This report is submitted in fulfillment of the requirement in Revenue and Taxation Code Section 19270.

Federal Income Tax Changes
1983

Prepared by Staff of the

FRANCHISE TAX BOARD

State of California

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Executive Summary

In 1983 Congress passed and the President signed legislation which encompassed three major income tax policy initiatives which the California Legislature needs to address in 1984.

The first policy initiative was the taxation, for the first time, of a portion of Social Security and Railroad Retirement Benefits. Beginning in 1984, a portion of Social Security and Tier I Railroad Retirement benefits will be included in gross income for taxpayers whose adjusted gross income (including tax exempt interest) combined with 50% of their benefits exceeds the base amounts of $25,000 for a single return and $32,000 for a married couple filing a joint return. In no case will more than 50% of the benefits be taxed. Other railroad retirement benefits will be considered taxable under the same rules as other pension plans.

The question for the Legislature is whether California will conform to: 1) the taxation of Social Security and Railroad Retirement benefits; and 2) the taxation of other railroad retirement benefits in the same manner as other pension plans.

The second policy initiative was the inclusion of totally and permanently disabled individuals under age 65 as eligible for the credit for the elderly, raising the amount of the credit and eliminating the former maximum exclusion ($5,200) for payments received on account of permanent and total disability and repealing eligibility for the credit to retirees of a public retirement system.

The question for the Legislature is whether California will conform to: 1) raising the amount of the credit; 2) allowing permanently and totally disabled individuals under 65 to be eligible for the credit; 3) eliminating the $5,200 (maximum) exclusion for payments received on account of permanent and total disability; and 4) excluding retirees of public retirement systems from the credit.

The third policy initiative was the enactment of backup withholding at a 20% rate for payments which are subject to information reporting where taxpayer identification numbers are either not furnished or are incorrect. This system was enacted as a part of the federal repeal of withholding at a 10% rate on payments of interest, dividends and patronage dividends to which California did not conform.

The question for the Legislature is whether, first, California will conform to a backup withholding system at an appropriate state withholding rate where taxpayer identification numbers are either not furnished or are incorrect. Secondly, if a backup withholding system is decided upon, the Legislature needs to address the level of funding necessary for extensive expansion of what is currently a very minor program for withholding of taxes by payors other than employers.

Purpose of the Report

The Personal Income Tax Law was restructured in 1983 to incorporate by reference many provisions of the Internal Revenue Code. In some instances, entire subchapters of the Internal Revenue Code are brought into California law. In these general areas of conformity any differences between state and federal law are clearly identified by a specific provision in California law.

The restructured California law includes a provision for annual review of federal legislative changes. After such review, Section 17024.5 will be amended to specify the effective date of Internal Revenue Code provisions to be used by California for the current year. When the effective date is amended into Section 17024.5, California law will include all of the federal changes in the areas of general conformity except where specifically provided otherwise.

This report provides the basis for legislative review of the federal changes to determine which, if any, of those changes should be incorporated into California law. In 1983 the following public laws were enacted which modify the Internal Revenue Code:

1. Payment-in-Kind Tax Treatment Act of 1983
   Public Law 98-4

2. Social Security Amendments of 1983
   Public Law 98-21

3. Supplemental Appropriations Act of 1983
   Public Law 98-63

4. Interest and Dividend Tax Compliance Act of 1983/Caribbean Basin Economic Recovery Act
   Public Law 98-67

5. Railroad Retirement Solvency Act of 1983
   Public Law 98-76

The effect of these five laws, including the fiscal impact of conformity, is explained in Appendices I, II, and III relating to Individuals, Businesses, and Administration.

Appendix I

Provisions Which Affect Individuals

Appendix I

Provisions Which Affect Individuals

A. Inclusion of Social Security, Railroad Retirement and Railroad Sick Pay Benefits in Gross Income

Summary of Differences Between State and Federal Law
(I.T. 3194, 1938-1 C.B. 114, I.T. 3229, 1938-2 C.B. 136, I.T. 3447, 1941-1 C.B. 191, Rev. Rul. 70-217, 1970-1 C.B. 12, PITL 17081, 17085, 17131, 17501, 17504, IRC 72, 86, 104, 105, 106, 401, 402)

Prior to 1984 the state and federal laws were the same in that social security benefits and railroad retirement benefits were excluded from gross income. Beginning in 1984 a portion of these benefits will be included in federal taxable income for taxpayers whose adjusted gross income (AGI) combined with 50% of their benefits exceeds a base amount.

#5 ...

Fiscal Effect - (1) Social Security and Tier I Railroad Retirement Benefits ....$60 million revenue gain*
(2) Tier II Railroad Retirement Benefits $~~300 thousand~~ revenue gain*
(3) Railroad Sick Pay Benefits ....$200 thousand revenue gain*

*Based upon a proration of federal estimates

To conform to the 1983 federal changes (Social Security Act Amendments and the Railroad Retirement Solvency Act) California would, beginning in 1984, include in taxable income:

1. A portion of Social Security and Tier I Railroad Retirement benefits. The amount of benefits that could be included in taxable income would be the lesser of one-half of the benefits or one-half of the excess of the taxpayer's combined income (AGI + one-half of benefits) over the base amount. The base amount would be:

   a. $25,000 for individuals

   b. $32,000 for married persons filing a joint return, and

   c. Zero for married persons filing separate returns.

   Interest on tax-exempt bonds is added to adjusted gross income for the purpose of determining whether an individual's income exceeds the base amount.

   Benefits subject to tax would include any worker's compensation if its receipt caused a reduction in disability benefits under the Social Security Act.

In no case will more than 50% of benefits be taxed.

2. Tier II Railroad Retirement Benefits and dual benefit payments ("windfall"). The amount is determined in the same manner as a benefit provided under a tax qualified pension plan. The general provisions are:

   a. The trust under the plan is generally exempt from income tax,

   b. Benefits distributed as a lump sum distribution are eligible to be:

      (1) Accorded special long-term capital gain treatment, or

      (2) Spread over a ten-year period (income averaging), or

      (3) Rolled over, tax-free, to an individual retirement account, annuity, or bond or to another qualified plan.

   c. If payable in the form of an annuity, the benefit is includible in gross income when paid.

   d. Employee contributions to these plans are generally not deductible from an employee's gross income when contributed. Accordingly, when benefits are provided under a qualified plan, employee contributions are not includible in gross income. The basis is recovered by either:

      (1) Not including in gross income any amounts paid under the annuity until the nondeductible employee contributions have been recovered, or

      (2) If the basis can not be recovered within three years of the date the annuity starts, then each annuity payment is prorated into taxable and nontaxable portions to reflect employee contributions.

   e. The benefits under this plan may affect the extent to which the employer could provide contributions or benefits under another qualified plan.

3. Sick pay benefits provided under the Railroad Unemployment Compensation Program, except for sick pay resulting from on-the-job injuries. These benefits would be subject to tax in the same manner as sick pay received by workers in other industries.

   a. Employees generally pay income tax on amounts received for personal injuries or sickness, since these amounts generally substitute for wages, which are also taxable.

   b. Amounts received by an employee through accident or health insurance for personal injuries or sickness, other than reimbursements for medical expenses, generally are includible in gross income if:

(1) The amounts are attributable to contributions by the employer that were not includible in the employee's gross income, or

(2) The amounts are paid by the employer.

Appendix I

Provisions Which Affect Individuals

B. Changes in the Credit for the Elderly to Include Disabled Individuals and Repeal of the Deduction for Payments to Disabled Individuals

Summary of Differences Between State and Federal Law (PITL 17052.9, 17131, IRC 37, 105(d))

Prior to 1984 the state and federal laws were the same for the credit for the elderly both in requirements and amounts, except California denied the credit to a nonresident while federal denied the credit to a nonresident alien. Under both state and federal laws prior to 1984 a disabled individual was allowed an exclusion of up to $100 a week ($5,200 per year) for payments received while absent from work on account of permanent and total disability. This exclusion was phased out to the extent that the adjusted gross income on the return exceeded $15,000. In 1984 federal law repeals the exclusion from income and restructures the credit for the elderly to apply to the totally and permanently disabled of all ages and increases the size of the credit available by increasing the base amounts to which the 15% credit applies. The eligibility for the credit for retirees of a public retirement system, under age 65, who are not disabled has been repealed.

Fiscal Effect - (1) Increase in base amounts - revenue loss .....$3.0 million
(2) Changes for disabled eligible individuals - revenue loss ....$2.5 million
(3) Repeal of credit for public retirees - revenue gain ....$6.5 million

The net effects of the above indicated changes would be a $1.0 million increase in General Fund revenues based upon the 1981 income year. However, we are unsure as to the relative elasticities of these three changes as they interact over time. If we project the net effect to the 1984-85 fiscal years (based on a 1984 income year effective date) it is possible that there could be either a positive or negative effect on General Fund revenues.

To conform to the 1983 federal changes (Social Security Act amendments) California would, beginning in 1984,

1. Increase the amount of the credit to an amount equal to 15% of a base amount as follows:

   a. Taxpayers age 65 or older,

      (1) $5,000 for a single individual or a married couple with only one eligible spouse,

      (2) $7,500 for a married couple with two eligible spouses, and

(3) $3,750 for a married person filing a separate return.

b. For taxpayers under age 65, the base amount is limited to disability income, which is defined as amounts paid under an employee's accident or health or pension plan that are includible in gross income as wages or payments in lieu of wages while absent from work on account of permanent and total disability.

c. The base amount is further reduced by amounts which are paid as a pension or annuity or as a disability benefit which are excluded from gross income and payable under:

(1) Title II of the Social Security Act plus any worker's compensation if its receipt caused a reduction in disability benefits under the Social Security Act,

(2) The Railroad Retirement Act of 1974

(3) A law administered by the Veterans' Administration, or

(4) Any federal law other than the Internal Revenue Code.

No reduction is to be made for amounts received as a pension, annuity or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country, the Coast and Geodetic Survey, the Public Health Service, or as a disability annuity payable under the Foreign Service Act of 1980.

d. If one spouse has attained age 65 and the other has not, the base amount can not exceed $5,000 plus the disability income of the spouse who has not attained age 65 by the close of the taxable year.

e. If the adjusted gross income exceeds the following amounts, the base amount is reduced by one-half of the excess:

(1) $7,500 in the case of a single individual

(2) $10,000 in the case of a joint return, or

(3) $5,000 in the case of a married individual filing a separate return.

2. Repeal the eligibility for the credit to retirees under a public retirement system, under age 65, unless they are permanently and totally disabled.

3. Retain the nonrefundability of the credit and the denial of the credit to any nonresident as well as the requirement for married couples to file joint returns unless they live separate and apart for the entire year.

4. Adopt the federal definition of permanent and total disability within this credit.

5. Repeal the disability income exclusion.

Appendix I

Provisions Which Affect Individuals

C. Granting Retroactive Eligibility for Federal Residential Energy Tax Credits to Certain Veterans Using Subsidized Energy Financing in Years Before 1983

Summary of Differences Between State and Federal Law (PITL 17052.8, IRC 44C)

The amount of expenditures eligible for the federal residential energy tax credit and California tax credit for energy conservation measures must be reduced under both laws for amounts received which provide subsidized financing for this activity. The California reduction is for any grant or any nonreimbursable financial assistance (other than interest charges) provided by a public utility or a public entity. The federal reduction is for financing received under a federal, state or local program a principle purpose of which is to provide subsidized financing for projects designed to conserve or produce energy. In the Supplemental Appropriations Act (Public Law 98-63) an exception to the federal reduction was made for payments provided before January 1, 1983 under a state program in existance before 1978 where the residence has a first mortgage financed by a qualified veterans' mortgage bond even though the payments constituted subsidized energy financing.

Fiscal Effect - Revenue loss of an unknown amount relating to tax years 1980, 1981, and 1982

To conform to the 1983 federal change, California would have to retroactively allow, without reduction, for taxable years prior to 1983, the cost of energy conservation measures installed under a program in existance before 1978 on a residence where the first mortgage was financed by a qualified veterans' mortgage bond even though a grant or other nonreimbursable financial assistance was provided by a utility or a public entity.

Appendix II

Provisions Which Affect Business

Appendix II

Provisions Which Affect Business

A. Deferral of Reporting Receipts for the 1983 Crop Year Under the Payment-In-Kind (PIK) Program

<u>Summary of Differences Between State and Federal Law</u>
(PITL 17551, B&CTL 24652, IRC 446, 447, 451)

Under California and federal laws prior to these amendments, taxpayers engaged in farming may determine their income under either the cash or accrual method of accounting. However, corporations and certain partnerships must use the accrual method of accounting. Under the cash method of accounting, income is recognized for the year in which it is actually or constructively received. Income is constructively received when it is credited to the taxpayers account, set apart, or otherwise made available so that it may be drawn upon at any time. A taxpayer who uses the cash method of accounting must recognize income when first entitled to receive commodities under a PIK program.

Under the accrual method of accounting, income is generally recognized when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy, regardless of when received. A taxpayer who uses the accrual method of accounting must recognize income upon receipt of the right to receive commodities under a PIK program, regardless of the time of actual receipt.

Thus, under both the cash and accrual methods of accounting, the taxpayer will recognize income when the commodities are first made available to the farmer. In addition, under both methods, when property rather than cash is received, the amount to be included in income is the fair market value of the property on the date the taxpayer recognizes the income.

For the 1983 crop year only, the federal law was amended to provide that a qualified taxpayer will not be treated as having realized income when he or she receives, or has the right to receive, a commodity under a 1983 PIK program. Thus, both accrual and cash basis taxpayers can defer the recognition of income that would otherwise be recognized until the year the commodities are sold, exchanged or otherwise disposed of.

Fiscal Effect - Cash flow revenue loss for taxable year (PIT) and income year (B&C) 1983 of $10 million*.

*Based upon a proration of federal estimates

<u>To conform to the 1983 federal changes</u> (Payment-In-Kind Tax Treatment Act and Supplemental Appropriations Act) California would retroactively allow the deferral of income with respect to PIK commodities received for the 1983 crop year by a qualified taxpayer.

1. The 1983 crop year means, for these purposes, payments with respect to all crops normally harvested or planted on or before December 31, 1983. These provisions would apply to PIK payments received with respect to real property withdrawn from production during the 1983 crop year. All land rented or leased, and in production for crop year 1982, if now rented or leased by the same individual, partnership, or corporation, and eligible for acreage reduction qualifies for designation under the PIK program for crop year 1983, the same as land owned by the producer.

2. For purposes of determining the gain or loss from the sale, exchange or other disposition of the commodity, the unadjusted basis of the commodity will be zero. The commodity will be treated as produced by the taxpayer for purposes of determining the character of the gain (ordinary income or capital gain) from the sale of the commodity.

3. In cases where Commodity Credit Corporation Loans are involved a three step process is specified to ensure that a qualified taxpayer who receives a PIK in the third step will be entitled to the same tax treatment as a qualified taxpayer who receives a PIK where a Commodity Credit Corporation Loan is not involved.

4. A qualified taxpayer is any taxpayer who meets the following two requirements:

    a. The taxpayer must be a producer (as defined in U.S. Department of Agriculture regulations) of agricultural commodities within the meaning of the 1983 PIK program.

    b. The taxpayer must divert farm acreage from production and devote the acreage to conservation uses in return for receiving any commodity under the 1983 PIK programs. The taxpayer includes not only the person who actually diverts the acreage from production (such as the land owner) but also any other producer who receives a PIK with respect to the acreage (such as a sharecropper).

5. Income from the sale or exchange of PIK commodities will be treated as income from the trade or business of farming. The taxpayer will be treated as using in the trade or business of farming any land so diverted for all purposes including, but not limited to:

    a. Payments of estimated tax;

    b. Method of accounting of a corporation engaged in farming;

    c. Expensing of certain soil and water conservation expenses;

    d. Expensing of certain expenditures by farmers for fertilizer;

    e. Expensing of certain expenditures by farmers for clearing land;

    f. Deductibility of expenses attributable to activities not engaged in for profit;

g. Net farm loss item of tax preference;

h. Limitation on deduction of investment interest;

i. Tax on unrelated business income of charitable, etc. organizations

6. Regulations by the Franchise Tax Board would be necessary to modify the regulation of the Secretary of the Treasury to modify the tax treatment of PIK payments received by cooperatives on behalf of a qualified taxpayer to take into account the difference in the treatment of patronage dividends by California. The recipient of patronage dividends in California law is allowed to make an election regarding the year in which the patronage dividend is included in the recipient's income.

7. The anti-speculation rules in federal law would be adopted for California purposes.

Appendix II

Provisions Which Affect Business

B. Business Convention Expenses in Caribbean Basin Countries and Bermuda

Summary of Differences Between State and Federal Law (PIT 17201, B&C 24443 and IRC 274)

Prior to this legislation, state and federal laws were generally the same with respect to deductions for convention expenses. Both state and federal laws generally do not allow deductions for business expenses incurred while attending a convention held outside the North American Area (the United States, the U.S. possessions, the Trust Territory of the Pacific Islands, Canada and Mexico). Deductions for attending conventions held outside the North American Area are allowable only if the taxpayer can show that it was as reasonable to hold the convention outside the North Americn Area as within it. The income tax treaty with Jamaica allows deductions for attending conventions held in Jamaica. Both state and federal tax agencies have significant problems obtaining from some Caribbean Basin countries information needed to enforce the tax laws.

Fiscal Effect - Revenue loss of $100 thousand* annually

*Based upon a proration of federal estimates

To conform to the 1983 federal changes (Interest and Dividend Tax Compliance Act/Caribbean Basin Economic Recovery Act) California would, beginning in 1984, allow business expense deductions for attending conventions held in certain Caribbean countries, but only if the country met the following criteria:

1. The country would have to be a "beneficiary country" designated by the President as provided in the trade portion of the federal law. In addition, a deduction would be provided for conventions held in Bermuda provided that Bermuda met the other criteria in the federal law applicable to Caribbean Basin countries.

2. The country would have to enter into an executive agreement with the United States to provide, on a reciprocal basis, for information relating to U.S. tax matters to be made available to U.S. tax officials. The agreement would be mandatory regarding criminal and civil tax matters unless, regarding civil tax matters, an agreement cannot be negotiated but the President determines that the agreement which has been negotiated is in the national security interest of the United States. The agreement would impose on the officials of each country a duty not to disclose this information, other than to those involved in its tax administration.

3. No deduction would be available for attending a convention in a country found by the Secretary of Treasury to discriminate in its tax laws against conventions held in the United States.

Appendix III

Provisions Which Affect Administration

Appendix III

Provisions Which Affect Administration

A. Prohibition Relating to Assessments Based on the Value of Campus Lodging Furnished to an Employee

Summary of Differences Between State and Federal Law (PITL 17131, IRC 119)

State and federal laws are the same regarding the treatment of lodging furnished for the convenience of the employer and provide that certain lodging will not be included in the gross income of the employee when the employee is required to accept the lodging on the business premises of the employer as a condition of employment. The Supplemental Appropriations Act of 1983 prohibits the Internal Revenue Service from using any funds appropriated by that Act to:

1. Enforce any ruling making taxable or subjecting to withholding the value of campus lodging furnished by, or on behalf of, any educational institution which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on, to any employee of the institution or any spouse or dependent of the employee, or

2. Conduct any other activity with respect to the assessment or collection of any tax on such value.

Fiscal Effect - Revenue loss of an unknown amount.

To conform to this 1983 appropriation restriction, California would have to retroactively allow, for open years, exclusions from gross income for the value of campus lodging furnished to employees, spouses or dependents without regard to whether the acceptance of the lodging was a condition of employment.

Provisions Which Affect Administration

B. Information Reporting on Social Security and Tier I Railroad Retirement Benefits

Summary of Differences Between State and Federal Law (IRC 6050F)

Prior to 1984 state and federal laws did not require information reporting by either the Secretary of Health and Human Services regarding Social Security benefits or the Railroad Retirement Board in the case of Tier I Railroad Retirement benefits, since these benefits were not included in gross income. Beginning in 1984, these two federal agencies are required to file information returns as follows:

1. With the Secretary of the Treasury, an information return showing:

   a. The aggregate amount of Social Security benefits paid to the individual during the calendar year,

   b. The aggregate amount of Social Security benefits repaid by the individual during the calendar year,

   c. The aggregate reductions in benefits which would otherwise have been paid to the individual during the calendar year on account of amounts received under a worker's compensation act, and

   d. The name and address of the individual;

2. With each individual, by January 31 of the year following the calendar year during which payments were made, an information return showing:

   a. The name of the agency making the payment, and

   b. The aggregate amount of payments, repayments, and reductions shown on the information return filed with the Secretary with respect to that individual.

Fiscal Effect - None

To conform to the 1983 federal changes (Social Security Act Amendments) California would, beginning in 1984, require the two federal agencies to file with the Franchise Tax Board a copy of the information return filed with the Secretary of the Treasury with respect to recipients who have a California address. California would also require that those agencies notify individual recipients that information on their benefits has been provided to the California Franchise Tax Board.

Provisions Which Affect Administration

C. Repeal of Withholding on Interest and Dividends and Enactment of Backup Withholding

Summary of Differences Between State and Federal Law (U.I. Code 13020.5 Statutes 1983 C.H. 498, IRC 3402(s), IRC 3406, 6705, 6676, 6653, 6682(a), 7205, 6042, 6044(e), 6049(c)(2), 6011, 7701, IRC 31, 6678)

1. Both state and federal laws require individuals who have a tax liability in excess of amounts withheld to pay estimated taxes in four equal installments during the taxable year. No estimates are required by California if the excess tax liability is less than $100 while the federal law does not require estimate payments unless the excess tax liability is $300 or more increasing to $500 by 1985.

   California did not enact legislation to conform to federal law which required withholding at a rate of 10% on any payment or credit of interest (including original issue discount), dividends, or patronage dividends. This requirement was in effect for amounts paid or credited after July 31, 1983 generally, and after December 31, 1983 in the case of original issue discount.

   Public Law 98-67 retroactively repeals federal withholding on interest (including original issue discount), dividends, or patronage dividends as of June 30, 1983. In addition, to protect payors who actually withheld from interest, dividend, or patronage dividend payments, the law provides that the payor may elect to have the repeal apply to amounts which are, in fact, deducted and withheld before September 2, 1983. Procedures also will be announced by the Secretary of the Treasury by press release, revenue procedure, or regulation under which payors may elect to refund withheld taxes to payees and receive a return of deposited funds from the Treasury.

   The law also provides that in determining an estimated tax penalty, credit will be given for amounts that would have been withheld on interest, dividends or patronage dividends had the withholding on these items not been repealed. Also, no make up of estimated taxes underpaid because of repeal of withholding is required prior to the due date of the income tax return.

2. Prior to the changes to backup withholding made by this law, certain payments made after 1983 were to be subject to backup withholding in both state and federal laws. California would have subjected only wages to backup withholding at a rate of 5%, while the federal law would have required withholding at a rate of 15% if:

   a. The payee failed to furnish a taxpayer identification number (TIN) to the payor, or

b. The Secretary of the Treasury notified the payor that the TIN furnished by a payee was incorrect.

Payments subject to these rules for federal purposes were payments required to be shown on an information return relating to information at source (for example, compensation or rents), payments to non-employees, payments of dividends or interest, broker transactions, and certain fishing boat operators.

If the payee failed to furnish a TIN (or furnishes a TIN with an incorrect number of digits, an "obviously incorrect" TIN), backup withholding would have applied to any payment made after the account was opened. If a payee furnished a TIN to the payor, and the Secretary later notified the payor that the number supplied was incorrect, backup withholding was mandatory with respect to any payment made after the close of the 15th day after the day on which the payor was notified that the TIN was incorrect (although the payor could have started withholding at any time after notice). If a taxpayer was subject to backup withholding and furnished a TIN (or a new TIN) to the payor, the payor had 15 days to correct its records and cease withholding.

If the payee twice furnished an incorrect number to a payor, the payor was required to ignore any further TINs received from the payee until the day on which the payor was notified by the Secretary that a correct TIN had been supplied. A 15-day grace period would have applied in which the payor had to cease withholding.

In general, payors were allowed 15 days in which to implement backup withholding triggered by a notice from the Internal Revenue Service that the payee supplied an incorrect TIN (unless the payor elected to withhold earlier).

The backup withholding did not apply to amounts subject to withholding under other provisions of the federal law, including mandatory withholding on interest, dividends, and patronage dividends.

This law repeals the backup withholding provisions in IRC Section 3402(s) and enacts a new backup withholding Section 3406 and sets the rate at 20% on all reportable payments including rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, payments of remuneration for services or direct sales, broker payments, fishing boat operators, as well as payments of interest, dividends, and patronage dividends. Backup withholding is required with respect to reportable payments if:

a. The payee fails to furnish a TIN in the required manner,

b. The Secretary notifies the payor that the payee furnished an incorrect TIN,

c. The Secretary notifies the payor that backup withholding should be commenced in the circumstance in which the payee failed to report properly interest, dividends, or patronage dividends, or

d. When required to do so, the payee fails to certify, under penalties for perjury, that the payee is not subject to backup withholding.

Items "c" and "d" (above) only apply to reportable interest or dividend payments.

Fiscal Effect - It is anticipated that California would experience an unknown but probably minor revenue gain from implementation of a comparable backup withholding system.

<u>To conform to the 1983 federal changes</u> (Interest and Dividend Tax Compliance Act/Carribbean Basin Economic Recovery Act) California would:

1. Amend the Unemployment Insurance Code to substitute IRC Section 3406 for the current reference to IRC Section 3402(s). This change would, for reportable payments to employees, continue the California backup withholding for 1984 and subsequent years at a 5% rate.

2. Adopt a new section in the Revenue and Taxation Code to provide for backup withholding administered by the Franchise Tax Board with respect to all other reportable payments, as defined in IRC Section 3406, at a withholding rate appropriate for California for 1984 and subsequent years.

3. Adopt a penalty for failure to transmit information by any retail broker who intentionally fails to provide a payor with a TIN or backup withholding status report when obligated to do so at an appropriate state amount. The federal amount is $500 per failure.

4. Adopt civil and criminal penalties for a false backup withholding or TIN certificate to be the same as those for false wage withholding certificates.

5. Make the civil liability for misuse of tax return information apply to any payor who uses information that a payee is subject to backup withholding for any purpose other than to comply with the backup withholding requirement. Good faith but erroneous interpretation of permissible uses does not result in liability.

6. Amend the current penalty on a payor for failure to report a TIN to repeal the $10,000 limitation on the $10 penalty for failure to supply TINs with respect to interest, dividends or patronage dividends and replace the reasonable cause defense with a due diligence defense. The federal penalty is five times larger than the state's. Also, the federal penalty is made to be a self-assessed exise tax for purposes of procedures and administration due and payable on April 1 of the

calendar year following the calendar year for which the return or statement to which the penalty relates is made. Since the penalty is treated as an exise tax only for purposes of Subtitle F, Procedures and Administration, the payment of the penalty does not give rise to any deduction for income tax purposes. The normal deficiency procedures do not apply. Also, a broker, acting willfully, who fails to secure non-withholding certificates and to notify the payor that the payee is subject to backup withholding when required to do so is subject to a $500 penalty per failure.

7. Adopt a penalty for failure to file information returns or statements with respect to the payment to another person of interest, dividends or patronage dividends who fails to do so on the date prescribed of $10 per failure (20% of the federal $50 penalty) with no maximum. If there is intentional disregard of the filing requirements, the penalty is 2% (federal is 10%) of the aggregate amount of items required to be reported. If there is substantial noncompliance the penalty is increased to $40 per failure ($200 on federal law). This penalty is made self-assessed for federal purposes in the same manner as was provided for TIN penalties in Item 6.

8. Adopt a magnetic media reporting requirement for any person (individual, estate or trust) required to file more than 50 returns in the aggregate with respect to payments of interest, dividends or patronage dividends for any calendar year. The Franchise Tax Board may relieve a payor of the magnetic media requirement upon a showing of undue hardship.

9. Adopt a provision to require payors to provide payees with information statements with respect to interest, dividend or patronage dividend payments in the form required by Treasury regulations. These statements must be in a separate mailing which contains no additional information other than information relating to the correction of TINs.

10. Adopt a provision which makes a failure to report interest, dividend or patronage dividend income that is subject to information reporting, deemed to have resulted from negligence in the absence of clear and convincing evidence to the contrary.

11. Appropriations to fund the Franchise Tax Board above the current levels for 1983-84 and subsequent fiscal years to achieve the greater tax compliance with respect to backup withholding of not only payments subject to information reporting but also the payments of interest, dividends and patronage dividends. The sense of Congress in this statute was that for fiscal years 1984 thru 1988 $600 million be appropriated for this effort by the Internal Revenue Service with a minimum of $315 million to be appropriated. The funding is to be used primarily to hire essential in-house, IRS staff personnel to complete matching, analyze returns, contact taxpayers, and respond to taxpayer inquiries with regard to underreported interest and dividends of filers and nonfilers. Some additional personnel would be needed to assist in identifying nonfilers.