underlying law related to the above technical amendment. California has not yet conformed to the technical amendments.

## Impact on California Revenue

Conforming to these federal provisions would have negligible impact on state revenues. Estimates for this proposal are based on original federal projections in the Estimated Revenue Effects of the "Job Creation and Worker Assistance Act of 2002".

Amendment to other Acts.

Advance payments of earned income credit.--The provision corrects a reference in section 32(g)(2) to refer to credits allowable under this part (i.e., all tax credits) rather than under this subpart (i.e., the refundable credits). The provision is effective as if included in section 474 of the Tax Reform Act of 1984.

Coordination of wash sale rules and section 1256 contracts.--The Act clarifies that the wash sale rules do not apply to any loss arising from a section 1256 contract. This rule is similar to the rule in present-law section 475 applicable to securities that are marked to market under that section. The provision is effective as if included in section 5075 of the Technical and Miscellaneous Revenue Act of 1988.

Disclosure by the Social Security Administration to Federal child support enforcement agencies.--Section 6103(l)(8) permits the Social Security Administration (SSA) to disclose certain tax information in its possession to State child support enforcement agencies. The Office of Child Support Enforcement (OCSE), a Federal agency, oversees child support enforcement at the Federal level and acts as a coordinator for most programs involved with child support enforcement. OCSE acts as a conduit for the disclosure of tax information from the Internal Revenue Service to the various State and local child support enforcement agencies. The change to section 6103(l)(8) permits SSA to make disclosures directly to

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OCSE, which in turn would make the disclosures to the State and local child support enforcement agencies. The provision is effective on March 9, 2002.

Treatment of settlements under partnership audit rules.--The provision clarifies that the partnership audit procedures that apply to settlement agreements entered into by the Secretary also apply to settlement agreements entered into by the Attorney General. Under present law, when the Secretary enters into a settlement agreement with a partner with respect to partnership items, those items convert to nonpartnership items, and the other partners in the partnership have a right to request consistent settlement terms. The conversion of the settling partner's partnership items to nonpartnership items is the mechanism by which the settling partner is removed from the ongoing partnership proceeding. If these rules did not apply to settlement agreements entered into by the Attorney General (or his delegate), it is possible that a settling partner would inadvertently be bound by the outcome of the partnership proceeding rather than the settlement agreement entered into with the Attorney General (or his delegate) (sec. 6224(c)(2)). Similar changes are made to related provisions with respect to settlement agreements. The provision is effective for settlement agreements entered into after March 2, 2002.

Clarification of permissible extension of limitations period for installment agreements.--Uncertainty existed as to whether the permissible extension of the period of limitations in the context of installment agreements is governed by reference to an agreement of the parties pursuant to section 6502 or by reference to the period of time during which the installment agreement is in effect pursuant to sections 6331(k)(3) and (i)(5). A 2000 technical correction clarified that the permissible extension of the period of limitations in the context of installment agreements is governed by the pertinent provisions of section 6502. The provision further clarifies that the elimination of the application of the section 6331(i)(5) rules applies only to section 6331(k)(2)(C). The provision modifies section 313(b)(3) of H.R. 5662, the Community Renewal Tax Relief Act of 2000 (Pub. Law No. 106-554). This is the further technical correction referred to in footnote 185a, Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 106th Congress* (JCS-2-01), April 19, 2001, page 162. The provision is effective on March 2, 2002.

Determination of whether a life insurance contract is a modified endowment contract.--The provision clarifies that, for purposes of determining whether a life insurance contract is a modified endowment contract, if there is a material change to the contract, appropriate adjustments are made in determining whether the contract meets the 7-pay test to take into account the cash surrender value under the contract. No reference is needed to the cash surrender under the "old contract" (as was provided under section 318(a)(2) of H.R. 5662, the Community Renewal Tax Relief Act of 2000 (Pub. Law No. 106-554)) because prior and present law provide a definition of cash surrender value for this purpose (by cross reference to section 7702(f)(2)(A)). It is reiterated that Code section 7702A(c)(3)(ii) is not intended to permit a policyholder to engage in a series of "material changes" to circumvent the premium limitations in section 7702A. Thus, if there is a material change to a life insurance contract, it is intended that the fair market value of the contract be used as the cash surrender value

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under the provision, if the amount of the putative cash surrender value of the contract is artificially depressed. For example, if there is a material change because of an increase in the face amount of the contract, any artificial or temporary reduction in the cash surrender value of the contract is not to be taken into account, but rather, it is intended that the fair market value of the contract be used as cash surrender value, so that the substance rather than the form of the transaction is reflected. Further, as stated in the 1988 Act legislative history to section 7702A, in applying the 7-pay test to any premiums paid under a contract that has been materially changed, the 7-pay premium for each of the first 7 contract years after the change is to be reduced by the product of (1) the cash surrender value of the contract as of the date that the material change takes effect (determined without regard to any increase in the cash surrender value that is attributable to the amount of the premium payment that is not necessary), and (2) a fraction the numerator of which equals the 7- pay premium for the future benefits under the contract, and the denominator of which equals the net single premium for such benefits computed using the same assumptions used in determining the 7- pay premium. The provision is effective as if section 318(a) of the Community Renewal Tax Relief Act of 2000 (114. Stat. 2763A-645) had not been enacted.

### California Law

California is conformed to the underlying federal law regarding wash sales and life insurance contracts. California has not yet conformed to the technical amendments. California law does not conform the earned income credit or partnership audit rules. California law contains separate rules regarding installment agreements.

### Impact on California Revenue

Conforming to these federal provisions would have negligible impact on state revenues. Estimates for this proposal are based on original federal projections in the Estimated Revenue Effects of the "Job Creation and Worker Assistance Act of 2002".

Clerical amendments.

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

### Additional Corrections to Previous Acts

Adoption credit and employer-provided adoption assistance exclusion rounding rules.--The provision provides uniform rounding rules (to the nearest multiple of \$10) for the inflation-adjusted dollar limits and income limitations in the adoption credit and the employer provided adoption assistance exclusion. The provision is effective as if included in the provision of the Economic Growth and Tax Reform Reconciliation Act of 2001 to which it relates.

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Dependent care credit.--The provision conforms the dollar limit on deemed earned income of a taxpayer's spouse who is either (1) a full-time student, or (2) physically or mentally incapable of caring for himself, to the dollar limit on employment-related expenses applicable in determining the maximum credit amount. The 2001 Act increased the dollar limit on employer related expenses to \$3,000 for one qualifying individual or \$6,000 for two or more qualifying individuals annually but did not conform the dollar limit on deemed earned income of a spouse. The provision is effective as if included in the provision of the Economic Growth and Tax Reform Reconciliation Act of 2001 to which it relates.

### California Law

California law contains its own separate adoption credit. California is conformed to the underlying law regarding the dependent care credit and the adoption assistance exclusion. California has not yet conformed to the technical amendments.

### Impact on California Revenue

Conforming to these federal provisions would have negligible impact on state revenues. Estimates for this proposal are based on original federal projections in the Estimated Revenue Effects of the "Job Creation and Worker Assistance Act of 2002".

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<u>Section</u>	<u>Section Title</u>
601	Extend Alternative Minimum Tax Relief for Individuals

### Background

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit<sup>30</sup>, the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, the IRA credit, and the D.C. homebuyer's credit). For taxable years beginning after 2001, these credits (other than the adoption credit, child credit and IRA credit) are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit. The adoption credit, child credit, and IRA credit are allowed to the full extent of the individual's regular tax and alternative minimum tax.

For taxable years beginning in 2001, all the nonrefundable personal credits are allowed to the extent of the full amount of the individual's regular tax and alternative minimum tax.

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<sup>30</sup> A portion of the child credit may be refundable.

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The alternative minimum tax is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is an amount equal to (1) 26% of the first \$175,000 (\$87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income (AMTI) in excess of a phased-out exemption amount and (2) 28% of the remaining AMTI. The maximum tax rates on net capital gain used in computing the tentative minimum tax are the same as under the regular tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments. The exemption amounts are: (1) \$45,000 (\$49,000 in taxable years beginning before 2005) in the case of married individuals filing a joint return and surviving spouses; (2) \$33,750 (\$35,750 in taxable years beginning before 2005) in the case of other unmarried individuals; (3) \$22,500 (\$24,500 in taxable years beginning before 2005) in the case of married individuals filing a separate return; and (4) \$22,500 in the case of an estate or trust. The exemption amounts are phased out by an amount equal to 25% of the amount by which the individual's AMTI exceeds (1) \$150,000 in the case of married individuals filing a joint return and surviving spouses, (2) \$112,500 in the case of other unmarried individuals, and (3) \$75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

### New Federal Law (Sec. 26)

The provision allows an individual to offset the entire regular tax liability and alternative minimum tax liability by the personal nonrefundable credits in 2002 and 2003.

### Effective Date

The provision is effective for taxable years beginning in 2002 and 2003.

### California Law

California law permanently allows personal type credits to fully offset regular tax below the tentative minimum tax to zero.

### Impact on California Revenue

Conformed in AB 1122 (Stats. 2002, Ch. 35).



# Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

<u>Section</u>	<u>Section Title</u>
602	Extend Credit for Purchase of Electric Vehicles

## Background

A 10% tax credit is provided for the cost of a qualified electric vehicle, up to a maximum credit of \$4,000 (sec. 30). A qualified electric vehicle is a motor vehicle that is powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electrical current, the original use of which commences with the taxpayer, and that is acquired for the use by the taxpayer and not for resale. The full amount of the credit is available for purchases prior to 2002. The credit phases down in the years 2002 through 2004, and is unavailable for purchases after December 31, 2004.<sup>31</sup>

## New Federal Law (Secs. 30 and 280F)

The Act defers the phase down of the credit for two years. Taxpayers may claim the full amount of the credit for qualified purchases made in 2002 and 2003. Under the Act, the phase down of the credit value commences in 2004 and the credit is unavailable for purchases after December 31, 2006. A conforming modification is made to section 280F.

## Effective Date

The provision is effective for property placed in service after December 31, 2001.

## California Law

California law does not have a comparable credit.

## Impact on California Revenue

Not applicable.

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<sup>31</sup> The amount the taxpayer may claim as a depreciation deduction for any passenger automobile is limited (sec. 280F). In the case of a passenger vehicle designed to be propelled primarily by electricity and built by an original equipment manufacturer, the otherwise applicable limitation amounts are tripled. These exceptions from sec. 280F apply to vehicles placed in service prior to January 1, 2005.

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<u>Section</u>	<u>Section Title</u>
603	Extend Section 45 Credit for Production of Electricity from Wind, Closed Loop Biomass and Poultry Litter

### Background

An income tax credit is allowed for the production of electricity from either qualified wind energy, qualified "closed-loop" biomass, or qualified poultry waste facilities (sec. 45). The credit applies to electricity produced by a wind energy facility placed in service after December 31, 1993, and before January 1, 2002, to electricity produced by a closed-loop biomass facility placed in service after December 31, 1992, and before January 1, 2002, and to a poultry waste facility placed in service after December 31, 1999, and before January 1, 2002.

The credit is allowable for production during the 10-year period after a facility is originally placed in service. In order to claim the credit, a taxpayer must own the facility and sell the electricity produced by the facility to an unrelated party. In the case of a poultry waste facility, the taxpayer may claim the credit as a lessee/operator of a facility owned by a governmental unit. Closed-loop biomass is plant matter, where the plants are grown for the sole purpose of being used to generate electricity. It does not include waste materials (including, but not limited to, scrap wood, manure, and municipal or agricultural waste). The credit also is not available to taxpayers who use standing timber to produce electricity. Poultry waste means poultry manure and litter, including wood shavings, straw, rice hulls, and other bedding material for the disposition of manure.

The credit for electricity produced from wind, closed-loop biomass, or poultry waste is a component of the general business credit (sec. 38(b)(8)). The credit, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25% of net regular tax liability above \$25,000, or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39). To coordinate the carryback with the period of application for this credit, the credit for electricity produced from closed-loop biomass facilities may not be carried back to a tax year ending before 1993 and the credit for electricity produced from wind energy may not be carried back to a tax year ending before 1994 (sec. 39).

### New Federal Law (Sec. 45)

The Act extends the placed in service date for qualified facilities by two years to include those facilities placed in service prior to January 1, 2004.

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## Effective Date

The provision is effective for facilities placed in service after December 31, 2001.

## California Law

California does not conform to the above credit. California law does contain a 15% nonrefundable solar energy credit for the production of electricity. The electricity produced must be primarily used by the residential building it is installed on and cannot be produced for resale.

## Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
604	Extend the Work Opportunity Tax Credit

## Background

In general.

The work opportunity tax credit (WOTC) is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The credit equals 40% (25% for employment of less than 400 hours) of qualified wages. Generally, qualified wages are wages attributable to service rendered by member of a targeted group during the one-year period beginning with the day the individual began work for the employer.

The maximum credit per employee is \$2,400 (40% of the first \$6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is \$1,200 (40% of the first \$3,000 of qualified first-year wages). For purposes of the credit, wages are generally defined as under the Federal Unemployment Tax Act, without regard to the dollar cap.

Targeted groups eligible for the credit.

The eight targeted groups are: (1) families eligible to receive benefits under the Temporary Assistance for Needy Families ("TANF") Program; (2) high-risk youth; (3) qualified ex-felons; (4) vocational rehabilitation referrals; (5) qualified summer youth employees; (6) qualified veterans; (7) families receiving food stamps; and (8) persons receiving certain Supplemental

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Security Income (“SSI”) benefits. The employer's deduction for wages is reduced by the amount of the credit.

Expiration date.

The credit is effective for wages paid or incurred to a qualified individual who began work for an employer before January 1, 2002.

### New Federal Law (Sec. 51)

The Act extends the work opportunity tax credit for two years (through December 31, 2003).

### Effective Date

The provision is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 2002, and before January 1, 2004.

### California Law

California does not conform to this federal credit. However, the local agency military base recovery area (LAMBRA) and enterprise zone hiring credits must be reduced by any allowable federal WOTC.

### Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
605	Extend the Welfare-To-Work Tax Credit

### Background

In general.

The welfare-to-work tax credit is available on an elective basis for employers for the first \$20,000 of eligible wages paid to qualified long-term family assistance recipients during the first two years of employment. The credit is 35% of the first \$10,000 of eligible wages in the first year of employment and 50% of the first \$10,000 of eligible wages in the second year of employment. The maximum credit is \$8,500 per qualified employee.

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Qualified long-term family assistance recipients are: (1) members of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) members of a family that has received family assistance for a total of at least 18 months (whether or not consecutive) after the date of enactment of this credit if they are hired within 2 years after the date that the 18-month total is reached; and (3) members of a family that is no longer eligible for family assistance because of either Federal or State time limits, if they are hired within two years after the Federal or State time limits made the family ineligible for family assistance. Family assistance means benefits under the Temporary Assistance to Needy Families ("TANF") program.

For purposes of the credit, wages are generally defined under the Federal Unemployment Tax Act, without regard to the dollar amount. In addition, wages include the following: (1) educational assistance excludable under a section 127 program; (2) the value of excludable health plan coverage but not more than the applicable premium defined under section 4980B(f)(4); and (3) dependent care assistance excludable under section 129. The employer's deduction for wages is reduced by the amount of the credit.

Expiration date.

The welfare to work credit is effective for wages paid or incurred to a qualified individual who began work for an employer before January 1, 2002.

### New Federal Law (Sec. 51A)

The Act extends the welfare to work credit for two years (through December 31, 2003).

### Effective Date

The provision is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 2002, and before January 1, 2004.

### California Law

California does not conform to this federal credit. However, the local agency military base recovery area (LAMBRA) and enterprise zone hiring credits must be reduced by any allowable federal WOTC or Welfare-to Work Tax Credit.

### Impact on California Revenue

Not applicable.

## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

<u>Section</u>	<u>Section Title</u>
606	Extend Deduction for Qualified Clean-Fuel Vehicle Property and Qualified Clean-Fuel Vehicle Refueling Property

### Background

Certain costs of qualified clean-fuel vehicle property and clean-fuel vehicle refueling property may be expensed and deducted when such property is placed in service (sec. 179A). Qualified clean-fuel vehicle property includes motor vehicles that use certain clean-burning fuels (natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity and any other fuel at least 85% of which is methanol, ethanol, any other alcohol or ether). The maximum amount of the deduction is \$50,000 for a truck or van with a gross vehicle weight over 26,000 pounds or a bus with seating capacities of at least 20 adults; \$5,000 in the case of a truck or van with a gross vehicle weight between 10,000 and 26,000 pounds; and \$2,000 in the case of any other motor vehicle. Qualified electric vehicles do not qualify for the clean-fuel vehicle deduction.

Clean-fuel vehicle refueling property comprises property for the storage or dispensing of a clean-burning fuel, if the storage or dispensing is the point at which the fuel is delivered into the fuel tank of a motor vehicle. Clean-fuel vehicle refueling property also includes property for the recharging of electric vehicles, but only if the property is located at a point where the electric vehicle is recharged. Up to \$100,000 of such property at each location owned by the taxpayer may be expensed with respect to that location.

The deduction for clean-fuel vehicle property phases down in the years 2002 through 2004, and is unavailable for purchases after December 31, 2004. The deduction for clean-fuel vehicle refueling property is unavailable for property placed in service after December 31, 2004.

### New Federal Law (Sec. 179A and 280F)

The Act defers the phase down of the deduction for clean-fuel vehicle property by two years. Taxpayers may claim the full amount of the deduction for qualified vehicles placed in service in 2002 and 2003. Under the Act, the phase down of the deduction for clean-fuel vehicles commences in 2004 and the deduction is unavailable for purchases after December 31, 2006. A conforming modification is made to section 280F. The amount the taxpayer may claim as a depreciation deduction for any passenger automobile is limited (sec. 280F). In the case of a qualified clean-burning fuel vehicle, the limitation of sec. 280F applies only to that portion of the vehicle's cost not represented by the installed qualified clean-burning fuel property. The taxpayer may claim an amount otherwise allowable as a depreciation deduction on the installed qualified clean-burning fuel property, without regard to the limitation. These exceptions from sec. 280F apply to vehicles placed in service prior to January 1, 2005.

## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

The provision extends the placed in service date for clean-fuel vehicle refueling property by two years. The deduction for clean-fuel vehicle refueling property is available for property placed in service prior to January 1, 2007.

### Effective Date

The provision is effective for property placed in service after December 31, 2001.

### California Law

California law was in conformity to federal law as it related to qualified clean-fuel property expensing until December 31, 1994, when the California provision sunsetted. California law did not conform to any subsequent federal extension.

### Impact on California Revenue

Estimated Revenue Impact for Extending the Deduction for Qualified Clean-Fuel Vehicle Property and Qualified Clean Vehicle Refueling Property			
Fiscal Years			
(In Millions)			
	2003-04	2004-05	2005-06
	-\$10	-\$4	-\$2

Estimates for this proposal are based on original federal projections and assumes California was already in conformity with the clean vehicle tax incentives, the revenue impact from the "Job Creation and Worker Assistance Act of 2002" for California would be -\$10 million in 2003-04, -\$4 million in 2004-05 and -\$2 million in 2005-06.

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<u>Section</u>	<u>Section Title</u>
607	Taxable Income Limit on Percentage Depletion for Marginal Production

### Background

In general

Depletion, like depreciation, is a form of capital cost recovery. In both cases, the taxpayer is allowed a deduction in recognition of the fact that an asset -- in the case of depletion for oil or gas interests, the mineral reserve itself -- is being expended in order to produce income.

## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

Certain costs incurred prior to drilling an oil or gas property are recovered through the depletion deduction. These include costs of acquiring the lease or other interest in the property and geological and geophysical costs (in advance of actual drilling). Depletion is available to any person having an economic interest in a producing property.

Two methods of depletion are allowable under the Code: (1) the cost depletion method, and (2) the percentage depletion method (secs. 611-613). Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the depletable property which is equal to the ratio of units sold from that property during the taxable year to the number of units remaining as of the end of taxable year plus the number of units sold during the taxable year. Thus, the amount recovered under cost depletion may never exceed the taxpayer's basis in the property.

Under the percentage depletion method, generally, 15% of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year (sec. 613A(c)). The amount deducted generally may not exceed 100% of the net income from that property in any year (the "net-income limitation") (sec. 613(a)). The Taxpayer Relief Act of 1997 suspended the 100% -of-net-income limitation for production from marginal wells for taxable years beginning after December 31, 1997, and before January 1, 2000. The limitation subsequently was extended to include taxable years beginning before January 1, 2002.

Additionally, the percentage depletion deduction for all oil and gas properties may not exceed 65% of the taxpayer's overall taxable income (determined before such deduction and adjusted for certain loss carrybacks and trust distributions) (sec. 613A(d)(1)). Because percentage depletion, unlike cost depletion, is computed without regard to the taxpayer's basis in the depletable property, cumulative depletion deductions may be greater than the amount expended by the taxpayer to acquire or develop the property. A taxpayer is required to determine the depletion deduction for each oil or gas property under both the percentage depletion method (if the taxpayer is entitled to use this method) and the cost depletion method. If the cost depletion deduction is larger, the taxpayer must utilize that method for the taxable year in question (sec. 613(a)). Amounts disallowed as a result of this rule may be carried forward and deducted in subsequent taxable years, subject to the 65% taxable income limitation for those years.

### Limitation of oil and gas percentage depletion to independent producers and royalty owners

Generally, only independent producers and royalty owners (as contrasted to integrated oil companies) are allowed to claim percentage depletion. Percentage depletion for eligible taxpayers is allowed only with respect to up to 1,000 barrels of average daily production of domestic crude oil or an equivalent amount of domestic natural gas (sec. 613A(c)). For producers of both oil and natural gas, this limitation applies on a combined basis. In addition to the independent producer and royalty owner exception, certain sales of natural gas under a fixed contract in effect on February 1, 1975, and certain natural gas from geopressured brine, are eligible for percentage depletion, at rates of 22% and 10%, respectively. These



## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

exceptions apply without regard to the 1,000-barrel-per-day limitation and regardless of whether the producer is an independent producer or an integrated oil company.

### New Federal Law (Sec. 613A)

The provision extends the period when the 100% net-income limit is suspended to include taxable years beginning in 2002 and 2003.

### Effective Date

The provision is effective for taxable years beginning after December 31, 2001, and before January 1, 2004.

### California Law

For the 2002 taxable year, California law is in full conformity with federal law as it read on January 1, 2001, as it relates to percentage depletion of oil and gas wells, including the temporary suspension of the 100%-of-net-income limitation. Under California law the limitation applies again for taxable years beginning on or after January 1, 2002. (Note: For California purposes the 100%-of-net-income limitation applied to taxable years beginning in 2000 and 2001.)

### Impact on California Revenue

Estimated Revenue Impact of SEC 607 Effective for Tax Years 2002 and 2003			
Fiscal Years			
(In Millions)			
Provision	2003-04	2004-05	2005-06
Taxable Income Limit on Percentage Depletion for Marginal Production	-\$1	-\$1	-

Estimates for this proposal are based on original federal projections in the Estimated Revenue Effects of the "Job Creation and Worker Assistance Act of 2002" adjusted to reflect enactment after June 30, 2003 for California tax purposes.

# Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

<u>Section</u>	<u>Section Title</u>
608	Extension of Authority to Issue Qualified Zone Academy Bonds

## Background

### Tax-exempt bonds.

Interest on State and local governmental bonds generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units. Activities that can be financed with these tax-exempt bonds include the financing of public schools (sec. 103).

### 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” (“QZABs”) (sec. 1397E). A total of \$400 million of qualified zone academy bonds may be issued annually in calendar years 1998 through 2001. The \$400 million aggregate bond cap 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 authority to qualified zone academies within such State. Financial institutions 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. A taxpayer holding a qualified zone academy bond on the credit allowance date is entitled to a credit. The credit is includable in gross income (as if it were a taxable interest payment on the bond), and may be claimed against regular income tax and AMT liability.

The Treasury Department sets the credit rate 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 bond 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. “Qualified zone academy bonds” are defined as any bond issued by a State or local government, provided that (1) at least 95% of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a “qualified zone academy” 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 an empowerment zones enterprise community designated under the Code, or (b) it is reasonably expected that

## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

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 (Sec. 1397E)

The provision authorizes issuance of up to \$400 million of qualified zone academy bonds annually in calendar years 2002 and 2003.

### Effective Date

The provision is effective for obligations issued after March 9, 2002.

### California Law

The Personal Income Tax Law (PITL) specifically does not conform to federal law regarding private activity bonds. The California Constitution provides an exemption from income taxation for all interest from bonds issued by this state or a local government of this state. Federal law, other than the IRC, prohibits state taxation of interest on federal bonds, if the interest on state obligations is exempt from tax. Taxpayers subject to the corporate franchise tax must report as income all interest received. Interest received from federal obligations and California obligations or obligations of its political subdivision generally is excluded from income subject to the corporation and personal income tax.

Since California has not conformed to federal law related to qualified zone academy bonds and the federal credit for holders of those bonds, the federal credit (which is subject to federal income tax) is not includible in income subject to the corporate or personal income tax and is not subject to the corporate franchise tax.

### Impact on California Revenue

Not applicable.

# Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

<u>Section</u>	<u>Section Title</u>
609	Extension of Increased Coverover Payments to Puerto Rico and the Virgin Islands

## Background

A \$13.50 per proof gallon<sup>32</sup> excise tax is imposed on distilled spirits produced in, or imported or brought into, the United States. The excise tax does not apply to distilled spirits that are exported from the United States or to distilled spirits that are consumed in U.S. possessions (e.g., Puerto Rico and the Virgin Islands). The Code provides for coverover (payment) of \$13.25 per proof gallon of the excise tax imposed on rum imported (or brought) into the United States (without regard to the country of origin) to Puerto Rico and the Virgin Islands during the period July 1, 1999 through December 31, 2001. Effective on January 1, 2002, the coverover rate is scheduled to return to its permanent level of \$10.50 per proof gallon. Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.

## New Federal Law (Sec. 7652)

The provision extends the \$13.25-per-proof-gallon coverover rate for two additional years, through December 31, 2003.

## Effective Date

The provision is effective for articles brought into the United States after December 31, 2001.

## California Law

California excise taxes are administered by the State Board of Equalization (BoE).

## Impact on California Revenue

Defer to the BoE.

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<sup>32</sup> A proof gallon is a liquid gallon consisting of 50% alcohol.

# Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

<u>Section</u>	<u>Section Title</u>
610	Tax on Failure to Comply with Mental Health Parity Requirements

## Background

The Mental Health Parity Act of 1996 amended ERISA and the Public Health Service Act to provide that group health plans that provide both medical and surgical benefits and mental health benefits cannot impose aggregate lifetime or annual dollar limits on mental health benefits that are not imposed on substantially all medical and surgical benefits. The provisions of the Mental Health Parity Act are effective with respect to plan years beginning on or after January 1, 1998, but do not apply to benefits for services furnished on or after September 30, 2001.

The Taxpayer Relief Act of 1997 added to the Internal Revenue Code the requirements imposed under the Mental Health Parity Act, and imposed an excise tax on group health plans that fail to meet the requirements. The excise tax is equal to \$100 per day during the period of noncompliance and is imposed on the employer sponsoring the plan if the plan fails to meet the requirements. The maximum tax that can be imposed during a taxable year cannot exceed the lesser of 10% of the employer's group health plan expenses for the prior year or \$500,000. No tax is imposed if the Secretary determines that the employer did not know, and exercising reasonable diligence would not have known, that the failure existed.

The excise tax is applicable with respect to plan years beginning on or after January 1, 1998, and expired with respect to benefits for services provided on or after September 30, 2001.

Section 701 of Public Law 107-116 (providing appropriations for the Departments of Labor, Health and Human Services, and Education for fiscal year 2002), which was enacted January 10, 2002, restored the excise tax retroactively to September 30, 2001. The excise tax will expire with respect to benefits provided for services on or after December 31, 2002.

## New Federal Law (Sec. 9812(f))

With respect to services provided on or after September 30, 2001, the excise tax on failures to comply with mental health parity requirements is amended to apply to benefits for such services provided on or after January 10, 2002, and before January 1, 2004.

## Effective Date

The provision is effective with respect to plan years beginning after December 31, 2000.

## California Law

California excise taxes are administered by the BoE.

# Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

## Impact on California Revenue

Defer to the BoE.

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<u>Section</u>	<u>Section Title</u>
611	Suspension of Reduction of Deductions for Mutual Life Insurance Companies

## Background

In general, a corporation may not deduct amounts distributed to shareholders with respect to the corporation's stock. The Deficit Reduction Act of 1984 added a provision to the rules governing insurance companies that was intended to remedy the failure of prior law to distinguish between amounts returned by mutual life insurance companies to policyholders as customers, and amounts distributed to them as owners of the mutual company.

Under the provision, section 809, a mutual life insurance company is required to reduce its deduction for policyholder dividends by the company's differential earnings amount. If the company's differential earnings amount exceeds the amount of its deductible policyholder dividends, the company is required to reduce its deduction for changes in its reserves by the excess of its differential earnings amount over the amount of its deductible policyholder dividends. The differential earnings amount is the product of the differential earnings rate and the average equity base of a mutual life insurance company.

The differential earnings rate is based on the difference between the average earnings rate of the 50 largest stock life insurance companies and the earnings rate of all mutual life insurance companies. The mutual earnings rate applied under the provision is the rate for the second calendar year preceding the calendar year in which the taxable year begins. Under present law, the differential earnings rate cannot be a negative number.

A company's equity base equals the sum of: (1) its surplus and capital increased by 50% of the amount of any provision for policyholder dividends payable in the following taxable year; (2) the amount of its nonadmitted financial assets; (3) the excess of its statutory reserves over its tax reserves; and (4) the amount of any mandatory security valuation reserves, deficiency reserves, and voluntary reserves. A company's average equity base is the average of the company's equity base at the end of the taxable year and its equity base at the end of the preceding taxable year.

A recomputation or "true-up" in the succeeding year is required if the differential earnings amount for the taxable year either exceeds, or is less than, the recomputed differential earnings amount. The recomputed differential earnings amount is calculated taking into

## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

account the average mutual earnings rate for the calendar year (rather than the second preceding calendar year, as above). The amount of the true-up for any taxable year is added to, or deducted from, the mutual company's income for the succeeding taxable year.

### New Federal Law (Sec. 809)

The provision provides a zero rate for both the differential earnings rate and recomputed differential earnings rate ("true-up") for a life insurance company's taxable years beginning in 2001, 2002, or 2003, under the rules requiring reduction in certain deductions of mutual life insurance companies (sec. 809).

### Effective Date

The provision is effective for taxable years beginning after December 31, 2000.

### California Law

Under California law, insurance companies are generally not subject to the income or franchise tax. Instead, insurers pay a tax based generally on premiums received during the year from business transacted in California. The gross premiums tax rate is set each year and administered by the Insurance Commissioner, the Department of Insurance, and the BoE. Since 1990, the tax has been set at 2.35%.

### Impact on California Revenue

Defer to the Insurance Commissioner, the Department of Insurance, and the BoE.

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<u>Section</u>	<u>Section Title</u>
612	Extension of Archer Medical Savings Accounts (MSAs)

### Background

In general.

Within limits, contributions to a an Archer medical savings account ("MSA") are deductible in determining adjusted gross income if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Earnings on amounts in an Archer MSA are not currently taxable. Distributions from an Archer MSA for medical expenses are not taxable. Distributions not used for medical

## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

expenses are taxable. In addition, distributions not used for medical expenses are subject to an additional 15% tax unless the distribution is made after age 65, death, or disability.

Eligible individuals.

Archer MSAs are available to employees covered under an employer-sponsored high deductible plan of a small employer and self-employed individuals covered under a high deductible health plan.<sup>33</sup> An employer is a small employer if it employed, on average, no more than 50 employees on business days during either the preceding or the second preceding year. An individual is not eligible for an Archer MSA if they are covered under any other health plan in addition to the high deductible plan.

Tax treatment of and limits on contributions.

Individual contributions to an Archer MSA are deductible (within limits) in determining adjusted gross income (i.e., "above the line"). In addition, employer contributions are excludable from gross income and wages for employment tax purposes (within the same limits), except that this exclusion does not apply to contributions made through a cafeteria plan. In the case of an employee, contributions can be made to an Archer MSA either by the individual or by the individual's employer. The maximum annual contribution that can be made to an Archer MSA for a year is 65% of the deductible under the high deductible plan in the case of individual coverage and 75% of the deductible in the case of family coverage.

Definition of high deductible plan.

A high deductible plan is a health plan with an annual deductible of at least \$1,600 and no more than \$2,400 in the case of individual coverage and at least \$3,200 and no more than \$4,800 in the case of family coverage. In addition, the maximum out-of-pocket expenses with respect to allowed costs (including the deductible) must be no more than \$3,200 in the case of individual coverage and no more than \$5,850 in the case of family coverage. A plan does not fail to qualify as a high deductible plan merely because it does not have a deductible for preventive care as required by State law. A plan does not qualify as a high deductible health plan if substantially all of the coverage under the plan is for permitted coverage (as described above). In the case of a self-insured plan, the plan must in fact be insurance (e.g., there must be appropriate risk shifting) and not merely a reimbursement arrangement.

Taxation of distributions

Distributions from an Archer MSA for the medical expenses of the individual and his or her spouse or dependents generally are excludable from income. However, in any year for which a contribution is made to an Archer MSA, withdrawals from an Archer MSA maintained by

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<sup>33</sup> Self-employed individuals include more than 2% shareholders of S corporations who are treated as partners for purposes of fringe benefit rules pursuant to section 1372.



## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

that individual generally are excludable from income only if the individual for whom the expenses were incurred was covered under a high deductible plan for the month in which the expenses were incurred. For this purpose, medical expenses are defined as under the itemized deduction for medical expenses, except that medical expenses do not include expenses for insurance other than long-term care insurance, premiums for health care continuation coverage, and premiums for health care coverage while an individual is receiving unemployment compensation under Federal or State law.

Distributions that are not used for medical expenses are includible in income. Such distributions are also subject to an additional 15% tax unless made after age 65, death, or disability.

Cap on taxpayers utilizing Archer MSAs.

The number of taxpayers benefiting annually from an Archer MSA contribution is limited to a threshold level (generally 750,000 taxpayers). If it is determined in a year that the threshold level has been exceeded (called a "cut-off" year) then, in general, for succeeding years during the pilot period 1997-2002, only those individuals who (1) made an Archer MSA contribution or had an employer Archer MSA contribution for the year or a preceding year (i.e., are active Archer MSA participants) or (2) are employed by a participating employer, those individuals are eligible for an Archer MSA contribution. In determining whether the threshold for any year has been exceeded, Archer MSAs of individuals who were not covered under a health insurance plan for the six month period ending on the date on which coverage under a high deductible plan commences would not be taken into account.<sup>34</sup> However, if the threshold level is exceeded in a year, previously uninsured individuals are subject to the same restriction on contributions in succeeding years as other individuals. That is, they would not be eligible for an Archer MSA contribution for a year following a cut-off year unless they are an active Archer MSA participant (i.e., had an Archer MSA contribution for the year or a preceding year) or are employed by a participating employer.

The number of Archer MSAs established has not exceeded the threshold level.

End of Archer MSA pilot program.

After 2002, no new contributions may be made to Archer MSAs except by or on behalf of individuals who previously had Archer MSA contributions and employees who are employed by a participating employer. An employer is a participating employer if (1) the employer made any Archer MSA contributions for any year to an Archer MSA on behalf of employees or (2) at least 20% of the employees covered under a high deductible plan made Archer MSA contributions of at least \$100 in the year 2001. Self-employed individuals who made

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<sup>34</sup> Permitted coverage, as described above, does not constitute coverage under a health insurance plan for this purpose.

## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

contributions to an Archer MSA during the period 1997-2002 also may continue to make contributions after 2002.

### New Federal Law (Sec. 220)

The provision extends the Archer MSA program for another year, through December 31, 2003.

### Effective Date

The provision is effective on January 1, 2002.

### California Law

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

### Impact on California Revenue

The baseline annual revenue losses associated with this provision are expected to be negligible. The revenue losses are baseline because California automatically conformed to this change.

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<u>Section</u>	<u>Section Title</u>
613	Extension of Tax Incentives for Investment on Indian Reservations

### Background

Present law provides the following tax incentives in order to encourage investment on Indian reservations.

Indian employment credit.

A general business credit is available for an employer of qualified employees that work on an Indian reservation. The credit is equal to 20% of the excess of qualified wages and health insurance costs paid to qualified employees in the current year over the amount paid in 1993,

## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

up to a maximum of \$20,000. Wages for which the work opportunity credit is available are not qualified wages and are not eligible for the credit.

Employees generally are qualified employees if they (or their spouse) are enrolled in an Indian tribe and live on or near the Indian reservation where they work, perform services that are all or substantially all within an Indian reservation, and do not receive wages greater than \$30,000 (adjusted for inflation after 1994) for the taxable year. The credit is not available for employees involved in certain gaming activities or who work in a building that houses certain gaming activities.

The Indian employment credit is not available after December 31, 2003.

Accelerated depreciation of property on Indian reservations.

A special depreciation recovery period is available to qualified Indian reservation property. In general, qualified Indian reservation property is property used predominantly in the active conduct of a trade or business within an Indian reservation, which is not used outside the reservation on a regular basis and was not acquired from a related person. Property used to conduct or house certain gaming activities is not qualified Indian reservation property.

The applicable recovery period for qualified Indian reservation property is as follows:

In the case of:	The applicable recovery period is:
3 year property	2 years
5 year property	3 years
7 year property	4 years
10 year property	6 years
15 year property	9 years
20 year property	12 years
Nonresidential real property	22 years

Accelerated depreciation of property on Indian reservations is not available for property placed in service after December 31, 2003.

### New Federal Law (Sec. 45A and 168(j))

The provision extends for one year (i.e., through December 31, 2004) the Indian employment credit and the accelerated depreciation rules for property on Indian reservations.

### Effective Date

The provision is effective on March 9, 2002.

# Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

## California Law

California law does not conform to the Indian employment credit or the accelerated depreciation of property on Indian reservations.

## Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
614	Extension and Modification of Exceptions under Subpart F for Active Financing Income

## Background

Under the subpart F rules, 10% U.S. shareholders of a controlled foreign corporation (“CFC”) are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, foreign personal holding company income and insurance income. In addition, 10% U.S. shareholders of a CFC are subject to current inclusion with respect to their shares of the CFC's foreign base company services income (i.e., income derived from services performed for a related person outside the country in which the CFC is organized).

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities transactions; (4) net gains from foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC's

## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

country of organization is taxable as subpart F insurance income (Prop. Treas. Reg. sec. 1.953-1(a)).

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called “active financing income”).<sup>35</sup>

With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit (“QBU”) of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met. Additional exceptions from foreign personal holding company income apply for certain income derived by a securities dealer within the meaning of section 475 and for gain from the sale of active financing assets.

In the case of insurance, in addition to a temporary exception from foreign personal holding company income for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization, certain temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met.

In the case of a life insurance or annuity contract, reserves for such contracts are determined as follows for purposes of these provisions. The reserves equal the greater of: (1) the net surrender value of the contract (as defined in sec. 807(e)(1)(A)), including in the case of pension plan contracts; or (2) the amount determined by applying the tax reserve method that would apply if the qualifying life insurance company were subject to tax under Subchapter L of the Code, with the following modifications. First, there is substituted for the applicable Federal interest rate an interest rate determined for the functional currency of the qualifying

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<sup>35</sup> Temporary exceptions from the subpart F provisions for certain active financing income applied only for taxable years beginning in 1998. Those exceptions were modified and extended for one year, applicable only for taxable years beginning in 1999. The Tax Relief Extension Act of 1999 (P.L. No. 106-170) clarified and extended the temporary exceptions for two years, applicable only for taxable years beginning after 1999 and before 2002.

## Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

insurance company's home country, calculated (except as provided by the Treasury Secretary in order to address insufficient data and similar problems) in the same manner as the mid-term applicable Federal interest rate (within the meaning of sec. 1274(d)). Second, there is substituted for the prevailing State assumed rate the highest assumed interest rate permitted to be used for purposes of determining statement reserves in the foreign country for the contract. Third, in lieu of U.S. mortality and morbidity tables, mortality and morbidity tables are applied that reasonably reflect the current mortality and morbidity risks in the foreign country. Fourth, the Treasury Secretary may provide that the interest rate and mortality and morbidity tables of a qualifying insurance company may be used for one or more of its branches when appropriate. In no event may the reserve for any contract at any time exceed the foreign statement reserve for the contract, reduced by any catastrophe, equalization, or deficiency reserve or any similar reserve.

Present law also provides a temporary exception from foreign personal holding company income for income from investment of assets equal to 10% of reserves (determined for purposes of the provision) for contracts regulated in the country in which sold as life insurance or annuity contracts. This exception does not apply to investment income with respect to excess surplus.

### New Federal Law (Secs. 953 and 954)

The provision extends for five years the present-law temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business.

The provision generally retains present law with respect to the determination of an insurance company's reserve for a life insurance or annuity contract under these exceptions. The provision does, however, permit a taxpayer in certain circumstances, subject to approval by the IRS through the ruling process or in published guidance, to establish that the reserve for such contracts is the amount taken into account in determining the foreign statement reserve for the contract (reduced by catastrophe, equalization, or deficiency reserve or any similar reserve). IRS approval is to be based on whether the method, the interest rate, the mortality and morbidity assumptions, and any other factors taken into account in determining foreign statement reserves (taken together or separately) provide an appropriate means of measuring income for Federal income tax purposes. In seeking a ruling, the taxpayer is required to provide the IRS with necessary and appropriate information as to the method, interest rate, mortality and morbidity assumptions and other assumptions under the foreign reserve rules so that a comparison can be made to the reserve amount determined by applying the tax reserve method that would apply if the qualifying insurance company were subject to tax under Subchapter L of the Code (with the modifications provided under present law for purposes of these exceptions). The IRS also may issue published guidance indicating its approval. Present law continues to apply with respect to reserves for any life insurance or annuity contract for which the IRS has not approved the use of the foreign statement reserve.

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An IRS ruling request under this provision is subject to the present-law provisions relating to IRS user fees.

### Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 2001, and before January 1, 2007, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

### California Law

In general, California does not conform to the federal rules relating to controlled foreign corporations. However, for California water's-edge purposes, a controlled foreign corporation (CFC) is required to be included in the water's-edge combined report if the CFC has Subpart F income, as defined in Section 952 of the Internal Revenue Code.

The income and apportionment factors of the CFC included within a water's-edge combined report is the CFC's net income and apportionment factors determined under the Revenue and Taxation Code multiplied by the ratio of subpart F income, as defined by Section 952 of the Internal Revenue Code, over earnings and profits, as defined in Section 964 of the Internal Revenue Code.

The deemed dividend treatment for subpart F income prescribed by section 951 of the Code is not applicable for California purposes.

Under California law, insurance companies are generally not subject to the income or franchise tax. Instead, insurers pay a tax based generally on premiums received during the year from business transacted in California. The gross premiums tax rate is set each year and administered by the Insurance Commissioner, the Department of Insurance, and the BoE. Since 1990, the tax has been set at 2.35%.

### Impact on California Revenue

Not applicable.

# Job Creation and Worker Assistance Act of 2002 (P.L. 107-147)

<u>Section</u>	<u>Section Title</u>
615	Repeal of Dyed-Fuel Requirement for Registered Diesel or Kerosene Terminals

## Background

Excise taxes are imposed on highway motor fuels, including gasoline, diesel fuel, and kerosene, to finance the Highway Trust Fund programs. Subject to limited exceptions, these taxes are imposed on all such fuels when they are removed from registered pipeline or barge terminal facilities, with any tax-exemptions being accomplished by means of refunds to consumers of the fuel. One such exception allows removal of diesel fuel or kerosene without payment of tax if the fuel is destined for a nontaxable use (e.g., use as heating oil) and is indelibly dyed.

Terminal facilities are not permitted to receive and store non-tax-paid motor fuels unless they are registered with the Internal Revenue Service. Under present law, a prerequisite to registration is that if the terminal offers for sale diesel fuel, it must offer both dyed and undyed diesel fuel. Similarly, if the terminal offers for sale kerosene, it must offer both dyed and undyed kerosene. This “dyed-fuel mandate” was enacted in 1997, to be effective on July 1, 1998. Subsequently, the effective date was delayed until July 1, 2000, and later until January 1, 2002.

## New Federal Law

The diesel fuel and kerosene dyeing mandate is repealed.

## Effective Date

The provision is effective on January 1, 2002.

## California Law

California excise taxes are administered by the BoE.

## Impact on California Revenue

Defer to the BoE.



# Clergy Housing Allowance Clarification Act of 2002 (P.L. 107-181)

<u>Section</u>	<u>Section Title</u>
2	Clarification of Parsonage Allowance Exclusion

## Background

Section 107 of the IRC provides that a minister of the gospel's gross income does not include: (1) the rental value of a home furnished as part of his or her compensation; or (2) the rental allowance paid as part of his or her compensation, to the extent used to rent or provide a home. The IRS's position (Rev. Rul. 71-280, 1971-2 C.B. 92) is that the amount of the section 107 rental allowance exclusion may not exceed the fair rental value of the home plus the cost of the utilities.

In *Warren v. Commissioner*, 114 T.C. No. 23 (2000), the Tax Court ruled that the section 107 rental allowance exclusion is limited to the amount used to provide the home, and not the fair rental value of the home. That case was appealed to the United States Court of Appeals for the Ninth Circuit. Subsequent to the enactment of P.L. 107-181, that appeal was dismissed (302 F.3d 1012).

## New Federal Law (Sec. 107)

The Act clarifies that the amount of the section 107 rental allowance exclusion may not exceed the fair rental value of the home (including furnishings and appurtenances) plus the cost of utilities.

## Effective Date

The Act is generally applicable for taxable years beginning on or after December 31, 2001. The Act also applies to taxable years beginning before January 1, 2002, for which the taxpayer: (1) filed a tax return before April 17, 2002, indicating that the section 107 rental allowance exclusion is limited to the fair rental value of the home (including furnishings and appurtenances) plus the cost of utilities; or (2) files a return after April 16, 2002. Other tax returns for taxable years beginning before January 12, 2002, are not subject to the fair rental value limitation added by the bill.

## California Law

California is in conformity with federal law as it read on January 1, 2001, as it relates to the parsonage allowance exclusion. California law has not conformed to the changes made to the IRC by the Clergy Housing Allowance Clarification Act of 2002.

## Impact on California Revenue

Conforming to these federal provisions would have negligible impact on state revenues.

## Trade Act of 2002 (P.L. 107-210)

<u>Section</u>	<u>Section Title</u>
201-203	Credit for Health Insurance Costs of Eligible Individuals

### Background

Under present law, the tax treatment of health insurance expenses depends on the individual's circumstances. In general, employer contributions to an accident or health plan are excludable from an employee's gross income.

Self-employed individuals are entitled to deduct a portion of the amount paid for health insurance expenses for the individual and his or her spouse and dependents. The percentage of deductible expenses is 70% in 2002 and 100% in 2003 and thereafter.

Individuals other than self-employed individuals who purchase their own health insurance and itemize deductions may deduct their expenses to the extent that their total medical expenses exceed 7.5% of adjusted gross income.

Present law does not provide a tax credit for the purchase of health insurance.

The health care continuation rules (commonly referred to as "COBRA" rules, after the Consolidated Omnibus Budget Reconciliation Act of 1985 in which they were enacted) require that employer-sponsored group health plans of employers with 20 or more employees must offer certain covered employees and their dependents ("qualified beneficiaries") the option of purchasing continued health coverage in the event of loss of coverage resulting from certain qualifying events. These qualifying events include: termination or reduction in hours of employment, death, divorce or legal separation, enrollment in Medicare, the bankruptcy of the employer, or the end of a child's dependency under a parent's health plan. In general, the maximum period of COBRA coverage is 18 months. An employer is permitted to charge qualified beneficiaries 102% of the applicable premium for COBRA coverage.

Under present law, individuals without access to COBRA are able to purchase individual policies on a guaranteed issue basis without exclusion of coverage for pre-existing conditions if they had 18 months of creditable coverage under an employer sponsored group health plan, governmental plan, or a church plan. Those with access to COBRA are required to exhaust their 18 months of COBRA prior to obtaining a policy on a guaranteed issue basis without exclusion of coverage for pre-existing conditions.

### New Federal Law (Sec. 35, 6050T, 7213A, 7501)

#### *Refundable health insurance credit: in general*

In the case of taxpayers who are eligible individuals, the act provides a refundable tax credit for 65% of the taxpayer's expenses for qualified health insurance of the taxpayer and qualifying family members for each eligible coverage month beginning in the taxable year. The credit is available only with respect to amounts paid by the taxpayer.

## Trade Act of 2002 (P.L. 107-210)

Qualifying family members are the taxpayer's spouse and any dependent of the taxpayer with respect to whom the taxpayer is entitled to claim a dependency exemption.<sup>36</sup>

Any individual who has other specified coverage is not a qualifying family member.

### Persons eligible for the credit

Eligibility for the credit is determined on a monthly basis. In general, an eligible coverage month is any month if, as of the first day of the month, the taxpayer (1) is an eligible individual, (2) is covered by qualified health insurance, (3) does not have other specified coverage, and (4) is not imprisoned under Federal, State, or local authority. In the case of a joint return, the eligibility requirements are met if at least one spouse satisfies the requirements. An eligible month must begin more than 90 days after August 6, 2002.

An eligible individual is (1) an eligible Trade Adjustment Assistance (TAA) recipient, (2) an eligible alternative TAA recipient, and (3) an eligible Pension Benefit Guaranty Corporation (PBGC) pension recipient.

An individual is an eligible TAA recipient during any month if the individual (1) is receiving for any day of such month a trade adjustment allowance<sup>37</sup> or who would be eligible to receive such an allowance but for the requirement that the individual exhaust unemployment benefits before being eligible to receive an allowance and (2) with respect to such allowance, is covered under a certification issued under subchapter A or D of chapter 2 of title II of the Trade Act of 1974. An individual is treated as an eligible TAA recipient during the first month that such individual would otherwise cease to be an eligible TAA recipient.

An individual is an eligible alternative TAA recipient during any month if the individual (1) is a worker described in section 246(a)(3)(B) of the Trade Act of 1974 who is participating in the program established under section 246(a)(1) of such Act, and (2) is receiving a benefit for such month under section 246(a)(2) of such Act. An individual is treated as an eligible alternative TAA recipient during the first month that such individual would otherwise cease to be an eligible TAA recipient.

An individual is a PBGC pension recipient for any month if he or she (1) is age 55 or over as of the first day of the month, and (2) is receiving a benefit any portion of which is paid by the Pension Benefit Guaranty Corporation (PBGC).

An otherwise eligible taxpayer is not eligible for the credit for a month if, as of the first day of the month the individual has other specified coverage. Specified coverage would be (1)

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<sup>36</sup>Present law allows the custodial parent to release the right to claim the dependency exemption for a child to the noncustodial parent. In addition, if certain requirements are met, the parents may decide by agreement that the noncustodial parent is entitled to the dependency exemption with respect to a child. In such cases, the provision would treat the child as the dependent of the custodial parent for purposes of the credit.

<sup>37</sup> Part I of subchapter B, or subchapter D, of chapter 2 of title II of the Trade Act of 1974.

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coverage under any insurance which constitutes medical care (except for insurance substantially all of the coverage of which is for excepted benefits)<sup>38</sup> if at least 50 percent of the cost of the coverage is paid by an employer<sup>39</sup> (or former employer) of the individual or his or her spouse or (2) coverage under certain governmental health programs.<sup>40</sup> A rule aggregating plans of the same employer applies in determining whether the employer pays at least 50% of the cost of coverage. A person is not an eligible individual if he or she may be claimed as a dependent on another person's tax return. A special rule applies with respect to alternative TAA recipients.

### *Qualified health insurance*

Qualified health insurance eligible for the credit is: (1) COBRA continuation coverage; (2) State based continuation coverage provided by the State under a State law that requires such coverage; (3) coverage offered through a qualified State high risk pool; (4) coverage under a health insurance program offered to State employees or a comparable program; (5) coverage through an arrangement entered into by the State and a group health plan, an issuer of health insurance coverage, an administrator, or an employer; (6) coverage offered through a State arrangement with a private sector health care coverage purchasing pool; (7) coverage under a State-operated health plan that does not receive any Federal financial participation; (8) coverage under a group health plan that is available through the employment of the eligible individual's spouse; and (9) coverage under individual health insurance if the eligible individual was covered under individual health insurance during the entire 30-day period that ends on the date the individual became separated from the employment which qualified the individual for the TAA allowance, the benefit for an eligible alternative TAA recipient, or a pension benefit from the PBGC, whichever applies.<sup>41</sup>

Qualified health insurance does not include any State-based coverage (i.e., coverage described in (2)-(8) in the preceding paragraph), unless the State has elected to have such

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<sup>38</sup> Excepted benefits are: (1) coverage only for accident or disability income or any combination thereof; (2) coverage issued as a supplement to liability insurance; (3) liability insurance, including general liability insurance and automobile liability insurance; (4) worker's compensation or similar insurance; (5) automobile medical payment insurance; (6) credit-only insurance; (7) coverage for on-site medical clinics; (8) other insurance coverage similar to the coverages in (1)-(7) specified in regulations under which benefits for medical care are secondary or incidental to other insurance benefits; (9) limited scope dental or vision benefits; (10) benefits for long-term care, nursing home care, home health care, community-based care, or any combination thereof. and (11) other benefits similar to those in (9) and (10) as specified in regulations. (12) coverage only for a specified disease or illness; (13)-hospital indemnity or other fixed indemnity insurance; and (14) Medicare supplemental insurance.

<sup>39</sup> An amount would be considered paid by the employer if it is excludable from income. Thus, for example, amounts paid for health coverage on a salary reduction basis under an employer plan are considered paid by the employer.

<sup>40</sup> Specifically, an individual would not be eligible for the credit if, as of the first day of the month, the individual is (1) entitled to benefits under Medicare Part A, enrolled in Medicare Part B, or enrolled in Medicaid or SCHIP, (2) enrolled in a health benefits plan under the Federal Employees Health Benefit Plan, or (3) entitled to receive benefits under chapter 55 of title 10 of the United States Code (relating to military personnel). An individual is not considered to be enrolled in Medicaid solely by reason of receiving immunizations.

<sup>41</sup> For this purpose, "individual health insurance" means any insurance which constitutes medical care offered to individuals other than in connection with a group health plan. Such term does not include Federal- or State-based health insurance coverage.

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coverage treated as qualified health insurance and such coverage meets certain requirements. Such State coverage must provide that each qualifying individual is guaranteed enrollment if the individual pays the premium for enrollment or provides a qualified health insurance costs eligibility certificate and pays the remainder of the premium. In addition, the State-based coverage cannot impose any pre-existing condition limitation with respect to qualifying individuals. State-based coverage cannot require a qualifying individual to pay a premium or contribution that is greater than the premium or contribution for a similarly situated individual who is not a qualified individual. Finally, benefits under the State-based coverage must be the same as (or substantially similar to) benefits provided to similarly situated individuals who are not qualified individuals. A qualifying individual is an eligible individual who seeks to enroll in the State-based coverage and who has aggregate periods of creditable coverage<sup>42</sup> of three months or longer, does not have other specified coverage, and who is not imprisoned. A qualifying individual also includes qualified family members of such an eligible individual.

Qualified health insurance does not include coverage under a flexible spending or similar arrangement or any insurance if substantially all of the coverage is of excepted benefits.

### *Other rules*

Amounts taken into account in determining the credit could not be taken into account in determining the amount allowable under the itemized deduction for medical expenses or the deduction for health insurance expenses of self-employed individuals. Amounts distributed from a medical savings account would not be eligible for the credit. The amount of the credit is reduced by any credit received on an advance basis. Married taxpayers filing separate returns are eligible for the credit; however, if both spouses are eligible individuals and the spouses file a separate return, then the spouse of the taxpayer is not a qualifying family member.

The Secretary of the Treasury is authorized to prescribe such regulations and other guidance as may be necessary or appropriate to carry out the provision.

### *Advance payment of refundable health insurance credit; reporting requirements*

The Act provides for payment of the credit on an advance basis (i.e., prior to the filing of the taxpayer's return) pursuant to a program to be established by the Secretary of the Treasury no later than August 1, 2003. Such program is to provide for making payments on behalf of certified individuals to providers of qualified health insurance. In order to receive the credit on an advance basis, a qualified health insurance costs credit eligibility certificate would have to be in effect for the taxpayer. A qualified health insurance costs credit eligibility certificate is a written statement that an individual is an eligible individual for purposes of the credit, provides

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<sup>42</sup> Creditable coverage is determined under the Health Care Portability and Accountability Act (Code sec. 9801 (c)).

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such information as the Secretary of the Treasury may require, and is provided by the Secretary of Labor or the PBGC (as appropriate) or such other person or entity designated by the Secretary.

The Act permits the disclosure of return information of certified individuals to providers of health insurance information to the extent necessary to carry out the advance payment mechanism.

The Act provides that any person who receives payments during a calendar year for qualified health insurance and claims a reimbursement for an advance credit amount is to file an information return with respect to each individual from whom such payments were received or for whom such a reimbursement is claimed. The return is to be in such form as the Secretary may prescribe and is to contain the name, address, and taxpayer identification number of the individual and any other individual on the same health insurance policy, the aggregate of the advance credit amounts provided, the number of months for which advance credit amounts are provided, and such other information as the Secretary may prescribe. The Act requires that similar information be provided to the individual no later than January 31 of the year following the year for which the information return is made.

### Effective Date

The provision is generally effective with respect to taxable years beginning after December 31, 2001. The provision relating to the advance payment mechanism to be developed by the Secretary would be effective on August 6, 2002.

### California Law

California law does not provide a tax credit for the purchase of health insurance. California law, however, is in conformity with federal law as it read on January 1, 2001, as it relates to the tax treatment (deduction or exclusion) of health insurance expenses.

### Impact on California Revenue

Not applicable.

# An Act to Amend Section 527 of the IRC (P.L. 107-276)

<u>Section</u>	<u>Section Title</u>
1-6	Exemption for Certain State and Local Political Committees from Notification Requirements

## Background

### *In general*

Under present law, section 527 provides a limited tax-exempt status to "political organizations," meaning a party, committee, association, fund, or other organization (whether or not incorporated) organized and operated primarily for the purpose of directly or indirectly accepting contributions or making expenditures (or both) for an "exempt function." These organizations generally are exempt from federal income tax on their "exempt function income" (e.g., contributions they receive, membership dues, other income related to an exempt function) but are subject to tax on their net investment income and certain other income at the highest corporate income tax rate (political organization taxable income). Donors are exempt from gift tax on their contributions to such organizations. For purposes of section 527, the term "exempt function" means: the function of influencing or attempting to influence the selection, nomination, election, or appointment of any individual to any federal, state, or local public office or office in a political organization, or the election of Presidential or Vice-Presidential electors, whether or not such individual or electors are selected, nominated, elected, or appointed.

### *Notice of formation as a section 527 organization*

An organization is not treated as a section 527 organization unless it has given notice to the Secretary of the Treasury (Secretary), electronically and in writing, that it is a section 527 organization. The notice is not required (1) of any person required to report as a political committee under the Federal Election Campaign Act of 1971, (2) by organizations that reasonably anticipate that their annual gross receipts always will be less than \$25,000, and (3) organizations described in section 501(c). All other section 527 organizations, including state and local candidate committees and state and local party committees, are required to file the notice.

The notice is required to be transmitted no later than 24 hours after the date on which the organization is organized. The notice is required to include the following information: (1) the name and address of the organization and its electronic mailing address, (2) the purpose of the organization, (3) the names and addresses of the organization's officers, highly compensated employees, contact person, custodian of records, and members of the organization's Board of Directors, (4) the name and address of, and relationship to, any related entities, and (5) such other information as the Secretary may require.

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The organization and the Internal Revenue Service ("IRS") are required to make the notice of status as a section 527 organization open to public inspection. In addition, the Secretary is required to make publicly available on the Internet and at the offices of the IRS a list of all political organizations that file a notice with the Secretary under section 527 and the name, address, electronic mailing address, custodian of records, and contact person for such organization. The IRS is required to make this information available within five business days after the Secretary receives a notice from a section 527 organization.

An organization that fails to file a notice with the Secretary is not treated as a section 527 organization and its exempt function income is taken into account in determining taxable income.

### *Disclosure of expenditures and contributors*

A political organization that accepts a contribution or makes an expenditure for an exempt function during any calendar year is required to file with the Secretary certain reports. The following reports are required: either (1) in the case of a calendar year in which a regularly scheduled election is held, quarterly reports, a pre-election report, and a post-general election report and, in the case of any other calendar year, a report covering January 1 to June 30 and a report covering July 1 to December 31, or (2) monthly reports for the calendar year, except that, in lieu of the reports due for November and December of any year in which a regularly scheduled general election is held, a pre-general election report, a post-general election report, and a year end report are to be filed. A political organization may choose to file pursuant to either option described above, but it must file on the same basis for the entire calendar year. An amount to be paid by the organization is imposed for a failure to file a report or to provide the required information in the report.

The reports are required to include the following information: (1) the amount of each expenditure made to a person if the aggregate amount of expenditures to such person during the calendar year equals or exceeds \$500 and the name and address of the person (in the case of an individual, including the occupation and name of the employer of the individual); and (2) the name and address (in the case of an individual, including the occupation and name of employer of such individual) of all contributors that contributed an aggregate amount of \$200 or more to the organization during the calendar year and the amount of the contribution.

The disclosure requirements do not apply (1) to any person required to report as a political committee under the Federal Election Campaign Act of 1971, (2) to any state or local committee of a political party or political committee of a state or local candidate, (3) to any organization that reasonably anticipates that it will not have gross receipts of \$25,000 or more for any taxable year, (4) to any organization described in section 501(c), or (5) with respect to any expenditure that is an independent expenditure (as defined in section 301 of the Federal Election Campaign Act of 1971).



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For purposes of the disclosure requirements, the term "election" means (1) a general, special, primary, or runoff election for a federal office, (2) a convention or caucus of a political party that has authority to nominate a candidate for federal office, (3) a primary election held for the selection of delegates to a national nominating convention of a political party, or (4) a primary election held for the expression of a preference for the nomination of individuals for election to the office of President.

The IRS is required to make available to the public any report filed by a political organization. In addition, the organization is required to make any such report available to the public for inspection at the organization's principal office (and in certain cases, regional or district offices) during regular business hours, and provide a copy of such report upon a request made in person or in writing.

### *Return requirements*

Under present law, a section 527 organization that has political organization taxable income is required annually to file Form 1120-POL (Return for Certain Political Organizations). Section 527 organizations (other than organizations described in section 501(c)) that do not have political organization taxable income but have gross receipts of \$25,000 or more during the taxable year also are required to file a Form 1120-POL. In addition, section 527 organizations that are required to file Form 1120-POL also are required to file an annual information return, Form 990 (Return of Organization Exempt from Income Tax). The annual tax return and the annual information return must be made available to the public both by the organization and by the IRS.

### New Federal Law (Sec. 527)

#### *Notice of formation and purpose (sections 1, 6(c), (f), and (g) of the Act)*

The Act provides that a political organization that is a political committee of a state or local candidate, or that is a state or local committee of a political party, is exempt from the requirement of section 527(i) to provide notice to the Secretary of its formation and purpose.

For all political organizations subject to the notice filing requirement, the Act provides that the notice be filed electronically only, thus eliminating the requirement that the notice be filed in writing as well as electronically.

In addition, the Act requires that an organization that is required to file the notice and that intends to claim exemption from the expenditure and contribution reporting requirements of section 527(j), or the information return requirements of section 6033, state such intention in the notice. If there is a material change to information provided in the notice, the organization must file a new notice not later than 30 days after the material change. An organization that fails to file a new notice is not treated as a section 527 organization and its exempt function

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income is taken into account in determining taxable income from the date of the material change until such time as a modified notice is filed.

### *Disclosure of expenditures and contributor:* Exemption for qualified state or local political organizations

The Act exempts qualified state or local political organizations from the requirement provided by section 527(j)(2) to file regular reports with the Secretary detailing contribution and expenditure information. For this purpose, a qualified state or local political organization means an organization meeting the following requirements.

First, the organization must not engage in any exempt function activities other than to influence or attempt to influence the selection, nomination, election, or appointment of any individual to any state or local public office or office in a state or local political organization.

Second, the organization must be subject to a state law that requires the organization to report (and it so reports) information regarding each separate expenditure and contribution (including information regarding the person who makes such contribution or receives such expenditure) that otherwise would be required to be reported to the Secretary. An organization would not fail this condition solely because: (1) the minimum amount of any expenditure or contribution required to be reported under state law is not more than \$300 greater than the minimum amount required to be reported to the Secretary; (2) state law does not require the organization to report the employer or occupation of any person who makes contributions or receives expenditures, or the date of the contribution, or the date or purpose of any expenditure of the organization; or (3) the organization makes de minimis errors in complying with state law reporting requirements, so long as such errors are corrected within a reasonable period after the organization becomes aware of such errors.

Third, the state agency receiving such information must make the information public. In addition, the organization must make the information public in a manner described in section 6104(d). De minimis errors in making the information publicly available that are corrected within a reasonable period after the organization becomes aware of such errors are permitted.

Fourth, no candidate for nomination or election to federal elective public office or individual holding such office is permitted to control or materially participate in the direction of the organization, solicit contributions to the organization (with an exception for certain de minimis contributions), or direct, in whole or in part, disbursements by the organization.

### Other provisions

The Act provides that section 527(j) reports include the date and purpose (in addition to the amount) of each expenditure of \$500 or more and the date of each contribution of \$200 or more. In addition, the Act mandates electronic filing of section 527(j) reports for organizations

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that have, or have reason to expect, contributions or expenditures exceeding \$50,000 in a calendar year.

### *Tax and information return requirements (sec. 3 of the Act)*

The Act provides that a political organization is required to file an income tax return (Form 1120-POL) only if such organization has political organization taxable income for the taxable year. Thus, political organizations without political organization taxable income and with gross receipts of at least \$25,000 for the taxable year are no longer required to file an income tax return. In addition, the Form 1120-POL is no longer required to be publicly available.

The Act modifies the present law rule that an information return (Form 990) is required to be filed by organizations that are required to file an income tax return. Instead, under the Act, information returns are required for political organizations that have gross receipts of \$25,000 or more for the taxable year except that, for qualified state or local political organizations, the gross receipts threshold is \$100,000. In addition, the Act exempts the following organizations from the information return filing requirement: (1) a state or local committee of a political party, or a political committee of a state or local candidate; (2) a caucus or association of state or local officials; (3) an authorized committee (as defined in section 301(6) of the Federal Election Campaign Act of 1971) of a candidate for federal office; (4) a national committee (as defined in section 301(14) of the Federal Election Campaign Act of 1971) of a political party; (5) a U.S. House of Representatives or U.S. Senate campaign committee of a political party committee; (6) a political committee (as defined in section 301(4) of the Federal Election Campaign Act of 1971) required to report under such Act; or (7) an organization described in section 501(c). In addition, the Act directs the Secretary to review the information return for possible modification. Also, the Secretary retains the discretion to waive the information return filing requirement.

### *Public availability of notices and reports*

Under the Act, the Secretary must make the section 527(i) notices and the electronically filed section 527(j) reports available for public inspection on the Internet not later than 48 hours of filing, and must make the entire database of such notices and reports searchable by names, states, zip codes, custodians of records, directors, and general purposes of the organization; entities related to the organization; contributors to the organization; employers of contributors; recipients of expenditures by the organization; ranges of contributions and expenditures; and time periods of the notices and reports. In addition, the database must be downloadable.

### *Other provisions and technical corrections (secs. 4, 5, 6(a), (b), (d), and 7 of the Act)*

The Act gives the Secretary the authority to waive all or any portion of the taxes imposed on an organization for failure to notify the Secretary of the organization's establishment (or to file a modified notice) or the amounts imposed for failure to file a report. Such waiver would be

## An Act to Amend Section 527 of the IRC (P.L. 107-276)

subject to a showing by the organization that the failure was due to reasonable cause and not to willful neglect.

The Act further provides that the Secretary in consultation with the Federal Election Commission shall publicize the effects of the Act and the interaction of the requirements to file a notification or report under section 527 and reports under the Federal Election Campaign Act of 1971.

Finally, the Act makes the following modifications. The Act clarifies that in computing taxable income for organizations that fail to notify the Secretary of their status as a political organization, all exempt function income, whether or not segregated for use for an exempt function, is taken into account. The Act also clarifies that amounts imposed for failure to report under section 527(j) are to be assessed and collected in the same manner as penalties imposed on exempt organizations for failure to file returns (sec. 6652(c)). The Act applies the penalty for fraudulent returns, statements, or other documents (sec. 7207) to the notification (sec. 527(i)) and reporting (sec. 527(j)) requirements of political organizations. In addition, the Act provides that notices and reports already made public by the Secretary may remain public, even if the retroactive effective dates of certain parts of the Act mean that a notice or report was not required to have been filed.

### Effective Date

The provision exempting certain organizations from the filing of notice requirement and the provision regarding electronic filing are effective as if included in the amendments made by Public Law Number 106-230.

The provision requiring that an organization indicate its intent to claim a section 527(j) or section 6033 exemption is effective for notices required to be filed more than 30 days after November 2, 2002.

The provision requiring filing of a modified section 527(i) notice upon a material change in information generally is effective for material changes occurring on or after November 2, 2002. However, a transition rule applies in the case of material changes that occur during the 30-day period beginning on November 2, 2002. In such cases, the notice is not required to be filed before the later of: (1) 30 days after the date of the material change, or (2) 45 days after November 2, 2002.

The provision exempting qualified state or local political organizations from the section 527(j) reporting requirements is effective as if included in the amendments made by Public Law Number 106-230.

The provision requiring additional disclosures in the section 527(j) reports is effective for reports required to be filed more than 30 days after November 2, 2002. The provision regarding electronic filing is effective for reports required to be filed on or after June 30, 2003.

## An Act to Amend Section 527 of the IRC (P.L. 107-276)

The provisions regarding tax and information return requirements are effective as if included in the amendments made by Public Law Number 106-230.

The provision regarding public availability of notices and reports is effective for notices and reports required to be filed on or after June 30, 2003.

The provision giving the Secretary the authority to waive penalties and amounts is effective for any tax assessed or amount imposed after June 30, 2000.

The remaining provisions are effective on November 2, 2002.

### California Law

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

Another significant difference is that California has not conformed to the changes in federal law enacted in 2000 by Public Law No. 106-230.

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

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

Any information reported on a tax return is confidential and may not be disclosed by the Franchise Tax Board. Limited exceptions that permit disclosure include "extraneous information as defined in R&TC Section 19543. California does not have any law requiring an exempt organization to disclose its return or its exemption application upon request.

### Impact on California Revenue

Not applicable.

Veterans Improvement Act of 2002  
(P.L. 107-330)

<u>Section</u>	<u>Section Title</u>
306	Extension of Authority to Disclose Certain Return Information

Under existing law the Commissioner of Social Security and the Internal Revenue Service are authorized to disclose certain tax return information to the Department of Veterans Affairs for purposes of administering several programs that provide benefits for veterans. These programs are: 1) any needs-based pension provided under chapter 15 of title 38, United States Code, 2) parents' dependents and indemnity compensation provided under section 1315 of title 38, United States Code, 3) health care services provided under certain sections of title 38, United States Code, and 4) compensation paid under chapter 11 of title 38, United States Code, in certain circumstances. The authority of the Commissioner of Social Security and the Internal Revenue Service to disclose return information expires on September 30, 2003.

New Federal Law (Sec. 6103(l)(7)(D)(ix))

The Act extends the authority to disclose to September 30, 2008.

California Law

Not applicable.

# Holocaust Restitution Tax Fairness Act of 2002 (P.L. 107-358)

<u>Section</u>	<u>Section Title</u>
2	Repeal of Sunset Date for Exclusion from Income Tax for Restitution Received by Victims of Nazi Regime

## Background

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

Like all other provisions contained in EGTRA of 2001, the above provision sunsets on December 31, 2010.

## New Federal Law

The Act repeals the sunset date contained in EGTRA as it relates to restitution payments received by holocaust victims. Therefore, restitution payments received by holocaust victims are permanently excludable from income.

## Holocaust Restitution Tax Fairness Act of 2002 (P.L. 107-358)

### California Law

Similar to federal law, discussed above, California law excludes from an individual's gross income "excludable restitution payments" and their related "excludable interest" (Stats. 2002, Ch. 701). However, unlike federal law, California has no sunset provision.

### Impact on California Revenue

Conforming to these federal provisions would have no impact on state revenues since California law currently excludes from an individual's gross income "excludable restitution payments" and their related "excludable interest".



**EXHIBIT A**  
**EXPIRING TAX PROVISIONS**

<u>Calif. Sunset*</u>	<u>Calif. Section</u>	<u>Federal Section</u>	<u>Fed. Sunset</u>	<u>Description and Comments</u>
06/30/03	19444	N/A	N/A	Administration: High Risk Collection Procedures
12/31/03 <sup>1</sup>	17053.49 23649	N/A	N/A	Credit: Manufacturers' Investment
12/31/03	17276.3 24416.3	172	N/A	Deduction: NOL Suspension
12/31/03	18785	N/A	N/A	Voluntary Contribution: D.A.R.E. California (Drug Abuse Resistance Education) Fund
12/31/03	18816	N/A	N/A	Voluntary Contribution: California Public School Library Protection Fund
12/31/03	18855	N/A	N/A	Voluntary Contribution: Emergency Food Assistance Program
12/31/03	19559	6103(i)	1/1/04	Administration: Terrorism Disclosure Procedures
05/31/04 <sup>2</sup>	17053.46 23646	N/A	N/A	Credit: Hiring in the Local Agency Military Base Recovery Area
05/31/04 <sup>2</sup>	17268 24356.8	N/A	N/A	Deduction: Expensing Business Property in Local Agency Military Base Recovery Area
05/31/04 <sup>2</sup>	17276.2 24416.2	N/A	N/A	Deduction: Net Operating Losses in the Local Agency Military Base Recovery Area
12/31/04	18724	N/A	N/A	Voluntary Contribution: California Fund for Senior Citizens
12/31/04	18824	N/A	N/A	Voluntary Contribution: Mexican American Veterans' Memorial Account
12/31/04	18865	N/A	N/A	Voluntary Contribution: Birth Defects Research Fund
12/31/04	18766	N/A	N/A	Voluntary Contribution: Alzheimer's Disease and Related Disorders Research Fund
12/31/05	17053.36 17053.37 23636 23637	N/A	N/A	Credit: Joint Strike Fighters Wage & Property
12/31/05	17053.84 23684	N/A	N/A	Credit: Solar Energy
12/31/05	18804	N/A	N/A	Voluntary Contribution: California Firefighter Memorial Fund
12/31/05	18807	N/A	N/A	Voluntary Contribution: California Peace Officer Memorial Fund

## EXHIBIT A

### EXPIRING TAX PROVISIONS

<u>Calif. Sunset*</u>	<u>Calif. Section</u>	<u>Federal Section</u>	<u>Fed. Sunset</u>	<u>Description and Comments</u>
12/31/05	19283	N/A	N/A	Administration: Court Imposed Amounts Collection Study
12/31/05	21028	Title 31	Perm.	Taxpayer's Bill of Rights: Attorney Client Privilege
12/31/06	17052.17 23638	45F	Perm	Credit: Employer Child Care Facility
12/31/06	17052.18 23617.5	N/A	N/A	Credit: Employer Dependent Care Plan
12/31/06	17053.57 23657	N/A	N/A	Credit: Community Development Financial Institution Deposits
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
12/31/07	18716	N/A	N/A	Voluntary Contribution: State Children Trust Fund
12/31/07	18744	N/A	N/A	Voluntary Contribution: Rare & Endangered Species Preservation Fund
12/31/07	18796	N/A	N/A	Voluntary Contribution: California Breast Cancer Research Fund
12/31/07	18835	N/A	N/A	Voluntary Contribution: Asthma & Lung Disease

#### Footnotes

This table only extends out eight years.

- \* In general, this is the last taxable year to which the provision applies. Fiscal years beginning within this taxable year are, in general, also covered by the provision. In some cases, the expiration applies to transactions occurring after this date.
1. The actual date this provision expires is unknown at this time. The law provides that the credit will expire on January 1, 2001, or on January of the earliest year thereafter, if the total employment in this state on the preceding January 1 does not exceed by 100,000 jobs the total employment in this state on January 1, 1994. EDD has made this determination for 2003 and has certified the availability of the credit. The expiration date listed is the earliest date the credit could expire.
  2. The LAMBRA provisions expire eight years after one of two events occur. The expiration date listed for LAMBRAs is the earliest date the tax preferences or incentives can expire.

## EXHIBIT B

Conformity Revenue Estimates for H.R. 3090, Job Creation and Worker Assistance Act Of 2002  
Effective Date –Tax Years Beginning after 12/31/01 Unless Otherwise Noted  
Assumed Enactment After June 30, 2003

	Provisions	Footnotes	State Revenue Impact (in millions)		
			2003-4	2004-5	2005-6
<b>Act Section</b>	<i>Conformity Items</i>				
101	Special Depreciation Allowance for Certain Property	PPIS 9/10/01- 9/10/04	-\$400	-\$195	-\$70
102	Five- Year Carryback of Net Operating Losses		N/A	N/A	N/A
301	Expansion of Work Opportunity Tax Credit Targeted Categories to Include Certain Employees in New York City		N/A	N/A	N/A
301	Special Depreciation Allowance for Certain Property		Negl. Loss	Negl. Loss	Negl. Loss
301	Authorize Issuance of Tax-Exempt Private Activity Bonds for Rebuilding the Portion of New York City Damaged in the September 11, 2001, Terrorist Attack		N/A	N/A	N/A
301	Allow One Additional Advance Refunding for Certain Previously Refunded Bonds for Facilities Located in New York City		N/A	N/A	N/A
301	Increase in Expensing Treatment for Business Property Used in the New York Liberty Zone 21		Negl. Loss	Negl. Loss	Negl. Loss
301	Extension of Replacement Period for Certain Property Involuntarily Converted in the New York Liberty Zone		Negl. Loss	Negl. Loss	Negl. Loss
301	Treatment of Qualified Leasehold Improvement Property		Negl. Loss	Negl. Loss	Negl. Loss
401	Allowance of Electronic Forms 1099		-	-	-
402	Discharge of Indebtedness of an S Corporation (Occurring after 10/11/01)		-	-	-
403	Limitation on Use of Non-Accrual Experience Method of Accounting (TYE after 3/9/02)		\$3.5	\$1	minor
404	Expansion of the Exclusion from Income for Qualified Foster Care Payments		-\$5	-\$3	-\$3
405	Interest Rate Used in Determining Additional Required Contributions to Defined Benefit Plans and PBGC Variable Rate Premiums (Plan Yrs. After 12/31/01, before 1/1/04)	a/	*	*	*
406	Deduction for Classroom Materials (TY 2002 +2003)		-\$10		
401-418	TAX TECHNICAL CORRECTIONS				
601	Extend Alternative Minimum Tax Relief for Individuals		N/A	N/A	N/A

602	Extend Credit for Purchase of Electric Vehicles		N/A	N/A	N/A
603	Extend Section 45 Credit for Production of Electricity from Wind, Closed Loop Biomass and Poultry Litter		N/A	N/A	N/A
604	Extend the Work Opportunity Tax Credit		N/A	N/A	N/A
605	Extend the Welfare-To-Work Tax Credit		N/A	N/A	N/A
606	Extend Deduction for Qualified Clean-Fuel Vehicle Property and Qualified Clean Vehicle Refueling Property	b/	-\$10	-\$4	-\$2
607	Taxable Income Limit on Percentage Depletion for Marginal Production (TY 2002 +2003)		-\$1	-\$1	-
608	Extension of Authority to Issue Qualified Zone Academy Bonds		N/A	N/A	N/A
609	Extension of Increase Coverover Payments to Puerto Rico and the Virgin Islands		N/A	N/A	N/A
101	Tax on Failure to Comply with Mental Health Parity Requirements		N/A	N/A	N/A
611	Suspension of Reduction of Deductions for Mutual Life Insurance Companies		N/A	N/A	N/A
612	Extension of Archer Medical Savings Account (MSA)		-	-	-
613	Extension of Tax Incentives for Investment on Indian Reservations		N/A	N/A	N/A
614	Extension and Modification of Exceptions under Subpart F for Active Financing Income 63		N/A	N/A	N/A
615	Repeal of Dyed-Fuel Requirement for Registered Diesel or Kerosene Terminals		N/A	N/A	N/A
2	Clarification of Parsonage Allowance Exclusion		Negl. Gain	Negl. Gain	Negl. Gain
201-203	Credit for Health Insurance Costs of Eligible Individuals (Trade Act of 2002)		N/A	N/A	N/A
	<b>TOTALS</b>		-\$422.5	-\$202	-\$75

Estimates above exclude "baseline" revenue effects that would occur independently of state conformity legislation.

N/A = Not applicable.

Negligible = not exceeding \$250,000

Minor = not exceeding \$500,000

**Legend for "Footnotes" column:**

PPIS - Property placed in service

a/ A baseline reporting issue for state tax purposes, projected at \$50 gain for 2001-02, \$125 million gain for 2002-03 and \$10 million for 2003-04.

b/ Estimates for this proposal are based on federal projections and assumes California has been in conformity with the Clean Vehicle tax incentives and are incremental.

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