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

# Federal Income Tax Changes

1985

Prepared by Staff of the

FRANCHISE TAX BOARD

State of California

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# EXECUTIVE SUMMARY

In 1985 Congress passed and the President signed the following public laws which revised the provisions of the Internal Revenue Code (IRC):

1. Public Law 99-44 (signed May 24, 1985), and
2. Public Law 99-121 (signed October 11, 1985).

This report explains the 1985 federal changes, with a discussion of current California law and an estimate of the fiscal impact to the state from conforming to the federal change. The sequence of the discussion of the 1985 federal changes follow the lines on the state income tax forms where these transactions are reportable.

These items will be submitted for review by a Federal Conformity Task Force appointed by the Chairman of the Assembly Revenue and Taxation Committee.

# A. GOLDEN PARACHUTE PAYMENTS

PIT Form: 540
Line Number: 12

B&C Form: 100
Line Number: 12

PUBLIC LAW 99-121 SECTION 102

INTRODUCTION

Corporations sometimes enter into agreements with their key employees that have come to be called "golden parachutes" under which the corporation agrees to pay these key employees amounts, often in excess of their usual compensation, if control of the corporation changes.

CURRENT CALIFORNIA LAW (PITL 17288;B&CTL 24343)

In 1985 California specifically did not conform to the 1984 Tax Reform Act change in the treatment of "Golden Parachute" payments. The rules which continue to apply in California are that only reasonable compensation is deductible as an ordinary and necessary business expense. Compensation which is not reasonable is in the nature of a dividend and not deductible by the corporation even though includible in the employee's gross income. The determination of reasonable compensation will be made on a case-by-case basis using the facts and circumstances in each case.

NEW FEDERAL LAW (IRC 280G)

The 1984 Tax Reform Act codified the treatment of these "golden parachute" payment agreements. Payments in money or property in excess of "base amount" under an agreement entered into or amended after June 14, 1984 are nondeductible. Also, the recipient is subject to a nondeductible 20 percent penalty tax on such excess. The payments are also subject to FICA (social security) taxes. Excess payments exist when the total present value (determined using a discount rate equal to 120% of the applicable federal rate (AFR)) of the parachute payments made or to be made equals or exceeds three time the "base amount". The AFR was keyed by reference to the 120% penalty rate used for imputing interest on seller-financed transactions. Since the penalty rate was eliminated in those provisions in 1985 by Public Law 99-121, the Golden Parachute provision was amended to specifically incorporate the 120% of the AFR penalty provision.

The "base amount" is an individual's average annual compensation for the most recent five taxable years before the date on which the control of the corporation changed.

REVENUE IMPACT

None. Not applicable to California.

## POLICY ISSUES

None. The Legislature decided not to conform to federal law during the 1985 legislative session.

# B. INTEREST-FREE, BELOW MARKET LOANS, MARKET DISCOUNT AND ORIGINAL ISSUE DISCOUNT RULES

PIT Form: 540 | B&C Form: 100

Line Number: 13 | Line Number: 18

INTRODUCTION

California, during the 1985 Legislative session, did not conform to the federal law changes made in 1984 but instead retained the same rules that were contained in federal law for years prior to 1984. This nonconformity position was taken so that the decision regarding state conformity would be based upon the final statutory rules Congress enacted in 1985.

## I. ORIGINAL ISSUE DISCOUNT RULES
TAX REFORM ACT OF 1984 SECTIONS 41-44
PUBLIC LAW 99-121 SECTIONS 101-102

CURRENT CALIFORNIA LAW (PITL 17024.5, B&CTL 23051.5, 24272.5)

The issuer and holder of an original issue discount (OID) bond are required to report the interest annually regardless of whether they are on the cash or accrual basis. However, exceptions to this treatment are allowed for obligations issued by natural persons or obligations issued in exchange for property or services.

NEW FEDERAL LAW (IRC 103A, 163, 249, 409, 483, 871, 881, 1037, 1232-1232B, 1286-1288, 1441, 6706)

Generally, effective January 1, 1985, the 1984 Tax Reform Act restructures the code provisions containing debt instrument provisions into the new OID rule structure with technical and conforming changes and extends the application of the OID rules to:

- o Debt instruments that are not publicly traded and that are issued for nontraded property,
- o Obligations issued by individuals,
- o Obligations not held as capital assets by cash basis taxpayers, and
- o Debt instruments that are issued for services or for the use of property.

The OID rules have been extended by the Act to apply to a privately placed debt instrument given in consideration for the sale or exchange of property (including right to use property and services) if:

(1) some or all of the payments are due more than six months after the date of the sale or exchange, and

(2) the stated redemption price at maturity exceeds either the stated principal amount (if there is adequate stated interest) or the "testing" amount (if there is inadequate state interest).

The new section enacted in 1984 and modified in 1985 serves two roles. First, it tests the adequacy of stated interest in a <u>seller-financed transaction</u> and, if the stated interest proves to be inadequate, <u>imputes</u> interest to the transaction. Second, it places the parties to the transaction on the <u>accrual-method</u> of accounting with respect to the transaction in order to prevent the mis-matching of interest income and interest expense between cash-basis taxpayers and accrual-basis taxpayers.

Not all seller-financed transactions are subject to the OID rules. Those exempt from OID rules, however, must still be examined as deferred payment sales between related taxpayers, if applicable. There are eight statutory exemptions from the OID rules for seller-financed transactions as follows:

- Sales in which total payments do not exceed $250,000.
- Sales of principal residences.
- Sales of farms by individuals, estates, trusts or small business entities for not more than $1 million.
- In the case of the borrower, sales of personal use property (property not connected with a trade or business or income-producing activity).
- Annuity contracts issued by life insurance companies or in connection with a qualified retirement plan.
- Transfers of all the substantial rights to a patent if the price is contingent on productivity, use or disposition of the property transferred.
- Sales of land between related parties which are subject to the rules for deferred payment sales between related parties.
- Existing debt instruments assumed in connection with

the sale or exchange of property, or if the property is taken subject to the existing debt instrument, unless the terms and conditions of the instrument are modified or the nature of the transaction is changed in connection with the assumption or acquisition.

In addition to these eight exemptions there is a special exemption for the period 1/1/85 to 7/1/85 for the sale of farm assets (other than new property eligible for investment credit) if the borrowed amount does not exceed $2 million.

For those transactions not exempted, the interest income and interest expense will be reported on the accrual method regardless of the taxpayers normal method of accounting. There is, however, one way for both the lender and the borrower to jointly elect to report on the cash basis if:

- o Stated principal does not exceed $2 million,
- o The lender is not a dealer and uses the cash basis method of accounting, and
- o A joint election is made.

In that instance both the borrower and the lender (and any successor to the note) will report on the cash basis method of accounting. The IRS is to prescribe regulations to prevent any abuse of this special treatment.

The determination of whether adequate interest is stated in the note is shown in Chart 1 (Page 6) and the imputed rate to be used for notes which fail the test is shown in Chart 2 (Page 6).

These charts refer to a percentage of the "Applicable Federal Rate" (AFR) which is based upon the weighted average of yields of publicly traded United States obligations for three categories of instruments:

- o short-term maturity (three years or less),
- o mid-term maturity (more than three years but not more than nine years), and
- o long-term maturity (more than nine years).

The period for computing the weighted average was six months for transactions between 1/1/85 and 6/30/85 and is one month for transactions after 6/30/85. Also, the lowest AFR in effect for any month in the three calendar month period ending with the month of the transaction will be the AFR that governs that transaction.

CHART 1

| CATEGORY | 1/1 - 6/30/85 | AFTER 6/30/85 |
|---|---|---|
| TEST RATE | | |
| Property eligible for investment credit | 110% of AFR | 100% of AFR |
| Other property under $2 mil ($2.8 mil after 6/30/85) | 9% | 9% or AFR whichever is less |
| Other property over $2 mil ($2.8 mil after 6/30/85) | Blend of 9% up to $2 mil and 110% of AFR on amt over $2 mil | 100% of AFR |
| Any Sale-Leaseback | ------------ | 110% of AFR |

CHART 2

| CATEGORY | 1/1 - 6/30/85 | AFTER 6/30/85 |
|---|---|---|
| IMPUTED RATE WHEN NOTE FAILS TEST RATE | | |
| Property eligible for investment credit | 120% of AFR | 100% of AFR |
| Other property under $2 mil ($2.8 mil after 6/30/85) | 10% | 9% or AFR whichever is less |
| Other property over $2 mil ($2.8 mil after 6/30/85) | Blend of 10% up to $2 mil and 120% of AFR on amt over $2 mil | 100% of AFR |
| Any Sale-Leaseback | ------------- | 110% of AFR |

AFR equals Applicable Federal Rate

As the charts show, the rates have been much simplified for transactions from July 1, 1985 and forward. There are only three breakpoints now, i.e. 9% for smaller transactions (those under $2.8 million), 110% of the AFR for sale-leaseback transactions, and 100% of the AFR for all other transactions. These rules apply to seller-financed transactions which are not exempt. For those seller-financed transactions which are exempt from the OID rules above, but are between related taxpayers, the rules for deferred payment sales may still apply.

## II. DEFERRED PAYMENT SALES

TAX REFORM ACT OF 1984 SECTIONS 41-44
PUBLIC LAW 99-121 SECTIONS 101-102

### CURRENT CALIFORNIA LAW (PITL 18031, 18151)

The maximum imputed interest rate that applies to real estate transactions between related parties involving $500,000 or less is 7 percent. A rate of 9 percent is used to determine whether stated interest is adequate for sales of personal residences of $250,000 or less and farm sales of $1 million or less. If the note fails the 9 percent test, the imputed interest on the note is deemed to be 10 percent.

The imputed interest determined under these rules is included in the income of the seller and deductible by the buyer in accordance with their respective accounting methods (i.e. when payment is made on the cash basis and when liability is incurred on the accrual method).

### NEW FEDERAL LAW (IRC 483, 1274, 1275)

If a deferred payment sale is made between related parties and the OID rules do not apply, then the transaction is tested to determine whether unstated interest exists. The test is made for payments that are part of sales price but are due more than six months after the date of the sale, provided some of the payments are due more than one year after the date of the sale. Rules similar to those for testing seller-financed transactions under the OID rules are used to test for unstated interest in deferred payment sales between related parties.

The following transactions are exempt from the deferred payment sale rules:

- o Sales in which the sales price is less than $3,000.

- o With respect to the purchaser, any purchase of personal property or educational services on an installment basis where the interest charge cannot be ascertained and is treated as 6 percent.

- o Sales of patents to the extent of any payments which are contingent on the productivity, use or disposition of the property transferred.

- o In the case of the borrower, sales of property not connected with a trade or business or income producing activity (called "personal use property").

- o Annuity contracts issued by life insurance companies or in connection with qualified retirement plans.

- o Any debt instrument to which the OID rules for a publicly traded debt instrument apply.

- o Sales which are subject to the OID rules for seller-financed transactions.

- o Existing debt instruments assumed in connection with the sale or exchange of property, or if the property is taken subject to the existing debt instrument, unless the terms and conditions of the instrument are modified or the nature of the transaction is changed in connection with the assumption or acquisition.

For those transactions which are not exempt, Chart 3 (Page 9) shows the testing rate used to determine whether there is unstated interest and Chart 4 (Page 10) shows the rate of imputed interest used when the note fails the test.

As in the case of transactions subject to the OID rules, the test and imputed interest rates for transactions after June 30, 1985 have been simplified. For deferred payment sales between related parties there are now only four different categories of rates, i.e. 6% for land sales between family members on the first $500,000; 9% for sales of $2.8 million or less; 110% of the AFR for sale-leasebacks and 100% of the AFR for all other transactions. These rules apply to deferred payment sales between related parties which are not exempt.

| CHART 3 | | |
|---|---|---|
| CATEGORY | 1/1 - 6/30/85 | AFTER 6/30/85 |
| TEST RATE | | |
| Property eligible for investment credit | 110% of AFR | 100% of AFR |
| Personal Residence for $250,000 or less ($2.8 after 6/30/85) | 9% | 9% or AFR whichever is less |
| Personal Residence for more than $250,000 ($2.8 mil after 6/30/85) | Blend of 9% up to $250,000 and 110% of AFR on amt over $250,000 | 100% of AFR |
| Farmland for $1 mil or less ($2.8 mil after 6/30/85) | 9% | 9% or AFR whichever is less |
| Farmland for more than $1 mil ($2.8 mill after 6/30/85) | Blend of 9% up to $1 mil and 110% of AFR on amt over $1 mil | 100% of AFR |
| Land between family members for $500,000 or less | 7% | 6% |
| Land between family members for more than $500,000 | Blend of 7% up to $500,000 and 110% of AFR on amt over $500,000 | Blend of 6% up to $500,000 and 100% of AFR on amt over $500,000 |
| Other property under $2 mil ($2.8 mil after 6/30/85) | 9% | 9% or AFR whichever is less |
| Other property over $2 mil ($2.8 mil after 6/30/85) | Blend of 9% up to $2 mil and 110% of AFR on amt over $2 mil | 100% of AFR |
| Any Sale-Leaseback | ------------ | 110% of AFR |

AFR equals Applicable Federal Rate

CHART 4

| CATEGORY | 1/1 - 6/30/85 | AFTER 6/30/85 |
|---|---|---|
| IMPUTED RATE WHEN NOTE FAILS TEST RATE | | |
| Property eligible for investment credit | 120% of AFR | 100% of AFR |
| Personal Residence for $250,000 or less ($2.8 after 6/30/85) | 10% | 9% or AFR whichever is less |
| Personal Residence for more than $250,000 ($2.8 mil after 6/30/85) | Blend of 10% up to $250,000 and 110% of AFR on amt over $250,000 | 100% of AFR |
| Farmland for $1 mil or less ($2.8 mil after 6/30/85) | 10% | 100% of AFR |
| Farmland for more than $1 mil ($2.8 mill after 6/30/85) | Blend of 10% up to $2 mil and 120% of AFR on amt over $2 mil | 100% of AFR |
| Land between family members for $500,000 or less | 7% | 6% |
| Land between family members for more than $500,000 | Blend of 7% up to $500,000 and 120% of AFR on amt over $500,000 | Blend of 6% up to $500,000 and 100% of AFR on amt over $500,000 |
| Other property under $2 mil ($2.8 mil after 6/30/85) | 10% | 9% or AFR whichever is less |
| Other property over $2 mil ($2.8 mil after 6/30/85) | Blend of 10% up to $2 mil and 120% of AFR on amt over $2 mil | 100% of AFR |
| Any Sale-Leaseback | ------------ | 110% of AFR |

AFR equals Applicable Federal Rate

## III. MARKET DISCOUNT BONDS
TAX REFORM ACT OF 1984 SECTIONS 41-44

CURRENT CALIFORNIA LAW (PITL 17081, 17201 B&CTL 24271)

For personal income tax, capital gain treatment is allowed for the appreciation in value attributable to market discount on an obligation held for more than one year. Interest on indebtedness incurred to purchase or carry a market discount bond is deductible currently against ordinary income, even though the income eventually generated by the investment is not taxed until disposition (and then only at capital gain rates).

Discounts on short term government obligations, payable without interest at a fixed maturity date not exceeding one year, are exempt by law from the rules requiring the periodic inclusion of acquisition discount. IRS regulations, for years prior to 1984, provide a similar exception for OID on short term obligations other than government bonds. Interest on indebtedness incurred to purchase or carry the nongovernmental bonds is currently deductible against ordinary income and is used to generate a one year tax deferral.

NEW FEDERAL LAW (IRC 1271 - 1278, 1281 - 1283)

For obligations issued after July 18, 1984, new rules are established to treat gain on the sale of market discount bonds as ordinary interest income to the extent of the market discount and only the gain over that amount is eligible for capital gain treatment.

For obligations issued after July 18, 1984, such as Treasury Bills and OID obligations with fixed maturity dates not exceeding one year form date of issue, the Act requires that the discount received upon the bond's acquisition be included in income (i.e. accrued and reported as interest income in the year acquired).

## IV. BELOW MARKET LOANS
TAX REFORM ACT OF 1984 SECTION 172
PUBLIC LAW 99-121 SECTIONS 201-202

CURRENT CALIFORNIA LAW (PITL 17081, 17201)

Interest-free and below market interest not on an arm's length basis (i.e. between family members or corporation/shareholder) is not includible in income of the lender and the forgone interest is not deductible by the recipient.

NEW FEDERAL LAW (IRC 7872)

The Act reclassifies interest-free and below market rate loans as "arm's length" transactions with the parties treated as if:

- The lender made a loan to the borrower in exchange for a note requiring the payment of interest at the applicable federal rate,

- The borrower paid interest in the amount of the "forgone" interest. This treatment requires the lender to include the forgone interest as income and the borrower has an interest expense deduction for that amount,

- In the case of a gift loan, the lender made a gift subject to gift tax,

- In the case of a corporation/shareholder loan, the corporation paid a dividend includible in the shareholder's income, and

- In the case of a compensation related loan (i.e., employer to employee or service recipient to service provider), paid compensation that is includible in the employee's or service provider's income and deductible by the lender.

These new rules are generally effective for loans made or renegotiated after June 6, 1984. Exceptions are provided for certain loans to qualified continuing care facilities. Also, the time for determining the AFR for term loans made by employers to employees to purchase a principal residence in connection with a qualified employee relocation is changed. The test rate for this type of loan is the AFR for the month in which the employee enters into the written contract for the purchase of the principal residence. This new rule applies to contracts entered into after June 30, 1985, in tax years ending after that date.

REVENUE IMPACT

Assuming a 1985 effective date, the revenue impact from conforming to federal law for all these provisions would be a revenue gain of $18 million for 1985-86, $31 million for 1986-87, and $46 million for 1987-88 based upon a proration of federal estimates for the 1984 federal Tax Reform Act and the modifications made by Public Law 99-121 in 1985. Revenue gains for BELOW MARKET LOAN provisions for 1985/86 would be in the $5 million range while the remaining $13 million is attributable to the items of ORIGINAL ISSUE DISCOUNT, DEFERRED PAYMENT SALES and MARKET DISCOUNT BONDS.

## POLICY ISSUES

The questions for California consideration are:

I. Does the potential for abuse exist in state law which conformity to the federal changes would prevent?

II. Should California be different with respect to either the calculation of "true interest" or the time at which the interest is includible in income or deducted as an expense?

III. If conformity with federal law is desired, what taxable or income years should these changes be applied to in state law?

### I. DOES THE POTENTIAL FOR ABUSE EXIST IN STATE LAW WHICH CONFORMITY TO THE FEDERAL CHANGES WOULD PREVENT?

The purpose of the 1984 federal changes was to prevent mis-matching of interest income and interest deductions by requiring both the buyer and the seller to account for the interest in the transaction on the accrual method of accounting and to determine the "true" amount of interest. Without changing California law to conform to federal law the potential for mis-matching the understatement of "true" interest by individuals would still exist under state law.

The imputed interest rules in the 1984 Tax Reform Act, however, have been perceived as complex in several respects. The 1985 changes to these rules attempt to simplify the imputed interest rules, while retaining the basic purposes of the 1984 legislation.

While the 1984 Act was directed at stopping abuses that result from the manipulation of principal and interest in a debt instrument arising from a seller-financed transaction, many taxpayers have argued that the assumption of a debt instrument when its terms are not modified should not be subject to these new rules since there is no opportunity for the parties to manipulate principal and interest on the loan. Accordingly, under the 1985 modifications, the imputed interest rules generally will not apply to assumptions of loans.

### II. SHOULD CALIFORNIA BE DIFFERENT WITH RESPECT TO EITHER THE CALCULATION OF "TRUE INTEREST" OR THE TIME AT WHICH THE INTEREST IS INCLUDIBLE IN INCOME OR DEDUCTED AS AN EXPENSE?

If the state does not conform to the federal rules as revised, the reporting of interest income and interest expense will be totally different on California returns than on the federal return not only for the year of sale but for all years thereafter until the mortgage is paid off. Since the seller-financing form of sale is very common in California, this different treatment would impact many taxpayers.

The use by California of the federal rules would eliminate complexity since the same calculation and reporting would be used on state returns as are being reported on federal returns.

III. IF CONFORMITY WITH FEDERAL LAW IS DESIRED, WHAT TAXABLE OR INCOME YEARS SHOULD THESE CHANGES BE APPLIED TO IN STATE LAW?

If the same operative dates are to apply to state law as apply for federal purposes then a bill would be required to be introduced and chaptered before taxpayers are required to file their 1985 state tax returns (March 15, 1986, for corporate taxpayers). Otherwise, the 1985 state returns would be filed under the rules which allow the manipulation of principal and interest in debt instruments arising from seller-financed transactions.

## C. REAL PROPERTY RECOVERY PERIOD EXTENDED

PIT Form: 540 B&C Form: 100

Line Number: 16 Line Number: 21

PUBLIC LAW 99-121 SECTION 103

CURRENT CALIFORNIA LAW (PITL 17250; 17250.5;B&CTL 24349.5)

California did not generally conform to the federal accelerated cost recovery system (ACRS) enacted in 1981. However, SB 2198 (Royce) (Chapter 1699 of 1984) provides that residential rental property may utilize the ACRS system to compute California depreciation and the property is considered 18-year real property (15 yrs for low-income rental property). As an alternative, the straight-line method of depreciation may be used with an election of a recovery period of 18, 35, or 45 years. To qualify the residential rental property must meet all of the following conditions:

1. Be located in California,

2. Construction commenced on or after July 1, 1985 and before July 1, 1988, and

3. Eighty percent or more of the gross income from the property must come from the rental of dwelling units.

NEW FEDERAL LAW (IRC 57; 168)

Public Law 99-121 extends the recovery period for real property which is not low income housing from 18 years to 19 years for realty placed in service after May 8, 1985.

REVENUE IMPACT

The revenue gain from this one year change in the recovery period for newly constructed residential rental property located in California would be in the $1 million range annually. This estimate is based upon the prior revenue analysis made for SB 2198 (Royce) in 1984 modified to reflect a recovery period of 19 years rather than 18 years. The reduction in the revenue loss estimate using a 19 year recovery period represents the revenue gain for residential rental property only.

POLICY ISSUES

In 1984 SB 2198 (Royce) provided for the use of federal ACRS depreciation for state purposes on certain new residential rental property beginning on July 1, 1985. The federal recovery period for those properties was changed in 1985 from 18 to 19 years. If the same recovery period of 19 years is to be used on state and federal returns for 1985 then a bill would be required to be introduced and chaptered before taxpayers are required to file their 1985 California tax returns (March 15, 1986, for corporate taxpayers). Otherwise, the 1985 state returns would use an 18 year recovery period while the 1985 federal returns would use a 19 year recovery period.

## D. LIMITATION ON CREDITS AND DEPRECIATION — AUTOMOBILES AND MIXED USE PROPERTY

PIT Form: 540 | B&C Form: 100

Line Number: 16 | Line Number: 21

PUBLIC LAW 99-44

CURRENT CALIFORNIA LAW (PITL 17250; 17250.5;B&CTL 24349)

California has never allowed an investment tax credit.

California did not generally conform to the federal ACRS enacted in federal law in 1981 nor to the election to expense in the year acquired $5,000 of the cost of the asset. Expensing of a portion of capital assets is allowed in California only for property used in a business located in an enterprise zone or Program Area. ACRS is allowed only for residential rental property constructed after July 1, 1985 and located in California.

California allows a deduction for depreciation for the business use of an asset using either the straight-line method, the double declining balance method for new property having a useful life of three years or more, or the 150 percent declining balance method for used property over the class life of the asset. The straight-line method is simply the recovery of cost in excess of salvage value in equal amounts over the life of the asset. Under both declining balance methods the depreciation is greatest in the first year and gets smaller each year. The double declining balance method produces deductions in the first year which are twice the deduction computed under the straight-line method. That rate is multiplied against the remaining cost to be depreciated (the declining balance) in each succeeding year. The 150 percent method uses the same procedure except that the rate used is only 150 percent of the straight-line rate rather than twice the straight-line rate.

The class life system measures the period over which assets are to be depreciated. That system specifies a long list of assets by classification. For example, the class life for automobiles is three years, airplanes have a six-year life, office furniture, fixtures, and equipment have a ten-year life, and computers and peripheral equipment have a six-year life.

California allows taxpayers to elect an initial deduction for additional depreciation in the year an asset is acquired equal to 20 percent of the cost, but only for tangible personal property (movable assets) with a class life of six years or more.

California conformed to the limits on the yearly deduction under ACRS and regular state depreciation for automobiles, computers, and other mixed-use property by adopting, by reference in state law, Internal Revenue Code Section 280F. AB 66 in 1985 conformed to federal PL 99-44 (signed into law on May 24, 1985) which further reduced the depreciation deductions for luxury automobiles; and, which rescinded the provisions for contemporaneous records of business expenses, rescinded the provision for presumed negligence if adequate contemporaneous records were not kept, rescinded requirements that preparers inform clients of record keeping requirements, and rescinded the provision for penalties against preparers who do not inform clients of record keeping requirements.

NEW FEDERAL LAW (IRC 280F, 274)

The Act provides that effective for property leased or placed in service after June 18, 1984, "listed" property which is not used more than 50 percent for business will not qualify for investment tax credit. Also, the ACRS recovery allowance (depreciation) is to be determined under the straight-line method over the earnings and profits life for that property. If the percentage of business use was originally more than 50 percent, but drops below 50 percent in a later year, any depreciation taken in excess of the amount computed using the straight-line method over the earnings and profits life will be recaptured as ordinary income in the year the business usage drops to 50 percent or less.

"Listed" property includes:

1. Passenger automobiles and other property used as a means of transportation,

2. Property generally used for purposes of entertainment, recreation, or amusement,

3. Computers not used exclusively at a regular business establishment (including home offices), and

4. Other property to be specified by regulations.

The earnings and profits lives are:

1. A 5-year life for 3-year ACRS property,

2. A 12-year life for 5-year ACRS property,

3. A 25-year life for 10-year property,

4. A 35-year life for 15-year public utility property, and

5. A 40-year life for 19-year property and low-income housing.

Special limitations are placed on luxury automobiles which are used more than 50 percent for business. These limitations are effective for vehicles placed in service after June 18, 1984. Additional reductions are made for automobiles placed in service after April 2, 1985.

1. The investment credit is limited to $1,000 unless the taxpayer elects to use a reduced investment credit percentage, in which case the credit is reduced by one-third. For automobiles placed in service after April 2, 1985 the maximum is $675.

2. The ACRS recovery deduction, including the amount elected to be deducted as an expense, is limited to a total of $4,000 for the year the automobile is placed in service. For those placed in service after April 2, 1985, the first year maximum is $3,200.

3. The ACRS deduction for each succeeding year is limited to $6,000. For those placed in service after April 2, 1985, the yearly maximum is $4,800.

4. If there is cost unrecovered attributable to business use at the end of the three year recovery period, that unrecovered basis may be recovered each year to a maximum of $6,000 ($4,800 for autos placed in service after April 2, 1985). Property must continue to be used for business.

5. If business use falls to 50 percent or less, the depreciation taken in excess of straight-line over the earnings and profits life will be recaptured as ordinary income in the year of the reduced business use.

6. The credit and deduction limits are adjusted for inflation in the automobile component of the Consumer Price Index for years after 1988.

These limits apply before making the allocation between business and nonbusiness use.

A lessee is subject to reduced lease deductions for the amount attributable to the limitations on investment credit and depreciation deductions. Regulations will specify the computation of the lease limitation.

## REVENUE IMPACT

None. California has already conformed state law to the 1985 federal changes in Public Law 99-44.

## POLICY ISSUES

None. The Legislature decided to conform to federal law during the 1985 legislative session.