

California
Franchise
Tax
Board

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SUMMARY OF FEDERAL INCOME TAX CHANGES — 2006

Laws Affected:

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

**SUMMARY OF
FEDERAL INCOME TAX
CHANGES
2006**

**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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EXECUTIVE SUMMARY FEDERAL INCOME TAX CHANGES - 2006

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

During 2006, the Internal Revenue Code or its application by California was changed by:

PUBLIC LAW	TITLE
109-222	Tax Increase Prevention and Reconciliation Act (TIPRA) of 2005 (May 17, 2006)
109-227	Heroes Earned Retirement Opportunities (HERO) Act (May 29, 2006)
109-264	Clarification of Limitation on State Taxation of Retirement Income (August 3, 2006)
109-280	Pension Protection Act of 2006 (August 17, 2006)
109-432	Tax Relief and Health Care (TRHCA) of 2006 (December 20, 2006)
109-445	Fallen Firefighters Assistance Tax Clarification Act of 2006 (December 21, 2006)
109-241, 109-304	2006 Miscellaneous Federal Acts Impacting the Internal Revenue Code (IRC) and Not Requiring A California Response.

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 federal Public Law (PL), the Internal Revenue Code (IRC), and the California Revenue and Taxation Code (R&TC) impacted by the federal changes.

Following is a list of California tax provisions that expire in 2007. See Exhibit B for a complete listing of expiring provisions in California law.

California Sunset	California Section	Federal Section	Federal Sunset	Description and Comments
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's Trust Fund

California Sunset	California Section	Federal Section	Federal Sunset	Description and Comments
12/31/07	18744	N/A	N/A	Voluntary Contribution: Fish & Game Preservation Fund
12/31/07	18796	N/A	N/A	Voluntary Contribution: California Breast Cancer Research Fund

This report contains the following exhibits:

Exhibit A – 2006 Miscellaneous Federal Acts Impacting the IRC Not Requiring A California Response. This exhibit contains a short explanation of the federal change where that change is either not administered by the Franchise Tax Board or not applicable to California.

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

Exhibit C contains revenue tables.

Exhibit D contains a glossary of abbreviations used in this report.

In addition, a topical index is provided at the end of the report.

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TAX INCREASE PREVENTION AND RECONCILIATION ACT (TIPRA) OF 2005 (PL 109-222, MAY 17, 2006)

TITLE I – EXTENSION AND MODIFICATION OF CERTAIN PROVISIONS

<u>Section</u>	<u>Section Title</u>
101	Increased Expensing for Small Business

Background

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct (or “expense”) such costs. Federal law prior to TIPRA provides that the maximum amount a taxpayer may expense, for taxable years beginning in 2003 through 2007, is \$100,000 of the cost of qualifying property placed in service for the taxable year.¹ 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. Off-the-shelf computer software placed in service in taxable years beginning before 2008 is treated as qualifying property. The \$100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$400,000. The \$100,000 and \$400,000 amounts are indexed for inflation for taxable years beginning after 2003 and before 2008.

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 IRC section 38 is allowed with respect to any amount for which a deduction is allowed under IRC section 179. An expensing election is made under rules prescribed by the Secretary.²

Federal law prior to TIPRA provides that for taxable years beginning in 2008 and thereafter (or before 2003), the following rules apply. A taxpayer with a sufficiently small amount of annual investment may elect to deduct up to \$25,000 of the cost of qualifying property placed in service for the taxable year. The \$25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000. The \$25,000 and \$200,000 amounts are not indexed. In general,

¹ Additional IRC § 179 incentives are provided with respect to a qualified property used by a business in the New York Liberty Zone (IRC § 1400L(f)), an empowerment zone (IRC § 1397A), or a renewal community (IRC § 1400J).

² IRC § 179(c)(1). Under Treasury Reg. § 179–5, applicable to property placed in service in taxable years beginning after 2002 and before 2008, a taxpayer is permitted to make or revoke an election under IRC § 179 without the consent of the Commissioner on an amended Federal tax return for that taxable year. This amended return must be filed within the time prescribed by law for filing an amended return for the taxable year. T.D. 9209, July 12, 2005.

TAX INCREASE PREVENTION AND RECONCILIATION ACT (TIPRA) OF 2005 (PL 109-222, MAY 17, 2006)

qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business (not including off-the-shelf computer software). An expensing election may be revoked only with consent of the Commissioner.³

New Federal Law (IRC section 179)

TIPRA extends for two years the increased amount that a taxpayer may deduct and the other IRC section 179 rules applicable in taxable years beginning before 2008. Thus, under the provision, these present-law rules continue in effect for taxable years beginning after 2007 and before 2010.

Effective Date

This provision is effective for taxable years beginning after 2007 and before 2010.

California Law (R&TC sections 17250 and 24349)

California law, as it relates to the IRC Section 179 deduction, conforms to federal law with significant exceptions. California specifically does not conform to the increased small business expensing enacted in the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003 and extended in the American Jobs Creation Act of 2004 (AJCA). Thus, under California law, both corporate and non-corporate taxpayers with a sufficiently small amount of annual investment may elect to deduct up to \$25,000 of the cost of qualifying property placed in service for the taxable year. The \$25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The 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).

Impact on California Revenue

Not applicable.

<u>Section</u>	<u>Section Title</u>
102	Capital Gains and Dividend Rates

³ IRC § 179(c)(2).

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Background

A. Capital gains

In general

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

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

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

Tax rates before 2009

Under federal law before TIPRA, for taxable years beginning before January 1, 2009, the maximum rate of tax on the adjusted net capital gain of an individual is 15%. Any adjusted net capital gain which otherwise would be taxed at a 10 or 15% rate is taxed at a 5% rate (zero for taxable years beginning after 2007). These rates apply for purposes of both the regular tax and the alternative minimum tax.

Under federal law before TIPRA, the "adjusted net capital gain" of an individual is the net capital gain reduced (but not below zero) by the sum of the 28% rate gain and the unrecaptured IRC section 1250 gain. The net capital gain is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation under IRC section 163(d).

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

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

An individual’s unrecaptured IRC section 1250 gain is taxed at a maximum rate of 25%, and the 28% rate gain is taxed at a maximum rate of 28%. Any amount of unrecaptured IRC section 1250 gain or 28% rate gain otherwise taxed at a 10 or 15% rate is taxed at the otherwise applicable rate.

Tax rates after 2008

Under federal law before TIPRA, for taxable years beginning after December 31, 2008, the maximum rate of tax on the adjusted net capital gain of an individual is 20%. Any adjusted net capital gain that otherwise would be taxed at a 10 or 15% rate is taxed at a 10% rate.

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

The tax rates on 28% gain and unrecaptured IRC section 1250 gain are the same as for taxable years beginning before 2009.

B. Dividends

In general

A dividend is the distribution of property made by a corporation to its shareholders out of its after-tax earnings and profits.

Tax rates before 2009

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Under federal law before TIPRA, dividends received by an individual from domestic corporations and qualified foreign corporations are taxed at the same rates that apply to capital gains. This treatment applies for purposes of both the regular tax and the alternative minimum tax. Thus, for taxable years beginning before 2009, dividends received by an individual are taxed at rates of five (zero for taxable years beginning after 2007) and 15%.

If a shareholder does not hold a share of stock for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date (as measured under IRC section 246(c)), dividends received on the stock are not eligible for the reduced rates. Also, the reduced rates are not available for dividends to the extent that the taxpayer is obligated to make related payments with respect to positions in substantially similar or related property.

Qualified dividend income includes otherwise qualified dividends received from qualified foreign corporations. The term “qualified foreign corporation” includes a foreign corporation that is eligible for the benefits of a comprehensive income tax treaty with the United States which the Treasury Department determines to be satisfactory and which includes an exchange of information program. In addition, a foreign corporation is treated as a qualified foreign corporation with respect to any dividend paid by the corporation with respect to stock that is readily tradable on an established securities market in the United States.

Dividends received from a corporation that is a passive foreign investment company (as defined in IRC section 1297) in either the taxable year of the distribution, or the preceding taxable year, are not qualified dividends.

Special rules apply in determining a taxpayer’s foreign tax credit limitation under IRC section 904 in the case of qualified dividend income. For these purposes, rules similar to the rules of IRC section 904(b)(2)(B), concerning adjustments to the foreign tax credit limitation to reflect any capital gain rate differential, will apply to any qualified dividend income.

If a taxpayer receives an extraordinary dividend (within the meaning of IRC section 1059(c)) eligible for the reduced rates with respect to any share of stock, any loss on the sale of the stock is treated as a long-term capital loss to the extent of the dividend.

A dividend is treated as investment income for purposes of determining the amount of deductible investment interest only if the taxpayer elects to treat the dividend as not eligible for the reduced rates.

The amount of dividends qualifying for reduced rates that may be paid by a regulated investment company (RIC) for any taxable year in which the qualified dividend income received by the RIC is less than 95% of its gross income (as specially computed) may not exceed the sum of (i) the qualified dividend income of the RIC for the taxable year and (ii) the amount of earnings and profits accumulated in a non-RIC taxable year that were distributed by the RIC during the taxable year.

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The amount of dividends qualifying for reduced rates that may be paid by a real estate investment trust (REIT) for any taxable year may not exceed the sum of (i) the qualified dividend income of the REIT for the taxable year, (ii) an amount equal to the excess of the income subject to the taxes imposed by IRC section 857(b)(1) and the regulations prescribed under IRC section 337(d) for the preceding taxable year over the amount of these taxes for the preceding taxable year, and (iii) the amount of earnings and profits accumulated in a non-REIT taxable year that were distributed by the REIT during the taxable year.

The reduced rates do not apply to dividends received from an organization that was exempt from tax under IRC section 501 or was a tax-exempt farmers' cooperative in either the taxable year of the distribution or the preceding taxable year; dividends received from a mutual savings bank that received a deduction under IRC section 591; or deductible dividends paid on employer securities.⁴

Tax rates after 2008

Under federal law before TIPRA, for taxable years beginning after 2008, dividends received by an individual are taxed at ordinary income tax rates.

New Federal Law (IRC section 1(h))

TIPRA extends for two years the present-law provisions relating to lower capital gain and dividend tax rates (through taxable years beginning on or before December 31, 2010).

Effective Date

This provision applies to taxable years beginning after December 31, 2008.

California Law (R&TC section 17041)

Under current California law, dividends and capital gains received by an individual are taxed at ordinary income tax rates.

Impact on California Revenue

Not applicable.

⁴ In addition, for taxable years beginning before 2009, amounts treated as ordinary income on the disposition of certain preferred stock (IRC § 306) are treated as dividends for purposes of applying the reduced rates; the tax rate for the accumulated earnings tax (IRC § 531) and the personal holding company tax (IRC § 541) is reduced to 15%; and the collapsible corporation rules (IRC § 341) are repealed.

TAX INCREASE PREVENTION AND RECONCILIATION ACT (TIPRA) OF 2005 (PL 109-222, MAY 17, 2006)

<u>Section</u>	<u>Section Title</u>
103	Controlled Foreign Corporations

Background

A. Subpart F exception for active financing

Under the subpart F rules (including IRC sections 951–964), 10% U.S. shareholders of a controlled foreign corporation (CFC) are subject to U.S. tax currently on certain income earned by the CFC, regardless of whether such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, insurance income and foreign base company income. Foreign base company income includes, among other things, foreign personal holding company income and foreign base company services income (i.e., income derived from services performed for or on behalf of 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 certain foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; (7) payments in lieu of dividends; and (8) amounts received under personal service contracts.

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

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").⁵

⁵ 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. The Job Creation and Worker Assistance Act of 2002 (P. L. No. 107–147) modified and extended the temporary exceptions for five years, for taxable years beginning after 2001 and before 2007.

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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 IRC 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 IRC section 807(e)(1)(A)), including 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 IRC, 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 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 IRC section 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.

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Present law permits a taxpayer in certain circumstances, subject to approval by the IRS through the ruling process or in published guidance, to establish that the reserve of a life insurance company for life insurance and annuity 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 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 IRC (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. An IRS ruling request under this provision is subject to the present-law provisions relating to IRS user fees.

B. Look-through treatment of payments between related controlled foreign corporations under foreign personal holding company income rules

In general, the rules of subpart F (including IRC sections 951–964) require U.S. shareholders with a 10% or greater interest in a controlled foreign corporation (CFC) to include certain income of the CFC (referred to as “subpart F income”) on a current basis for U.S. tax purposes, regardless of whether the income is distributed to the shareholders.

Subpart F income includes foreign base company income. One category of foreign base company income is foreign personal holding company income. For subpart F purposes, foreign personal holding company income generally includes dividends, interest, rents, and royalties, among other types of income. However, foreign personal holding company income does not include dividends and interest received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized, or rents and royalties received by a CFC from a related corporation for the use of property within the country in which the CFC is organized. Interest, rent, and royalty payments do not qualify for this exclusion to the extent that such payments reduce the subpart F income of the payor.

New Federal Law (IRC sections 953 and 954)

A. Subpart F exception for active financing

TIPRA extends for two years (for taxable years beginning before 2009) 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

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active conduct of a banking, financing, or similar business, or in the conduct of an insurance business.

B. Look-through treatment of payments between related controlled foreign corporations under foreign personal holding company income rules

TIPRA provides that for taxable years beginning after 2005 and before 2009, dividends, interest,⁶ rents, and royalties received by one CFC from a related CFC are not treated as foreign personal holding company income to the extent attributable or properly allocable to non-subpart-F income of the payor. For this purpose, a related CFC is a CFC that controls or is controlled by the other CFC, or a CFC that is controlled by the same person or persons that control the other CFC. Ownership of more than 50% of the CFC's stock (by vote or value) constitutes control for these purposes. TIPRA provides that the Secretary shall prescribe such regulations as are appropriate to prevent the abuse of the purposes of this provision.

Effective Date

A. Subpart F exception for active financing

This provision is effective for taxable years of foreign corporations beginning after December 31, 2006, and before January 1, 2009, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

B. Look-through treatment of payments between related controlled foreign corporations under foreign personal holding company income rules

This provision is effective for taxable years of foreign corporations beginning after December 31, 2005, but before January 1, 2009, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

California Law (R&TC section 25110)

California does not conform by reference to IRC sections 951 through 971.

However, R&TC section 25110, relating to the water's-edge election, specifically provides that the amount of a CFC's income and apportionment factors included in California taxable income when the CFC has federal subpart F income is determined by multiplying these items by the ratio, the numerator of which is the CFC's federal subpart F income for the current year, and the denominator of which is the CFC's current year earnings and profits, as defined by IRC section 964. Subpart F income, as defined in IRC section 952, includes:

- International Boycott Income (IRC sections 952(a)(3) and 999)

⁶ Interest for this purpose includes factoring income which is treated as equivalent to interest under IRC § 954(c)(1)(E).

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- Income From Illegal Bribes and Kickbacks (IRC section 952)
- Insurance Income (IRC section 953)
- Foreign Base Company Income (FBCI) (IRC section 954)
- IRC 901(j) Foreign Country Income (IRC section 952(a)(5))

Therefore, under California water's-edge rules, the TIPRA changes to federal subpart F income automatically apply.

Impact on California Revenue

No conformity revenue impact. Baseline revenue losses would occur under California's water's-edge rules beginning in 2007-08.

TITLE II – OTHER PROVISIONS

<u>Section</u>	<u>Section Title</u>
201	Clarification of Taxation of Certain Settlement Funds

Background

Federal law prior to TIPRA provides that if a taxpayer makes a payment to a designated settlement fund pursuant to a court order, the deduction timing rules that require economic performance generally are deemed to be met as the payments are made by the taxpayer to the fund. A designated settlement fund means a fund which: (1) is established pursuant to a court order; (2) extinguishes completely the taxpayer's tort liability arising out of personal injury, death or property damage; (3) is administered by persons a majority of whom are independent of the taxpayer; and (4) under the terms of the fund the taxpayer (or any related person) may not hold any beneficial interest in the income or corpus of the fund.

Generally, a designated or qualified settlement fund is taxed as a separate entity at the maximum trust rate on its modified income. Modified income is generally gross income less deductions for administrative costs and other incidental expenses incurred in connection with the operation of the settlement fund.

The cleanup of hazardous waste sites is sometimes funded by environmental "settlement funds" or escrow accounts. These escrow accounts are established in consent decrees between the Environmental Protection Agency (EPA) and the settling parties under the jurisdiction of a federal district court. The EPA uses these accounts to resolve claims against private parties under Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA).

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Federal law prior to TIPRA provides that nothing in any provision of law is to be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax.

New Federal Law (IRC section 468B)

TIPRA provides that certain settlement funds established in consent decrees for the sole purpose of resolving claims under CERCLA are to be treated as beneficially owned by the United States government and therefore not subject to federal income tax.

To qualify the settlement fund must be: (1) established pursuant to a consent decree entered by a judge of a United States District Court; (2) created for the receipt of settlement payments for the sole purpose of resolving claims under CERCLA; (3) controlled (in terms of expenditures of contributions and earnings thereon) by the government or an agency or instrumentality thereof; and (4) upon termination, any remaining funds will be disbursed to such government entity and used in accordance with applicable law. For purposes of the provision, a government entity means the United States, any state or political subdivision thereof, the District of Columbia, any possession of the United States, and any agency or instrumentality of the foregoing.

The provision does not apply to accounts or funds established after December 31, 2010.

Effective Date

This provision is effective for accounts and funds established after May 17, 2006.

California Law (R&TC section 24693)

California conforms to IRC section 468B, relating to designated settlement funds, as that section read on January 1, 2005, except that the rate of tax on the gross income of the fund is equal to the corporate franchise rate and is in lieu of any other tax imposed under the Personal Income Tax Law or the Corporate Tax Law.

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Impact on California Revenue

Estimated Revenue Impact of TIPRA of 2005 Effective On Or After January 1, 2007 Enactment Assumed After June 30, 2007 (\$ in Millions)		
2007-08	2008-09	2009-10
d\	d\	d\

Revenue estimates were based on Federal projections with modifications.

Based on the federal revenue estimate, if California conforms to this provision, the revenue loss would be negligible, less than \$250,000.

- a/ Insignificant gains of less than \$150,000
- b/ Insignificant losses of less than \$150,000
- c/ Negligible gains of less than \$250,000
- d/ Negligible losses of less than \$250,000
- e/ Minor gains of less than \$500,000
- f/ Minor losses of less than \$500,000

<u>Section</u>	<u>Section Title</u>
202	Modification of Active Business Definition under Section 355

Background

A corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) to its shareholders as if the corporation had sold such property for its fair market value. In addition, the shareholders receiving the distributed property are ordinarily treated as receiving a dividend of the value of the distribution (to the extent of the distributing corporation's earnings and profits), or capital gain in the case of a stock buyback that significantly reduces the shareholder's interest in the parent corporation.

An exception to these rules applies if the distribution of the stock of a controlled corporation satisfies the requirements of IRC section 355. If all the requirements are satisfied, there is no tax to the distributing corporation or to the shareholders on the distribution.

One requirement to qualify for tax-free treatment under IRC section 355 is that both the distributing corporation and the controlled corporation must be engaged immediately after the distribution in the active conduct of a trade or business that has been conducted for at least

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five years and was not acquired in a taxable transaction during that period (the “active business test”).⁷ For this purpose, a corporation is engaged in the active conduct of a trade or business only if (1) the corporation is directly engaged in the active conduct of a trade or business, or (2) the corporation is not directly engaged in an active business, but substantially all its assets consist of stock and securities of one or more corporations that it controls that are engaged in the active conduct of a trade or business.⁸

In determining whether a corporation is directly engaged in an active trade or business that satisfies the requirement, old IRS guidelines for advance ruling purposes required that the value of the gross assets of the trade or business being relied on must ordinarily constitute at least 5% of the total fair market value of the gross assets of the corporation directly conducting the trade or business.⁹ More recently, the IRS has suspended this specific rule in connection with its general administrative practice of moving IRS resources away from advance rulings on factual aspects of IRC section 355 transactions in general.¹⁰

If the distributing or controlled corporation is not directly engaged in an active trade or business, then the IRS takes the position that the “substantially all” test as applied to that corporation requires that at least 90% of the fair market value of the corporation’s gross assets consist of stock and securities of a controlled corporation that is engaged in the active conduct of a trade or business.¹¹

In determining whether assets are part of a five-year qualifying active business, assets acquired more recently than five years prior to the distribution, in a taxable transaction, are permitted to qualify as five-year “active business” assets if they are considered to have been acquired as part of an expansion of an existing business that does so qualify.¹²

When a corporation holds an interest in a partnership, IRS revenue rulings have allowed an active business of the partnership to count as an active business of a corporate partner in certain circumstances. One such case involved a situation in which the corporation owned at least 20% of the partnership, was actively engaged in management of the partnership, and the partnership itself had an active business.¹³

⁷ IRC § 355(b).

⁸ IRC § 355(b)(2)(A). The IRS takes the position that the statutory test requires that at least 90% of the fair market value of the corporation’s gross assets consist of stock and securities of a controlled corporation that is engaged in the active conduct of a trade or business. Rev. Proc. 96–30, § 4.03(5), 1996–1 C.B. 696; Rev. Proc. 77–37, § 3.04, 1977–2 C.B. 568.

⁹ Rev. Proc. 2003–3, § 4.01(30), 2003–1 I.R.B. 113.

¹⁰ Rev. Proc. 2003–48, 2003–29 I.R.B. 86.

¹¹ Rev. Proc. 96–30, § 4.03(5), 1996–1 C.B. 696; Rev. Proc. 77–37, § 3.04, 1977–2 C.B. 568.

¹² Treas. Reg. § 1.355–3(b)(ii).

¹³ Rev. Rul. 92–17, 1002–1 C.B. 142; see also, Rev. Rul. 2002–49, 2002–2 C.B. 50.

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In addition to its active business requirements, IRC section 355 does not apply to any transaction that is a “device” for the distribution of earnings and profits to a shareholder without the payment of tax on a dividend. A transaction is ordinarily not considered a “device” to avoid dividend tax if the distribution would have been treated by the shareholder as a redemption that was a sale or exchange of its stock, rather than as a dividend, if IRC section 355 had not applied.¹⁴

New Federal Law (IRC section 355)

Under TIPRA, the active business test is determined by reference to the relevant affiliated group. For the distributing corporation, the relevant affiliated group consists of the distributing corporation as the common parent and all corporations affiliated with the distributing corporation through stock ownership described in IRC section 1504(a)(1)(B) (regardless of whether the corporations are includible corporations under IRC section 1504(b)), immediately after the distribution. The relevant affiliated group for a controlled corporation is determined in a similar manner (with the controlled corporation as the common parent).

Effective Date

The provision applies to distributions after May 17, 2006, and before December 31, 2010, with three exceptions. The provision does not apply to distributions: (1) made pursuant to an agreement which is binding on May 17, 2006, and at all times thereafter, (2) described in a ruling request submitted to the IRS on or before May 17, 2006, or (3) described on or before May 17, 2006, in a public announcement or in a filing with the Securities and Exchange Commission. The distributing corporation may also irrevocably elect not to have the exceptions described above apply.

The provision also applies, solely for the purpose of determining whether, after May 17, 2006, there is continuing qualification under the requirements of IRC section 355(b)(2)(A) of distributions made before such date, as a result of an acquisition, disposition, or other restructuring after such date and before December 31, 2010.

California Law (R&TC sections 17321 and 24551)

California conforms by reference to IRC section 355 as of the “specified date” of January 1, 2005, in R&TC sections 17321 and 24551. California has not conformed to the changes made by TIPRA.

¹⁴ Treas. Reg. § 1.355-2(d)(5)(iv).

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Impact on California Revenue

Estimated Revenue Impact of TIPRA of 2005 Effective On Or After January 1, 2007 Enactment Assumed After June 30, 2007 (\$ in Millions)		
2007-08	2008-09	2009-10
f\	f\	f\

Revenue estimates were based on Federal projections with modifications.

Based on the federal revenue estimate, if California conforms to this provision, the revenue loss would be minor, less than \$500,000.

- a/ Insignificant gains of less than \$150,000
- b/ Insignificant losses of less than \$150,000
- c/ Negligible gains of less than \$250,000
- d/ Negligible losses of less than \$250,000
- e/ Minor gains of less than \$500,000
- f/ Minor losses of less than \$500,000

<u>Section</u>	<u>Section Title</u>
203	Veterans Mortgage Bonds

Background

Private activity bonds are 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 private person. The exclusion from income for state and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes (qualified private activity bonds). The definition of a qualified private activity bond includes both qualified mortgage bonds and qualified veterans' mortgage bonds.

Qualified veterans' mortgage bonds are private activity bonds the proceeds of which are used to make mortgage loans to certain veterans. Authority to issue qualified veterans' mortgage bonds is limited to states that had issued such bonds before June 22, 1984. Qualified veterans' mortgage bonds are not subject to the state volume limitations generally applicable to private activity bonds. Instead, annual issuance in each state is subject to a state volume limitation based on the volume of such bonds issued by the state before June 22, 1984. The five states eligible to issue these bonds are Alaska, California, Oregon, Texas, and Wisconsin. Loans financed with qualified veterans' mortgage bonds can be made only with respect to principal residences and cannot be made to acquire or replace existing mortgages. Mortgage loans made with the proceeds of these bonds can be made only to veterans who

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served on active duty before 1977 and who applied for the financing before the date 30 years after the last date on which such veteran left active service (the “eligibility period”).

Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for owner-occupied residences. The IRC imposes several limitations on qualified mortgage bonds, including income limitations for homebuyers and purchase price limitations for the home financed with bond proceeds. In addition, qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage (the “first-time homebuyer” requirement).

New Federal Law (IRC section 143)

TIPRA does not amend present law as it relates to qualified veterans’ mortgage bonds issued by the States of California and Texas. In the case of qualified veterans’ mortgage bonds issued by the States of Alaska, Oregon, and Wisconsin, (1) the requirement that veterans must have served before 1977 is repealed, and (2) the eligibility period for applying for a loan following release from the military service is reduced from 30 years to 25 years. In addition, the annual issuance of qualified veterans’ mortgage bonds in the States of Alaska, Oregon and Wisconsin is subject to new state volume limitations which are phased in between the years 2006 and 2010. The state volume limitation in these states for any calendar year after 2010 is zero.

Effective Date

The provision expanding the definition of eligible veterans applies to bonds issued on or after May 17, 2006. The provision amending state volume limitations applies to allocations of volume limitation made after April 5, 2006.

California Law (R&TC sections 17143 and 24272)

California law does not conform to the federal rules relating to exempting the interest earned on state or municipal bonds and the arbitrage rebate rules. In addition, the federal “private activity bond” rules have not been adopted by California. Also, the federal treatment of Indian tribal governments as states has never been adopted by California.

California state and municipal bonds

The general rule in California is that for income tax purposes all interest received or accrued is fully taxable, except for interest on federal obligations (such as Treasury bills, notes, and bonds, as more fully described below) and tax-exempt bonds issued by California or a local government in this State.

Unlike federal law, the interest earned on bonds issued by other states and municipalities in other states is fully taxable to a resident of California. The California exemption from income taxation of interest on bonds of the State and its political subdivisions is contained in the

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California Constitution (Art. XIII, § 26, subd. (b)). The Revenue and Taxation Code further provides, by statute, that the federal “private activity bond” analysis shall not be made in determining whether interest on bonds issued by the State or a political subdivision thereof shall be exempt from California income tax. Thus, in California, if the use of the bond proceeds of a California state or local issue is for private business use or is secured by property used for a private business use, the interest on that bond is still treated for California income tax purposes as tax exempt, even though the interest on the bond may well be taxable for federal income tax purposes.

California conduit revenue bonds

Conduit revenue bonds are issued by a governmental (state or municipal) entity for various purposes, including economic development, educational and health facilities construction, and multi-family housing. The funds obtained from the financing are loaned to a non-governmental borrower who builds and operates the project. The use by a private firm (via expenditure of the bond proceeds) of a governmental agency's authority to issue tax-exempt debt is premised on the fact that the project will provide public benefit. A conduit revenue bond is payable solely from the loan payments received from the non-governmental party (unless the bond is insured by a third party who guarantees payment in the event of a default by the private firm who has pledged the revenue source). The governmental issuer typically has no liability for debt service on the bonds, except for the administration of the bond.

Although the issuer has no actual liability on the bonds, their reputation and standing with respect to future debt financing may be negatively affected in the event of a default on the bonds. More importantly, should the bonds go into default, the governmental entity will likely be drawn into the settlement process. Most conduit revenue bonds are sold at negotiated sales with the interest rate and other terms of the bonds negotiated between the issuer, the non-governmental borrower, and an underwriter. The security for some of these transactions is sufficient to allow the underwriter to act as a pass-through for the bonds and in so doing act as a placement agent rather than an underwriter. Since the public agency's credit is not on the line, many issuers do not participate in any substantive fashion in the sale of the bonds. Rather, they may limit their role to reviewing the bond purchase contract and other legal and disclosure documents to ensure that they are adequately indemnified against liabilities and to accurately describe their role to investors as issuers and not as borrowers or guarantors of the debt.

Since the conduit revenue bonds issued in California are issued by this State or a local government in this State, the interest paid on such bonds is exempt from State income taxation under the California Constitution.

California treatment of federal bond interest

Interest earned on federal bonds is also tax-exempt for California income tax purposes. This results from federal law (31 U.S.C. § 3124(a)) that prohibits all states from imposing an income tax on interest income from direct obligations of the U. S. government. Examples of bonds that are exempt for California income tax purposes include those issued by federal

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land banks, the Federal Home Loan Bank, and Banks for Cooperatives. Not all federal bonds are direct obligations of the U.S. government and interest on those bonds is taxable. Examples of federal bonds not exempt are those issued by the Federal National Mortgage Association (Fannie Maes), Government National Mortgage Association (Ginnie Maes), and Federal Home Loan Mortgage Corporation (Freddie Macs).

California franchise tax treatment

Interest received from federal, state, municipal, or other bonds is includable in the gross income of corporations taxable under the franchise tax. The franchise tax is a nondiscriminatory privilege tax for the right to exercise the corporate franchise and is not a tax on the income received, but instead merely uses that income of the year as the measure of the tax for the privilege of exercising the corporate franchise.

Impact on California Revenue

Not applicable.

<u>Section</u>	<u>Section Title</u>
204	Capital Gains Treatment for Certain Self-Created Musical Works

Background

Capital gains

The maximum federal tax rate on the net capital gain income of an individual is 15% for taxable years beginning in 2006. By contrast, the maximum federal tax rate on an individual's ordinary income is 35%. The reduced federal 15% rate generally is available for gain from the sale or exchange of a capital asset for which the taxpayer has satisfied a holding-period requirement. Capital assets generally include all property held by a taxpayer with certain specified exclusions.

An exclusion from the definition of a capital asset applies to inventory property or property held by a taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. Another exclusion from capital asset status applies to copyrights, literary, musical, or artistic compositions, letters or memoranda, or similar property held by a taxpayer whose personal efforts created the property (or held by a taxpayer whose basis in the property is determined by reference to the basis of the taxpayer whose personal efforts created the property). Consequently, when a taxpayer that owns copyrights in, for example, books, songs, or paintings that the taxpayer created (or when a taxpayer to which the copyrights have been transferred by the works' creator in a substituted basis transaction) sells the copyrights, gain from the sale is treated as ordinary income, not capital gain.

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Charitable contributions

A taxpayer generally is allowed a deduction for the fair market value of property contributed to a charity. If a taxpayer makes a contribution of property that would have generated ordinary income (or short-term capital gain), the taxpayer's charitable contribution deduction generally is limited to the property's adjusted basis.

New Federal Law (IRC sections 170 and 1221)

TIPRA provides that at the election of a taxpayer, the sale or exchange before January 1, 2011, of musical compositions or copyrights in musical works created by the taxpayer's personal efforts (or having a basis determined by reference to the basis in the hands of the taxpayer whose personal efforts created the compositions or copyrights) is treated as the sale or exchange of a capital asset. The provision amends IRC section 170 to retain the present law limitation on a taxpayer's charitable deduction for the contribution of those compositions or copyrights.

Effective Date

The provision is effective for sales or exchanges in taxable years beginning after May 17, 2006.

California Law (R&TC sections 17041, 17201, and 18151)

California conforms by reference in the PITL in R&TC section 18151 to the IRC section 1221 definition of a capital asset as of the "specified date" of January 1, 2005, as well as the limitation on a taxpayer's charitable deduction contained in IRC section 170 in R&TC section 17201. However, California does not conform to the preferential federal tax rate structure for capital gains, but instead taxes capital gains at the same rate as ordinary income.

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Impact on California Revenue

Estimated Revenue Impact of TIPRA of 2005 Effective On Or After January 1, 2007 Enactment Assumed After June 30, 2007 (\$ in Millions)		
2007-08	2008-09	2009-10
No impact	No impact	No impact

Revenue estimates are based on Federal projections with modifications.

This provision reclassifies self-created musical income from ordinary income to capital gain income. California taxes ordinary income and capital gain income at the same rate, therefore this provision would not impact California income tax revenues.

<u>Section</u>	<u>Section Title</u>
205	Vessel Tonnage Limit

Background

The United States employs a “worldwide” tax system, under which domestic corporations generally are taxed on all income, including income from shipping operations, whether derived in the United States or abroad. In order to mitigate double taxation, a foreign tax credit for income taxes paid to foreign countries is provided to reduce or eliminate the U.S. tax owed on such income, subject to certain limitations.

Generally, the United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Thus, a foreign corporation is generally subject to U.S. tax only on income, including income from shipping operations, which is “effectively connected” with the conduct of a trade or business in the United States (IRC section 882). Such “effectively connected income” generally is taxed in the same manner and at the same rates as the income of a U.S. corporation.

The United States imposes a 4% tax on the amount of a foreign corporation’s U.S. source gross transportation income (IRC section 887). Transportation income includes income from the use (or hiring or leasing for use) of a vessel and income from services directly related to the use of a vessel; 50% of the transportation income attributable to transportation that either begins or ends (but not both) in the United States is treated as U.S. source gross transportation income. The tax does not apply, however, to U.S. source gross transportation income that is treated as income effectively connected with the conduct of a U.S. trade or business. U.S. source gross transportation income is not treated as effectively connected income unless (1) the taxpayer has a fixed place of business in the United States involved in

