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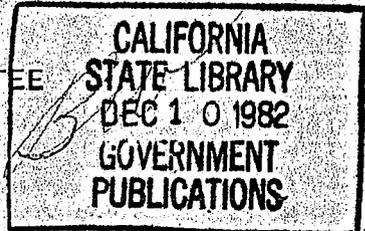
Enacting Conformity to Selected Items of the Federal Economic Recovery Tax Act of 1981

AB 2595 (Deddeh), Chapter 1558 of 1982
AB 2516 (Sher), Chapter 1525 of 1982
AB 3194 (Imbrecht), Chapter 1559 of 1982
SB 1326 (Alquist), Chapter 327 of 1982
SB 11 (Maddy), Chapter 1604 of 1982



Prepared by Staff of the
ASSEMBLY REVENUE AND TAXATION COMMITTEE

WADIE P. DEDDEH
Chairman



November 1982



ANALYSIS OF LEGISLATION
ENACTING CONFORMITY TO SELECTED ITEMS
OF THE
FEDERAL ECONOMIC RECOVERY TAX ACT OF 1981

AB 2595 (Deddeh), Chapter 1558 of 1982
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PART I
INTRODUCTION, SUMMARY
AND
FISCAL EFFECT

Introduction

In November and December 1981, the Assembly and Senate Revenue and Taxation Committees met jointly in three days of interim hearings on the subject of conformity to the federal Economic Recovery Tax Act (ERTA) of 1981, which had been signed into law by President Reagan on August 12, 1981.

The agenda for the hearings was a comprehensive briefing book prepared by a broad based legislative-executive staff task force, in which each of the 82 items in the federal act was reviewed*.

At the interim hearings, after hearing presentations by staff and testimony by the public, the members of the Revenue and Taxation Committees gave direction to staff on which of the ERTA provisions should be included in a federal income tax conformity bill.

In February 1982, Assembly Revenue and Taxation Committee Chairman Wadie P. Deddeh introduced the major federal conformity vehicle, AB 2595. The 27 items included in the original version of AB 2595 represented the implementation of the directions given during interim study. A listing of the Committees' directions on all 82 items is included as Appendix II (buff pages).

Several items were deleted from the original version of AB 2595 as it moved through the legislative process. Some items were dropped because they were revenue items that had already been chaptered as part of the 1982-83 Budget Trailer Bill. Others were deleted because they were made irrelevant by the repeal of the inheritance and gift tax in the June 1982 statewide election. Provisions dealing with IRA and Keogh Plans were deleted from AB 2595 because the subject of retirement plan conformity was being dealt with in separate legislation, AB 2516 by Assemblyman Sher.

This paper summarizes the federal conformity items enacted in AB 2595 and in four other bills which were chaptered during the 1982 session of the Legislature.

*That briefing book, "Report of the 1981 Federal Conformity Task Force on the Federal Economic Recovery Tax Act of 1981", Publication No. 885 (green cover), is available from the Assembly Publications Office, P.O. Box 90, State Capitol, for \$7.50 plus 6% tax.

Summary of the Bills

AB 2595 (Deddeh) contains 20 items in the personal income and bank and corporation tax laws, representing full or partial conformity to changes made in the federal ERTA of 1981. It also contains a provision permitting special capital gains treatment for corporate investors in small businesses. A few other minor, non-ERTA clean-up items are also included.

AB 2516 (Sher) provides for partial conformity to federal changes in the areas of IRA and Keogh Plan retirement accounts, by deferring tax on income earned on retirement plan contributions made up to federal levels. It also enacts conformity to a federal change effective in 1980 repealing the itemized deduction available for gasoline excise taxes. The California gas tax deduction is partially repealed in tax years 1982 and 1983 and is fully repealed in 1984 and thereafter.

AB 3194 (Imbrecht) enacts partial conformity to federal ERTA provisions providing tax incentives for corporate contributions of research property to colleges and universities. This makes slight modifications to one of the provisions previously enacted in AB 2595, described above. (This bill also establishes state tax incentives for contributions of computers to elementary and secondary schools, to which there is not a counterpart in the federal ERTA of 1981.)

SB 1326 (Alquist), the "trailer" bill to the 1982-83 Budget Act, enacts modified conformity to the corporate estimated payment provisions in the federal ERTA, and provides for non-disqualification of IRA and Keogh plans for state tax purposes.

SB 11 (Maddy) allows an "above-the-line" deduction for charitable contributions for non-itemizers, in effect for tax years 1984 through 1986.

Each provision of these five bills is described in detail in the yellow pages that follow in Part II. The item numbers refer to the designations in the green interim hearing briefing book (see Introduction above and Appendix II). Unless indicated otherwise, each provision represents full conformity to the corresponding federal law.

With a few exceptions, the non-federal conformity items in these bills are not described in this paper.

The accompanying cross-reference chart in Appendix I (green pages) indexes ERTA and Internal Revenue Code sections to the bills and to Revenue and Taxation Code sections.

Unless indicated otherwise, the provisions of these bills will be applicable to the 1982 taxable and income years and thereafter.

Fiscal Effect

The fiscal effects of the five bills, as estimated by Franchise Tax Board are summarized in the tables below and on the following pages.

Table 1

Estimated State General Fund Fiscal Effect of AB 2595 Deddeh
Enacting Partial Conformity to the Federal
Economic Recovery Tax Act of 1981
 (Non-Federal Conformity Items Not Included)

Briefing Book #	Item	(in millions)	
		1982-83	1983-84
#8	Basis of Certain Inherited Property	+ .5	+ .5
#24	Charitable Contribu- tions of Research Property**	-*	-*
#36	Incentive Stock Options	0	-*
#37	Property Transferred to Employees	-*	-*
#38	Targeted Jobs Tax Credit	+ .1	+ .1
#39	Low Income Housing Provisions	- .8	-1.0
#41	Employer Gift and Awards	- .1	- .1
#45	Commodity Straddles	+2.0	+2.0
#50	Tax Exempt Obliga- tions: Volunteer Fire Departments	0	0

--continued--

*Estimated annual loss or gain of less than \$100,000.

**This item modified by AB 3194 (Imbrecht). Refer to Table 3.

Table 1

--continued--

Briefing Book #	Item	(in millions)	
		1982-83	1983-84
#52	Prohibition of Disclosure	0	0
#54	Penalty for False Withholding Information	++	++
#55	Negligence Penalty	++	++
#56	Penalty for Value Overstatements	++	++
#57	Information Returns Penalty	0	0
#65	Employer-Provided Dependent Care Benefits	-*	-*
#67	Exclusion of Gain on Sale of Residence	++	++
#68	Gain on Sale of Residence: Rollover Period	- .2	- .2
#76	Contribution "Made Available" Rule	-*	-*
#79	Group Legal Services Plans	- 1.0	- 1.0
#82	Real Estate Installation Sales Between Related Parties	-*	-*
**	Capital Gains Treatment for Corporate Investments in Certain Small Businesses	<u>0</u>	<u>0</u>
	TOTAL FISCAL EFFECT	+\$0.3	+\$0.1

*Estimated annual loss or gain of less than \$100,000.

**Non-ERTA item not in Briefing Book. Refer to Item #82A in Part II of this paper.

Source: Fiscal estimates provided by Franchise Tax Board.

Table 2

Estimated State General Fund Fiscal
Effect of AB 2516 (Sher)
Enacting Partial Conformity to the
Federal Economic Recovery Tax Act of 1981

<u>Briefing</u> <u>Book #</u>	<u>Item</u>	<u>(in millions)</u>	
		<u>1982-83</u>	<u>1983-84</u>
*	Repeal of Gas Tax Deduction	\$ 9.0	\$ 20.3
71, 72, 73	Deferral of Tax on IRA, Keogh and SEP Earnings	<u>-9.0</u>	<u>-20.3</u>
TOTAL FISCAL EFFECT		\$- .0	\$.0

*Non-ERTA federal conformity item not included in Briefing Book. Refer to Item #73A in Part II of this paper.
Source: Gas tax estimate based on data provided by Franchise Tax Board. Assumes 41% of deduction repealed in 1982, 75% of deduction repealed in 1983, and 100% of deduction repealed in 1984 and thereafter. Retirement plans estimate based on data provided by Department of Finance.

Table 3

Estimated State General Fund Fiscal
Effect of AB 3194 (Imbrecht)
Enacting Partial Conformity to the
Federal Economic Recovery Tax Act of 1981

<u>Briefing</u> <u>Book #</u>	<u>Item</u>	<u>(in millions)</u>	
		<u>1982-83</u>	<u>1983-84</u>
#24	Deduction for Charitable Contributions of Research Property	Revenue loss in \$100,000 range annually	
*	Deduction or Credit for Contributions of Computers to K-12 Schools (Depends on Enactment of Federal Bill)	Unknown revenue loss, of a few million annually or a few hundred thousand annually, depending on enactment of federal bill	

TOTAL FISCAL EFFECT

Unknown revenue loss

*Non-ERTA item not included in Briefing Book. Refer to Item 24A in Part II of this paper.
Source: Fiscal estimates provided by Franchise Tax Board.

Table 4

Estimated State General Fund Fiscal
Effect of Provisions in SB 1326 (Alquist)
Enacting Partial Conformity to the
Federal Economic Recovery Tax Act of 1981

<u>Briefing</u> <u>Book #</u>	<u>Item</u>	<u>(in millions)</u>	
		<u>1982-83</u>	<u>1983-84</u>
#60	Corporate Estimated Taxes	\$+40	\$+25

Source: Fiscal estimate provided by Franchise Tax Board.

Table 5

Estimated State General Fund Fiscal
Effect of SB 11 (Maddy)
Enacting Partial Conformity to the
Federal Economic Recovery Tax Act of 1981

Briefing
Book #

Item

#66

Charitable Contribution Deduction
For Non-Itemizers

Fiscal Effect (in millions)

<u>1982-83</u>	<u>1983-84</u>	<u>1984-85</u>	<u>1985-86</u>	<u>1986-87</u>
\$ 0	\$ 0	\$ -22	\$ -45	\$ -95

Source: Fiscal estimates provided by Franchise Tax Board.

PART II
DETAILED DESCRIPTION
OF
FEDERAL CONFORMITY ITEMS

Item #8

BASIS OF CERTAIN INHERITED PROPERTY
(Section 20 of AB 2595)

Current State Law

Under existing state law, property acquired from a decedent generally takes a basis in the hands of the recipient equal to its fair market value as of the date of death.

What the Conformity Bill Does

AB 2595 retains the "fair market value as of the date of death" rule except in the case of appreciated property given to the decedent within one year prior to his death, if such property then passes back to the original donor or the donor's spouse. In such cases the property takes the same basis as it had to the decedent immediately prior to death.

This provision applies to property acquired after August 12, 1981, by decedents dying after December 31, 1981.

Reasons For Change

The purpose of this provision is to prevent taxpayers from transferring their own property to another person in contemplation of that person's death merely to obtain a stepped-up basis upon receipt of the property back from the decedent's estate, thereby avoiding income tax on the capital appreciation of the property.

Fiscal Effect

According to FTB, conformity will result in a minor revenue gain, probably less than \$500,000 annually.

Item #24

CHARITABLE CONTRIBUTION OF CERTAIN PROPERTY
USED FOR RESEARCH OR EXPERIMENTATION PURPOSES
(Section 40 of AB 2595, superceded
by Sections 2 and 3.5 of AB 3194)

Current State Law

Under current law, deductions allowed to corporations for the charitable donation of appreciated property are limited to the taxpayer's basis in the property.

What the Conformity Bills Do

AB 2595 and AB 3194 both contain provisions allowing a corporation a larger deduction for charitable contributions to colleges and universities of new tangible personal property which is of an inventory nature, as follows.

Under AB 2595, a larger deduction is allowed for corporate contributions to higher education of scientific apparatus for research and experimentation or for research training in physical or biological sciences.

To qualify for the larger deduction:

- (1) The property must be constructed by the taxpayer,
- (2) the contribution must be made within two years of the construction of the property,
- (3) the original use of the property must be by the donee, and
- (4) the donee must not transfer the property for money, other property, or services.

The allowable deduction is equal to the sum of the taxpayer's basis in the property plus one-half of the unrealized appreciation, not to exceed twice the basis of the property.

These provisions are in conformity with federal law.

AB 3194, chaptered after AB 2595, has almost identical provisions. The exception is that with respect to qualification for claiming the larger deduction, the requirement that the property be constructed by the taxpayer is deleted. AB 3194 is applicable to income years beginning on and after July 1, 1983.

AB 3194 law further provides that this deduction shall not be disallowed if the contribution benefits the donor by enlarging

his future potential market or developing a favorable public image. No comparable federal provision exists.

Legislative Counsel has concluded that the substantive differences between the two bills are "inconsistent, if not irreconcilable". Thus, in accordance with statutory requirements and judicially developed rules governing statutory construction that the later-enacted of two inconsistent statutes prevails, Legislative Counsel has concluded that AB 3194 shall be the law on this subject.

Reasons For Change

The purpose of this provision is to provide an additional incentive to encourage manufacturers to contribute "state-of-the-art" scientific equipment to colleges and universities for use in research activities. Studies indicate that in equipment-intensive research areas such as physics, chemistry, and electrical engineering, the continuing growth of university expenditures has not kept pace with the rising costs of scientific instrumentation.

These demonstrated deficiencies in scientific instrumentation and equipment used in colleges and universities for research and research training make it appropriate to provide a greater tax incentive than in present law for contributions of certain types of new inventory property, manufactured by the donor corporation no more than two years before contribution, which the donee university or college uses in carrying on scientific research activities, including research training. However, the deduction is designed so that the donor corporation cannot be in a better after-tax situation by donating the property than by selling it.

Fiscal Effect

According to FTB, based on a proration of federal estimates, conformity on this item will result in an annual revenue loss in the \$100,000 range.

Item #24A

DEDUCTION OR CREDIT FOR CONTRIBUTIONS
OF COMPUTERS TO K-12 SCHOOLS

(Non-ERTA item not included in Briefing Book)
(Sections 1, 3, 3.5, and 4 of AB 3194))

Current State Law

Under current state law, deductions allowed to corporations for the charitable donation of appreciated property are limited to the taxpayer's basis in the property.

What the Bill Does

AB 3194, in addition to the liberalized provision of donations to colleges and universities described in Item #24, also allows a larger deduction for corporate charitable contributions to K-12 schools of a "computer (or other sophisticated technological equipment or apparatus) all of the use of which by the donee is directly in the education of students of the State of California". The contribution must be made between January 1, 1983 and June 30, 1984.

To qualify for the larger deduction, the property must be contributed not more than two years after constructed and the original use of the property must be by the donee. Other restrictions apply.

This deduction will be allowed only if a federal bill, HR 5573 of the 97th Congress, becomes law.

If that federal bill does not become law, AB 3194 provides for a tax credit of 25% of the fair market value (not to exceed the basis of the property) of corporate contributions of computers or scientific apparatus to K-12 schools made during the 18-month period cited above. The credit would be in lieu of other allowable deductions. Limitations would be similar to those described above.

AB 3194 provides that either the deduction or the credit, whichever becomes operative, shall not be disallowed if the contribution benefits the donor by enlarging his future potential market or developing a favorable public image.

Neither of these optional provisions related to donations of computers to K-12 schools have a counterpart in current federal law.

Reasons For Change

According to the Assembly Office of Research, "proponents of this bill feel that computer literacy for children is becoming a necessity in today's world. They state that this bill will aid in placing needed 'hardware' in schools unable to afford computers in any other way".

Fiscal Effect

According to the Franchise Tax Board, the two optional provisions will result in an unknown revenue loss, of a few million annually or a few hundred thousand annually, depending on enactment of the federal bill.

Item #36

INCENTIVE STOCK OPTIONS
(Sections 16, 17, 18, 36, 42 and 43 of AB 2595)

Current State Law

Under current law, if a stock option has a readily ascertainable fair market value at the time it is granted, the value of the option constitutes ordinary income to the employee on which he is taxed at that time. Any gain realized at the time the stock is sold is treated as a capital gain.

If the stock option has no readily ascertainable fair market value at the time it is granted, it is not income at that time. However, when the option is exercised, the difference between the value of the stock at exercise and the option price constitutes ordinary income to the employee. Again, any gain realized later when the stock is sold is treated as a capital gain.

An employer who grants a stock option generally is allowed a business expense deduction equal to the amount includible in the employee's income in the corresponding tax year.

What the Conformity Bill Does

AB 2595 conforms to federal changes with respect to stock options, reinstating a system similar to the "restricted stock option" provisions which expired in both laws in 1976. The proposed changes recognize an "incentive stock option", which is an option granted to an individual for any reason connected with his or her employment by the employer corporation or by a parent or subsidiary corporation of the employer corporation to purchase stock of any of such corporations.

The bill provides that no tax consequence will result from either the granting or the exercising of an incentive stock option by the employee. However, the employee will be taxed at capital gains rates when he sells the stock if the stock is held for at least two years from the option grant date and at least one year from the stock transfer date. (If held for a shorter time, it is treated as ordinary income.)

In addition, for the entire time from the date of granting the option until three months before the date of exercise, the option holder must be an employee either of the company granting the option, or a parent or subsidiary of that corporation.

The basis of the stock is what the employee paid for it. The employer is not allowed a business expense deduction for shares granted as an incentive stock option, and must include in its income the amount the employee pays for the stock share.

For options to qualify as incentive stock options, they must meet various requirements including:

1. The option term may not exceed ten years.
2. The option price cannot be less than the fair market value of the stock on the date of the issuance.
3. The option must be transferable only by inheritance.
4. The option must not be exercisable while previously issued incentive stock options are outstanding.
5. The maximum value of stock for which any employee may be granted options in any calendar year generally cannot exceed \$100,000.

AB 2595 generally applies to options granted and exercised on or after January 1, 1982. (The federal legislation covers options granted on or after January 1, 1976 and exercised on or after January 1, 1981.)

Reasons For Change

The stock option provision is intended to provide an important incentive device for corporations to attract new management and to retain the service of executives who might otherwise leave, by providing an opportunity to acquire an interest in the business. Encouraging the management of a business to have a proprietary interest in its successful operation should provide an important incentive to expand and improve the profit position of the companies involved.

Fiscal Effect

According to FTB, the bill will have no effect in 1982-83 and will produce minor net revenue losses over the next few years, followed by slightly larger net revenue gains after that, perhaps in the \$200,000 range annually, reflecting the sale of option stock by employees at a lower basis than otherwise.

Item #37

PROPERTY TRANSFERRED TO EMPLOYEES
(Section 2 of AB 2595)

Current State Law

Generally, property received by employees as compensation for services is not includible in taxable income at the time of receipt if:

1. the property is subject to a substantial risk of forfeiture, and
2. the employee's interest in the property is non-transferable.

However, some courts have held that stock received by employees who could be required to pay over to the corporation any profits realized upon the sale of such stock within six months of acquisition (the insider's trading rule) is not considered to be "subject to a substantial risk of forfeiture" and thus could be taxable.

What the Conformity Bill Does

AB 2595 reverses the court holding, effective 1982, by providing that property received by a person who could be subject to suit under Section 16(b) of the Securities Act of 1934 (the insider's trading rule) is subject to a "substantial risk of forfeiture" and is "nontransferable" for the six-month period following the receipt of the stock. Therefore, receipt of such stock is not a taxable event.

At the time the restriction lapses, the employee would include it in income, and the employer may deduct the difference between the value of the stock at that time and the amount paid for the stock.

Reasons For Change

The imposition of Federal restrictions which limit the ability of an "insider" to dispose of stock for a six-month period of time after receipt should be taken into account in determining the manner in which the value of the stock is included in income. Because of these mandated restrictions on transferability, it is inequitable to tax the employee before the end of this six-month period.

Fiscal Effect

According to the Franchise Tax Board, conformity will result in an unknown, but probably minor, state revenue loss.

Item #38

TARGETED JOBS TAX CREDIT
(Sections 1, 38 and 47 of AB 2595)

Current State Law

California law allows employers to claim a credit against tax owed equal to a portion of wages paid to employees from targeted hard-core unemployed groups. This provision is generally similar to prior federal law, except that California's credit amount is lower (10% vs. the federal 50%), California's dollar cap on the credit is lower (\$600 vs. the federal \$4,500), and California has a narrower list of qualified employees.

What the Conformity Bill Does

AB 2595 provides for partial conformity with changes made in the 1981 federal act. Specifically, it makes rehires and relatives of the employer ineligible for the credit, prohibits retroactive certifications, and provides for revocation of certification if based on false information.

This is effective for 1982 through 1984, when the jobs tax credit sunsets.

Reasons For Change

The purpose of the provision preventing retroactive certifications is to put a stop to practices by employers of determining after hiring if employees qualify for the TJTC. There have been reports of consultants who will screen firms' current payrolls to discover any qualifying employees, and take as a "bounty" a portion of the jobs tax credit thereby claimed. The other new provision attempts to stop abuses by making rehires and relatives of the employer ineligible for the credit.

Fiscal Effect

According to FTB, there will be unknown minor savings from this provision, perhaps in the \$100,000 range annually.

Item #39

LOW INCOME HOUSING PROVISIONS (Sections 7, 9, and 39 of AB 2595)

Current State Law

Current law provides that no deductions are allowed for real property construction period interest and taxes, and that pursuant to a specified schedule, such costs would have to be amortized. For low income housing, deductions are allowable through December 31, 1981, and beginning in 1982, amortization is required. For other real property, amortization was begun in 1977 and 1978.

Current law also provides a special 60 month straight-line write-off of expenditures to rehabilitate low-income rental housing if, over a period of two consecutive years, aggregate expenditures exceed \$3,000. The maximum expenditure allowed the special treatment is \$20,000, and the expenditures must be incurred before January 1, 1982.

What the Conformity Bill Does

With respect to construction period interest and taxes, AB 2595 makes permanent the provision allowing these costs to be deducted if for low income housing or for real property that cannot reasonably be expected to be used in a trade or business or in a profit-making activity.

Regarding low income housing rehabilitation expenditures, the maximum expenditure is increased to \$40,000 for expenditures made after December 31, 1981 if the rehabilitation is conducted pursuant to a program certified by HUD or a state or federal subdivision, and if: (1) a certification of the program is made; (2) tenants occupy the units as principal residences; and (3) seller's profit is limited if there is a tenant purchase program.

Reasons For Change

The purpose of these provisions is to attract capital for the construction of low-income housing and to encourage the rehabilitation of low income housing.

Fiscal Effect

According to the Franchise Tax Board, the following estimated revenue losses will occur with California conformity to federal changes. The estimates are based on a proration of federal estimates.

<u>1982-83</u>	<u>1983-84</u>
-\$800,000	-\$1,000,000

Item #41

EMPLOYER GIFTS AND AWARDS (Sections 12 and 41 of AB 2595)

Current State Law

Employers may deduct an item of tangible personal property awarded to an employee by reason of length of service or for safety achievement when the cost of the item to the employer does not exceed \$100.

What the Conformity Bill Does

AB 2595 changes state law, effective 1982, to provide that employers may deduct an item of tangible personal property awarded to an employee by reason of length of service, for safety achievement, or productivity when the cost of the item to the employer does not exceed \$400.

Employers may create a permanent written nondiscriminatory plan whereby awards for the above-mentioned reasons may be made to employees. Such awards would be deductible provided the average cost of all items awarded under such plan do not exceed \$400. Items that cost in excess of \$1,600 may not be treated as a qualified plan award.

Reasons For Change

The purpose of this provision is to encourage employers to reward employees for length of service productivity or safety, and to help strengthen the relationships between businesses their employees.

Fiscal Effect

According to FTB, conformity will result in annual revenue losses in the \$100,000 range, based on proration of the federal estimate.

Item #45

COMMODITY STRADDLES
(Sections 11, 25, 26, 27
28, 29, 30 and 34 of AB 2595)

Current State Law

Under current law, the character of any gains or losses (whether capital or ordinary) with respect to option transactions generally depends on the character of the optioned property. Generally, any gains or losses are recognized at the time of disposition of the property. This is in conformity with prior federal treatment of commodity options.

What the Conformity Bill Does

AB 2595:

- (1) Provides that with respect to straddle options (situations in which both buy and sell positions are taken on a commodity in order to diminish the taxpayer's risk) losses may be taken only to the extent they exceed realized and unrealized gains involving the straddle. Alternatively, in the case of a straddle which is an "identified straddle", no loss may be recognized until all positions making up the straddle are disposed of.
- (2) Disallows losses involving commodity "wash sales"--situations in which a commodity is sold and immediately (within 30 days) repurchased so as to recognize a loss.
- (3) Disallows deduction of interest and carrying charges with respect to a straddle, and provides for capitalization of such costs.
- (4) Provides that "regulated futures contracts" (except "identified straddles"--see Item (1) above) are to be treated for tax purposes as sold on the last day of the year, and any "gain" or "loss" is to be based on the market value as of that date. If capital gains or losses are involved, 40% is to be treated as in our first tier (100% taken into account) and 60% is to be treated as in our third tier (50% taken into account).
- (5) Provides that gains or losses attributable to the lapse or expiration of an option shall be treated as a capital gain if the asset would, if acquired, have been a capital asset. (In the past, capital gain provisions have only applied to sale or exchange of assets, but not to lapse or expiration of options.)

- (6) Requires security dealers to indicate immediately whether securities are purchased for investment or resale to customers. (In the past dealers had 30 days in which to so indicate, allowing an opportunity to elect capital status for appreciating securities and ordinary status for securities which were declining in value.)

These changes apply to property acquired and positions established by the taxpayer after December 31, 1981.

The bill does not conform to the federal provision allowing losses from a regulated futures contract to be carried back for three years to offset gains on such contracts, since California has never conformed to federal loss-carryback provisions in general.

Reasons For Change

The primary reason for these changes is to limit opportunities for taxpayers to defer income and convert ordinary income and short-term capital gains into long-term capital gains for tax advantages. At the same time, it is intended that the efficiency and liquidity of the agricultural and commercial commodity futures markets be protected.

Fiscal Effect

According to FTB, conformity will result in unknown revenue gains, probably in the \$2 million range annually.

Item #50

TAX EXEMPT OBLIGATIONS: VOLUNTEER FIRE DEPARTMENTS
(Section 5 of AB 2595)

Current State Law

Interest on bonds issued by California local governments is exempt from income taxes. This exemption does not apply to volunteer fire departments, which are not political subdivisions of the state. Under current state law, volunteer fire departments are not authorized to issue debt.

What the Conformity Bill Does

In conformance with the new federal law, effective 1982, AB 2595 provides that income from obligations of volunteer fire departments is excluded from gross income if the proceeds from such obligations are used only for the acquisition, construction or improvement of fire trucks and firehouses.

The bill includes two further provisions not in the federal law:

- (1) The provisions are limited to interest on bonds issued by California volunteer fire departments.
- (2) The obligation must be part of an issue otherwise authorized by law to be issued.

Reasons For Change

Under limited conditions, volunteer fire departments should have the same ability as municipal fire departments to borrow money at tax-exempt interest rates, as now permitted under federal law. The further limitations placed in this bill are intended to restrict state tax savings to taxpayers investing in organizations located in California and ensure that proper statutory authorization for issuing obligations is a prerequisite to receiving the benefits.

Fiscal Effect

No effect, since volunteer fire departments are currently not authorized to issue debt.

Item #52

PROHIBITION OF DISCLOSURE OF AUDIT METHODS
(Sections 37 and 46 of AB 2595)

Current State Law

Under the Personal Income Tax Law, only the details and particulars shown on an individual's tax return are protected from disclosure. Under the Bank and Corporation Tax Law, only the amount of income or particulars relating to the business affairs of the taxpayer are not subject to disclosure.

Standards developed for audit purposes are not included as items which are protected as confidential tax data. However, the California Public Records Act (Govt. Code 6250 et seq.) permits the nondisclosure of an agency's records (tax audit standards) if the public interest served by not making the record public clearly outweighs the public interest served by such disclosure.

What the Conformity Bill Does

AB 2595 makes provision in the Revenue & Taxation Code that no state law is to be construed to require the disclosure of standards used or to be used for audit selection or data used or to be used in setting such standards. This provision is operative if the disclosure of the requested audit criteria would seriously impair tax assessment, collection or enforcement. This is effective 1982 and thereafter.

Reasons For Change

Maintaining the confidentiality of tax audit selection data outweighs any legitimate public interest or benefit that might be served by its disclosure. This provision makes it clear that certain data used by the FTB to establish its criteria for audit selection (including any such data that was being sought in any pending litigation) should be confidential, if it is determined that confidentiality is necessary to protect the integrity of the tax system.

Fiscal Effect

No effect.

Item #54

PENALTIES FOR FALSE WITHHOLDING INFORMATION
(Sections 49 and 50 of AB 2595)

Current State Law

State law provides for a criminal penalty of up to \$500 upon employees who file false withholding information. No imprisonment penalty is provided. State law does not contain any civil penalty for this violation.

What the Conformity Bill Does

AB 2595 provides for a new civil penalty for false wage withholding information of \$500 and increases the existing criminal penalty from \$500 to \$1,000. It also adds provision for a prison term not to exceed one year. These changes are effective 1982 and thereafter.

Reasons For Change

In recent years, it appeared that some individuals did not consider the current law monetary penalties to be a significant deterrent to supplying false wage withholding information. To attempt to correct this situation, those penalties are increased.

Fiscal Effect

According to FTB, conformity will result in a minor increase in penalty collections.

Item #55

NEGLIGENCE PENALTY
(Sections 32 and 44 of AB 2595)

Current State Law

California law provides for a penalty in the amount of 5% of any deficiency due to negligence or intentional disregard of rules and regulations not amounting to intent to defraud, plus interest.

What the Conformity Bill Does

Under AB 2595, the 5% penalty is augmented by an additional penalty in the amount of 50% of the interest due on the underpayment.

Reasons For Change

This provision is intended to encourage accurate compliance with tax laws. Current law allows interest paid on late taxes to be deducted. This new penalty is not deductible, and would offset the interest deduction, giving taxpayers an extra incentive to make sure that their actions or inactions are not negligent. In addition, by linking the new penalty to the interest payable on underpayments, there should be less incentive to delay unduly the settlement of outstanding tax disputes.

Fiscal Effect

According to FTB, conformity will result in a minor increase in penalty collections.

Item #56

PENALTY FOR VALUE OVERSTATEMENTS
(Section 33 of AB 2595)

Current State Law

There is presently no penalty provision for overstatements of value of property on a return.

What the Conformity Bill Does

A new penalty is imposed in AB 2595 equal to a specified percentage of the underpayment of taxes attributable to certain overstatements of value of property on the return (for example, charitable contributions or basis of property). The basic provisions are as follows:

- (1) The penalty applies when: (a) the value or adjusted basis of property claimed on return exceeds 150% of correctly determined amount; (b) the property was acquired within five years preceding the close of the tax year in which the overstatement was made; and (c) underpayment of attributable tax amounts to \$1,000 or more.

- (2) The penalty amount is determined as follows:

Claimed valuation as a percentage of correct valuation:	Penalty as percentage of resulting underpayment:
Under 150%	0%
150% but not more than 200%	10%
Over 200% but not over 250%	20%
Over 250%	30%

The new penalty becomes effective in 1982.

Reasons For Change

Valuation issues frequently involve difficult questions of fact. Often, these issues seem to be resolved simply by "dividing the difference" in the values asserted by the FTB and those claimed by the taxpayer. Because of this approach to valuation questions, taxpayers may be encouraged to overvalue certain types of property and to delay the resolution of valuation issues.

In recognition of the fact that valuation issues often are difficult, especially where unique property is concerned, this provision adopts a test for the application of a new penalty under

which only significant overvaluations will be penalized. This approach to the problem, however, is not intended to condone minor overvaluations. Rather, it is intended to remove questions involving small differences from the coverage of this new penalty.

Fiscal Effect

According to FTB, conformity should result in minor increases in penalty collections.

Item #57

INFORMATION RETURN PENALTY
(Sections 31, 35 and 48 of AB 2595)

Current State Law

Current California law provides for penalties for the failure to file information returns or to furnish information statements containing specified information. The penalty is one dollar for each failure, not to exceed \$1,000 per calendar year. California never conformed to federal law which provides, for certain of the failures, a penalty of \$10 per violation not to exceed \$25,000 per calendar year.

What the Conformity Bill Does

AB 2595 adopts partial conformity by adopting the new federal provision requiring the submittal of a written statement to each person whose name is shown on a return regarding payments made to that person in excess of \$1,000. The bill also specifies that in the case of failures to file information under Section 13050 of the U.I. Code, the maximum penalty in a calendar year shall be \$1,000.

These provisions are effective 1982 and thereafter.

Reasons For Change

The purpose of this provision is to ensure that persons to whom payments shown on information returns relate will receive a copy of the return, since the payment shown on the return could affect their tax liability.

Fiscal Effect

No effect.

Item #60

CORPORATE ESTIMATED TAXES
(Section 195 of SB 1326)

Current State Law

Banks and corporations are required to pay estimated tax for the current year. The taxes payable, in four equal installments and the sum of such payments must equal at least 80% of the bank's or corporation's tax for the current year. If this requirement is not met, a penalty of the underpayment is imposed, unless the bank or corporation satisfies one of three exceptions. (Under the changes just enacted in AB 8X, the penalty will be 18% in 1982, and adjusted to the prime rate annually thereafter.)

One of these exceptions is when the bank's or corporation's estimated tax payments equal or exceed the bank's or corporation's tax liability for the preceding year.

California did not adopt the 1980 federal change which required "large" corporations, as defined, to pay at least 60% of the tax shown on the return for the current year or 60% of the actual tax due if a return is not filed.

What the Conformity Bill Does

SB 1326 specifies that for "large" corporations, the penalty will apply unless the estimated payment equals specified percentages of current year liability. The percentage requirements are phased in, in conformance with the federal schedule, as follows:

<u>Year</u>	<u>Estimated Payments as % of Current Year Liability</u>
1982	65%
1983	75%
1984 and thereafter	80%

The bill also provides for a modified current-year estimated payment requirement for "large corporations" which have foreign-source income and apportionment factors they report for state purposes which they do not include on the federal return. The percentage requirements for these corporations would be:

<u>Year</u>	<u>Estimated Payments as a % of Current Year Liability</u>
1982	65%
1983 and thereafter	70%

A "large" corporation is one that has taxable income of \$1 million or more in any one of its immediately preceding three years. In the case of a group of controlled corporations, a "large" corporation is determined by equally dividing the taxable income to each member unless the members consent to an apportionment plan.

Reasons For Change

There is no reason to permit large corporations not to be current in estimated tax payments in the current year because they had little or no tax liability in their prior year.

Allowing these corporations to pay less than the generally required 80 percent of current year tax liability amounts, in effect, to a substantial interest-free loan from the state. Thus, this provision eliminates over a three-year period the prior year exceptions to the general estimated tax penalty rules in the case of about 2,000 large corporations (those with net income of \$1 million or more).

However, it is recognized that corporations with worldwide income have special problems estimating accurately during the tax year what year-end taxable income will be. The special difficulties arise from the volatility of foreign currency exchange rates, international economic and political events, and other factors. These companies do not have such problems in making federal estimated tax payments, since federal law does not require inclusion of worldwide income. For this reason, full conformity in state law to the federal estimated payment requirements is not justified, and a lower requirement is provided for these worldwide companies only.

Fiscal Effect

According to FTB, the cash flow revenue effect of this provision is as follows (in millions):

<u>1982-83</u>	<u>1983-84</u>	<u>1984-85</u>
+\$40	+\$25	+\$5

The cash flow effect brings in tax payments earlier than they would under present law, moving the receipts into the prior fiscal year. There are cash flow effects in more than one fiscal year because the change is phased in over three years.

Item #65

EMPLOYER-PROVIDED DEPENDENT CARE SERVICES
(Section 3 of AB 2595)

Current State Law

Under existing law, most types of monetary compensation or benefits provided to employees by employers must be included in the gross income of the employee. However, certain fringe benefits are excluded from employee gross income, such as health, dental and life insurance. There are no specific provisions dealing with dependent care benefits.

What the Conformity Bill Does

Under AB 2595, effective in 1982 and thereafter, the value of child or dependent care assistance provided under an employer's written, non-discriminating plan generally will not be includible in the employee's gross income. Amounts excluded under this rule may not be used by the employee to claim any credit or deduction. The value of benefits excluded shall not exceed the earned income of the employee.

Reasons For Change

The purpose of this provision is to provide an incentive for employers to become more involved in the provision of dependent care for their employees.

Also, under current state law, employees could be subject to differing tax treatment depending on the way the employer provides child care benefits: where the employer provides an on-site child care center or pays an independent child care operator directly, the employee is not taxed; however, where the employer pays or reimburses the employee who in turn pays for care, the employee is taxed. The new provision would guarantee the same tax treatment regardless of how the benefits are provided.

Fiscal Effect

According to FTB, the revenue effect is unknown, but likely will be a negligible loss since virtually no taxpayers are now reporting such benefits as income.

Item #66

CHARITABLE CONTRIBUTION DEDUCTION
FOR NON-ITEMIZERS
(Sections 1, 2, 3 and 4 of SB 11)

Current State Law

Currently, charitable contributions are deductible from adjusted gross income, along with other itemized deduction. They are not deductible from gross income. Deductions are limited to 20% of the taxpayer's adjusted gross income. Taxpayers who do not itemize deductions can claim a standard deduction (\$1,400 single, \$2,800 joint), which is intended to cover contributions, taxes, medical costs and other itemized expenses.

What the Conformity Bill Does

SB 11 provides, for tax years 1984 through 1986, that taxpayers who do not itemize and who take the standard deduction may deduct a specific percentage of their charitable contributions from gross income.

The percentage and dollar contribution limits would be:

	<u>1984</u>	<u>1985</u>	<u>1986</u>
Percentage of AGI	25%	50%	100%
Contribution Limit	\$300	20% of AGI	20%
Maximum Deduction	\$ 75	-	-

For purposes of determining the limit as a percent of AGI, AGI shall be computed without regard to the taxpayer's charitable contributions.

After 1986, the law would revert to current law.

Federal law under the ERTA is similar, except that the contribution limits in 1985 and 1986 differ. In federal law, the contribution limit is 50% of AGI. (This is consistent with the present difference between the maximum itemized charitable deduction in state and federal law.) Also, federal law is in effect for tax years 1982 through 1986.

Reasons For Change

This provision responds to the concern that many individuals who make charitable contributions did not receive a full tax benefit from those contributions under prior law. For an individual to receive a tax benefit from charitable giving under prior law, the individual must have been able to itemize deductions.

Individuals who could not itemize deductions, because they did not have deductions in excess of the standard deduction, realized no tax benefit from charitable contributions.

Many people believe that allowing a charitable deduction to nonitemizers stimulates charitable giving, thereby providing more funds for worthwhile nonprofit organizations, many of which provide services that otherwise might have to be provided by government.

This provision terminates after 1986, so that the Legislature will have the opportunity to review its effectiveness in stimulating contributions and any administrative problems it may have caused.

Fiscal Effect

The revenue loss from SB 11, according to Franchise Tax Board is (in millions):

<u>1984-85</u>	<u>1985-86</u>	<u>1986-87</u>
-\$22	-\$45	-\$95

Item #67

EXCLUSION OF GAIN ON SALE OF RESIDENCE
(Section 6 of AB 2595)

Current State Law

Current state law conforms to prior federal law in providing a one-time \$100,000 exclusion (\$50,000 for each married taxpayer filing separately) from the gain on the sale or exchange of a personal residence. However, unlike federal law which limited the benefit to taxpayers who were 55 years of age or older, the state tax exclusion has no age limits.

What the Conformity Bill Does

AB 2595 increases the one-time exclusion to \$125,000 (or \$62,500 for each married taxpayer filing separately) for sales and exchanges after December 31, 1981.

It also conforms to the federal age limit, allowing the one-time exclusion only to taxpayers who are 55 years of age or older.

Reasons For Change

The increase in the amount of gain excludable is intended to reflect more appropriately the current costs of residential property.

The purpose of instituting the age limit for those allowed to take advantage of the one-time exclusion is to offset the revenue loss caused by the increased exclusion. This also targets the tax benefits to older persons who may more likely be selling their homes due to retirement, desire to consume less housing space, or need to convert capital assets into current income.

Fiscal Effect

According to the Franchise Tax Board, full conformity to both the larger exclusion and the age 55 limit will result in minor net savings.

Item #68

ROLLOVER PERIOD FOR NONRECOGNITION OF GAIN
ON SALE OF RESIDENCE
(Sections 21, 22, 23 and 24 of AB 2595)

Current State Law

Current state law is in substantial conformity with former federal law in providing a nonrecognition of gain on the sale or exchange of a principal residence where the taxpayer replaces the residence with another whose price is equal to or greater than the residence sold. The new residence must be acquired within 18 months before or after the sale or transfer of the old residence.

What the Conformity Bill Does

AB 2595 extends the rollover period to 24 months for residences sold or transferred after July 1, 1980. (Residences sold prior to that date have already exhausted their 18-month period.)

Reasons For Change

The purpose of this change is to provide taxpayers with additional time to sell their old principal residences or to acquire new ones, in light of high mortgage interest rates and the resulting difficulties in acquiring replacement principal residences and in selling existing principal residences.

Fiscal Effect

According to the Franchise Tax Board, state conformity with federal law will result in an unknown revenue loss, probably in the \$200,000 range annually, based on pro-
ration of the federal estimate.

Item #71

SELF-EMPLOYED RETIREMENT SAVINGS (HR 10-KEOGH) PLANS
(Section 189 of SB 1326
and Sections 2 and 3 of AB 2516)

Current State Law

Under current law, there is allowed a deduction from the personal income tax for certain contributions made by self-employed persons to a Keogh Plan. Such deduction may not exceed 10%, up to \$2,500, of the employee's income from the trade or business for which the retirement plan is established. (This state provision is not in conformity with prior federal law, which allowed a 15% deduction up to \$7,500.)

Tax deferred on any income earned from contributions to Keogh plans. The amount of compensation which may be taken into account under the plan is \$100,000 (for a "defined benefit plan", the amount of compensation is \$25,000).

What the Conformity Bills Do

AB 2516 enacts partial conformity to the changes in Keogh provisions made by the 1981 federal act.

This bill does not conform to the increase in maximum deduction to \$15,000. The bill does conform to the deferral of tax on income earned from the increased allowable contributions to the retirement plan.

Further, SB 1326 conforms to the increase in the maximum amount of compensation which may be taken into account, from \$100,000 to \$200,000 (and from \$25,000 to \$50,000 for "defined benefit plans"), the so-called anti-discrimination rules.

These change are effective for 1982 and thereafter.

Reason For Change

It was the belief of the members of the Senate and Assembly Revenue and Taxation Committees during interim hearings in late fall 1981 that full conformity to the broadened federal Keogh plan provisions was too costly to include in this federal conformity package.

However, to prevent extremely burdensome state tax liabilities in later years for taxpayers who do contribute up to the new federal maximums, AB 2516 provides that any income earned from Keogh plan deposits will be deferred until it is withdrawn in retirement.

The increase in permissible contribution levels enacted in SB 1326 is intended to prevent California taxpayers from being disqualified for any state tax benefit because they make IRA or Keogh plan contributions up to the higher federal levels.

Fiscal Effect

Included in fiscal effect of Item #73, IRAs.

Item #72

SIMPLIFIED EMPLOYEE PENSION (SEP) PLANS
(Section 190 of SB 1326 and
Section 4 of AB 2516)

Current State Law

A simplified employee pension plan (SEP) is essentially an individual retirement account (IRA) to which both the employer and employee can contribute. The amount the employer can contribute is governed by the Keogh Plan limits and the amount the employee can contribute is governed by the IRA limits. The employee is required to report in his income the employer's contribution but is allowed an offsetting deduction. The employee is allowed a deduction for his contributions, if any, within the prescribed limits.

State law is in basic conformity to prior federal law, except the dollar limits differed. Under present state law, an employer may contribute on behalf of the employee an amount up to the limit allowed a self-employed individual under the Keogh Plan or H.R. 10 plan (lesser of \$2,500 or 15% of the employee's annual compensation). The employee is required to include the amount of the employer's contribution in his income but is allowed an offsetting deduction. The employee's contributions are limited by the IRA limit (lesser of \$1,500 or 15% of his compensation or actual amount contributed) less the amount contributed by the employer.

What the Conformity Bills Do

AB 2516 enacts partial conformity to the changes in the SEP provisions made by the 1981 federal act.

The bill does not conform to the federal increase in maximum contributions for employers and employees. The bill does conform to the deferral of tax on income earned from the increased allowable contributions to the SEP plan.

Further, SB 1326 conforms to the increase in the compensation limit for anti-discrimination rules from \$100,000 to \$200,000.

These provisions are effective for 1982 and thereafter.

Reasons For Change

It was the belief of the members of the Senate and Assembly Revenue and Taxation Committees during interim hearings in late fall 1981 that full conformity to the broadened federal SEP plan provisions was too costly to include in this federal conformity package.

However, to prevent extremely burdensome state tax liabilities in later years for taxpayers who do contribute up to the new federal maximums, this bill provides that any income earned from SEP deposits will be deferred until it is withdrawn in retirement.

The changes enacted in SB 1326 prevent plans designed to comply with federal law from being disqualified for state tax purposes.

Fiscal Effect

Included in Fiscal effect of Item #73, IRAs.

Item #73

INDIVIDUAL RETIREMENT ACCOUNTS (IRAs)
(Sections 2, 3 and 4 of AB 2516 and
Sections 184, 190 and 191 of SB 1326)

Current State Law

Under current law, a deduction is allowed certain individuals for contributions made to individual retirement accounts. The deduction may not exceed 15%, up to \$1,500, of the individual's annual compensation. Taxpayers with non-working spouses may set up separate accounts, and the combined deduction may not exceed 15%, up to \$1,750, of the individual's annual compensation. Individuals permitted to take deductions for IRA contributions are those who are not active participants in a qualified employer pension plan, tax-sheltered annuity plan, or governmental pension plan.

What the Conformity Bills Do

AB 2516 enacts partial conformity to the changes in the IRA provisions made by the 1981 federal act.

The bill does not conform to the federal increase in maximum deduction for contributions to an IRA. The bill also does not conform to the larger class of taxpayers made eligible under federal law to take deductions for contributions to individual retirement plans.

The bill does conform to the deferral of tax on income earned from the increased allowable contributions to the IRA. This applies both to taxpayers currently eligible for IRA deductions and to taxpayers not now eligible for state IRA deductions. This change is effective for 1982 and thereafter.

Further, SB 1326 conforms to the increase in the compensation limit for anti-discrimination rules from \$100,000 to \$200,000.

Reason For Change

It was the belief of the members of the Senate and Assembly Revenue and Taxation Committees during interim hearings in late fall 1981 that full conformity to the broadened federal IRA provisions was too costly to include in this federal conformity package.

However, to prevent extremely burdensome state tax liabilities in later years for taxpayers who do contribute up to the new federal maximums, this bill provides that any income earned from IRA deposits will be deferred until it is withdrawn in retirement.

The increase in permissible contribution levels enacted in SB 1326 is intended to prevent California taxpayers from being disqualified for any state tax benefit because they make IRA or Keogh plan contributions up to the higher federal levels.

Fiscal Effect

The revenue loss from deferral of tax on income from IRA, Keogh plan, and SEP deposits will be (in millions):

1982-83
-\$9.0

1983-84
-\$20.3

The revenue loss will increase in future years, probably substantially. This estimate is based on data provided by Department of Finance.

The revenue loss from this item is balanced by revenue gain from another provision enacted in AB 2516. Refer to Table 2 in Part I of this paper, and to Item #73A, next page.

Item #73A

REPEAL OF GAS TAX DEDUCTION
(Section 1 of AB 2516)

Current State Law

A personal income tax itemized deduction is allowed for state and local taxes on the sale of gasoline, diesel fuel and other motor fuels. This provision was amended by SB 320 in early 1982, to provide that taxpayers living in certain air quality non-attainment areas will be limited in the amount of fuel taxes they can deduct. This provision will be effective for tax years 1982 through 1987. (The purpose of this item is to generate revenue savings to fund ridesharing programs.)

What the Conformity Bill Does

AB 2516, described in item #73, enacts partial conformity on the treatment of IRA plans. It also phases out and finally fully repeals the gas tax deduction.

For the 1982 tax year, the gas tax deduction will be 59% of the amounts otherwise authorized to be deducted, for 1983 the gas tax deduction will be 25% of the amounts otherwise authorized to be deducted, and in 1984 and thereafter the gas tax deduction is not allowed.

Under federal law, no gas tax deduction was allowed effective the 1979 tax year and thereafter.

Reason For Change

The purpose of tying the phase-out and repeal of the gas tax deduction to the IRA partial conformity in AB 2516 was to offset the initial revenue losses arising from the IRA provisions with the revenue gain from elimination of the gas tax deduction. This makes for a net "wash" in the 1982-83 and 1983-84 fiscal years of the two provisions combined.

Furthermore, since the gas tax deduction in federal law was eliminated in 1979, this change brings about conformity with federal law in 1984 and thereafter when the gas tax deduction will be fully eliminated in state law.

Fiscal Effect

The revenue gain from repeal of the gas tax deduction will be (in millions):

<u>1982-83</u>	<u>1983-84</u>
\$9.0	\$20.3

The revenue gain will increase slightly in 1984-85 and likely hold steady or grow slowly thereafter. This estimate is based on data provided by Franchise Tax Board.

This revenue gain is offset by the IRA revenue loss provisions in AB 2516. Refer to Table 2 in Part I of this paper, and to Item #73, pages 43 and 44.

Item #76

CONTRIBUTION "MADE AVAILABLE" RULE
(Section 14 of AB 2595)

Current State Law

California law taxes benefits received under qualified pension or profit-sharing plans to the employee only when actually distributed "or made available" to the employee. Such distributions are usually taxed as though they were an annuity.

What the Conformity Bill Does

AB 2595 deletes the "or made available" provision for tax years beginning 1982 and thereafter. The benefits thus will be taxed when actually distributed.

Reasons For Change

The requirement that a qualified pension or profit-sharing plan must provide rules constituting a substantial restriction on an employee's right to make withdrawals under the plan has produced a significant administrative burden for plan participants, employers, plan administrators, and the FTB. Deletion of these rules, while promoting simplification, will not lead to abuse of the favorable tax treatment accorded qualified plans.

Further, it is a principle of taxation that income should be taxed only when it is actually received and the taxpayer has the ability to pay the tax. An example of benefits that are not distributed but are "made available" and thus are subject to tax under current law would be a pension plan which provides that an employee has the right to withdraw benefits at a certain time, but has not yet exercised that right.

Fiscal Effect

According to FTB, conformity to this provision will result in an unknown but likely minor revenue loss.

Item #79

GROUP LEGAL SERVICES PLANS
(Section 4 and 37.7 of AB 2595)

Current State Law

Under existing law, most types of monetary compensation or benefits provided to employees by employers must be included in the gross income of the employee. However, certain fringe benefits are excluded from employee gross income, such as health, dental and life insurance.

There are no specific provisions relating to group legal services plans.

Also under existing law, organizations forming part of a group legal services plan do not have tax exempt status.

What the Conformity Bill Does

AB 2595 excludes from an employee's income amounts paid by an employer on behalf of an employee or his dependents under a qualified group legal services plan. This exclusion will be in effect January 1, 1982 through December 31, 1984.

To qualify for exclusion, the qualified group legal services plan must be a separate written plan for the exclusive benefit of the employees or their dependents. The plan cannot discriminate between classes of employees, except under separate collective bargaining agreements. Not more than 25% of amounts contributed can benefit shareholders or owners who own in excess of 5% of stock, capital, or profit interest of the employer. Legal services must be prepaid or provided for in advance.

The bill also permits tax-exempt status for group legal services organizations or trusts, the exclusive function of which is to form part of a group legal services plan.

Reasons For Change

This item is intended to encourage employers to acquire group plans which would provide legal services to their employees, in conformance with federal law which has been in effect since 1977.

Fiscal Effect

Assuming these services will be taxed without a specific exclusion, the estimated revenue effect to California of conformity to this provision, based upon a proration of federal estimates, will be a revenue loss of less than \$1 million annually. However, it is doubtful that many taxpayers are including such benefits in taxable income now.

Item #82

REAL ESTATE INSTALLMENT SALES BETWEEN RELATED PARTIES
(Section 19 of AB 2595)

Current State Law

Current state law, which is the same as the former federal law, provides for the imposition of a minimum interest rate of 10% on installment contracts for the sale of property that are entered into after June 30, 1982, and that do not provide for at least 9% interest. What this means is that the seller realizes taxable interest income of at least the imputed rate amount. The buyer's interest deduction is whatever actual interest paid.

What the Conformity Bill Does

AB 2595 provides that for land installment sales of up to \$500,000 to spouses, siblings, ancestors and lineal descendants, a maximum imputed interest rate of 7% is used, effective with respect to payments made on or after January 1, 1982 for sales or exchanges after June 30, 1981.

Reasons For Change

The use of a single test rate in times of unusually high interest rates placed an undue burden on sales of land between related individuals. In addition, since land is not depreciable, the buyer will prefer that more of the monthly payment be treated as a deductible interest payment rather than a non-depreciable capital investment; therefore, interest rates are less likely to be understated in land sales.

Fiscal Effect

According to FTB, conformity will result in a revenue loss of less than \$100,000 per year, based on proration of federal estimates.

Item #82A

CAPITAL GAINS TREATMENT FOR CORPORATE
INVESTMENTS IN SMALL BUSINESSES
(Non-ERTA Item Not Included in Briefing Book)
(Section 38.5 of AB 2595)

Current State Law

Under current state law, there is no preferential capital gains treatment for banks or corporations which sell or exchange capital assets. Any gains or losses on capital assets are treated like ordinary income for banks and corporations.

Under current law for individual taxpayers, preferential treatment is given to certain gains from the sale of capital assets, by taking into account less than 100% of the gain. As amended by SB 690 (Presley) of 1981, California law now gives more preferential treatment to "small business stock" and less preferential treatment to "non-productive assets", as demonstrated below:

Percentage of Capital Gains Taxable
Personal Income Tax Law

<u>Time Asset Held</u>	<u>"Small Business Stock"</u>	<u>"Non-Productive Assets"</u>	<u>All Other Assets</u>
1 year or less	100%	100%	100%
1 to 3 years	65	70	65
3 to 5 years	0*	70	65
Over 5 years	0*	50	50

*Zero percent is taxable if at the time of sale the fair market value of land owned or controlled by the corporation does not exceed 25% of the fair market value of the corporation (as reflected in the price at which the stock was sold).

What the Bill Does

AB 2595 gives banks and corporations preferential treatment on gains from the sale or exchange of "small business stock". The percent of gain taxable is the same as shown above for "small business stock" for individual taxpayers, with the same proviso concerning land holdings.

"Small business stock" is the same as defined for individual taxpayers; that is, equity security issued by a corporation which has the following characteristics at the time of acquisition by the taxpayer:

- The commercial domicile or primary place of business is located within California.
- The total employment of the corporation in the prior year is not more than 500 employees; however, if more than 50% of the outstanding securities are held by another corporation, the employment of the controlling corporation would be counted.
- The outstanding issues of the corporation are not listed on the New York Stock Exchange, the American Stock Exchange, or the National Association of Securities Dealers Automated Quotation System.
- No more than 25% of gross revenues in the prior income year were obtained from rents, interest, dividends, or sales of assets.
- The corporation is not engaged primarily in the business of holding land.

This preferential treatment will apply to stock issued after the effective date of the act (September 30, 1982) and sold or exchanged on or after January 1, 1985. No such preferential treatment will be available to small business stock issued or purchased on or after January 1, 1990.

This is not a federal conformity item.

Reasons For Change

This change extends to corporate investors the same incentives already in California law for individual investors in small businesses. Small business investment growth is important in promoting employment and strengthening of California's economic base. Corporate investors control a large portion of available risk capital.

Fiscal Effect

According to Franchise Tax Board, this bill would result in an unknown revenue loss, which could amount to a few million annually after a few years. The first year with a fiscal effect would be 1984-85.

It's unknown to what extent there may be growth in small business activity attributable to this bill which would produce some offsetting revenue gains. This effect, if any, cannot be quantified.

APPENDICES

Appendix I

Cross-Reference Chart

Federal Economic Recovery Tax Act (ERTA) of 1981
Provisions and Internal Revenue Code Sections
Compared to
Conformity Bills' Provisions
and Revenue and Taxation Code Sections

CROSS-REFERENCE CHART

FEDERAL ECONOMIC RECOVERY TAX ACT (ERTA) OF 1981 PROVISIONS AND INTERNAL REVENUE CODE SECTIONS COMPARED TO CONFORMITY BILLS' PROVISIONS AND REVENUE AND TAXATION CODE SECTIONS

Note: Unless otherwise indicated, the Revenue and Taxation Code Sections listed are existing sections. Non-ERTA items included in conformity bills not listed here.

<u>Briefing Book #</u>	<u>Item</u>	<u>Rev & Tax Code Section</u>	<u>AB 2595* Section</u>	<u>Internal Rev Code Section</u>	<u>ERTA Section</u>
#8	Basis of Certain Inherited Property	18047(new)	20	1014	425
#24	Charitable Contributions of Research Property	24357.8(new)	40 of AB2595 (superceded) 2, 3.5 of AB 3194 (in effect)	170	222
#36	Incentive Stock Options	17531, 17532.5(new), 17535, 18802.7, 24621, 24622	16, 17, 18, 36, 42, 43	422A	251
#37	Property Transferred to Employees	17122.7	2	83	252
#38	Targeted Jobs Tax Credit	17053.7, 24330, 328 UI Code	1, 38, 47	50, 51	261

* Unless noted as other bill.

Briefing Book #	Item	Rev & Tax Code Section	AB 2595* Section	Internal Rev Code Section	ERTA Section
#39	Low Income Housing Provisions	17211.7, 17237, 24354.2	7, 9, 39	167, 189	262, 264
#41	Employer Gifts and Awards	17299.6, 24445	12, 41	274	265
#45	Commodity Straddles	17283, 18143(new), 18183, 18190, 18191.5(new), 18196, 18222(new), 18698.5(new)	11, 25, 26, 27, 28, 29, 30, 34	263, 1092, 1234, 1236, 1256	501, 502, 503, 504, 505, 506
#50	Tax Exempt Obligations: Volunteer Fire Departments	17137.2(new)	5	103	8122
#52	Prohibition of Disclosure	19282.5, 26451.5	37, 46	6013	701
#54	Penalty for False Withholding Information	13100 UI Code, 13101 UI Code(new)	49, 50	6682, 7205	721
#55	Negligence Penalty	18684, 25934	32, 44	6653	722(b)
#56	Penalty for Value Overstatements	18699(new)	33	6659	722(a)
#57	Information Returns Penalty	18681.1, 18802, 13051 UI Code	31, 35, 48	6041, 6652, 6678	723
#60	Corporate Estimated Taxes	25954	195 of SB 1326	6655	731
#65	Employer-Provided Dependent Care Benefits	17136.5(new)	3	129	124

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* Unless noted as other bill.

<u>Briefing Book #</u>	<u>Item</u>	<u>Rev & Tax Code Section</u>	<u>AB 2595* Section</u>	<u>Internal Rev Code Section</u>	<u>ERTA Section</u>
#66	Charitable Contribution Deduction for Non-Itemizers	17073, 17214, 17215, 17215.1	1, 2, 3, 4 of SB 11	170i	121
#67	Exclusion of Gain on Sale of Residence	17155	6	121	123
#68	Rollover Period for Nonrecognition of Gain on Sale of Residence	18091, 18093, 18094, 18098	21, 22, 23, 24	1034	122
#71	Self-Employed Retirement Savings (HR-10) Plans	17501, 17504	189 of SB 1326 2, 3 of AB 2516	401, 404	312
57 #72	Simplified Employee Pension (SEP) Plans	17530	190 of SB 1326 4 of AB 2516	408	312
#73	Individual Retirement Accounts (IRAs)	17241, 17530, 17530.1	184, 190, 191 of SB 1326 2, 3, 4 of AB 2516	219, 408, 409	311, 312
#76	Contribution "Made Available" Rule	17503	14	402	314
#79	Group Legal Services Plans	17136.6 (new), 23701q (new)	4, 37.7	120, 501(c) (20)	802
#82	Real Estate Installment Sales Between Related Parties	17617	19	483	126

* Unless noted as other bill.

Appendix II

Directions of Senate and Assembly
Tax Committees on
Federal Conformity Items -
Final Summary
of 1981 Interim Hearings
Fall 1981

MEMBERS

R. LEWIS
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Assembly California Legislature

STAFF
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COMMITTEE CONSULTANT

ELLEN WORCESTER
COMMITTEE CONSULTANT

HELEN JONES
COMMITTEE SECRETARY

REVENUE AND TAXATION COMMITTEE

STATE CAPITOL ROOM 2013
(916) 322-3730

WADIE P. DEDDEH
CHAIRMAN



December 16, 1981

MEMORANDUM

TO: COMMITTEE MEMBERS
INTERESTED PARTIES

FROM: ASSEMBLYMAN WADIE P. DEDDEH, CHAIRMAN,
ASSEMBLY REVENUE & TAXATION COMMITTEE
SENATOR ROBERT G. BEVERLY, CHAIRMAN,
SENATE REVENUE & TAXATION COMMITTEE

TO: COMMITTEES' "MARK-UP" DIRECTIONS ON FEDERAL
CONFORMITY ITEMS - FINAL SUMMARY

The Assembly and Senate Revenue and Taxation Committees met in a joint hearing on November 19 and 20, and December 16, 1981, on the subject of conformity to the federal Economic Recovery Tax Act of 1981.

The "mark-up" directions of the Committees to staff on all 82 items are summarized on the attached sheets. Items identified as "Do Conform" are being included in a bill being drafted by staff for introduction in January 1982. Items keyed "Inapplicable" are those which, in the Committees' judgment, do not have corresponding provisions in California law. Other recommendations are self-explanatory.

This memo supercedes the November 30 partial summary issued following the first two days of hearings.

EW:al

Attachment

ASSEMBLY REVENUE & TAXATION COMMITTEE
SENATE REVENUE & TAXATION COMMITTEE

Committees' "Mark-up" Directions on Conformity
to the
Federal Economic Recovery Tax Act of 1981
November 19, 20, and December 16, 1981

Estate and Gift Tax Provisions

<u>Item</u>	<u>ERTA Section</u>	<u>Page</u>	<u>Committees' "Mark-Up" Directions</u>
1. Unified Estate Tax Credit Increase.....	401	2	Defer, pending outcome of 1982 ballot initiatives on inheritance tax
2. Reduction in Maximum Tax Rate.....	402	5	Inapplicable.
3. Unlimited Marital Deduction.....	403	7	Inapplicable.
4. Special Use Valuation For Inherited Property.....	421	10	Do conform.
5. Installment Payments of Estate Tax....	422	12	Do conform.
6. Estate Tax Deduction For Charitable Gifts of Artworks.....	423	14	Inapplicable.
7. Gifts Made Within Three Years of Death.....	424	16	Defer.
8. Basis of Certain Inherited Property...	425	18	Do conform.
9. Disclaimers.....	426	19	Inapplicable.
10. Repeal of Orphan's Deduction.....	427	21	Do not conform.
11. Generation-Skipping Transfer Tax.....	428	22	Inapplicable.
12. Estate Tax Credit For Transfer to Smithsonian.....	429	24	Inapplicable.
13. Increase in Gift Tax Exclusion.....	441	25	Defer, pending outcome of 1982 ballot initiatives on inheritance tax
14. Annual Payment of Gift Tax.....	442	27	Do conform.

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Provisions Affecting Businesses

<u>Item</u>	<u>ERTA Section</u>	<u>Page</u>	<u>Committees' "Mark-Up" Directions</u>
15. Accelerated Cost Recovery System (ACRS).....	201	30	Do not conform.
16. Election to Expense Certain Depreciable Business Items.....	202	33	Do not conform.
17. Recapture on Disposition of Recovery Property.....	204	35	Do not conform.
18. Earnings and Profits Computation.....	206	37	Do not conform.
19. Minimum Tax on Preference Income.....	205	39	Do not conform.
20. Maximum Tax Rate on Earned Income.....	205	40	Inapplicable.
21. Extension of Carryover Periods.....	207,208	41	Inapplicable.
22. Investment Tax Credit Changes.....	211-214	43	Inapplicable.
23. Credit for Increasing Research.....	221	45	Do not conform.
24. Charitable Contributions of Research Property.....	222	48	Do conform.
25. Allocation of Research Expenditures....	223	52	Inapplicable.
26. Reduction in Corporate Tax Rates.....	231	54	Inapplicable.
27. Tax Exemption, Mutual Insurance Companies.....	231	56	Inapplicable.
28. Accumulated Earnings Credit.....	232	57	Inapplicable.
29. Change in Subchapter S Corporation Rules.....	233,234	58	Inapplicable.
30. Bad Debt Deduction of Commercial Banks.....	267	59	Do not conform.

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Provisions Affecting Businesses (continued)

<u>Item</u>	<u>ERTA Section</u>	<u>Page</u>	<u>Committees' "Mark-Up" Directions</u>
31. Thrift Institutions: Reorganizations...	241	60	Defer, pending further information from FTB.
32. Carryovers of Losses for Financial Institutions.....	242	62	Inapplicable.
33. Bad Debt Reserves For Savings & Loan Associations.....	243	63	Do not conform.
34. FSLIC Financial Assistance.....	244	64	Defer.
35. Conversions of Mutual Savings Banks to Stock Associations.....	245	66	Inapplicable.
36. Incentive Stock Options.....	251	67	Do conform.
37. Property Transferred to Employees.....	252	69	Do conform.
38. Targeted Jobs Tax Credit.....	261	71	Do conform, in part.
39. Low Income Housing Provisions.....	262,264	74	Do conform.
40. Charitable Contributions of Corporations.....	263	77	Defer.
41. Employer Gifts and Awards.....	265	80	Do conform.
42. Motor Carrier Operating Authorities....	266	82	Do not conform.
43. LIFO Inventory Changes.....	235-238	84	Defer, pending report back from FTB on ability to establish by regulation.
44. Changes in Windfall Oil Profits Tax....	601-604	86	Inapplicable.
45. Commodity Straddles.....	501-507	87	Do conform.
46. Production Credit for Certain Gases....	611	89	Inapplicable.

Administrative & Miscellaneous Provisions

<u>Item</u>	<u>ERTA Section</u>	<u>Page</u>	<u>Committees' "Mark-Up" Directions</u>
47. Private Foundations.....	823	91	Inapplicable.
48. State Legislators' Expenses.....	127	92	Defer, pending consultation with legislative leadership.
49. Campaign Funds.....	128	94	Do not conform.
50. Tax Exempt Obligations: Volunteer Fire Departments.....	812	96	Do conform.
51. Industrial Development Bonds: Transit Financing.....	811	98	Defer, pending further information from staff.
52. Prohibition of Disclosure.....	701	100	Do conform.
53. Interest Rate on Underpayments and Overpayments.....	711	102	Defer, pending action on AB 8X.
54. Penalty For False Withholding Information.....	721	104	Do conform.
55. Negligence Penalty.....	722	106	Do conform.
56. Penalty For Value Overstatements.....	722	107	Do conform.
57. Information Returns Penalty	723	109	Do conform.
58. Overstated Deposit Claims Penalty.....	724	111	Inapplicable.
59. Tax Court Filing Fee.....	751	113	Do not conform.
60. Corporation Estimated Taxes.....	731	114	Do conform.

Provisions Affecting Individuals

<u>Item</u>	<u>ERTA Section</u>	<u>Page</u>	<u>Committees' "Mark-Up" Directions</u>
61. Tax Rate Reductions	101,102	117	Inapplicable.
62. Deduction to Offset Marriage Tax Penalty	103	118	Do not conform.
63. Income Tax Indexing	104	120	Defer, pending outcome of 1982 initiative on indexing.
64. Child and Dependent Care Credit	124	122	Defer.
65. Employer-Provided Dependent Care Services	124	125	Do conform.
66. Charitable Contributions for Non- Itemizers	121	127	Defer, pending action on SB 11 of the 1981-82 Session.
67. Exclusion of Gain on Sale of Residence	123	132	Do conform.
68. Gain on Sale of Residence: Rollover Period	122	134	Do conform.
69. U.S. Citizens Working Abroad	111-113	136	Inapplicable.
70. Adoption Expenses Deduction	125	138	Do not conform.
71. Self-Employed Retirement Savings (HR 10-KEOGH)	312	141	Do conform partially--allow deferral of tax on income earned from deposits. Do not conform on allowable deduction.
72. Simplified Employee Pension Plan.	311	143	Do conform partially--allow deferral of tax on income earned from deposits. Do not conform on allowable deduction.
73. Individual Retirement Accounts	311-314	145	Do conform partially--allow deferral of tax on income earned from deposits. Do not conform on allowable deduction. Defer action on enlarging class of taxpayers eligible to establish IRAs.

Provisions Affecting Individuals (continued)

<u>Item</u>	<u>ERTA Section</u>	<u>Page</u>	<u>Committees' "Mark-Up" Directions</u>
74. Partial Dividend and Interest Exclusion	302	148	Do not conform.
75. Qualified Savings Certificates.	301	152	Do not conform.
76. Contribution "Made Available" Rule	314	155	Do conform.
77. Employee Stock Ownership Plans (ESOPs)	331-337	156	Do not conform.
78. Public Utility Dividend Reinvestment Plan	321	158	Do not conform.
79. Group Legal Services Plans	802	160	Do conform.
80. Fringe Benefit Regulations	801	162	Not applicable.
65 81. Estimated Income Taxes for Individuals	725	164	Defer.
82. Real Estate Installment Sales Between Related Parties	126	166	Do conform.