State of California
Franchise Tax Board

SUMMARY OF FEDERAL INCOME TAX CHANGES — 1990

Laws Affected
Personal Income Tax
Bank & Corporation Tax

SUMMARY OF

FEDERAL INCOME TAX CHANGES

1990

Prepared by the Staff of the

FRANCHISE TAX BOARD

State of California

Members of the Board:

State Controller

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

TABLE OF CONTENTS

Executive Summary

On November 5, 1990, the President signed into law the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508) which included the Revenue Reconciliation Act of 1990 (RRA).

The RRA modified and extended expiring tax provisions, including:

- o Employer-provided educational assistance.
- o Employer-provided group legal services.
- o Partial deduction of health insurance costs by self-employed individuals.
- o Tax credits for targeted jobs, low-income housing, research expenses, orphan drugs, and solar, geothermal and ocean thermal property.

With respect to individuals, the RRA:

1. Repealed the "bubble" in the tax rate by increasing the top marginal rate to 31 percent and repealing the phaseout of the 15 percent bracket. In addition, the phaseout of personal exemptions and a new overall limitation on itemized deductions become additional adjustments apart from the statutory rate structure.

2. Increased the Alternative Minimum Tax (AMT) rate from 21 to 24 percent but, for 1991 only, allows contributions of appreciated tangible personal property to be excluded from AMT.

3. Substantially revised the refundable Earned Income Tax Credit by increasing the credit amount, adjusting the credit to take into account the size of the taxpayer's family, providing a supplemental credit for health insurance coverage of one or more qualifying children and providing a supplemental credit for taxpayers with a child under 1 year of age.

With respect to businesses, the RRA:

1. Enacted a new credit for expenditures by small businesses to provide access to disabled individuals.

2. Enacted a new domestic energy tax credit for enhanced oil recovery costs, modifies the rules for the credits for nonconventional fuels, increases allowable percentage depletion and provides a special energy deduction for purposes of computing alternative minimum taxable income.

3. Requires recognition of gain at the corporate level with respect to certain corporate changes commonly referred to as "spin-off's," "split-off's," and "split-up's," as well as modifying the rules for carrybacks of net operating losses and other rules relating to corporate reorganizations.

The RRA also modified federal taxation of insurance companies, estate and gift tax rules relating to estate freezes, employment taxes, and made numerous technical corrections to prior Acts and repealed obsolete provisions.

This report also contains changes in federal income tax laws made by the Ethics Reform Act of 1989: Technical Amendments (P.L. 101-280).

Capital Gains Study

Exhibit C includes an estimate of the impact on California revenues that would have resulted from enactment of the president's capital gain tax proposal as contained in S. 2071 (Packwood, Dole, and Roth), and H.R. 3772 (Archer) during 1990. It also contains an analysis prepared by the federal Joint Committee on Taxation for a hearing on March 28, 1990, on proposals and issues relating to the taxation of capital gains and losses.

Exhibit C is included in this report in compliance with Assembly Bill 582 (Stats. 90-1174).

Expiring Provisions

Exhibit D is a list of expiring provisions in both state and federal law. The list begins with federal provisions expiring at the end of 1991, followed by state provisions expiring in 1991, and voluntary contributions which will not be shown on the 1991 state tax return.

The voluntary contributions are listed as expiring on 12/31/90 because that is the last calendar year return to which they apply. The actual sunset date is January 1, 1992, but that is prior to the filing of the returns for 1991.

Following the voluntary contributions are those federal and state provisions which expire in later years.

ACT SECTION: 11101

SECTION TITLE: ELIMINATION OF PROVISION REDUCING MARGINAL TAX RATE FOR HIGH-INCOME TAXPAYERS

Prior Federal Law (IRC Sec. 1)

For 1990, individual income tax rates are 15 and 28 percent, and the tax rates apply to taxable income brackets which vary according to the filing status of the taxpayer.

In addition, there is, in effect, a 33-percent marginal tax rate which serves to phase out the tax benefits of both the 15-percent tax rate and the personal exemption amounts i.e., "the bubble."

Capital gains are taxed at ordinary income tax rates.

The 1990 tax brackets are shown below for 3 income tax filing statuses.

Taxable Income Brackets

Tax Rate	Married Joint Return	Head of Household	Single Individual
15%	0-$32,450	0-$26,050	0-$19,450
28%	32,451-78,400	26,051-67,200	19,451-47,050
33%*	78,401-185,730	67,201-157,890	47,051-109,100
28%	Over 185,730	Over 157,890	Over 109,100

*The 33-percent tax rate terminates and the 28-percent tax rate again applies after the benefits of the 15-percent rate and the personal exemptions claimed by each taxpayer have been phased out. The amount of taxable income at which the phaseout is completed varies according to each taxpayer's family and filing status. This table shows the level at which the 33-percent tax rate would end in order to phase out completely the benefits of the 15-percent tax rate plus the minimum number of personal exemptions for each of the tax filing statuses shown. For this table, married individuals filing a joint return and heads of households are assumed to claim two personal exemptions; one personal exemption is assumed for a single individual. Each personal exemption is phased out over $11,480 of taxable income.

Current California Law (Sec. 17041)

The rate structure in California is highly progressive with numerous tax brackets. The tax rates apply to taxable income brackets which vary according to the filing status of the taxpayer. The maximum rate in 1990 is 9.3%. The California top rate is approximately one-third of the top federal rate.

New Federal Law (IRC Sec. 1, 41, 59, 63, 135, 151, 513, 691, 6103)

Starting in 1991, the maximum marginal income tax rate in the statutory rate structure is 31 percent; the phaseout of the personal exemptions and overall limitation on itemized deductions are additional adjustments apart from the statutory tax rate structure. The 31-percent marginal tax brackets in 1991 begin at the following amounts:

Single individual	$47,050
Joint return	78,400
Head of household	67,200
Married, filing separately	39,200
Estate and trusts	9,900

The Act also modifies the tax rates applicable to trusts and estates in order to not increase the benefit of the lower brackets that might otherwise arise from the adoption of the 31-percent marginal tax rate bracket. The conferees believe that modification of these rates is necessary to prevent additional undesirable incentives to create multiple trusts (i.e., the benefit of the lower brackets to a trust will be a maximum of $726.00 per year compared to $708.50 under present law).

Accordingly, the income tax rates and threshold amounts applicable to trusts and estates before the inflation adjustment for 1991 are adjusted as follows:

If taxable income is:	The tax is:
Not more than $3,300	15% of taxable income.
Over $3,300 but not over $9,900	$495.00 plus 28 percent of the excess over $3,300.
Over $9,900	$2,343.00 plus 31 percent of the excess of $9,900.

The Act also limits the maximum tax rate imposed on "net capital gain" to 28 percent. "Net capital gain" means the excess of net long-term capital gains over net short-term capital losses. Any net short-term capital gain would be taxed as ordinary income rates, including the 31 percent bracket.

Effective Date of New Federal Law

Applies to taxable years beginning on or after January 1, 1991.

Impact on California Revenue

Not applicable. California did not conform to the 1986 Tax Reform Act change which enacted a phase-out of personal exemption deductions. Thus, California does not have a tax rate "bubble" to eliminate.

ACT SECTION: 11102

SECTION TITLE: INCREASE IN RATE OF INDIVIDUAL ALTERNATIVE MINIMUM TAX

Prior Federal Law (IRC Sec. 55(b)(1(A)

An individual taxpayer is subject to an alternative minimum tax (AMT) which is payable to the extent it exceeds the taxpayer's regular income tax liability. The AMT rate is 21 percent of the alternative minimum taxable income. The AMT rate is set at 75 percent of the maximum regular marginal tax rate of 28 percent.

Current California Law (Sec. 17062(b)(3))

California generally is conformed to federal law with regard to alternative minimum tax but the rate is 7 percent versus the 21 percent federal rate. The California rate is one-third of the federal rate.

New Federal Law (IRC Sec. 55(b)(1)(A))

The individual rate is increased to 24 percent, in order to retain the relationship in present law between the AMT rate and the top marginal tax rate in the individual income tax.

Effective Date of New Federal Law

Applies to taxable years beginning on or after January 1, 1991.

Impact on California Revenue

Not applicable. The federal change in the AMT rate corresponds to an increase in the maximum rate for regular tax purposes. Unless California increases its maximum tax rate, the federal change is not applicable.

If California increases its maximum rate, the revenue estimate for this item will have to be determined at that time, since the amount of that increase would have a bearing on the amount of any corresponding increase in the AMT rate.

ACT SECTION: 11103

SECTION TITLE: OVERALL LIMITATION ON ITEMIZED DEDUCTIONS

Prior Federal Law (161-219 and 261-280H)

For 1990, individuals who do not elect the standard deduction may claim itemized deductions (subject to certain limitations) for certain nonbusiness expenses incurred during the taxable year. Among these deductible expenses are unreimbursed medical expenses, casualty and theft losses, charitable contributions, qualified residence interest, a portion of personal interest (10 percent in 1990; zero thereafter), State and local income and property taxes, moving expenses, unreimbursed employee business expenses, and certain other miscellaneous expenses.

Certain itemized deductions are allowed only to the extent that the amount of the expense incurred during the taxable year exceeds a specified percentage of the taxpayer's adjusted gross income (AGI). Unreimbursed medical expenses for care of the taxpayer and the taxpayer's spouse and dependents are deductible only to the extent that the total of such expenses exceeds 7.5 percent of the taxpayer's AGI. Nonbusiness casualty or theft losses are deductible only to the extent that the amount of the loss arising from each casualty or theft exceeds $100 and only to the extent that total casualty and theft losses exceed 10 percent of the taxpayer's AGI. Unreimbursed employee business expenses and certain other miscellaneous itemized deductions are deductible only to the extent that the total of such expenses and deductions exceeds two percent of the taxpayer's AGI.

Current California Law (Sec. 17201)

California conforms to federal law with regard to the allowance of itemized deductions. In addition, with respect to those deductions subject to limitations, California fully conforms by requiring the use of federal AGI in the calculation of the deductible amount. The deduction of state and local income tax, however, is not allowed for California purposes. In addition, the amount of investment interest expense may be different due to the differences in the bonds which are exempt from California tax versus those exempt from federal tax.

New Federal Law (IRC Sec. 56 and 68)

The Act provides that total otherwise allowable deductions (other than medical expenses, casualty and theft losses, and investment interest) are reduced by an amount equal to three percent of the amount of a taxpayer's AGI in excess of a threshold amount. For 1991 the threshold amount is $100,000 ($50,000 for married persons filing a separate return). The Act provides that for taxable years beginning after 1991, the threshold amount will be adjusted for inflation.

In no event, however, are total otherwise allowable deductions (excluding medical expenses, casualty and theft losses, and investment interest) be reduced by more than 80 percent. The provision applies only to individual taxpayers and not to an estate or trust.

In computing the amount of the reduction of total itemized deductions under the provision, all present-law limitations applicable to such deductions first are applied and the otherwise allowable total amount of deductions then is reduced pursuant to the provision. For purposes of the alternative minimum tax, itemized deductions which are otherwise allowed in computing AMTI are not reduced by the provision (i.e., the cutback amount determined for regular tax purposes is disregarded in calculating AMTI). For purposes of determining the tax treatment of State income tax refunds and other similar payments, the present-law tax benefit rule applies.

Effective Date of New Federal Law

The provision is effective for taxable years beginning on or after January 1, 1991. However, the Act provides that the provision will not apply to taxable years beginning after December 31, 1995.

Impact on California Revenue

Adoption of a similar limitation by California would result in revenue increases in the ranges of $179 million for the 1991 **taxable** year and $205 million for the 1992 **taxable** year.

The limitation would affect approximately 566,000 returns for the 1991 taxable year.

ACT SECTION: 11104

SECTION TITLE: PHASEOUT OF PERSONAL EXEMPTIONS .

Prior Federal Law (IRC Sec. 1(g))

A deduction for an individual, the individual's spouse, and each dependent is allowed. For 1989, the amount of the deduction was $2,050 for each exemption. The exemption amount is adjusted for inflation. The benefit of the deduction, as well as the benefit of the 15-percent tax bracket, is phased-out under present law by the imposition of the additional 5-percent tax (i.e. the "bubble"). Each personal exemption phases out over $11,480 of taxable income.

Current California Law (None)

California allows credits rather than deductions for personal exemptions and did not conform to the concept of a phase-out of the exemptions based upon the amount of taxable income. The indexed credit amount for each exemption for 1990 is $58.

New Federal Law (IRC Sec. 151(d))

Starting in 1991, the deduction for personal exemptions is phased-out as the taxpayer's adjusted gross income exceeds a threshold amount. The threshold amount is $150,000 for joint returns, $125,000 for a head of household, $100,000 for single taxpayers, and $75,000 for a married person filing a separate return. The phaseout range for the personal exemptions is $122,500. These amounts are indexed for inflation.

The exemption amount for each exemption is phased out by two percent for each $2,500 (or fraction thereof) by which the taxpayer's adjusted gross income exceeds the applicable threshold amount; the phaseout rate is 4 percent for a married person filing a separate return. Thus, for example, a joint return with an adjusted gross income of $212,500 (in 1991) would be entitled to deduct one-half the exemption amount for each exemption that otherwise would be deductible without regard to the phase-out.

Effective Date of New Federal Law

This provision is effective for taxable years beginning on or after January 1, 1991. However this provision does not apply to taxable years beginning after December 31, 1995.

Impact on California Revenue

Adoption of a similar phase-out by California would result in revenue increases in the ranges of $45 million for the 1991 **taxable** year and $54 million for the 1992 **taxable** year.

The phase-out would affect approximately 290,000 returns for the 1991 taxable year.

ACT SECTION: 11111-11116

SECTION TITLE: MODIFICATIONS OF EARNED INCOME TAX CREDIT

Prior Federal Law (IRC Sec. 32)

1. Credit Rates and Phase Out

Certain individuals who maintain a home for one or more children are allowed an advance refundable tax credit based on the taxpayer's earned income. In 1990, the earned income tax credit (EITC) is equal to 14 percent of the first $6,810 of earned income.

The credit is phased out at a rate of 10 percent of the amount of adjusted gross income (or, if greater, earned income) that, in 1990, exceeds $10,730. The $6,810 and $10,730 amounts are adjusted annually for inflation, so that the maximum amount of credit and the maximum amount of income eligible for the credit increase with inflation.

The projected maximum amount of the credit in 1991 is $994. The actual maximum will depend on future inflation.

2. Eligibility Rules

The earned income credit is available to: (1) married individuals filing a joint return who are entitled to a dependency exemption for a child, (2) a head of household who resides with a child, or (3) a surviving spouse. In order to qualify to file as a head of household or surviving spouse, a taxpayer must establish that he or she has provided over half of the cost of maintaining the household for the year. In order to be eligible to claim a dependency exemption, the taxpayer, in general, must provide over half of the support for the child, and the child must have the same principal place of abode as the taxpayer for at least half the year. Benefits under the Aid to Families with Dependent Children (AFDC) program and other public assistance programs are not considered support provided by the taxpayer. Thus, for example, if more than half of the taxpayer's income is from AFDC or sources other than the taxpayer's own income, the EITC generally is not available.

3. Supplemental Young Child Credit

Under present law, the EITC is not adjusted by reason of family size or the fact that an infant is under the age of 1 as of the close of the taxable year of the taxpayer.

4. Taxpayer Identification Number (TIN)

Under present law, a taxpayer is required to provide a taxpayer identification number (TIN) with respect to any dependent who has attained the age of 2 as of the close of the taxable year of the taxpayer (sec. 6109(e)).

5. Means-tested Programs

The AFDC statute provides for the disregard of the EITC from income in determining eligibility and benefits for AFDC recipients. The food stamp statute provides for disregarding the EITC for purposes of determining eligibility and benefits if it is paid as an advance payment. EITC payments received as a lump sum are counted as assets. Some means-tested programs, including housing assistance programs, treat the EITC as income for determining eligibility and benefits.

Current California Law (Sec. 17052.20, 17069 & 18934(b))

1. Low Income Credit (Sec. 17069)

California does not allow a refundable earned income credit but instead allows a nonrefundable credit for taxpayers with limited income. Although not refundable, the California credit has much broader coverage in that it applies to all taxpayers (including minor children subject to the "kiddie tax") which have income (whether or not it is earned income) below a specified amount which is indexed yearly for inflation. On the other hand, the federal credit only applies to earned income and only to those taxpayers maintaining a home for one or more children.

The California credit sunsets 1/1/92.

2. Credit for Qualified Parent with Child Under 13 Months of Age (Sec. 17052.20)

Starting on the 1991 return, SB 2208 (Chapter 90-1347) allows a credit for a qualified parent equal to $1,000. The credit is reduced by $200 for each $1,000 of AGI over $28,500 for head of household ($40,000 in the case of a surviving spouse or a married person filing a joint return). If the credit exceeds the tax, the excess may be carried over to future years until exhausted. However, the carryover ceases if the qualified parent claims the credit for child and dependent care expenses.

A "qualified parent" is one who maintains as his or her home, or if married the qualified parent and his or her spouse maintain as their home, a household which includes at least one member who is a child under the age of 13 months and who is a dependent of the qualified parent. Also, the qualified parent must have no earned income and must be a resident of this state.

The qualified parent must attach a copy of the birth certificate of the child to the return for each year in which the credit (or any carryover) is claimed. In addition, the qualified parent must qualify as head of household, or as a surviving spouse, or be considered married for tax purposes at the end of the year and file a joint return with his or her spouse for that year. [R&T Sec. 17052.20. Sunsets January 1, 1994.]

As part of the enactment of this credit by SB 2208 (Chapter 90-1347), the amount allowed for the Child Care Credit for 1991 and later years is phased down from 30% of the federal credit based on the AGI of the claimant as follows:

Adjusted Gross Income	Percentage of the federal is:
$40,000 or less	30%
Over $40,000 but less than $70,000	25%
Over $70,000 but less than $100,000	20%
Over $100,000	15%

[R&T Sec. 17052.6. Sunsets January 1, 1993.]

3. Taxpayer Identification Number (TIN) for Children (Sec. 18934(b))

California does not conform to the requirement to provide TINs for dependents.

New Federal Law (IRC Sec. 32, 162, 213 & 6109(e))

1. Rates and Phase Out

The Act modifies the credit percentages and phase-out rates and adjusts them for family size as follows:

For 1991:

	Credit Percentage	Phase-out Percentage
1 qualifying child	16.7	11.93
2 or more qual. children	17.3	12.36

For 1992:

	Credit Percentage	Phase-out Percentage
1 qualifying child	17.6	12.57
2 or more qual. children	18.4	13.14

For 1993:

	Credit Percentage	Phase-out Percentage
1 qualifying child	18.5	13.21
2 or more qual. children	19.5	13.93

For 1994 and thereafter:

	Credit Percentage	Phase-out Percentage
1 qualifying child	23	16.43
2 or more qual. children	25	17.86

For 1990, the maximum credit is $1,186 for taxpayers with one qualifying child and $1,228 for taxpayers with two or more qualifying children.

As under present law, a taxpayer may receive the EITC on an advanced basis. However, the amount of the credit that may be received on this basis is limited to the credit that the taxpayer could receive if the taxpayer had only one qualifying child. If the taxpayer is entitled to receive a larger credit (e.g., by reason of family size), the balance of the credit may be refunded after the taxpayer's income tax return has been filed.

2. Eligibility Rules

Under the Act, in order to qualify for the EITC, the taxpayer must meet the present-law earned income and adjusted gross income thresholds (as modified by the Act). In addition, the taxpayer must have a "qualifying child."

In order to be a qualifying child, an individual must satisfy a relationship test, a residency test, and an age test. The individual satisfies the relationship test if the individual is a son, stepson, daughter, or stepdaughter of the taxpayer, a descendent of a son or daughter of the taxpayer, or a foster or adopted child of the taxpayer.

As under present law, if the individual is married at the close of the taxpayer's year, the taxpayer generally must be entitled to a dependency deduction for the taxable year with respect to such individual in order to claim the EITC.

An individual satisfies the residency test if the individual has the same principal place of abode as the taxpayer for more than half the taxable year (the entire year for foster children). It is intended that the determination of whether the residency requirement is met is made under rules similar to those applicable with respect to whether an individual meets the requirements for head-of-household filing status. Thus, for example, certain temporary absences due to education or illness are disregarded for purposes of determining whether the child had the same principal place of abode as the taxpayer for over half the year. As under present law, the residence must be in the United States.

An individual satisfies the age test if the individual (1) has not attained the age of 19 at the close of the taxable year; (2) is a full-time student who has not attained the age of 24 at the close of the taxable year; or (3) is permanently and totally disabled. Whether a child is a full-time student is determined under the rules relating to the dependency exemption (sec. 151(c)(4)). An individual is permanently and totally disabled if such individual meets the requirements relating to the credit for the disabled (sec. 22(e)(3)).

If, with respect to a taxable year, an individual is a qualifying child with respect to more than one taxpayer, then only the taxpayer with the highest adjusted gross income may claim the EITC with respect to that child for that year. In addition, a taxpayer may not claim the EITC if the taxpayer is a qualifying child.

As under present law, married taxpayers may only claim the EITC if they file a joint return.

In order to claim the EITC, the taxpayer must complete and attach a separate schedule to his or her income tax return. In addition to the TIN requirement this schedule is required to include the name and age of any qualifying children and the Secretary may require adequate proof of the existence of health insurance if the taxpayer has claimed the supplemental EITC for health insurance (e.g., the policy number of the insurance or the employer identification number of the insurance company).

3. Supplemental Young Child Credit

If any of the taxpayer's qualifying children are under the age of 1 as of the close of the taxable year of the taxpayer, the Act allows an additional credit. The supplemental young child credit amount is available in addition to the amount determined by family size and is in addition to any supplemental credit for health insurance. Using present-law income limits and phaseout ranges, the supplemental young child credit provides an additional credit percentage of 5 percent and an increased phaseout percentage of 3.57 percent. Thus, the maximum supplemental young child credit is projected to be $355 in 1991.

If the taxpayer claims the supplemental young child credit, the child that qualifies the taxpayer for such credit is not a qualifying individual under the dependent care credit (sec. 21).

The portion of the credit available under the supplemental credit is not available on an advance basis.

4. Taxpayer Identification Number (TIN) for Children 1 Year or Older

Taxpayers are required to obtain and supply a taxpayer identification number (TIN) for each qualifying child who has attained the age of 1 as of the close of the taxable year of the taxpayer.

5. Supplemental EITC for certain health insurance premium expenses

Under the Act, a credit is available to taxpayers for qualified health insurance expenses that includes coverage for a qualifying child. The health credit is refundable, but not on an advance basis.

Qualified health insurance expenses for which the credit is available are amounts paid during the taxable year for health insurance coverage that includes one or more qualifying children (as defined for purposes of the EITC). These expenses include those relating to the cost of coverage (i.e., premium cost) only. Thus, expenses such as co-payments or deductibles under the insurance coverage, as well as other out-of-pocket medical expenses, are not eligible for the credit as qualified health insurance expenses. In addition, qualified health insurance expenses do not include amounts paid by an employee who contributes to his or her employer-sponsored health plan on a pre-tax basis (i.e., through a plan described in sec. 125). Qualified health expenses do include such employee contributions if made on an after-tax basis.

The calculation of the child health credit is generally the same as the calculation of the EITC. Thus, the same eligibility criteria and income phase-in and phase-out requirements apply. However, there is no family size adjustment with respect to the health credit.

The maximum amount of the credit is calculated based on a percentage of earned income. The credit percentage is 6 percent of earned income (up to the maximum amount of creditable earned income in effect for the EITC) and the phaseout rate is 4.285 percent. For 1991, the maximum health credit is projected to be $426.

The maximum credit after application of the phase-out requirement is limited to no more than the actual cost of coverage to the taxpayer for family coverage. Thus, the credit is limited to the lesser of the maximum amount of the credit as phased out with respect to the taxpayer and the actual qualified health insurance expenses.

Under the Act, the amount of any expenses eligible for the medical expense deduction or health insurance deduction for the self-employed is reduced dollar-for-dollar by the amount of allowable credit under this provision. Thus, for example, assume that a taxpayer pays a $3,000 premium for health insurance coverage for the taxpayer and his or her family (including at least one qualifying child), and by reason of such expense is entitled to a $200 credit under this provision. The amount of expenses (absent any other medical expenses for the taxable year) available to be considered by the taxpayer for purposes of the medical expense deduction under sec. 213 is $2,800 ($3,000 less $200).

6. Study of Advance Payments and Public Awareness Program

The Internal Revenue Service is to develop special procedures to notify taxpayers who have not claimed the EITC of their potential eligibility for the credit. In addition the Comptroller General of the United States is to conduct a study of the advance payment system for the EITC by November 5, 1991.

7. Means-tested Programs

Under the Act, the EITC (including the child health insurance portion) is not taken into account as income (for the month in which such refund or payment is made or any month thereafter) or as a resource (for the month in which such refund or payment is made or the following month) for the purpose of determining the eligibility or amount of benefit of such individual for AFDC, Medicaid, SSI, the food stamp program and for purposes of certain other housing programs including low-income housing programs.

Effective Date of New Federal Law

These provisions are effective for taxable years beginning on or after January 1, 1991.

Impact on California Revenue

Not applicable.

ACT SECTION: 11311

SECTION TITLE: SUSPENSION OF STATUTE OF LIMITATIONS DURING PROCEEDINGS TO ENFORCE CERTAIN SUMMONSES

Prior Federal Law (IRC Sec. 6503)

The federal statute of limitations for most tax returns (whether corporate or individual) is three years. The IRS and the taxpayer can together agree to extend the statute of limitations, either for a specified period of time or indefinitely. The taxpayer may terminate an indefinite agreement to extend the statute of limitations by providing notice to the IRS on the appropriate form. Because of the complexity of the issues involved, the IRS frequently cannot complete an audit of a corporate tax return within the statutorily specified three-year period.

During an audit, the IRS frequently requests informally that the taxpayer provide additional information necessary to arrive at a fair and accurate audit adjustment, if any adjustment is warranted. Not all taxpayers cooperate by providing the requested information on a timely basis. In some cases the IRS is compelled to seek information by issuing an administrative summons. Such a summons will not be enforced by judicial process unless the Government (as a practical matter, the Department of Justice) seeks and obtains an order for enforcement in Federal court. In addition, a taxpayer may petition in court to have an administrative summons quashed where this is permitted by statute (for example, under sections 6038A(e)(4) or 7609(b)(2)).

Current California Law (Sec. 18586, 18586.7, 25663 & 25663d)

The general California statute of limitations on assessment is four years instead of the three year federal period. California, in addition, does not use the federal summons procedure, but instead uses a subpoena for books and records necessary to complete an audit examination. California law, for both individuals and corporations, suspends the running of the limitation period for the time during which a proceeding (and appeals therein) is pending with respect to the enforcement of the subpoena.

New Federal Law (IRC Sec. 6503(k))

In general, the Act tolls the statute of limitations for a corporation during the period of time that the corporation and the IRS are in court litigating the issue of whether the corporation must comply with a specific type of summons issued by the IRS (called, for purposes of this provision, a "designated summons"). The statute of limitations may only be suspended with respect to a corporation; it may not be suspended with respect to individuals.

The IRS may issue a designated summons, which must be issued at least 60 days before the day on which the period for assessment of tax for the year in question (including any extensions) would otherwise expire. A designated summons may be issued by the IRS only once for any tax return of a taxpayer.

The statute of limitations is suspended for the period that commences when a lawsuit is brought in court to either enforce or quash the designated summons and ends on the date there is a final resolution of the summonsed person's response to the summons. For these purposes, the term "final resolution" means the same as it does in section 7609(e)(2)(B). In general, this means that no court proceeding remains pending and that the summonsed person has complied with the summons to the extent required by the court. If a court requires additional compliance to any extent with the summons, the statute of limitations is suspended for an additional 120 days after final resolution of the summonsed person's response. If additional compliance is not required, the assessment period would in no event expire until the 60th day after that final resolution. This provision is designed to preserve the ability of the IRS to conclude the audit and assess any taxes that may be due regardless of the length of time that it might take to obtain judicial resolution of the summons enforcement lawsuit.

These rules for suspending the statute of limitations also apply with respect to any summons issued to any person during the 30-day period following the issuance of the designated summons, so long as the subsequent summons pertains to the same tax return as the designated summons. This is necessary because, for example, a designated summons may be issued to a corporation that cannot respond adequately on the grounds that the summonsed information is in the control of a shareholder; a summons to the shareholder for the same information would be necessary to obtain the summonsed information. Thus, the statute of limitations is tolled during the course of any enforcement litigation over the subsequent summons.

Effective Date of New Federal Law

This provision applies to any tax (regardless of whether imposed before, on, or after the date of enactment) if the statute of limitations for the assessment of the tax has not expired on the date of enactment.

Impact on California Revenue

Not applicable.

ACT SECTION: 11312

SECTION TITLE: APPLY ACCURACY-RELATED PENALTY MORE EFFECTIVELY TO SECTION 482 ADJUSTMENTS

Prior Federal Law (IRC Sec. 6662)

Valuation questions are frequently central to disputes between taxpayers and the IRS' involving section 482. Substantial valuation overstatements are subject to penalty. A substantial valuation overstatement occurs if the value of any property claimed on a tax return is 200 percent or more of the amount determined to be correct. The penalty is 20 percent of the understatement of tax attributable to the substantial valuation overstatement. No penalty is imposed if it is shown that there was reasonable cause for the underpayment and that the taxpayer acted in good faith, or if the portion of the underpayment for the taxable year attributable to substantial valuation overstatements does not exceed $5,000 ($10,000 in the case of corporation other than an S corporation or a personal holding company).

Current California Law (Sec. 18685 & 25935)

California conforms by reference to federal law as of January 1, 1990.

New Federal Law (IRC Sec. 6662)

The present-law valuation overstatement penalty is extended to apply to specified valuation misstatements in connection with section 482.

1. The penalty applies to the understatement of tax attributable to a net section 482 transfer price adjustment for the taxable year that exceeds $10,000,000. These valuation misstatement penalties (and thresholds) relating to adjustments under section 482 apply to underpayments resulting from adjustments in prices for any property or services (or for the use of property). The net section 482 transfer price adjustment is the net increase in taxable income for a taxable year that results from all adjustments under section 482 in the price of any property or services. For this purpose, rules similar to the rules of the last sentence of section 55(b)(2) apply. Thus, the Act expressly provides that if the regular tax (as defined in section 55(c)) imposed on the taxpayer is determined by reference to an amount other than taxable income, such amount shall be treated as the taxable income of the taxpayer for purposes of the definition of net section 482 transfer price adjustment.

For example, assume that under section 482 the IRS makes a single adjustment to the net income of a foreign corporation for the taxable year, and that adjustment consists of a $25,000,000 decrease in the foreign corporation's interest expense. Assume also that the foreign corporation is subject to U.S. regular tax only with respect to its gross income which is either derived from sources within the United States or effectively connected with the conduct of a trade or business in the United States (or both). Further, assume that the section 482 decrease in interest expense increases by less than $10,000,000 the foreign corporation's taxable income effectively connected with the conduct of a trade or business in the United States. Under the Act, the net section 482 transfer price adjustment for the taxable year of the foreign corporation does not exceed $10,000,000.

2. The penalty also applies in instances where the transfer price claimed on the return is 200 percent or more (or 50 percent or less) of the amount determined to be the correct transfer price under section 482. Thus, a penalty may apply, for example, in a case where the amount of a royalty claimed on the tax return is 200 percent or more (or 50 percent or less) of the amount determined under section 482 to be the correct amount of the royalty (assuming that neither the de minimis exception nor the reasonable cause exception applies). In general, the conferees intend that the term "price for any property or services (or for the use of property)" be broadly interpreted to encompass consideration of all kinds that may be adjusted by the IRS under section 482, including but not limited to purchase prices, fees for services, royalties, interest, and rents.

3. As under present law, the penalty is doubled in cases of gross valuation misstatements (where the dollar amount described above exceeds $20,000,000 or the percentages described above are 400 percent or more (or 25 percent or less)).

The reasonable cause and de minimis exceptions in present law also apply to these modifications as follows:

A. There is disregarded any portion of the net increase in taxable income which is attributable to a redetermination of a price, if it is shown that there was a reasonable cause for the taxpayer's determination of the price, and that the taxpayer acted in good faith with respect to the price. The conferees intend that the same standard of reasonable cause and good faith apply for purposes of this modification as would otherwise apply to the valuation misstatement penalty under section 6664(c).

B. In determining whether a taxpayer's net section 482 transfer price adjustment exceeds the thresholds, under the Act there is disregarded any portion of the net increase in taxable income which is attributable to any transaction solely between foreign corporations (unless the treatment of that transaction affects the determination of any such foreign corporation's income from sources within the United States or taxable income effectively connected with the conduct of a trade or business in the United States). For example, assume that a net increase in the taxable income of a U.S. shareholder results from an adjustment in the royalty paid by one controlled foreign corporation to another controlled foreign corporation. Assume that neither foreign corporation earns any income from U.S. sources or income effectively connected with the conduct of a trade or business in the United States. Under the Act's foreign-to-foreign adjustment exception, the net increase in the U.S. shareholder's taxable income resulting from the IRS's adjustment of the royalty amount will not be counted in determining whether the net section 482 transfer price adjustment of the U.S. shareholder exceeds the thresholds.

Assume, however, that even without regard to the foreign-to-foreign royalty adjustment the net section 482 transfer price adjustment of the U.S. shareholder exceeds $10,000,000. Under the Act, the penalty does apply to any substantial valuation misstatement resulting from that foreign-to-foreign royalty adjustment (unless an exception, such as reasonable cause, applies).

Effective Date of New Federal Law

The provision is effective for taxable years ending after November 5, 1990.

Impact on California Revenue

Deferred. Transfer pricing has become a California issue with respect to corporations making a "Water's Edge" election. The penalty modifications made by Congress should be considered within the larger context of overall policy and objectives relating to transfer pricing.

ACT SECTION: 11313

SECTION TITLE: TREATMENT OF PERSONS PROVIDING SERVICES

Prior Federal Law (IRC Sec. 6103(n))

Tax returns and return information are confidential, and may not be disclosed without statutory authorization. Unauthorized disclosure is punishable upon conviction by a fine of up to $5,000, a prison sentence of not more than 5 years (or both) (Sec. 7213), or, in addition, a private lawsuit for damages (Sec. 7431).

The IRS is permitted to disclose returns and return information to other persons to the extent necessary in connection with the processing, storage, transmission, and reproduction of such returns.

Current California Law (Sec. 19282 & 19287)

Except as provided by statute, tax returns and return information may not be disclosed. Even those persons statutorily allowed to obtain return information are required to use that information in administering the tax laws or the laws of the authorized agency. Any unwarranted disclosure or use of that information is a misdemeanor.

New Federal Law (IRC Sec. 6103(n))

The Act provides that persons who provide services to the IRS and to whom the IRS discloses returns and return information pursuant to section 6103, are subject to the same penalties for unauthorized disclosure as are IRS employees. No inference is intended that these persons were not subject to these penalties for unauthorized disclosure prior to this amendment.

Effective Date of New Federal Law

The provision is effective on November 5, 1990.

Impact on California Revenue

Not applicable.

ACT SECTION: 11314

SECTION TITLE: APPLICATION OF 1989 INFORMATION REPORTING AND RELATED AMENDMENTS TO OPEN YEARS

Background

Information reporting and maintenance

Under present law, any corporation that is 25-percent owned by one foreign person and is either a domestic corporation or a foreign corporation that conducts a trade or business in the United States (a "reporting corporation") must furnish the IRS with such information as the Secretary may prescribe, with respect to taxable years beginning after July 10, 1989, regarding transactions carried out directly or indirectly with certain foreign persons treated as related to the reporting corporation ("reportable transactions") (sec. 6038A(a)). A related person for this purpose includes a 25-percent shareholder as well as any person that is treated as related within the meaning of sections 267(b), 707(b)(1), or 482.

A reporting corporation is also required to maintain (or cause another person to maintain), at the location, in the manner, and to the extent prescribed by regulations, any records deemed appropriate to determine the correct tax treatment of reportable transactions with respect to taxable years beginning after July 10, 1989 (Sec. 6038A(a)). The Secretary had broad flexibility in prescribing these regulations, as set forth in the "Explanation of Provisions Approved by the Committee on October 3, 1989," Senate Finance Committee Print, 101st Cong., 1st Sess. 114-16 (1989) including, for example, the flexibility to exclude classes of supporting documentation from any general regulatory specification that the required records be maintained within the United States.

Application of U.S. legal process to foreign persons

The statutory scope of general IRS summons authority extends to certain persons that are not themselves subject to tax in the United States. In addition, the Code provides that in order to avoid the consequences of the noncompliance rule (discussed below) with respect to certain reportable transactions for taxable years beginning after July 10, 1989, each foreign person that is a related party of a reporting corporation must agree to authorize the latter to act as its agent in connection with any request or summons by the IRS to examine records or produce testimony related to any reportable transaction, solely for the purpose of determining the tax liability of the reporting corporation (sec. 6038A(e)(1)).

Sanctions for noncompliance

Monetary penalty

Failure to furnish the IRS with information or to maintain records with respect to a taxable year beginning after July 10, 1989, as required under section 6038A(a) and (b) is subject to a monetary penalty of $10,000, and additional penalties are imposed if the failure continues more than 90 days after the IRS notifies the taxpayer of the failure (sec. 6038A(d)). The additional penalties are $10,000 for each 30-day period (or fraction thereof) during which the failure continues after the 90th day following IRS notification. An exception from liability for the monetary penalty exists in cases in which the taxpayer demonstrates to the satisfaction of the Secretary that reasonable cause exists for the failure to furnish required information or maintain required records (sec. 6038A(d)(3)).

Noncompliance rule

Failure of a related party to designate a reporting corporation as its agent for accepting service of process in connection with reportable transactions (as discussed above), or, under certain circumstances, noncompliance with IRS summonses in connection with reportable transactions, can result in the application of the noncompliance rule in computing tax liability with respect to a taxable year beginning after July 10, 1989. For certain payments to related parties in connection with reportable transactions, this rule permits the IRS to allow the reporting corporation only those deductions and amounts of cost of goods sold as shall be determined by the Secretary in the Secretary's sole discretion, based on any information in the knowledge or possession of the Secretary or on any information that the Secretary may choose to obtain through testimony or otherwise (sec. 6038A(e)).

Prior Federal Law (IRC Sec. 6038A)

The information reporting and related requirements described above reflect provisions of the Omnibus Budget Reconciliation Act of 1989 ("the 1989 Act") amending the prior-law provisions of Code section 6038A. The 1989 Act amendments apply only to taxable years beginning after July 10, 1989. The information reporting and related requirements applicable to taxable years beginning before July 11, 1989, are less extensive than those described above.

Current California Law (Sec. 25940)

California conformed to federal law by reference in AB 274 (Ch. 90-452) effective for income years beginning on or after January 1, 1990. The California requirement is satisfied by the filing of a copy of the federal information return with the Franchise Tax Board.

New Federal Law (IRC Sec. 6038A)

The Act generally extends the application of the 1989 Act amendments to the information reporting and related provisions of section 6038A so that they also apply to future acts (and failures to act) in connection with taxable years beginning before July 11, 1989.

Effective Date of New Federal Law

The provision is effective November 5, 1990.

Impact on California Revenue

Not applicable.

ACT SECTION: 11315

SECTION TITLE: INFORMATION REPORTING BY FOREIGN CORPORATIONS ENGAGED IN U.S. BUSINESS

Prior Federal Law (IRC Sec. 882 & 6038A)

In general

A foreign corporation that is engaged in a trade or business within the United States during the taxable year is subject to U.S. income tax on its taxable income which is effectively connected with the conduct of that trade or business (sec. 882(a)(1)). A foreign corporation is also subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the U.S. effectively connected earnings of the corporation that are removed in any year from the conduct of its U.S. trade or business.

In determining the taxable income of a foreign corporation, gross income includes only gross income which is effectively connected, whether derived from sources within or without the United States (sec. 882(a)(2)), and deductions generally are allowed only to the extent they are connected with such effectively connected gross income (sec. 882(c)(1)). For this purpose, deductible expenses (other than interest expense) are allocated and apportioned to effectively connected gross income under the same rules that are applicable for allocating and apportioning the expenses of U.S. persons between U.S. and foreign sources (Treas. Reg. sec. 1.882-4(c)). With respect to computing deductible interest expense, regulations generally require that the worldwide liabilities of the foreign corporation be taken into consideration in determining which liabilities are treated as "U.S.-connected liabilities," that amount being based on a specified percentage of the corporation's U.S. effectively connected assets. Deductible interest expense is determined by multiplying the amount of such U.S.-connected liabilities by one or more average rates of interest (Treas. Reg. sec. 1.882-5). A foreign corporation is also subject to a branch level interest tax, which amounts to a flat 30 percent of the interest deducted by the foreign corporation in computing its U.S. effectively connected income but not paid by the U.S. trade or business.

Information reporting and maintenance

A foreign corporation may claim the benefit of deductions and credits only if it files or causes to be filed with the Secretary a true and accurate return in the manner prescribed in subtitle F of the Code, which return includes all the information deemed necessary by the Secretary for the calculation of those deductions or credits (sec. 882(c)(2)). A foreign corporation that claims deductions from effectively connected gross income is subject to certain rules for providing information with respect to those expenses. Under regulations, if a foreign corporation is requested to do so by the IRS district director, it must furnish information, in English if so requested, sufficient to establish that the corporation is entitled to the deductions in the amounts claimed. The information must be submitted in a form suitable to permit verification of the deductions claimed (Treas. Reg. sec. 1.882-4(c)(2)).

Transactions with certain related persons

Any foreign corporation that conducts a trade or business in the United States and that is 25-percent owned by one foreign person (in terms defined by the Code, a "25-percent foreign-owned" corporation that is also a "reporting corporation") must furnish the IRS with such information as the Secretary may prescribe, with respect to taxable years beginning after July 10, 1989, regarding transactions carried out directly or indirectly with certain foreign persons treated as related to the reporting corporation ("reportable transactions") (sec. 6038A(a)). A reporting corporation is also required to maintain (or cause another person to maintain), at the location, in the manner, and to the extent prescribed by regulations, any records deemed appropriate to determine the correct tax treatment of reportable transactions with respect to taxable years beginning after July 10, 1989 (sec. 6038A(a)).

Failure to furnish the IRS with information or to maintain records with respect to a taxable year beginning after July 10, 1989, as required under section 6038A(a) and (b) is subject to a monetary penalty of $10,000, and additional penalties are imposed if the failure continues more than 90 days after the IRS notifies the taxpayer of the failure (sec. 6038A(d)). The additional penalties are $10,000 for each 30-day period (or fraction thereof) during which the failure continues following the 90th day after IRS notification.

Certain requirements for furnishing information to the IRS concerning certain related party transactions also apply to taxable years of a foreign corporation beginning before July 11, 1989, so long as the foreign corporation was 50 percent owned by one foreign person. The penalty for failure to meet these requirements is $1,000, plus an additional $1,000 (up to a maximum of $24,000) for each 30-day period (beginning 90 days after IRS notification) that the failure remained or remains outstanding.

Application of U.S. legal process to foreign persons

Failure of a related party to designate a reporting corporation as its agent for accepting service of process in connection with reportable transactions (as discussed in Part d. above), or, under certain circumstances, noncompliance with IRS summonses in connection with reportable transactions, can result in the application of the noncompliance rule (discussed in Part d. above) in computing tax liability with respect to a taxable year beginning after July 10, 1989.

The fact that compliance with the summons would lead to the imposition of civil or criminal penalties on the reporting corporation (or a related party) under any foreign law does not constitute grounds for either quashing or refusing to enforce the summons. Thus, although in some instances the noncompliance rules are inapplicable if the summons is quashed or a court refuses to enforce, the noncompliance rule DOES apply in a case where compliance with the summons is illegal under foreign law (unless an independent ground to quash or refuse enforcement exists, other than that the corporation is unable to provide records requested in the summons by reason of the fact that the reporting corporation failed to maintain records as required under the provision).

Current California Law (Sec. 25940)

California conformed to federal information reporting rules contained in Sec. 6038A of the Internal Revenue Code by reference in AB 274 (Ch. 90-452). California does not conform to Sec. 882 of the Internal Revenue Code since the state uses a unitary method to compute income attributable to California when business is conducted both inside and outside of the state.

New Federal Law (IRC Sec.6038C)

The Act adds new section 6038C to the Internal Revenue Code. The new provision subjects all foreign corporations that carry on trades or businesses in the United States to information reporting and record maintenance rules that are similar to the present-law rules contained in section 6038A applicable to certain 25-percent foreign-owned corporations. While under section 6038A these rules (and the related sanctions) are generally applicable only to furnishing information, maintaining records, and complying with summonses pertaining to related party transactions, and then only when the foreign corporation is 25-percent foreign-owned, under new section 6038C these rules apply to related party transactions in the case of any foreign corporation with a U.S. trade or business, whether or not the foreign corporation is 25-percent foreign-owned. In addition, under new section 6038C these rules apply to information, records, and summonses regarding such other information as the Secretary may prescribe by regulations relating to any item not directly connected with such a related party transaction. The Act generally applies the section 6038C provisions to future acts (and failures to act) without regard to the taxable year involved. The bill does not affect the application of section 6038A under present law (as amended by the 1989 Act) to foreign corporations in the case of past acts (and failures to act).

Effective Date of New Federal Law

The provision is effective November 5, 1990.

Impact on California Revenue

None. Attributing any revenue impact to these changes in information reporting would be conjectural.

ACT SECTION: 11316

SECTION TITLE: STUDIES AND OTHER ADMINISTRATIVE MATTERS

Prior Federal Law (None)

In the Tax Reform Act of 1986, Congress stated that a comprehensive study of intercompany pricing rules should be conducted by the Internal Revenue Service and that careful consideration should be given to whether the existing regulations could be modified in any respect. Such a study was issued by the Treasury and IRS in October 1988. Changes to the regulations are yet to be proposed. In addition, in the Revenue Reconciliation Act of 1989, a legislative intention was expressed that the IRS report on its efforts to audit U.S. taxpayers that are subsidiaries of or otherwise related to foreign corporations. It was intended that such a report be submitted to Congress within five years after the 1989 Act amendments to section 6038A took effect.

Current California Law (None)

Not applicable.

New Federal Law (Act Sec. 11326)

The Act provides for a report to be made by the Secretary of the Treasury or his delegate regarding the effectiveness of the compliance provisions contained in this part of the bill (described above) in increasing compliance with Code section 482, the use of advanced determination agreements with respect to section 482 issues, possible additional statutory provisions or administrative changes to assist the IRS in increasing compliance with section 482, and coordination of the administration of section 482 with the administration of similar provisions of foreign tax laws and of domestic non-tax laws.

Effective Date of New Federal Law

The Act provides for this report, along with such recommendations as the Secretary may deem advisable, to be submitted to the House Committee on Ways and Means and the Senate Committee on Finance no later than March 1, 1992.

Impact on California Revenue

Not applicable.

ACT SECTION: 11317

SECTION TITLE: EXTEND STATUTE OF LIMITATIONS FOR COLLECTION OF TAXES

Prior Federal Law (IRC Sec. 6502)

After an assessment of tax has been made, the Internal Revenue Service (IRS) must institute collection proceedings to collect this tax within 6 years. Otherwise, the IRS is barred from collecting the assessment.

Current California Law (18831, 18861, 26251, and 26350)

California law does not conform with the federal provision but instead allows the filing of a judgement lien at any time when the tax, interest or penalty imposed have not been paid. In addition, a court action may take place within six years after assessment or within the period during which a lien is in force. A lien is in force for 10 years after filing and may be extended in 10 year increments until satisfied.

New Federal Law (IRC Sec. 6502)

The Act extends the statute of limitations for the collection of taxes after assessment from 6 years to 10 years.

Effective Date of New Federal Law

This provision is effective November 5, 1990.

Impact on California Revenue

Not applicable.

ACT SECTION: 11318

SECTION TITLE: MODIFICATIONS RELATING TO REPORTING OF CASH RECEIVED IN A TRADE OR BUSINESS

Prior Federal Law (IRC Sec. 6050I & 6721)

A person engaged in a trade or business who receives, in the course of the trade or business, more than $10,000 in cash or foreign currency in one or more related transactions must report it to the Internal Revenue Service (IRS) and provide a statement to the payor. Reporting is required whether or not consideration is returned for the cash and whether or not the cash is received for the recipient's own account or for the account of another (with narrow exceptions provided by IRS regulations).

For purposes of the reporting requirement, only currency is treated as cash -- not checks, traveller's checks, drafts, money orders, or other cash equivalents. A transaction subject to reporting is any receipt of cash including receipt in connection with the purchase of goods or services, the purchase or exchange of property, the opening of a deposit or credit account, or any similar transaction.

The recipient of the cash is required to report the name, address and taxpayer identification number of the payor, the amount of cash received, the date and nature of the transaction, and such other information as the Secretary may require. In addition to furnishing reports on each cash transaction to the IRS, the recipient of the cash must furnish each payor an annual statement aggregating the amounts of cash received from him. This statement must be furnished on or before January 31 of the year following the year of the reportable event.

Any taxpayer subject to this provision who receives more than $10,000 in cash in one or more related transactions is required to report those transactions. For example, assume that an individual purchases a $8,000 item and a $1,500 item at an auction. The auction house adds a 10-percent buyer's premium and a 5-percent local sales tax. The taxpayer pays his $10,972.50 bill in cash. The auction house must report on that transaction. The auction house could not avoid the reporting requirement by presenting two separate bills of $9,240 and $1,732.50.

Reporting is not required on payments (1) that are received in a transaction reported under the Bank Secrecy Act if the Secretary of the Treasury determines that the report under this provision would duplicate the report under the Bank Secrecy Act, or (2) that are received by certain specified financial institutions within the meaning of the Bank Secrecy Act.

The penalty for failure to file required reports with the IRS and to furnish statements to taxpayers is similar to that imposed on failures to make other information reports and statements. Thus, the penalty is $50 per failure, subject to a maximum of $250,000 for any calendar year. The penalty is not applicable if the failure is due to reasonable cause and not to willful neglect. If, however, the failure to file required reports with the IRS is due to intentional disregard of the filing requirements, the penalty is 10 percent of the aggregate amount of the items required to be reported and the $250,000 limitation does not apply. In addition, under section 7203, any willful violation related to the filing of returns relating to cash receipts of more than $10,000 received in the course of conducting a trade or business is, upon conviction, punishable by a fine of not more than $25,000 ($100,000 in the case of a corporation) or imprisonment not to exceed 5 years or both. Similar civil and criminal penalties apply to persons who, for the purpose of evading the return requirement, cause or attempt to cause a trade or business to fail to file, or to file falsely, a required return.

Current California Law (Sec. 18802.6(d), 18681.1, and 26135)

California law (as amended by SB 2735 (Ch. 90-1484) requires that businesses required to report cash transactions to the Internal Revenue Service must send a copy of that information return to the Franchise Tax Board. California also conforms by reference to the federal penalty for failure to file the required return.

New Federal Law (IRC Sec. 6050I & 6721)

The Act provides that, to the extent provided in Treasury regulations, any monetary instrument (whether or not in bearer form), other than personal checks, with a face amount of not more than $10,000 is included in the definition of cash. Revised Treasury regulations must be issued not later than June 1, 1991. In addition, the bill increases the penalty for intentional disregard of these reporting requirements to mirror the civil penalty applicable for currency transaction reports filed under the Bank Secrecy Act. Thus, the penalty is the greater of $25,000 or the amount of cash received in the transaction (but no more than $100,000). The heading of the provision of present law prohibiting evasion techniques is clarified. The Treasury Department is required to submit to the Congress no later than March 31, 1991, a study of the operation of section 6050I.

Effective Date of New Federal Law

The Act is effective generally for cash received after November 5, 1990.

Impact on California Revenue

To be determined. Federal estimates have been deferred, pending the issuance of Treasury regulations. Consequently, the California impact must also be deferred.

ACT SECTION: 11319

SECTION TITLE: EXTEND IRS USER FEES

Prior Federal Law (Act Sec. 10511(c) of the Revenue Act of 1987)

The Internal Revenue Service (IRS) provides written responses to questions of individuals, corporations, and organizations relating to their tax status or the effects of particular transactions for tax purposes. The IRS responds to these inquiries through the issuance of letter rulings, determination letters, and opinion letters. The IRS charges a fee for most requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination. The legislation that requires the establishment of this fee program provides that it is not to apply to requests made after September 29, 1990.

Current California Law (None)

California did not conform to the imposition of fees by the Franchise Tax Board for responding to inquiries from taxpayers.

New Federal Law (Act Sec. 10511(c) of the Revenue Act of 1987)

The Act extends for five years the IRS program that requires the payment of a fee for most requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination.

Effective Date of New Federal Law

The IRS may collect the fee for requests made after September 29, 1990, and on or before the date that is 30 days after the date of enactment at such time as the IRS may determine in its discretion. The fee for any request made more than 30 days after November 5, 1990 must be collected in advance.

Impact on California Revenue

Not applicable.

ACT SECTION: 11321

SECTION TITLE: IMPOSE CORPORATE TAX ON DIVISIVE TRANSACTIONS IN CONNECTION WITH CERTAIN CHANGES OF OWNERSHIP

Background

Nonrecognition of gain benefits apply to receipt of stock in connection with corporate exchanges in distributions known as "spin-offs," "split-offs," or "split-ups." These corporate divisions are commonly called "divisive transactions." A "spin-off" occurs when a corporation distributes stock or securities in another corporation controlled by it (through at least 80% stock ownership) without requiring shareholders to surrender any shares. A "split-off" is a type of corporate separation, not necessarily in reorganization, whereby a parent corporation distributes to its shareholders stock in a controlled corporation, under the same conditions as in a "spin-off," except that the shareholders surrender a part of their stock in the parent corporation for the stock in the controlled corporation. In a "split-up," the distributing corporation's shareholders surrender all shares in such corporation and in return receive new shares both in the distributing corporation and in a corporation that it controlled immediately before the distribution.

Generally, there must be a valid business purpose for the transaction, and it cannot be principally a tax-avoidance device. Also, after the transaction, both the distributing and controlled corporations must conduct businesses previously actively conducted and owned (directly or indirectly) by the distributing corporation for at least five years. Other limitations relate to continuity of interest on the part of the owners, the amount of securities distributed, taxable acquisitions within five years, and receipt of other property or money.

Prior Federal Law (IRC Sec. 355 & 361)

A corporation generally must recognize gain on the sale or distribution of appreciated property, including stock of a subsidiary. However, corporate distributions of subsidiary stock that meet the requirements of section 355 of the Code are tax-free both to the distributing corporation and to the distributee shareholders.

Present law imposes a 5-year holding period requirement for any corporate distributee that has acquired 80 percent of the stock of a corporation ("target"), unless the stock was acquired solely in nontaxable transactions. If the 5-year holding period is not met, distributions of subsidiaries by the target corporation are not tax-free under section 355.

Current California Law (Sec. 17321, 24531, 24532, and 24551)

California conforms (by reference) to the federal provisions regarding the corporate-level effect of divisive transactions. The shareholder nonrecognition is conformed by reference in the Personal Income Tax Law and in the Bank and Corporation Tax Law is generally the same as federal although separate state language is used.

New Federal Law (IRC Sec. 355 & 361)

The Act generally requires recognition of corporate-level gain (but does not require recognition by the distributee shareholders) on a distribution of subsidiary stock or securities qualifying under section 355 (whether or not part of a reorganization otherwise described in section 361(c)(2)) if, immediately after the distribution, a shareholder holds a 50-percent or greater interest in the distributing corporation or a distributed subsidiary that is attributable to stock or securities that were acquired by purchase (as defined in the provision) within the preceding 5-year period. Thus, for example, under the provision, the distributing corporation will recognize gain on the distribution of subsidiary stock and securities if a person purchases distributing corporation stock or securities, and within 5 years, 50 percent or more of the subsidiary stock is distributed to that person in exchange for the purchased stock or securities. The distributing corporation will recognize gain as if it had sold the distributed subsidiary stock and securities to the distributee at fair market value.

Related persons are treated as one person for purposes of the provision. Thus, for example, in determining whether a person holds a 50-percent or greater interest, a corporation and its more than 50- percent-owned subsidiary are treated as one person. In addition, persons acting pursuant to a plan or arrangement with respect to acquisitions of stock or securities in the distributing or any controlled corporation are treated as one person for purposes of determining whether a shareholder holds a 50-percent or greater interest acquired by purchase.

Other attribution rules

For purposes of determining attribution from an entity, the rules of section 318(a)(2) are applied, substituting 10 percent for 50 percent in section 318(a)(2)(C). Where securities are owned by an entity, a person who would be deemed to own all or a portion of the stock (if any) owned by the entity under these attribution rules will be deemed to own the same proportion of securities (if any) held by such entity.

Disqualified distribution

A disqualified distribution is any section 355 distribution if, immediately after the distribution, any person holds disqualified stock in either the distributing corporation or any distributed controlled corporation constituting a 50-percent or greater interest in such corporation.

Disqualified stock

The Act defines disqualified stock to include any stock in the distributing corporation or any controlled corporation acquired by purchase (as defined) after October 9, 1990 and during the 5-year period ending on the date of the distribution. In addition, disqualified stock includes stock in any controlled corporation received in the distribution, to the extent attributable to distributions on stock or securities in the distributing corporation acquired by purchase after October 9, 1990 and during the 5-year period ending on the date of the distribution.

Example 1. -- Assume that after October 9, 1990, individual A acquires by purchase a 20-percent interest in the stock of corporation P and a 10-percent interest in the stock of its subsidiary, S, and 40 percent or more of the stock of S is distributed to A within 5 years in exchange for his 20-percent interest in P. (The remainder of the S stock distributed in the section 355 distribution is distributed to other shareholders). Under the Act, P must recognize gain with respect to the distributed stock of the S because all 50 percent of the stock of S held by A is disqualified stock.

Example 2. -- Assume that after October 9, 1990, individual A acquires by purchase a 20-percent interest in corporation P and P redeems stock of other shareholders so that A's interest in P increases to a 30 percent interest. Within 5 years of A's purchase, P distributes 50 percent of the stock of its subsidiary, S, to A in exchange for his 30 percent interest in P (the remainder of the stock of S distributed in the section 355 transaction is distributed to other shareholders). P recognizes gain on the distribution of the stock of S because all 50 percent of the stock of S held by A is disqualified stock.

Effective Date of New Federal Law

The provision generally applies to distributions of stock after October 9, 1990. In determining whether the distribution occurs within 5 years after stock or securities are acquired by purchase, only stock or securities acquired by purchase after October 9, 1990 are taken into account.

Transitional relief is provided for distributions after October 9, 1990 that are pursuant to a binding written contract in effect on October 9, 1990 and at all times thereafter before such distribution.

Transitional relief is also provided if the acquisition of stock or securities by purchase after October 9, 1990 is pursuant to a binding written contract in effect on October 9, 1990, and at all times thereafter before such acquisition. Transitional relief is further provided if the acquisition of stock or securities by purchase after October 9, 1990 is pursuant to a transaction reflected in documents filed with the Securities and Exchange Commission before October 10, 1990, or pursuant to a transaction the material terms of which were described in a written public announcement before October 10, 1990, which was the subject of a prior filing with the Securities and Exchange Commission, and which is the subject of a subsequent filing with the Securities and Exchange Commission before January 1, 1991. Stock or securities with respect to which transitional relief is provided under these rules is treated as acquired before October 10, 1990.

No inference is intended whether any distribution described in the transitional rules otherwise qualifies for tax-free treatment under section 355 of the Code.

Impact on California Revenue

Based on the low level of federal estimates, conformity by California would result in revenue gains of appoximately $2 million annually.

ACT SECTION: 11322

SECTION TITLE: MODIFY TREATMENT OF PREFERRED STOCK ISSUED WITH A REDEMPTION PREMIUM

Prior Federal Law (IRC Sec. 305(c))

If preferred stock is considered to have an unreasonable redemption premium, the portion of the premium that is considered to be unreasonable is deemed to be distributed to the preferred stockholder ratably over the time during which such stock cannot be called for redemption.

If a debt instrument is issued with original issue discount (OID), the holder of the instrument includes the entire amount of OID in gross income over the term of the instrument on an economic accrual basis if the amount of OID exceeds the product of (1) one-quarter of one percent of the stated redemption price and (2) the number of complete years to maturity.

Current California Law (Sec. 17321 and 24463)

California conforms to the disproportionate distribution requirements in federal law with separate state language including the requirement for regulations by the Franchise Tax Board. These rules are to apply to distributions of stock made on or after January 1, 1991.

New Federal Law (IRC Sec. 305(c))

The Act applies the economic accrual rule and the de minimis rule applicable to debt instruments issued with OID to preferred stock that is subject to mandatory redemption, or is puttable, at a premium, regardless of whether the stock is callable.

In general, the OID de minimis rule will not apply to preferred stock that is callable solely at the option of the issuer (unless such stock is subject to a mandatory redemption or is puttable). Nonetheless, the economic accrual rule will apply to the entire call premium on such stock if such premium is considered to be unreasonable without regard to this provision. In such cases, except as provided in regulations, the entire call premium will be accrued over the period of time during which the preferred stock cannot be called for redemption.

There is no intention to limit the present-law authority of the Secretary and the IRS regarding the proper treatment of redemption premiums on preferred stock. Thus, the Secretary may determine what constitutes a redemption premium (or a disguised redemption premium). For example, if at the time of issuance of cumulative preferred stock there is no intention for dividends to be paid currently, the IRS may treat such dividends as a disguised redemption premium. In addition, the Secretary may treat stock that, in form, is merely callable as being subject to mandatory redemption or a put if the existence of other arrangements effectively require the issuer to redeem the stock.

It is intended that the economic accrual and OID de minimis rules generally apply as described above as of the effective date of the bill without regard to when the regulations are amended to reflect such rules. Except as provided herein, there is no intention to limit the authority of the Secretary to promulgate regulations relating to the accrual of redemption premiums on callable preferred stock. It is expected that such regulations will be prospective.

Effective Date of New Federal Law

The provision is effective for stock issued on or after October 10, 1990, unless issued pursuant to a binding written contract in effect on October 9, 1990, and at all times thereafter until such issuance, or pursuant to an SEC or similar state registration statement filed before such date and the stock is issued within 90 days of the filing. In addition, the provision does not apply to stock issued after October 9, 1990, pursuant to a plan filed before October 10, 1990, in a title 11 or similar case.

Impact on California Revenue

Based on federal estimates, conformity by California would result in revenue gains that would range from $3 to $5 million over the initial three years of implementation.

ACT SECTION: 11323

SECTION TITLE: EXPAND AND CLARIFY INFORMATION REPORTING AND ALLOCATION RULES FOR CERTAIN ACQUISITIONS

Background

Special rules allow a corporation that buys a controlling stock interest in a target corporation to elect to treat the transaction as a purchase of the corporation's assets for tax purposes. To set up a purchase of stock to get assets, the acquiring corporation must: (1) make a qualifying purchase of the stock of the target corporation, and (2) not later than the 15th day of the ninth month following the month of the acquisition date, elect to treat the target as if it sold all its assets at fair market value in a single transaction, and as a new corporation that purchased all of those assets as of the start of the day after the acquisition date. The target corporation does not have to be liquidated. No gain or loss is recognized by the target corporation as a result of the election by the acquiring corporation but any recapture will be recognized and tax attributes (such as net operating losses) are terminated.

Prior Federal Law (IRC Sec. 338, 1060 and 6724)

Special allocation and information reporting rules apply to applicable asset acquisitions. The information reporting rules of section 1060 do not apply to an acquisition of a trade or business which is structured as a stock acquisition if the transferee does not elect under section 338 to treat the stock purchase as an asset acquisition. It is unclear, however, whether these reporting rules apply to such a stock acquisition if a section 338 election or a section 338(h)(10) election is made.

Courts apply different standards in determining whether a party to a sale of a business can assert an allocation of consideration to assets that is inconsistent with the allocation contained in a written agreement. In the Danielson case, the Third Circuit held that a party could refute a purchase price allocation only if the proof would be admissible in an action to show unenforceability because of mistake, undue influence, fraud, or duress.

Current California Law (Sec. 17321, 18031, 18681.1, 24519, and 24966.2)

California is conformed by reference to federal law as of January 1, 1990 with regard to asset acquisitions and the special allocation and information reporting rules.

New Federal Law (IRC Sec. 338, 1060, and 6724)

The Act provides that in the case of a stock purchase where a section 338(h)(10) election is made, the purchasing corporation and the selling consolidated group must report information with respect to the consideration received in the transaction at such times and in such manner as may be provided in regulations under section 338. The committee report clarifies that, in general, the reporting and allocation rules of section 1060 do not apply in any case in which a stock purchase is treated as an asset purchase under section 338.

In addition, the Act provides that where a person holds at least 10 percent of the value of an entity and both transfers an interest in the entity and also enters into an employment contract, covenant not to compete, royalty or lease agreement or other agreement with the transferee, such person and the transferee must report information concerning the transaction at such time and in such manner as the Secretary may require.

Finally, the Act provides that a written agreement regarding the allocation of consideration to, or the fair market value of, any of the assets in an applicable asset acquisition will be binding on both parties for tax purposes, unless the parties are able to refute the allocation or valuation under the standards set forth in the Danielson case. In addition, the conferees are aware that the information reporting rules under section 1060 may, in certain circumstances, duplicate the reporting requirements under section 6050J (relating to foreclosures and abandonments of security). Thus, the conferees intend that if a lender is required to report under section 6050J upon the foreclosure of property, no reporting is required under section 1060 by the lender, provided that no allocation is required to be made (under the residual method required by section 1060) to goodwill or going concern value. The conferees do not intend to limit the Secretary's authority under section 6050J. In particular, the conferees do not intend to limit the Secretary's authority to: (1) require reporting under section 6050J of information that is similar to that required under section 1060: or (2) exempt borrowers and lenders that are required to report under section 6050J from the reporting rules of section 1060.

Effective Date of New Federal Law

The provision is effective for acquisitions on or after October 10, 1990, unless pursuant to a binding written contract in effect before and on such date and at all times thereafter until such acquisition.

Impact on California Revenue

Based on the low level of federal estimates, conformity by California would result in minor revenue gains in the $500,000 to $1 million range annually.

ACT SECTION: 11324

SECTION TITLE: EXPAND THE DEFINITION OF A CORPORATE EQUITY REDUCTION TRANSACTION FOR PURPOSES OF LIMITING CERTAIN NOL CARRYBACKS

Prior Federal Law (IRC Sec. 172(m))

The ability of a C corporation to obtain refunds of taxes paid in prior years by carrying back net operating losses (NOLs) is limited in cases where the losses are created by interest deductions allocable to a corporate equity reduction transaction ("CERT"). A CERT includes the acquisition of 50 percent or more of the vote or value of the stock of another corporation. However, a CERT does not include the acquisition of the stock of another corporation (1) that, immediately before the acquisition, was a subsidiary of an affiliated group, or (2) with respect to which an election under section 338 was made to treat the stock acquisition as an asset acquisition.

Current California Law (Sec. 24416(d))

California does not allow any net operating loss (NOL) carryback.

New Federal Law (IRC Sec. 172(m))

The Act repeals the exception to the definition of a CERT relating to the acquisition of the stock of another corporation which, immediately before the acquisition, was a member of an affiliated group (other than the parent of such group).

Effective Date of New Federal Law

The provision is effective for acquisitions on or after October 10, 1990, unless pursuant to a binding written contract in effect before and on such date and at all times thereafter until such acquisition.

Impact on California Revenue

Not applicable.

ACT SECTION: 11325

SECTION TITLE: CLARIFY TREATMENT OF DEBT EXCHANGES

Prior Federal Law (IRC Sec. 108)

Income from the cancellation of indebtedness

In general. -- Gross income includes income from the cancellation of indebtedness (COD). Taxpayers in title 11 cases and insolvent debtors generally exclude COD from income but reduce tax attributes by the amount of COD created on the discharge of debt. The amount of COD excluded from income by an insolvent debtor not in a title 11 case cannot exceed the amount by which the debtor is insolvent. For all taxpayers, the amount of COD generally is the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy such debt. The COD rules generally apply to the exchange of an old obligation for a new obligation, including a modification of the old debt that is treated as an exchange (a debt-for-debt exchange).

Treatment of stock-for-debt exchanges. -- For purposes of determining COD, if a debtor corporation transfers stock to a creditor in satisfaction of debt, the corporation is treated as having satisfied the debt with an amount of money equal to the fair market value of the stock. However, taxpayers in title 11 cases and insolvent debtors generally may issue stock in satisfaction of debt without creating COD (the stock-for-debt exception).

Original issue discount rules

The issuer of a debt instrument with original issue discount (OID) generally accrues and deducts the discount, as interest, over the term of the instrument on an economic accrual basis. The holder of an OID instrument also includes the amount of OID in income on an economic accrual basis. Original issue discount is the excess of the stated redemption price at maturity over the issue price of a debt instrument. For purposes of the OID rules, the issue price of a debt instrument that is issued for property generally is determined by reference to fair market value if either the debt instrument or the property for which it was issued is publicly traded (sec. 1273(b)(3)). If neither the debt instrument nor the property for which it is issued is publicly traded, the issue price of the instrument generally is its stated principal amount, provided the instrument has adequate stated interest. If the debt instrument lacks adequate stated interest, the issue price of the instrument generally is determined by using the applicable Federal rate to discount all payments due under the instrument (sec. 1274). Finally, for debt-for-debt exchanges in a reorganization, the issue price of a new debt instrument is not less than the adjusted issue price of the old debt instrument (sec. 1275(a)(4)). In certain other cases, issue price is equal to stated redemption price at maturity (sec. 1273(b)(4)).

Current California Law (Sec. 17131, 18151, 24307, 24990, and 24991)

California is conformed by reference to federal law as of January 1, 1990 with regard to cancellation of indebtedness income for both individuals and corporations.

New Federal Law (IRC Sec. 108 & 1275)

Debt-for-debt exchanges

Under the Act, for purposes of determining the amount of COD of a debtor that issues a new debt instrument in satisfaction of an old debt, such debtor will be treated as having satisfied the old debt with an amount of money equal to the issue price of the new debt. For this purpose, the issue price of the new obligation will be determined under the general rules applicable to debt instruments issued for property (i.e., secs. 1273(b) and 1274). For debt instruments subject to section 483 (rather than sec. 1274), the issue price as determined under section 1273(b) (4) is reduced to exclude unstated interest for purposes of determining COD.

In addition, the reorganization exception in section 1275(a)(4) of the OID rules is repealed. Thus, either or both COD or OID may be created in a debt-for-debt exchange that qualifies as a reorganization, so long as the exchange qualifies as a realization event under section 1001 for the holder. The provision does not change the present-law rules of section 354, 355, or 356 regarding the amount of gain or loss recognized or not recognized in a reorganization. The repeal of section 1275(a)(4) will be applicable to the holder (as well as the issuer) of the new debt instrument for purposes of determining the issue price of the new debt instrument received in a debt-for-debt exchange.

Stock-for-debt exchanges

The Act also repeals the stock-for-debt exception for title 11 cases and insolvent debtors for taxpayers that issue disqualified stock in exchange for debt. For this purpose, disqualified stock is any stock with a stated redemption price and that either has a fixed redemption date, is callable by the issuer, or is puttable by the holder. In addition, disqualified stock will not be considered to be stock for purposes of the de minimis rule of section 108(e)(8).

Effective Date of New Federal Law

Under the Act, the provision generally is effective for debt instruments issued, or stock transferred, after October 9, 1990, in satisfaction of any indebtedness. The provision does not apply to a debt issuance or a stock transfer that is pursuant to a written binding contract in effect on October 9, 1990, and all times thereafter before such issuance or transfer. The provision does not apply to a debt issuance or a stock transfer that is pursuant to a transaction that was described in documents filed with the Securities and Exchange Commission before October 10, 1990. The provision does not apply to a debt issuance or a stock transfer that is pursuant to a transaction the material terms of which were described in a written public announcement before October 10, 1990, and which was the subject of a prior filing with the Securities and Exchange Commission, and which is the subject of a subsequent filing with the Securities and Exchange Commission before January 1, 1991.

The conferees recognize that, with respect to debt restructurings, documents filed with the Securities and Exchange Commission may not initially describe all the final terms relevant to the instruments to be issued in connection with such filings. Amendments or supplements may be required in response to certain market conditions, comments by the Securities and Exchange Commission, continuing negotiations with bondholders, and otherwise. The conferees intend that the transition rules provided in this provision would continue to apply in those instances.

Finally, the provision does not apply to an issuance or transfer in a title 11 or similar case which was filed before October 10, 1990.

Impact on California Revenue

Based on federal estimates, conformity by California would result in revenue gains that would range from $5 million in the first full year down to, after three years, $1 million annually.

ACT SECTION: 11341

SECTION TITLE: INCREASE IN RATE OF INTEREST PAYABLE ON LARGE CORPORATE UNDERPAYMENTS

Prior Federal Law (IRC Sec. 6621)

Interest is charged on the underpayment of tax. The underpayment rate is the sum of the short-term Federal rate plus 3 percentage points.

Current California Law (Sec. 19269 & 25901)

California conforms by reference to the federal law as of January 1, 1990 except that there is no difference in rate for interest paid by a taxpayer versus interest owed by a taxpayer and is determined semiannually.

New Federal Law (IRC Sec. 6621(c))

The Act establishes an underpayment rate equal to the sum of the short-term Federal rate plus 5 percentage points (the "AFR plus 5 rate"). The AFR plus 5 rate is applicable to C corporations for purposes of determining the rate of interest attributable to periods after the 30th day following the earlier of the furnishing of a notice of proposed deficiency (commonly called a 30-day letter) or the furnishing of a statutory notice of deficiency issued pursuant to section 6212 (commonly called a 90-day letter). In the case of an underpayment of a tax other than an income tax, a notice provided by the IRS that is similar to these notices is treated similarly. For example, a notice under section 6303 is one type of similar notice.

The AFR plus 5 rate applies to the amount determined to be the underpayment, regardless of the amount of tax assessed in the 30-day letter, 90-day letter, or other notice.

The AFR plus 5 rate does not apply to the interest charges that the taxpayer timely assesses against itself in return for using a method of tax accounting or reporting that defers the payment of tax. For example, the AFR plus 5 rate does not apply to the interest charges relating to installment obligations of nondealers (sec. 453A(c)) or passive foreign investment companies (sec. 1291(c)).

The AFR plus 5 rate does not apply to any underpayment of a tax for any taxable period if the underpayment is $100,000 or less. Underpayments of different types of taxes (e.g., income taxes and employment taxes) as well as underpayments relating to different taxable periods would not be added together for purposes of determining the $100,000 threshold.

Under present law, the Secretary has the authority to credit the amount of any overpayment against any liability under the Code (sec. 6402). To the extent a portion of tax due is satisfied by a credit of an overpayment, no interest is imposed on that portion of the tax (sec. 6601(f)). The Secretary should implement the most comprehensive crediting procedures under section 6402 that are consistent with sound administrative practice.

Effective Date of New Federal Law

The provision is effective for purposes of determining interest for periods after December 31, 1990, regardless of the taxable period (if any) to which the underlying tax may relate.

Impact on California Revenue

Potential cash flow revenue gains depend upon the effective date of any changes in California law. If this change is made effective on January 1, 1992, preliminary estimates of potential cash flow gains are:

$10 million for the 1991/92 fiscal year

$ 7 million for the 1992/93 fiscal year

$ 3 million for the 1993/94 fiscal year

Most of these gains represent accelerated tax payments rather than additional interest payments.

ACT SECTION: 11342

SECTION TITLE: DENIAL OF DEDUCTION FOR UNNECESSARY COSMETIC SURGERY

Prior Federal Law (IRC Sec. 213)

For purposes of the medical expense deduction, eligible "medical care" expenses are defined as amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body (sec. 213(d)(1)(A)). The Internal Revenue Service (IRS) has interpreted "medical care" as including procedures that permanently alter any structure of the body, even if the procedure generally is considered to be an elective, purely cosmetic treatment (such as removal of hair by electrolysis and face-lift operations).

Current California Law (Sec. 17201)

California is fully conformed to the federal law relating to deductible medical expenses.

New Federal Law (IRC Sec. 213)

The Act provides that expenses paid for cosmetic surgery or other similar procedures are not deductible medical expenses, unless the surgery or procedure is necessary to ameliorate a deformity arising from, or directly related to, a congenital abnormality, a personal injury resulting from an accident or trauma, or disfiguring disease. For purposes of this provision, cosmetic surgery is defined as any procedure which is directed at improving the patient's appearance and does not meaningfully promote the proper function of the body or prevent or treat illness or disease.

In addition, the Act provides that if expenses for cosmetic surgery are not deductible under this provision, then amounts paid for insurance coverage for such expenses are not deductible under section 213 and reimbursement for such expenses is not excludable from the gross income of an individual under a health plan provided by an employer (including under a flexible spending arrangement).

Effective Date of New Federal Law

The provision is effective for taxable years beginning on or after January 1, 1991.

Impact on California Revenue

It is estimated that conformity by California would result in revenue gains of $3 million annually.

ACT SECTION: 11343

SECTION TITLE: SPECIAL RULES WHERE GRANTOR OF TRUST IS A FOREIGN PERSON

Prior Federal Law (IRC Sec. 672)

A grantor who transfers property to a trust while retaining certain powers or interests over the trust is treated as the owner of the trust for income tax purposes under the so-called "grantor trust rules." If a grantor or other person is treated as the owner of a trust, the income and deductions of the trust are included directly in the grantor's taxable income. The nominal grantor is not treated as the grantor if another party is in fact the grantor.

Current California Law (Sec. 17731)

California is conformed by reference to federal law as of January 1, 1990 with regard to the "grantor trust rules."

New Federal Law (IRC Sec. 672(f))

The Act provides that a U.S. person who is a beneficiary of a trust is treated as the grantor to the extent that the beneficiary transferred property, directly or indirectly, to a foreign person who otherwise would have been treated as the owner under the "grantor trust rules." This rule applies even if the beneficiary was not a U.S. person at the time of the transfer. For purposes of the rule, annual gifts of less than $10,000 are disregarded.

Effective Date of New Federal Law

The provision applies to any trust created after November 5, 1990 and any portion of an existing trust that is attributable to amounts contributed after that date. The conferees intend that no inference be drawn that would prevent a court from treating a person who is not directly the grantor as the grantor under present-law trust rules.

Impact on California Revenue

Based on the low level of federal estimates, conformity by California would result in minor revenue gains in the $500,000 to $1 million range annually.

ACT SECTION: 11344

SECTION TITLE: DEDUCTION FOR CONTRIBUTION OF APPRECIATED PROPERTY

Prior Federal Law (IRC Sec. 57(a)(6))

The amount of the deduction allowable for charitable contributions may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer (secs. 170(b) and 170(e)). Special rules also limit the amount of a charitable contribution deduction to less than the contributed property's fair market value in cases of contributions of inventory or other ordinary income property and short-term capital gain property. A taxpayer generally is allowed to deduct the fair market value of property contributed to a charitable organization if the use of the property by the charity is related to the organization's tax-exempt purpose. In the case of a charitable contribution of tangible personal property, however, a taxpayer's deduction for regular tax purposes is limited to the adjusted basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose (sec. 170(e)(1)(B)(i)).

For purposes of computing alternative minimum taxable income (AMTI), the deduction for charitable contributions of capital gain property (real, personal, or intangible) is disallowed to the extent that the fair market value of the property exceeds its adjusted basis.

Current California Law (Sec. 17062 & 23457(b))

For individuals, California is conformed to prior federal law for both regular tax and alternative minimum tax purposes regarding the contribution of appreciated property to charity.

For banks and corporations, California denies a deduction for regular tax purposes for the appreciated portion of the charitable contribution (Sec. 24357.1) except for certain contributions of scientific equipment to institutions of higher education (Sec. 24357.8). For alternative minimum tax purposes, therefore, California's item of tax preference will be the amount not previously brought into income for regular tax purposes (i.e. the deduction allowed for contributions of scientific equipment to institutions of higher education which exceeds the taxpayer's adjusted basis).

New Federal Law (IRC Sec. 57(a)(6))

For purposes of computing alternative minimum taxable income, the present-law rule that treats as a tax preference item the amount of appreciation with respect to a charitable contribution of capital gain property (sec. 57(a)(6)) is repealed (for 1991 only) in the case of a contribution of tangible personal property. Thus, if a taxpayer makes a charitable contribution of tangible personal property in 1991 (other than inventory or other ordinary income property, or short-term capital gain property), the use of which is related to the donee's tax-exempt purpose, the taxpayer is entitled to claim a deduction for both regular tax and alternative minimum tax purposes in the amount of the property's fair market value (subject to present-law percentage limitations).

(Section 57(a)(6) will continue to apply to contributions of tangible personal property made in taxable years beginning after 1991.) Contributions of inventory or other ordinary income property and short-term capital gain property continue to be governed by present-law rules.

Effective Date of New Federal Law

This provision is effective only for taxable years beginning on or after January 1, 1991 and before January 1, 1992.

Impact on California Revenue

Conformity by California would result in a minor revenue loss in the $500,000 range for the 1991 taxable year only, largely under the Personal Income Tax Law.

ACT SECTION: 11401

SECTION TITLE: ALLOCATION AND APPORTIONMENT OF RESEARCH AND EXPERIMENTAL EXPENDITURES

Prior Federal Law (IRC Sec. 864(f))

Under a statutory rule, research and experimental expenditures are allocated as follows: (1) expenses for research that is undertaken solely to meet certain legal requirements imposed by a political entity and which cannot reasonably be expected to generate income (beyond de minimis amounts) outside that entity's jurisdiction are allocated to income from sources in that jurisdiction; (2) remaining research expenses which are conducted in the United States are allocated 64 percent to U.S. source income, and such expenses which are conducted outside of the United States are allocated 64 percent to foreign source income; and (3) remaining research expenses are allocated and apportioned on the basis of either sales or gross income. If gross income is used, however, the amount apportioned to foreign source income can be no less than 30 percent of the amount that would be so apportioned under the sales method.

Research expenses incurred by U.S. persons for activities conducted in space, in Antarctica, or on or under water not within the jurisdiction (as recognized by the United States) of a foreign country, U.S. possession, or the United States, are allocated and apportioned in the same manner as if they were attributable to activities conducted in the United States. Such expenses incurred by foreign persons are allocated and apportioned as if they were attributable to activities conducted outside the United States.

The statutory allocation rule is effective only for the taxpayer's first taxable year beginning after August 1, 1989 and before August 2, 1990, and applies only to that portion of research expenses treated as having been paid or incurred during the first nine months of the first taxable year beginning after August 1, 1989 and before August 2, 1990. In determining which research expenses for that year are treated as paid or incurred in the first nine months of the year, research expenses are treated as if paid or incurred ratably throughout the taxable year.

Research expenditures that are not covered by the effective date of the statutory rule are allocated pursuant to Treasury regulations which were promulgated in 1977. Under those regulations, research and experimental expenditures are generally allocated as follows: (1) expenses for research that is undertaken solely to meet certain legal requirements imposed by a political entity and which cannot reasonably be expected to generate income (beyond de minimis amounts) outside a single geographical source are allocated to income from that source; and (2) remaining research expenses are generally apportioned to foreign source income based on either (a) gross sales, except that a taxpayer using this method may first apportion at least 30 percent of such expenses exclusively to the source where over 50% of the taxpayer's research is performed; or (b) gross income, except that expenses apportioned to U.S. and foreign source income using a gross income method can not be less than 50% of the respective portions that would be apportioned to each income grouping using a combination of the sales and place-of-performance methods.

Current California Law (None)

Not applicable. California uses the unitary method to apportion income and expenses.

New Federal Law (IRC Sec. 864(f))

The Act extends the application of the statutory allocation rule so that it applies to the taxpayer's first two taxable years beginning after August 1, 1989, and on or before August 1, 1991.

Effective Date of New Federal Law

The statutory allocation rule applies to the remainder of the year covered by the 1989 Act as well as to the subsequent year.

Impact on California Revenue

Not applicable.

ACT SECTION: 11402

SECTION TITLE: RESEARCH AND EXPERIMENTATION TAX CREDIT

Prior Federal Law (IRC Sec. 28 and 41)

A 20-percent tax credit is allowed to the extent that a taxpayer's qualified research expenditures for the current year exceed its base amount for that year. The credit will not apply to amounts paid or incurred after December 31, 1990, and a special rule to prorate qualified research expenditures applies in the case of any taxable year which begins before October 1, 1990, and ends after September 30, 1990. Under this special proration rule, the amount of qualified research expenses incurred by a taxpayer prior to January 1, 1991, is multiplied by the ratio that the number of days in that taxable year before October 1, 1990, bears to the total number of days in such taxable year before January 1, 1991. The 20-percent tax credit also applies to certain payments to universities for basic research.

Current California Law (Sec. 17052.12, 17057, 23609, and 23609.5)

California's research credit percentage is 8 percent versus the federal 20 percent credit and uses a different method of determining base period expenses to determine the amount of current years expense eligible for the credit but in general uses the rules in federal law in computing the state credit. The state credit, however, does not sunset until the end of 1992.

New Federal Law (IRC Sec. 28 and 41)

The 20-percent incremental credit for qualified research expenditures and the university basic research credit are extended through December 31, 1991. The special rule to prorate research expenditures incurred during 1990 is repealed.

Effective Date of New Federal Law

The provision is effective for taxable years beginning on or after January 1, 1990.

Impact on California Revenue

Not applicable.

ACT SECTION: 11403

SECTION TITLE: EXCLUSION FOR EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE

Prior Federal Law (IRC Sec. 127)

An employee (including a self-employed individual) must include in income and wages, for income and employment tax purposes, the value of educational assistance provided by an employer to the employee, unless (1) the cost of such assistance qualifies as a deductible job-related expense of the employee (secs. 132, 162) or (2) the educational assistance is provided under an educational assistance program that meets certain requirements (sec. 127).

The exclusion for educational assistance benefits provided pursuant to an educational assistance program described in section 127 expired for taxable years beginning after September 30, 1990. Only amounts paid before October 1, 1990, in a taxable year beginning in 1990 are taken into account in determining the amount of the exclusion.

No more than $5,250 of educational assistance benefits provided during any calendar year can be excluded from the income of an employee. In addition, the exclusion for educational assistance benefits does not apply to graduate level courses. Specifically, the exclusion does not apply to any payment for, or the provision of any benefits with respect to, any course taken by an employee who has a bachelor's degree or is receiving credit toward a more advanced degree if the particular course can be taken for credit by any individual in a program leading to a law, business, medical, or other advanced academic or professional degree.

To the extent that employer-provided educational assistance is not excludable from income because it exceeds the maximum dollar limitation or because of the limitation on graduate-level courses, it may be excludable from income as a working condition fringe benefit (sec. 132(d)), provided the requirements of that section are otherwise satisfied (e.g., the education is job related as defined under sec. 162).

Current California Law (Sec. 17131 & 17151)

California conforms to the federal exclusion from income for educational assistance programs, including the prohibition on graduate level courses. The provision is permanent in California law but only provides an exclusion from income when there is a comparable federal provision.

New Federal Law (IRC Sec. 127)

The Act extends the exclusion for employer-provided educational assistance benefits through taxable years beginning before January 1, 1992. The special rule limiting the exclusion in the case of a taxable year beginning in 1990 is repealed.

In addition, the restriction on graduate level courses is repealed.

Effective Date of New Federal Law

The provision generally is effective for taxable years beginning on or after January 1, 1990, except that the repeal of the restriction on graduate level courses is effective for taxable years beginning on or after January 1, 1991.

Impact on California Revenue

This provision has two effects, one on the baseline and the other on an ongoing basis.

Baseline Impact. The extension of the current exclusion (resulting from extention of the federal exclusion) is a revenue loss in the $15 million range.

Ongoing Impact. Conformity to the removal of the graduate student restriction would result in a revenue loss in the $4 million range with most of that loss occurring automatically as employers anticipate state conformity.

ACT SECTION: 11404

SECTION TITLE: EXCLUSION FOR EMPLOYER-PROVIDED GROUP LEGAL SERVICES; TAX EXEMPTION FOR QUALIFIED GROUP LEGAL SERVICES ORGANIZATIONS

Prior Federal Law (IRC Sec. 120)

Amounts contributed by an employer to a qualified group legal services plan for an employee (or the employee's spouse or dependents) are excluded from the employee's gross income for income and employment tax purposes. The exclusion also applies to any services received by an employee (or the employee's spouse or dependents) or any amounts paid to an employee under such a plan as reimbursement for the cost of legal services for the employee (or the employee's spouse or dependents). The exclusion is limited to an annual premium value of $70. In order to be a plan under which employees are entitled to tax-free benefits, a group legal services plan is required to fulfill certain requirements. One such requirement is that group legal services benefits may not discriminate in favor of highly compensated employees in certain respects.

The exclusion for group legal services benefits expired for taxable years beginning after September 30, 1990. Only amounts paid before October 1, 1990, in taxable years beginning in 1990 for coverage before October 1, 1990, are taken into account in determining the amount of the exclusion for the year.

In addition, present law provides tax-exempt status for an organization the exclusive function of which is to provide legal services or indemnification against the cost of legal services as part of a qualified group legal services (sec. 501(c)(20)). The tax exemption for such an organization expired for taxable years beginning after September 30, 1990.

Current California Law (Sec. 17131 and 17157)

California conforms by reference to federal law, however, the exclusion is permanent but is only allowed in years in which federal law allows a similar exclusion.

New Federal Law (IRC Sec. 120)

The Act extends the exclusion for employer-provided group legal services and the tax exemption for qualified group legal services organizations through taxable years beginning before January 1, 1992. In addition, the special rule limiting the exclusion in the case of taxable years beginning in 1990 is repealed.

Effective Date of New Federal Law

The provision is effective for taxable years beginning on or after January 1, 1990.

Impact on California Revenue

Baseline Impact. The extension of the current exclusion (resulting from extention of the federal exclusion) is a revenue loss in the $5 million range.

ACT SECTION: 11405

SECTION TITLE: TARGETED JOBS TAX CREDIT

Prior Federal Law (IRC Sec. 51(c)(4))

A tax credit is available on an elective basis to employers of individuals described in at least one of nine targeted groups. The nine groups consist of individuals who are either recipients of payments under means-tested transfer programs, economically disadvantaged (as measured by family income), or disabled. The credit generally is equal to 40 percent of the first $6,000 of qualified first year wages. A credit equal to 40 percent of up to $3,000 of wages to any disadvantaged summer youth employees is also allowed. The employer's deduction for wages must be reduced by the amount of the credit. The credit expired on September 30, 1990.

Present law also authorizes appropriations for administrative and publicity expenses relating to the credit through September 30, 1990. These monies are to be used by the Internal Revenue Service (IRS) and Department of Labor to inform employers of the credit program.

Current California Law (Sec. 17053.7 and 23621)

California allows a credit equal to 10 percent of wages paid by an employer to each employee certified as eligible by EDD. The credit is limited to the first $3,000 in wages by employer per year for the first 24 months with a maximum credit of $600 for each qualified employee. The list of eligible persons is different than those eligible for the federal jobs credit.

The employee must begin work before 12/31/93 to qualify.

New Federal Law (IRC Sec. 51(c)(4))

The Act extends the targeted jobs tax credit through December 31, 1991. Generally, the authorization for appropriations also is extended.

The Act also clarifies that an individual is to be treated as convicted, for purposes of the credit, if a State court places him on probation without making a finding of guilty (deferred adjudication). This clarification is made on a prospective basis and no inference is intended by this clarification as to present law.

Effective Date of New Federal Law

This provision is effective for individuals who begin work after September 30, 1990.

Impact on California Revenue

Not applicable.

ACT SECTION: 11406

SECTION TITLE: BUSINESS ENERGY TAX CREDITS

Prior Federal Law (IRC Sec. 46)

Business energy tax credits were allowed through September 30, 1990, for three types of energy property:

Solar energy	10-percent credit
Geothermal energy	10-percent credit
Ocean thermal energy	15-percent credit.

Current California Law (Sec. 17052.5)

California does not conform to the provisions relating to business energy tax credits. Instead, California provides a credit for certain commercial solar electric systems. The California credit sunsets at the end of 1993.

New Federal Law (IRC Sec. 46)

The business energy tax credits are extended for qualified property which is placed in service after September 30, 1990, through December 31, 1991. However, the one-year extension of the business energy tax credits does not include ocean thermal property.

Effective Date of New Federal Law

This provision is effective for taxable years beginning on or after January 1, 1990.

Impact on California Revenue

Not applicable.

ACT SECTION: 11407

SECTION TITLE: LOW-INCOME RENTAL HOUSING TAX CREDIT

Prior Federal Law (IRC Sec. 42)

A tax credit is allowed in annual installments over 10 years for qualifying low-income rental housing, which may be newly constructed or substantially rehabilitated residential rental property. For most newly constructed and substantially rehabilitated housing placed in service after 1987, the credit percentages are adjusted monthly to maintain a present value of the credit stream of 70 percent of the total qualified expenditures. In the case of housing receiving other Federal subsidies (including the use of the proceeds of tax-exempt bonds) and the acquisition of an existing building which is substantially rehabilitated, monthly adjustments are made to maintain a present value of the credit stream of 30 percent of the total qualified expenditures. Generally, that part of the building for which the credit is claimed must be rented to qualified low-income tenants at restricted rents for 15 years after the building is placed in service. In addition, a subsequent additional 15-year period of low-income use is generally also required.

In order for a credit to be claimed with respect to a building, the building owner generally must receive a credit allocation from the appropriate credit authority. An exception is provided for property which is substantially financed with the proceeds of tax-exempt bonds subject to the State's private-activity bond volume limitation. The low-income housing credit is allocated by State or local government authorities subject to an annual limitation for each State. The annual State credit limitation was $1.25 per resident for years before 1990 and is $0.9375 per resident for 1990.

Current California Law (Sec. 17058 & 23610.5)

California generally conforms to the federal credit except that the credit is 30 percent over 4 years versus 90 percent over 10 years. Also, the California allocation amount available per year is $35 million and is not based on state population. The state credit is allowed for as long as there is a federal low-income housing credit.

New Federal Law (IRC Sec. 42)

The Act extends the low-income rental housing tax credit through December 31, 1991. It also restores the credit allocation limit to $1.25 per State resident for 1990 and makes several changes to the low-income credit. In addition, the Act makes the following amendments to current law.

Rights of first refusal

This amendment expands present law to provide that tenant cooperatives, resident management corporations, qualified nonprofits, and governmental agencies, as well as tenants acting individually, may have a right of first refusal to purchase their units at the end of the compliance period.

Definition of qualified nonprofit

The amendment provides that a qualified nonprofit organization must own (directly or indirectly) an interest in the project throughout the compliance period. Also, a qualified nonprofit organization (as determined by the State housing credit agency) may not be affiliated with or controlled by a for-profit organization.

10-year rule

The amendment provides an exception from the 10-year placed-in-service rule for owner-occupied single family dwelling units that have had no use other than as a principal residence for the owner thereof for the 10-year period before its placement in service with respect to which the credit is claimed.

Compliance

The amendment provides that qualified allocation plans must include a procedure for monitoring and reporting noncompliance to the IRS.

Intermediary costs

The requirement that the amount of intermediary costs be given the highest priority in allocating the credit is deleted from the qualified plan requirements and is instead made a factor in project evaluations.

Gross rent limitation

For purposes of the gross rent rules, the amendment provides that FHA's Section 515 program is to be treated comparably to the HUD Section 8 program.

Qualified census tracts

The amendment authorizes the Secretary of Housing and Urban Development (HUD) to use data from census enumeration districts in lieu of data from census tracts in situations where data from census tracts is unavailable.

Credit and HUD Section 8 programs

The amendment provides an exception from the denial of the credit in conjunction with the Section 8 Moderate Rehabilitation program for funds disbursed under the Stewart B. McKinney Homeless Assistance Act of 1988. The Act also mandates a study to be undertaken jointly by the Secretary of the Treasury and the Inspector General of the Department of Housing and Urban Development. The purpose of the study is to report on the combined use of the low-income credit and Section 8 Moderate Rehabilitation funds and the effectiveness of this provision in meeting the objectives of the low-income housing credit. Congress is concerned about the use of the low-income credit with such funds in light of previous allegations of questionable practices with the Section 8 Moderate Rehabilitation program. The report is to be submitted to the House Ways and Means Committee and the Senate Finance Committee by January 1, 1993.

Units occupied by students

The amendment provides that dwelling units occupied by students receiving AFDC payments do not fail to qualify for the credit.

Election to accelerate credit

The Act permits individual taxpayers, who held an interest in a low-income housing credit property on October 26, 1990, to claim credits in taxable year 1990 with respect to that interest which are otherwise allowable in future years. The election may increase the credit claimed in 1990 by up to 50 percent of the otherwise allowable credit. This election is binding on all successors in interest to the taxpayer. In the case of property owned by a partnership, the election is made at the partnership level and is binding on all partners.

Allowable credits, in future years, for the same property are ratably reduced by the additional amount of the credit claimed in 1990. For example, if a taxpayer elected to claim an additional $70 of credit, with respect to a credit property which is eligible for seven years of credit after 1990, then the allowable credit in each of the subsequent seven years is reduced by ten dollars per year.

Effective Date of New Federal Law

The amendments generally are effective for determinations made under section 42 with respect to housing credit dollar amounts allocated from State housing credit ceilings for calendar years after 1990. For projects not subject to credit allocation limits, the amendments generally apply to buildings placed in service after December 31, 1990 but only with respect to bonds issued after December 31, 1990.

The provisions relating to rights of first refusal, the definition of a qualified nonprofit, the 10-year rule, and units occupied by students are effective November 5, 1990.

The provision relating to compliance monitoring and reporting procedures in the State allocation plans is effective after December 31, 1991.

The provision relating to the election to accelerate the credit is generally effective for taxable years ending after October 26, 1990.

The provision relating to bond-financed buildings in progress in the termination year of the credit (section 42(o)) is effective for calendar years after 1989.

Impact on California Revenue

Baseline Impact. The extension of the current credit (resulting from extention of the federal credit) is a revenue loss of $35 million, the annual cap on credits authorized for allocation by California Tax Credit Allocation Committee.

ACT SECTION: 11408

SECTION TITLE: MORTGAGE REVENUE BONDS AND MORTGAGE CREDIT CERTIFICATES

Prior Federal Law (IRC Sec. 25)

Qualified mortgage bonds (QMBs) generally are used to finance the purchase or qualifying rehabilitation or improvement of single family, owner-occupied homes. The recipients of QMB-financed loans must meet purchase price, income, and other restrictions.

Qualified governmental units may elect to exchange qualified mortgage bond authority for authority to issue mortgage credit certificates (MCCs). MCCs entitle homebuyers to nonrefundable income tax credits for a specified percentage of interest paid on mortgage loans on their principal residences. Once issued, an MCC generally remains in effect as long as the residence being financed continues to be the certificate-recipient's principal residence. MCCs generally are subject to the same borrower eligibility requirements as QMBs.

Effective for loans originating after December 31, 1990, a portion of the QMBs and MCC subsidy (other than qualified home improvement loans) is recaptured upon disposition of a house financed with an assisted loan within ten years. The amount of the recapture is phased out for taxpayers who have resided in the home for more than five years. The recapture is the lesser of fifty percent of the gain realized on disposition or 1.25 percent of the initial loan principal multiplied by the number of years (up to a maximum of 5 years) that the taxpayer has owned the home. Recapture only applies to certain recipients whose income rises substantially after the financing is received.

Authority to issue QMBs and to exchange private activity bond volume authority for authority to issue MCCs expired on September 30, 1990.

Current California Law (None)

Not applicable.

New Federal Law (IRC Sec. 25)

The Act extends the QMB and MCC programs through December 31, 1991. The Act includes three principal modifications to the present-law rules governing recapture of the subsidy provided by QMBs and MCCs. First, the maximum recapture period is reduced from 10 years to 9 years. Second, the amount recaptured is adjusted annually throughout this 9-year period rather than monthly. Thus, the recapture amount is the lesser of: (1) 50 percent of the gain realized on disposition or (2) a percentage of the imputed MRB or MCC subsidy (other than qualified home improvement loans). The imputed subsidy limitation is 20 percent for dispositions within one year after a homebuyer receives the MRB or MCC financing. The percentage increases to 40 percent in year two, 60 percent in year three, 80 percent in year four, and 100 percent in year five. The imputed subsidy limitation then is reduced to 80 percent in year six, 60 percent in year seven, 40 percent in year eight, 20 percent in year nine and zero thereafter. Third, the recapture provision's income adjustment exception is liberalized to determine the 5-percent-per-year inflation adjustment with compounding.

Effective Date of New Federal Law

These modifications are effective as if included in the Technical and Miscellaneous Revenue Act of 1988.

Impact on California Revenue

Not applicable.

ACT SECTION: 11409

SECTION TITLE: QUALIFIED SMALL-ISSUE BONDS

Prior Federal Law (IRC Sec. 144)

Interest on certain small issues of private activity bonds is exempt from tax if at least 95 percent of the net proceeds of the bonds is to be used to finance manufacturing facilities or certain land or property for first-time farmers ("qualified small-issue bonds").

The issuer of a qualified small-issue bond must receive an allocation from the State private activity volume cap. Authority to issue qualified small-issue bonds expired September 30, 1990.

Current California Law (Sec. 17143)

Not applicable. California does not conform to federal rules for private activity bonds due to the differences between federal and state requirements for tax exempt bonds.

New Federal Law (IRC Sec. 144)

The Act extends authority to issue qualified small-issue bonds through December 31, 1991.

Effective Date of New Federal Law

This provision is effective for taxable years beginning on or after January 1, 1990.

Impact on California Revenue

Not applicable.

ACT SECTION: 11410

SECTION TITLE: DEDUCTION FOR HEALTH INSURANCE COSTS OF SELF-EMPLOYED INDIVIDUALS

Prior Federal Law (IRC Sec. 162(l))

Present law provides a deduction for 25 percent of the amounts paid for health insurance for a taxable year on behalf of a self-employed individual and the individual's spouse and dependents. The 25-percent deduction is also available to a more than 2-percent shareholder of an S corporation.

No deduction is allowable for any taxable year in which the self-employed individual or eligible S corporation shareholder is eligible to participate (on a subsidized basis) in a health plan of an employer of the self-employed individual (or of such individual's spouse).

The 25-percent deduction expires for taxable years beginning after September 30, 1990. For taxable years beginning in 1990, the deduction is allowed only for premiums paid for coverage before October 1, 1990. In addition, an individual's earned income for the taxable year beginning in 1990 is prorated in determining the applicable deduction for such year.

Current California Law (Sec. 17201 and 24343)

California is conformed by reference to federal law as of January 1, 1990, including the expiration on September 30, 1990.

New Federal Law (IRC Sec. 162(l))

The Act extends the 25-percent deduction for health insurance costs of self-employed individuals through taxable years beginning before January 1, 1992. In addition, the special rule prorating the deduction for taxable years beginning in 1990 is repealed.

Effective Date of New Federal Law

This provision is effective for taxable years beginning on or after January 1, 1990.

Impact on California Revenue

Since California has been in conformity with federal law, most taxpayers will continue to follow federal law. Using federal estimates, this will result in a total revenue loss in the $12 million range.

The revenue loss resulting from conformity by California to this federal extension would most likely be minor, in the $1 to $2 million range, and would affect only those taxpayers who would have made the adjustment on their state return if California had not conformed.

ACT SECTION: 11411

SECTION TITLE: ORPHAN DRUG TAX CREDIT

Prior Federal Law (IRC Sec. 28)

A 50-percent tax credit is allowed for qualified clinical testing expenses incurred during the taxable year for human clinical tests of drugs for certain rare diseases or conditions. Clinical testing expenses do not qualify for the credit unless the drug previously has been approved for human testing by the Food and Drug Administration (FDA), but the drug has not yet been approved for sale by the FDA.

This tax credit expires after December 31, 1990.

Current California Law (Sec. 17057 & 23609.5)

California conforms to federal law except that the percentage for state purposes is 15 percent versus the 50 percent federal credit and the testing must be conducted in California. The California credit sunsets at the end of 1992.

New Federal Law (IRC Sec. 28)

There is a one year extension of the credit.

Effective Date of New Federal Law

The credit will be allowed for expenses incurred in qualified human clinical testing after December 31, 1990, and before January 1, 1992.

Impact on California Revenue

Not applicable.

ACT SECTION: 11501

SECTION TITLE: Extension and Modification of Credit for Producing Fuel from Nonconventional Sources

Prior Federal Law (IRC Sec. 29)

Nonconventional fuels are eligible for a production credit that is equal to $3 per barrel or BTU equivalent (adjusted for inflation). Qualified fuels must be produced from a well drilled, or a facility placed in service, before January 1, 1991. The production credit is available for qualified fuels sold before January 1, 2001.

Qualified fuels include (1) oil produced from shale and tar sands, (2) gas produced from geopressured brine, Devonian shale, coal seams, a tight formation, or biomass, and (3) liquid, gaseous, or solid synthetic fuels produced from coal (including lignite), including such fuels used as feedstocks.

Gas produced from a tight formation qualifies for the credit only if the price of the gas is regulated by the United States or the maximum lawful price is at least 150 percent of the applicable price under the Natural Gas Policy Act of 1978. As a cumulative result of various legislative and regulatory actions since the credit was enacted, most gas produced from tight formations does not currently qualify for the credit.

Current California Law (None)

California law does not include any special incentives for the production of nonconventional fuels.

New Federal Law (IRC Sec. 29)

The federal Act extends both the drilled or placed-in-service date and the fuels sold date for two years. Thus, the credit will apply with respect to qualified fuels which are produced from a well drilled before January 1, 1993, or produced in a facility placed in service before January 1, 1993, and which are sold before January 1, 2003.

The federal Act treats as qualifying tight formation gas any gas produced from a tight formation (1) which is produced from a well drilled after December 31, 1990, or (2) which, as of April 20, 1977, was committed or dedicated to interstate commerce.

The federal Act also specifies that the amount of credit allowable, with respect to any qualifying production from an "enhanced oil recovery project", must be reduced by the amount of general business credit claimed with respect to that project.

Effective Date of New Federal Law

The provisions related to natural gas produced from tight formations apply to qualifying tight formation gas which is produced after December 31, 1990.

The provisions related to interaction with the credit for an "enhanced oil recovery project" apply to taxable years beginning on or after January 1, 1991.

Impact on California Revenue

Not applicable.

ACT SECTION: 11502

SECTION TITLE: Credit for Small Producers of Ethanol; Modification of Alcohol Fuels Credit

Prior Federal Law (IRC Sec. 40)

An income tax credit of 60 cents per gallon is allowed to producers and blenders of alcohol (190 or greater proof) used as fuel, sold at retail for use as fuel, or mixed with fuel in a mixture used as fuel in a motor vehicle driven on highways. Alcohol with a proof greater than 150 but less than 190 is allowed a credit of 45 cents per gallon. The alcohol fuels may be blended with gasoline, diesel fuel, or special motor fuels. The income tax credit is scheduled to expire after December 31, 1992.

Alternatively, in lieu of the income tax credit, a 6-cents-per-gallon excise tax exemption is allowed on the sale of an alcohol fuel mixture that consists of 10-percent alcohol fuel and 90-percent motor fuel. The excise tax exemption terminates after September 30, 1993.

In addition, a tariff of 15.85 cents per liter (metric equivalent of 60 cents per gallon) of imported alcohol fuel is levied to offset the domestic alcohol fuels tax credit and excise tax exemption. Certain quantities of alcohol fuel may be imported duty-free from Caribbean Basin Initiative (CBI) countries, if the alcohol fuel meets statutory requirements with respect to value added in the CBI. Imports of ETBE (ethyl tertiary butyl ether) enter with a duty rate of 6.66 cents per liter. The three import provisions terminate after December 31, 1992 (except that the ETBE tariff also expires on an earlier date, if any, that Treas. Reg. 1.40-1 is withdrawn or declared invalid).

Current California Law (None)

California law does not include any special incentives for the production of alcohol fuels.

New Federal Law (IRC Sec. 40)

In addition to the existing credit for producing alcohol fuel, a new 10-cents per gallon income tax credit is allowed for production of up to 15 million gallons per year of ethanol by an eligible small ethanol producer, defined as a person with a productive capacity for alcohol not in excess of 30 million gallons of alcohol per year.

Appropriate anti-abuse rules are included (1) to recapture the credit in event of failure to use ethanol or an ethanol fuel mixture as fuel and (2) to prevent the credit from benefiting directly or indirectly any producer with a productive capacity in excess of 30 million gallons of alcohol per year or any person with respect to more than 15 million gallons of ethanol per year. In the case of flow-thru entities, the productive capacity limitation will be applied at both the entity and interest holder levels.

For ethanol fuels or ethanol fuel mixtures, the income tax credit is reduced from 60 to 54 cents per gallon for 190 or greater proof ethanol and from 45 to 40 cents per gallon for 150 to 190 proof ethanol. The exemption from excise taxes is reduced from 6.0 to 5.4 cents per gallon of gasohol mixture.

Corresponding adjustments are made to the tariffs on ethanol and ETBE. The tariff on ethanol will decrease to 14.27 cents per liter (11.34 cents per liter on imports from Canada) and the tariff on ETBE will decrease to 5.99 cents per liter (4.76 cents per liter on imports from Canada).

The credit and the excise tax exemption for alcohol fuels and alcohol fuel mixtures are extended through December 31, 2000, and September 30, 2000, respectively. In addition, at any time prior to January 1, 2001, the credit and the excises tax exemption will terminate, or will be reinstituted, at the same time that the Highway Trust Fund financing rates under the motor fuels excise taxes expire, are terminated, or are reinstituted. The tariff rate is inapplicable during any period when the Highway Trust Fund financing rate is not in effect.

Unused credits may be carried forward only for two taxable years after termination of the credit.

The Act also includes an extension of the tax and tariff provisions relating to ethanol. As under present law, the tariff provision on ETBE would cease to have effect in the event that Treasury regulation sec. 1. 40-1 (relating to ETBE) is withdrawn or judicially declared invalid.

Effective Date of New Federal Law

The amendments made by this Act apply to alcohol produced, and sold or used, in taxable years beginning on or after January 1, 1991.

Impact on California Revenue

Not applicable.

ACT SECTION: 11511

SECTION TITLE: Tax Credit for Enhanced Oil Recovery

Background

Intangible Drilling Costs

An operator who pays or incurs intangible drilling or development costs (IDCs) in the development of a domestic oil or gas property may elect either to expense or capitalize such amounts. If a taxpayer elects to expense IDCs, the taxpayer deducts the amount of the IDCs as an expense in the taxable year the cost is paid or incurred. Generally, if IDCs are not expensed, but are capitalized, they can be recovered through depletion or depreciation, as appropriate, or under a special election, they may be amortized over a 60-month period. In the case of a nonproductive well ("dry hole"), IDCs may be deducted, at the election of the operator, as an ordinary loss in the taxable year in which the dry hole is completed. In the case of an integrated oil company, 30 percent of the IDCs on productive wells must be capitalized and amortized over a 60-month period.

Tertiary Injectants

A current deduction is allowed for tertiary injectants used as a part of a qualified tertiary recovery method to recover crude oil. The specific methods qualified are described in subparagraphs (1) through (9) of Section 212.78(c) of the June, 1979, energy regulations.

California law

California law generally follows federal law with respect to IDCs, but does not allow current deduction of tertiary injectants.

Prior Federal Law (None)

No tax credit is allowed for costs related to "enhanced oil recovery" projects (generally referred to as tertiary recovery projects).

Current California Law (None)

California law does not include any tax credit for "enhanced oil recovery" projects.

New Federal Law (IRC Sec. 43)

A new domestic energy exploration and production tax credit is allowed as a component of the general business credit. The credit is equal to 15 percent of qualified costs attributable to qualified "enhanced oil recovery" (EOR) projects.

The amount of the credit is to be reduced in a taxable year following a calendar year during which the average price of crude oil exceeds $28 (adjusted for inflation). The credit will be reduced ratably over a $6 phaseout range.

To the extent that a credit is allowed for these costs, the taxpayer must reduce the amount otherwise deductible or required to be capitalized and recovered through depreciation, depletion, or amortization, as appropriate, with respect to these costs.

Qualified enhanced oil recovery costs include the following costs which are paid or incurred with respect to a qualified domestic EOR project: (1) the cost of tangible property which is an integral part of the project and with respect to which depreciation or amortization is allowable; (2) intangible drilling and development costs with respect to which a taxpayer may make an election to deduct under IRC Section 263(c); and (3) the cost of tertiary injectants with respect to which a deduction is allowable under section 193.

In the case of an integrated oil company, the credit base includes those intangible drilling costs which the taxpayer is required to capitalize under IRC Section 291(b)(1).

Nine tertiary recovery methods were listed in the June 1979 Department of Energy regulations (section 212.78(c)). The Act intends that a project employing one of these listed methods generally be considered a qualified enhanced oil recovery project. In addition, for purposes of the enhanced oil recovery credit, immiscible non-hydrocarbon gas displacement generally is considered a qualifying tertiary recovery method, even if the gas injected is not carbon dioxide.

The Secretary of the Treasury is granted the authority to clarify the scope and parameters of the listed tertiary recovery methods for application of the enhanced oil recovery credit (e.g., the Secretary may re-examine the use of polymer-augmented water flooding and may distinguish situations in which this method is appropriately treated as a tertiary recovery method from situations in which it is not). In addition, the Secretary is given discretion to add to the list of qualifying methods to take into account advances in enhanced oil recovery technology.

Effective Date of New Federal Law

The credit is effective for taxable years beginning on or after January 1, 1991, with respect to costs paid or incurred in EOR projects begun or significantly expanded on or after that date.

Impact on California Revenue

Not applicable. California law is not conformed to federal law with respect to the items that interact with this credit, such as the deduction of tertiary injectants, percentage depletion, and depreciation.

ACT SECTION: 11521

SECTION TITLE: Percentage Depletion Permitted After Transfer of Property

Prior Federal Law (IRC Sec. 613A)

Certain persons owning economic interests in domestic oil and gas producing properties may deduct an allowance for depletion in computing taxable income. The percentage depletion allowance for oil and gas is generally equal to 15 percent of the gross income from the oil or gas property.

The allowance for percentage depletion generally does not apply to interests in oil or gas properties that were transferred after December 31, 1974, by one taxpayer to another if, at the time of the transfer, the principal value of the property had been demonstrated by prospecting, exploration, or discovery work.

Current California Law (Sec. 17683, 24833)

California law incorporates the provisions of Subchapter I of Chapter 1 of the Internal Revenue Code, relating to natural resources, with certain exceptions. One of those exceptions is that Section 613A of the Internal Revenue Code, relating to percentage depletion of oil and gas wells, does not apply for state purposes.

Under California law, percentage depletion for foreign and domestic oil, gas, and geothermal wells is 22 percent of the gross income from the property. Also, California does not prohibit percentage depletion for certain properties transferred after December 31, 1974, as described above.

New Federal Law (IRC Sec. 613A)

The federal Act repeals the provision that prohibits an allowance for percentage depletion with respect to transferred properties with proven value.

Effective Date of New Federal Law

Property transfers occurring after October 11, 1990.

Impact on California Revenue

Not applicable. California law does not contain the federal restriction being repealed.

ACT SECTION: 11522

SECTION TITLE: Net Income Limitation on Percentage Depletion Increased from 50 to 100 Percent of Property Net Income

Prior Federal Law (IRC Sec. 613, 613A, 614)

Certain persons owning economic interests in domestic oil and gas producing properties may deduct an allowance for depletion in computing taxable income. The percentage depletion allowance for oil and gas is generally equal to 15 percent of the gross income from the oil or gas property.

The allowance for percentage depletion is subject to a net income limitation; that is, the deduction for percentage depletion is limited (on a property by property basis) to an amount not in excess of 50 percent of the net taxable income from the property, computed without a deduction for depletion.

Current California Law (Sec. 17681-83, 24831-33)

California law incorporates the provisions of Subchapter I of Chapter 1 of the Internal Revenue Code, relating to natural resources, with certain exceptions.

Under California law, percentage depletion for foreign and domestic oil, gas, and geothermal wells is 22 percent of the gross income from the property limited to an amount not in excess of 50 percent of the net taxable income from the property, computed without a deduction for depletion.

New Federal Law (IRC Sec. 613, 613A, 614)

The net income limitation on oil and gas percentage depletion is increased from 50 percent to 100 percent of the net taxable income from the property.

Effective Date of New Federal Law

Taxable years beginning on or after January 1, 1991.

Impact on California Revenue

Based on the low level of federal estimates for this provision and federal Act Section 11523 (the next section in this report), conformity by California would result in minor revenue losses ranging from $1 to $3 million over the initial three years.

ACT SECTION: 11523

SECTION TITLE: Increase in Percentage Depletion Allowable for Marginal Production

Prior Federal Law (IRC Sec. 613A)

Certain persons owning economic interests in domestic oil and gas producing properties may deduct an allowance for depletion in computing taxable income. The percentage depletion allowance for oil and gas is generally equal to 15 percent of the gross income from the oil or gas property.

Current California Law (Sec. 17683, 24833)

California law incorporates the provisions of Subchapter I of Chapter 1 of the Internal Revenue Code, relating to natural resources, with certain exceptions.

Under California law, percentage depletion for foreign and domestic oil, gas, and geothermal wells is 22 percent of the gross income from the property.

New Federal Law (IRC Sec. 613A)

Under the federal Act, the statutory percentage depletion rate will be increased by one percent (subject to a maximum rate increase of 10 percent) for each whole dollar that the average domestic wellhead price of crude oil for the immediately preceding calendar year is less than $20 per barrel (not to be adjusted for inflation). This provision applies only to interests in marginally producing oil and gas wells (i.e., stripper wells or wells that produce heavy oil) held by independent producers or royalty owners.

Under the federal Act, the term marginal production includes (1) crude oil and natural gas produced from a domestic stripper well property, and (2) oil produced from a domestic property, substantially all of the production from which during the year is heavy oil (i.e., oil that has a weighted average gravity of 20 degrees API or less corrected to 60 degrees Fahrenheit). A stripper well property is any oil or gas producing property which produces a daily average of 15 or less equivalent barrels of oil and gas per producing oil or gas well on such property in the calendar year during which the taxpayer's taxable year begins.

The determination of whether a property qualifies as a stripper well property under the federal Act is made separately for each calendar year. The fact that a property does or does not qualify as a stripper well property for one year shall not affect the determination of the status of that property for a subsequent year. The stripper well property determination is to be made by a taxpayer for each separate property interest held by the taxpayer during a calendar year. The determination is to be based on the total amount of production from all producing wells that are treated as part of the same property interest of the taxpayer. For this purpose, a well is considered a producing well only if it produces more than an insignificant amount of oil or gas during the calendar year. A property qualifies as a stripper well property for a calendar year only if the wells on such property were producing during that period at their maximum efficient rate of flow.

Where a taxpayer's property consists of a partial interest in one or more oil or gas producing wells, the determination of whether the property is a stripper well property or a heavy oil property shall be made with respect to total production from such wells, including the portion of total production attributable to ownership interests other than the taxpayer's.

The federal Act also clarifies the application of the marginal property determination with respect to a taxpayer with a taxable year other than the calendar year. In such a case, the taxpayer must determine whether its property interest qualifies as a stripper well property or a heavy oil property on the basis of production from the producing wells on the property during the calendar year. If a property qualifies as a stripper well or heavy oil property for a calendar year, then the taxpayer's share of production from that property for its taxable year beginning in that calendar year will qualify as marginal production. If in the following calendar year the property does not satisfy the definition of a stripper well property, then the taxpayer's share of production from that property for its following taxable year will not be treated as marginal production.

Effective Date of New Federal Law

Taxable years beginning on or after January 1, 1991.

Impact on California Revenue

See Act Section 1522 (the immediately preceeding section of this report).

ACT SECTION: 11531

SECTION TITLE: Special Energy Deduction for Minimum Tax

Prior Federal Law (IRC Sec. 56, 59)

Under present law, corporations and individuals are subject to an alternative minimum tax which is payable, in addition to all other tax liabilities, to the extent that it exceeds the taxpayer's regular income tax owed. The tax is imposed at a flat rate of 20 percent (for corporations) or 21 percent (individuals) on alternative minimum taxable income in excess of an exemption amount.

The items of tax preference relating to oil and gas operations are as follows: (1) to the extent that a percentage depletion deduction for regular tax purposes represents depletion in excess of the taxpayer's basis in the depletable property, that deduction constitutes an item of tax preference (the percentage depletion preference), and (2) the amount of intangible drilling costs (IDCs) that are expensed in excess of the amount that would have been allowable if the costs had been capitalized and recovered through cost depletion or amortized ratably over a 10-year period and that are in excess of 65 percent of the amount of net oil and gas income is an item of tax preference (the excess IDC preference).

For taxable years beginning after 1989, the alternative minimum taxable income of a corporation is increased by an amount equal to 75 percent of the amount by which adjusted current earnings (ACE) exceed pre-net operating loss alternative minimum taxable income. In general, adjusted current earnings means alternative minimum taxable income with additional adjustments. These adjustments generally follow the rules presently applicable to corporations in computing their earnings and profits.

The adjustments specifically relating to oil and gas operations are as follows: (1) the allowance for depletion for any property placed in service in a taxable year beginning after 1989 shall be computed using the cost depletion method (the ACE depletion adjustment), and (2) intangible drilling costs deductible under IRC Section 263(c) in taxable years beginning after 1989 are capitalized and amortized over the 60-month period beginning with the month in which such costs are paid or incurred (the ACE-IDC adjustment).

Current California Law (Sec. 17062-17063, 23400-23459)

California law is conformed to federal law relating to alternative minimum tax, with certain specified exceptions which, in general, are required by other differences between state and federal law.

New Federal Law (IRC Sec. 56, 59)

The federal Act provides a special energy deduction for purposes of computing alternative minimum taxable income. The deduction is allowable to any taxpayer other than an integrated oil company and is the lesser of --

(1) The alternative tax energy preference deduction, or

(2) 40 percent of alternative minimum taxable income (computed without taking into account the special energy deduction and the alternative minimum tax net operating loss deduction.

The deduction is based on a specified portion of the various oil and gas related tax preference items. In addition, for corporations, the deduction generally includes a specified percentage of the energy-related portion of the adjusted current earnings adjustment.

Specifically, the special energy deduction is <u>initially</u> determined by determining the taxpayer's (1) intangible drilling cost preference and (2) marginal production depletion preference.

The intangible drilling cost preference is the amount by which the taxpayer's alternative minimum taxable income would be reduced if it were computed without regard to (1) the excess IDC preference computed under IRC Section 57(a)(2), (2) the ACE-IDC adjustment computed under IRC Section 56(g)(4)(D)(i), (3) the special energy deduction, and (4) the alternative minimum tax net operating loss deduction.

The marginal production depletion preference is the amount by which the taxpayer's alternative minimum taxable income would be reduced if it were computed without regard to (1) the excess depletion preference computed under IRC Section 57(a)(2), (2) the ACE depletion adjustment computed under IRC Section 56(g)(4)(G), (3) the special energy deduction, and (4) the alternative minimum tax net operating loss deduction.

Then, the intangible drilling cost preference is apportioned between (1) the portion of the preference related to qualified exploratory costs and (2) the remaining portion of the preference.

The portion of the preference related to qualified exploratory costs is multiplied by 75 percent and the remaining portion is multiplied by 15 percent.

The marginal production depletion preference is multiplied by 50 percent.

The three products described above are added together to arrive at the taxpayer's special energy deduction (subject to certain limitations).

Qualified exploratory costs, in general, are IDCs which the taxpayer may elect to deduct as expenses under section 263(c), and which are attributable to the drilling of a domestic oil or gas well. IDCs attributable to the drilling of nonproductive wells are not precluded from being treated as qualified exploratory costs. In addition, costs which the taxpayer elects to capitalize and amortize under section 59(e) are treated as IDCs for purposes of determining total IDCs and the exploratory portion of total IDCs. IDCs paid or incurred after the installation of the production string of casing begins with respect to a well also are not precluded from being treated as qualified exploratory costs.

Under the federal Act, a well (the new well) generally qualifies as an exploratory well if at the time it is completed (or if not completed, at the time drilling operations cease), there is no completed oil or gas well that is capable of production in commercial quantities within a 1.25 mile radius of the new well. If the new well is drilled within 1.25 miles of a completed well capable of production in commercial quantities of oil or gas, it will qualify as an exploratory well if it is drilled to a total depth at least 800 feet below the completion depth of the deepest completion depth of any oil or gas well capable of production in commercial quantities within that 1.25 mile radius. If the new well fails both the distance and depth tests, it nevertheless will be considered an exploratory well if it is drilled into a new reservoir of oil or gas and is capable of production in commercial quantities. A reservoir, for this purpose, generally is a separate and distinct producing oil or gas reservoir that is not in communication with any other producing reservoir. A gas well will not be treated as having been completed into a new reservoir if the reservoir consists of a deposit of tight formation gas, Devonian shale, or coal seams gas.

The federal Act provides that with respect to the drilling of offshore wells, the term exploratory well generally includes wells drilled from a mobile drilling rig or ship. The federal Act provides, however, that qualified exploratory costs do not include IDCs attributable to any well drilled from an offshore platform, unless it can be demonstrated by the taxpayer that the well is drilled into a reservoir that has not previously been penetrated by any well.

A well generally is presumed to be capable of production in commercial quantities at the time that it has been completed with the installation of a "christmas tree" or other mechanism to regulate the flow of oil or gas. An offshore well generally is deemed not to be capable of production in commercial quantities prior to the time of the installation of the related offshore platform or other production system. A well generally is considered completed when the production string of casing and a "christmas tree" or other mechanism to regulate the flow of oil or gas has been installed.

The combination of the special energy deduction, the alternative tax net operating loss deduction, and the alternative minimum tax foreign tax credit cannot reduce more than 90 percent of the taxpayer's alternative minimum tax liability determined without such items.

The special energy deduction will be phased out in taxable years that follow calendar years in which the price of crude oil exceeds a specified level. The amount of the special energy deduction (determined without regard to the phase-out) is to be reduced for any taxable year that immediately follows a calendar year during which the average price of crude oil exceeds $28 per barrel (adjusted for inflation using the GNP implicit price deflator) and will be completely phased out if the average price of oil exceeds such inflation adjusted amount by $6 or more in such year.

Effective Date of New Federal Law

The special energy deduction is effective for taxable years beginning on or after January 1, 1991.

Impact on California Revenue

Conformity by California would result in revenue losses in the $5 to $10 million range, largely attributed to the IDC preference.

ACT SECTION: 11601-11602

SECTION TITLE: Treatment of Estate Tax Freezes

Prior Federal Law (IRC Sec. 2036(c))

If a person, in effect, transfers property having a disproportionately large share of the potential appreciation in such person's interest in an enterprise while retaining an interest, or right in, the enterprise, then the transferred property is includible in his gross estate. Dispositions of either the transferred or retained property prior to the transferor's death result in a deemed gift equal to the amount that would have been includible in the gross estate had the transferor died at the time of the transfer.

Current California Law (None)

The California gift and inheritance tax laws were repealed in 1982. The state currently imposes only a "pick-up" tax which is equal to the amount of the credit allowed against the federal tax as an offset for taxes paid at the state level. The "pick-up" tax is administered by the State Controller.

New Federal Law (IRC Sec. 2701-2704, 6501(c))

IRC Section 2036(c) is repealed retroactively (to December 17, 1987) and replaced with a new method of preventing the tax avoidance possible through use of the estate freeze strategy. The new rules take a more direct approach, seeking to provide a more accurate gift tax valuation of the interests transferred. These rules modify the valuation of certain retained rights in corporations and partnerships, the valuation of split temporal interests in property, the effect of buy-sell agreements and options upon value, and the transfer tax consequences of lapsing rights.

Effective Date of New Federal Law

The repeal of IRC Section 2036(c) is effective 12/17/87.

The new valuation rules apply, in general, to transfers made and agreements entered into (or substantially modified) after October 8, 1990.

Impact on California Revenue

Baseline impact -- to be determined by the State Contoller.

ACT SECTION: 11611

SECTION TITLE: Credit for Cost of Providing Access for Disabled Individuals

Prior Federal Law (IRC Sec. 190)

Under present law, a taxpayer may elect to deduct up to $35,000 of certain architectural and transportation barrier removal expenses for the taxable year in which paid or incurred rather than capitalizing such expenses.

Current California Law (Sec. 17201, 24383)

The Personal Income Tax Law is conformed to federal law by reference, with no exceptions.

The Bank and Corporation Tax Law is generally patterned after federal law, including the $35,000 limitation.

New Federal Law (IRC Sec. 44, 190)

An eligible small business is defined for any taxable year as a person that had gross receipts for the preceding taxable year that did not exceed $1 million or had no more than 30 full-time employees during the preceding taxable year.

A new tax credit is allowed to small businesses for 50 percent of eligible access expenditures for the taxable year that exceed $250 but do not exceed $10,250.

Eligible access expenditures are defined as amounts paid or incurred by an eligible small business for the purpose of enabling such eligible small business to comply with applicable requirements of the Americans With Disabilities Act of 1990 (as in effect on November 5, 1990). Eligible access expenditures generally include amounts paid or incurred:

(1) For the purpose of removing architectural, communication, physical, or transportation barriers which prevent a business from being accessible to, or usable by, individuals with disabilities;

(2) To provide qualified interpreters or other effective methods of making aurally delivered materials available to individuals with hearing impairments;

(3) To provide qualified readers, taped texts, and other effective methods of making visually delivered materials available to individuals with visual impairments;

(4) To acquire or modify equipment or devices for individuals with disabilities; or

(5) To provide other similar services, modifications, materials, or equipment. The expenditures must be reasonable and necessary to accomplish these purposes.

The disabled access credit is included as a general business credit and, thus, is subject to the rules of present law that limit the amount of the general business credit that may be used for any taxable year. The portion of the unused business credit for any taxable year that is attributable to the disabled access credit is not to be carried back to any taxable year ending before the date of enactment of the credit.

The federal Act reduces the amount of architectural and transportation barrier removal expenses that may be deducted for any taxable year to $15,000.

Effective Date of New Federal Law

The disabled access credit applies to expenditures paid or incurred after the date of enactment.

The reduction in the amount of deductible architectural and transportation barrier removal expenses applies to taxable years beginning after November 5, 1990.

Impact on California Revenue

It is estimated that reducing the maximum deduction from $35,000 to $15,000 would result in a revenue gain of approximately $1.5 million annually.

The impact of any new credit has not been determined at this time.

ACT SECTION: 6

SECTION TITLE: SALE OF PROPERTY TO COMPLY WITH CONFLICT OF INTEREST REQUIREMENTS

Prior Federal Law (IRC Sec. 1043)

The Ethics Reform Act of 1989 allowed deferral of gain when property was sold by Executive Branch personnel to comply with an order to divest issued either by the President or the Office of Government Ethics (OGE).

Current California Law (Sec. 18031)

California conforms by reference to federal law as of January 1, 1990.

New Federal Law (IRC Sec. 1043)

The tax deferral is extended to certain assets held in a trust in which the officer or employee has a beneficial interest. Also, the Act provides a transition rule to allow certain sales to be eligible if made after November 30, 1989 (the effective date of the Ethics Reform Act of 1989) and before June 19, 1990 which is 60 days after publication of OGE's interim regulations.

Effective Date of New Federal Law

The provisions are effective for sales after November 30, 1989.

Impact on California Revenue

The deferral of gains in any given year is unknown. Any cash flow revenue effect for assets that would have normally been sold would most likely be negligible.

REVENUE RECONCILIATION ACT OF 1990

Exhibit A

Technical Amendments

Act Section	IRC Section	PIT Section	BCT Section	Federal Effective Date	Description of Act Provision
11701(a)	42	17058	23610.5	Credits allocated after 1989 from housing credit ceilings.	Technical amendment to Rev. Rec. Act of 1989, Sec. 7108, Low-income housing credit.
11701(b)(1)	163(e)	17201	24344	Instruments issued after 7/10/89	Technical amendment to Rev. Rec. Act of 1989, Sec. 7202, High yield Original Issue Discount obligations.
11701(b)(2)	163(i)	17201	24344	Instruments issued after 7/10/89	Technical amendment to Rev. Rec. Act of 1989, Sec. 7202, High yield Original Issue Discount obligations.
11701(c)	163(j)	17201	24344	Instruments issued after 7/10/89	Technical amendment to Rev. Rec. Act of 1989, Sec. 7210, Limitation on deduction of interest paid to a related person.
11701(d)	172	17201	24416	Corporate equity reduction transactions after 8/2/89	Technical amendment to Rev. Rec. Act of 1989, Sec. 7211, Limitations on refunds due to NOL carrybacks.
11701(e)	4980B(e)	N/A	N/A	Loans made after 7/10/89	Technical amendment to Rev. Rec. Act of 1989, Sec. 7301, Partial exclusion of interest on loans to an ESOP.
11701(f)	6038	N/A	25401	TYBOA 7/11/89	Technical amendment to Rev. Rec. Act of 1989, Sec. 7401, Taxable year of foreign corporations.
11701(g)	4682	N/A	N/A	N/A	Technical amendment to Rev. Rec. Act of 1989, Sec. 7506, Excise tax on sale of chemicals which deplete the ozone layer.
11701(h)	1031	18031	24941	Transactions after 7/10/89, except binding contracts	Technical amendment to Rev. Rec. Act of 1989, Sec. 7601, Like-kind exchanges between related persons.
11701(i)	1253	18151	24990	Transfers after 10/2/89	Technical amendment to Rev. Rec. Act of 1989, Sec. 7622, Changes in treatment of transfers of franchises, trademarks, and trade names.
11701(j)	148	N/A	N/A	Bonds issued after 12/19/89	Technical amendment to Rev. Rec. Act of 1989, Sec. 7652, Exceptions from arbitrage rebate requirement.
11701(k)	403	17501	N/A	TYBOA 1/1/87	Technical amendment to Rev. Rec. Act of 1989, Sec. 7811, Nondiscrimination requirements.
11701(l)	2056	N/A	N/A	N/A	Technical amendment to Rev. Rec. Act of 1989.
11701(m)	4975	N/A	N/A	N/A	Technical amendment to Rev. Rec. Act of 1989.
11702(a)(1)	367	17321	24561	Exchanges after 6/21/88	Clerical amendment to TAMRA (1988), Sec. 1006, Distributions in complete liquidation.
11702(a)(2)	453B	17551	24667	Distributions and sales or exchanges after 7/31/86	Technical amendment to TAMRA (1988), Sec. 1006, Distributions in complete liquidation.
11702(b)	447	17551	24652	TYBOA 1/1/87	Clerical amendment to TAMRA (1988), Sec. 1008, Method of accounting for corporations engaged in farming.

REVENUE RECONCILIATION ACT OF 1990

Exhibit A

Technical Amendments

Act Section	IRC Section	PIT Section	BCT Section	Federal Effective Date	Description of Act Provision
11702(c)	6114	N/C	N/C	TYBOA 10/1/88	Technical amendment to TAMRA (1988), Sec. 1012, Treaty-based return provisions.
11702(d)	59	17062	23459	TYBOA 1/1/89	Technical amendment to TAMRA (1988), Sec. 1014, AMT treatment of unearned income of minor child.
11702(e)(1)	468B	17551	24693	7/18/84	Technical amendment to TAMRA (1988), Sec. 1018, Special rules for designated settlement funds.
11702(e)(2)	355(c)	17321	N/C	TRA-86	Technical amendment to TAMRA (1988), Sec. 1018, Taxability of corporation on distribution of stock and securities of a controlled corporation.
11702(f)	4980B	N/A	N/A	N/A	Technical amendment to TAMRA (1988), Sec. 3011.
11702(g)	2523	N/A	N/A	N/A	Technical amendment to TAMRA (1988), Sec. 5033.
11702(h)	135	17131	N/A	N/A	Technical amendment to TAMRA (1988), Sec. 6009.
11702(i)	216	17201	24382	Distributions and sales or exchanges after 7/31/86	Clerical amendment to TAMRA (1988), Sec. 6282, Distributions by cooperative housing associations.
11703(a)	1043	18031	None	Sales after 11/30/89	Sales to comply with conflict of interest requirements.
11703(b)	414	17501	N/A	TYBOA 1/1/89	Technical amendment to Sec. 1151 of Tax Reform Act of 1986, repeal of Sec 89 nondiscrimination rules.
11703(c)	0	N/A	N/A	N/A	Generation-skipping tax.
11703(d)	1031	18031	24941	Transfers after 7/18/84	Treatment of certain partnership interests.
11703(e)	79	17081	N/A	Employees separating from service after 11/5/90	Treatment of certain separated employees with respect to nondiscrimination rules.
11703(f)	3401	UIC	UIC	TRA-86	Medicare.
11703(g)	0	N/A	N/A	N/A	Windfall profits tax.
11704(a)(01)	56	17062	23456	11/5/90	Clerical Amendment
11704(a)(02)	172(m)(4)	17276	24416	11/5/90	Clerical Amendment
11704(a)(03)	351	17321	24521	11/5/90	Clerical Amendment
11704(a)(04)	413	17501	N/A	11/5/90	Clerical Amendment
11704(a)(05)	461	17551	24681	11/5/90	Clerical Amendment
11704(a)(06)	469(m)(3)(A	17561	24692	11/5/90	Clerical Amendment
11704(a)(07)	597	N/A	24322	11/5/90	Clerical Amendment
11704(a)(08)	860D	17940	24870	11/5/90	Clerical Amendment
11704(a)(09)	860G	17940	24870	11/5/90	Clerical Amendment

REVENUE RECONCILIATION ACT OF 1990

Exhibit A

Technical Amendments

Act Section	IRC Section	PIT Section	BCT Section	Federal Effective Date	Description of Act Provision
11704(a)(12)	1017	18031	24918	11/5/90	Clerical Amendment
11704(a)(13)	1245(a)(3)(A	18151	24990	11/5/90	Clerical Amendment
11704(a)(22)	6013(e)	18402.9	N/A	11/5/90	Clerical Amendment
11704(a)(23)	6038A(c)	N/A	N/A	11/5/90	Clerical Amendment
11704(a)(24)	6039D	N/C	N/C	11/5/90	Clerical Amendment
11704(a)(25)	6045(e)	18802.3	25401e	11/5/90	Clerical Amendment
11704(a)(25)	6045(e)	18802.10	N/A	11/5/90	Clerical Amendment
11704(a)(25)	6045(e)	18802.10	N/A	11/5/90	Clerical Amendment
11704(a)(25)	6045(e)	18802.3	25401e	11/5/90	Clerical Amendment
11704(a)(28)	6655(g)(3)	N/A	25954	11/5/90	Clerical Amendment
11704(a)(29)	7519(c)(3)	N/C	N/C	11/5/90	Clerical Amendment
11704(a)(30)	7521	N/A	N/A	11/5/90	Clerical Amendment
11704(a)(30)	7522	N/A	N/A	11/5/90	Clerical Amendment
11704(a)(34)	7701(j)	17501	N/A	11/5/90	Clerical Amendment

REVENUE RECONCILIATION ACT OF 1990

Exhibit B

Repeal of Expired or Obsolete Provisions

Act Section	IRC Section	PIT Section	BCT Section	Description of Act Provision
11801(a)(03)	56(f)	17062	23456	Repeal of expired or obsolete provision
11801(a)(04)	63(h)	17073	N/A	Repeal of expired or obsolete provision
11801(a)(05)	83	17081	24379	Repeal of expired or obsolete provision
11801(a)(06)	110	17731	N/A	Repeal of expired or obsolete provision
11801(a)(07)	113	17131	N/A	Repeal of expired or obsolete provision
11801(a)(08)	114	17131	N/A	Repeal of expired or obsolete provision
11801(a)(09)	124	17731	N/A	Repeal of expired or obsolete provision
11801(a)(10)	128	17731	N/A	Repeal of expired or obsolete provision
11801(a)(11)	170(i)	17731	N/A	Repeal of expired or obsolete provision
11801(a)(12)	184	17201	N/A	Repeal of expired or obsolete provision
11801(a)(13)	188	17201	N/A	Repeal of expired or obsolete provision
11801(a)(14)	190(d)	17201	24383	Repeal of expired or obsolete provision
11801(a)(15)	250	N/A	N/A	Repeal of expired or obsolete provision
11801(a)(16)	263	17201	24422	Repeal of expired or obsolete provision
11801(a)(17)	305	17321	24463	Repeal of expired or obsolete provision
11801(a)(18)	306(h)	17321	24471	Repeal of expired or obsolete provision
11801(a)(19)	370	N/A	24570	Repeal of expired or obsolete provision
11801(a)(19)	371	N/A	24571-24573	Repeal of expired or obsolete provision
11801(a)(19)	372	N/A	24575-24575.1	Repeal of expired or obsolete provision
11801(a)(19)	374	N/A	24576-24578	Repeal of expired or obsolete provision
11801(a)(20)	422	17501	N/A	Repeal of expired or obsolete provision
11801(a)(21)	424	17501	N/A	Repeal of expired or obsolete provision
11801(a)(22)	503(d)	17639	N/A	Repeal of expired or obsolete provision
11801(a)(23)	512	17651	23732	Repeal of expired or obsolete provision
11801(a)(25)	582(c)	N/A	N/A	Repeal of expired or obsolete provision
11801(a)(26)	585	N/A	24348	Repeal of expired or obsolete provision
11801(a)(27)	617	17681	24831	Repeal of expired or obsolete provision
11801(a)(28)	621	17681	24831	Repeal of expired or obsolete provision
11801(a)(33)	1039	18031	24953.5	Repeal of expired or obsolete provision
11801(a)(33)	1039	18031	24953	Repeal of expired or obsolete provision
11801(a)(33)	1039	18031	24955	Repeal of expired or obsolete provision
11801(a)(34)	1101	18031	24999	Repeal of expired or obsolete provision
11801(a)(34)	1102	18031	24999.1	Repeal of expired or obsolete provision
11801(a)(34)	1103	18031	24999.2	Repeal of expired or obsolete provision
11801(a)(35)	1238	18151	24990	Repeal of expired or obsolete provision

REVENUE RECONCILIATION ACT OF 1990

Exhibit B

Repeal of Expired or Obsolete Provisions

Act Section	IRC Section	PIT Section	BCT Section	Description of Act Provision
11801(a)(37)	1481	18351	25001	Repeal of expired or obsolete provision
11801(a)(37)	1481	18351	25002	Repeal of expired or obsolete provision
11801(a)(37)	1481	18351	25003	Repeal of expired or obsolete provision
11801(a)(37)	1481	18351	25004	Repeal of expired or obsolete provision
11801(a)(37)	1481	18351	25005	Repeal of expired or obsolete provision
11801(a)(37)	1481	18351	25006	Repeal of expired or obsolete provision
11801(a)(37)	1481(a)(1)	18351	25201	Repeal of expired or obsolete provision
11801(a)(37)	1481(a)(2)	18351	25202	Repeal of expired or obsolete provision
11801(a)(37)	1481(a)(3)	18351	25203	Repeal of expired or obsolete provision
11801(a)(37)	1481(a)(4)	18351	25204	Repeal of expired or obsolete provision
11801(a)(37)	1482	18351	25208	Repeal of expired or obsolete provision
11801(a)(41)	3402(a)	18491	N/A	Repeal of expired or obsolete provision
11801(a)(41)	3402(a)	18806	26131	Repeal of expired or obsolete provision
11801(a)(43)	6018	N/A	N/A	Repeal of expired or obsolete provision
11801(a)(44)	6158	N/A	N/A	Repeal of expired or obsolete provision
11801(b)	0			Repeal of expired or obsolete provisions - CLERICAL AMENDMENTS
11801(c)(01)	1016(a)	18031	24916.2	Repeal of expired or obsolete provision
11801(c)(02)	56	17062	23456	Repeal of expired or obsolete provision
11801(c)(02)D	59	17062	23459	Repeal of expired or obsolete provision
11801(c)(02)E	59A	N/A	N/A	Repeal of expired or obsolete provision
11801(c)(03)	125	17131	N/A	Repeal of expired or obsolete provision
11801(c)(04)	265	17201	24425	Repeal of expired or obsolete provision
11801(c)(05)	170(i)	17131	N/A	Repeal of expired or obsolete provision
11801(c)(06)B	642(f)	17731	N/A	Repeal of expired or obsolete provision
11801(c)(06)D	1082	18031	24988	Repeal of expired or obsolete provision
11801(c)(06)E	1245	18151	24990	Repeal of expired or obsolete provision
11801(c)(06)F	1250	18151	24990	Repeal of expired or obsolete provision
11801(c)(07)	305	17321	24463	Repeal of expired or obsolete provision
11801(c)(08)B	168(i)	17201	N/A	Repeal of expired or obsolete provision
11801(c)(08)D	354	17321	24531	Repeal of expired or obsolete provision
11801(c)(08)E	356(d)	17321	24538	Repeal of expired or obsolete provision
11801(c)(08)F	357	17321	24540	Repeal of expired or obsolete provision
11801(c)(08)G	358	17321	24541	Repeal of expired or obsolete provision
11801(c)(08)G	1245	18151	24990	Repeal of expired or obsolete provision
11801(c)(08)H	1250	18151	24990	Repeal of expired or obsolete provision

REVENUE RECONCILIATION ACT OF 1990

Exhibit B

Repeal of Expired or Obsolete Provisions

Act Section	IRC Section	PIT Section	BCT Section	Description of Act Provision
11801(c)(09)A	422	17501	N/A	Repeal of expired or obsolete provision
11801(c)(09)A	422A	17501	24621	Repeal of expired or obsolete provision
11801(c)(09)A	425	17501	N/A	Repeal of expired or obsolete provision
11801(c)(09)B	421(a)	17501	24435	Repeal of expired or obsolete provision
11801(c)(09)B	421(a)	17501	24621	Repeal of expired or obsolete provision
11801(c)(09)B	421(b)	17501	24622	Repeal of expired or obsolete provision
11801(c)(09)B	421(c)	17501	N/A	Repeal of expired or obsolete provision
11801(c)(09)C	422	17501	N/A	Repeal of expired or obsolete provision
11801(c)(09)D	423	17501	N/A	Repeal of expired or obsolete provision
11801(c)(09)E	423	17501	N/A	Repeal of expired or obsolete provision
11801(c)(09)F	424	17501	N/A	Repeal of expired or obsolete provision
11801(c)(09)G	56	17062	23456	Repeal of expired or obsolete provision
11801(c)(09)H	1042	18031	24954	Repeal of expired or obsolete provision
11801(c)(09)I	402	17501	N/A	Repeal of expired or obsolete provision
11801(c)(09)J	6039	18802.7	N/A	Repeal of expired or obsolete provision
11801(c)(10)A	381(c)(15)	17321	24591	Repeal of expired or obsolete provision
11801(c)(11)	582(c)	N/A	N/A	Repeal of expired or obsolete provision
11801(c)(12)	585	N/A	24348	Repeal of expired or obsolete provision
11801(c)(12)A	57	17062	23457	Repeal of expired or obsolete provision
11801(c)(12)B	291	N/A	24449	Repeal of expired or obsolete provision
11801(c)(12)F	593	N/A	N/A	Repeal of expired or obsolete provision
11801(c)(13)	617	17681	24831	Repeal of expired or obsolete provision
11801(c)(15)	1250	18151	24990	Repeal of expired or obsolete provision
11801(c)(17)B	6511(d)	19053.7	26073.6	Repeal of expired or obsolete provision
11801(c)(19)C	6018	N/A	N/A	Repeal of expired or obsolete provision
11801(c)(20)A	6503	18586.7	25663	Repeal of expired or obsolete provision
11801(c)(20)B	6601(b)	18687.1	N/A	Repeal of expired or obsolete provision
11801(c)(20)B	6601(b)(c)	18687	25901a	Repeal of expired or obsolete provision
11801(c)(22)C	6511(e)	N/A	N/A	Repeal of expired or obsolete provision
11802(a)	72	17081	24272.2	Repeal of expired or obsolete provision
11802(b)	274	17201	24443	Repeal of expired or obsolete provision
11802(c)	468	17551	24689	Repeal of expired or obsolete provision
11802(e)(1)	62	17072	N/A	Repeal of expired or obsolete provision
11802(e)(2)	220	17201	N/A	Repeal of expired or obsolete provision
11802(e)(2)	221	17201	N/A	Repeal of expired or obsolete provision

REVENUE RECONCILIATION ACT OF 1990

Exhibit B

Repeal of Expired or Obsolete Provisions

Act Section	IRC Section	PIT Section	BCT Section	Description of Act Provision
11802(f)(2)	665	17731	N/A	Repeal of expired or obsolete provision
11802(f)(3)	668	17731	N/A	Repeal of expired or obsolete provision
11802(f)(4)	1503	N/A	23364	Repeal of expired or obsolete provision
11811(a)	172(b)	17276	24416	Elimination of expired provisions in Section 172.
11811(b)	172	17276	24416	Elimination of expired provisions in Section 172.
11812(a)	167(b)	17201	24349	Elimination of expired provisions in Section 167.
11812(a)	167(c)	17201	24350	Elimination of expired provisions in Section 167.
11812(a)	167(d)	17201	24351	Elimination of expired provisions in Section 167.
11812(a)	167(e)	17201	24352	Elimination of expired provisions in Section 167.
11812(a)(1)	167(e)	17201	24352.1	Elimination of expired provisions in Section 167.
11812(a)(1)	167(f)	17201	24352.5	Elimination of expired provisions in Section 167.
11812(a)(1)	167(g)	17201	24353	Elimination of expired provisions in Section 167.
11812(a)(1)	167(h)	17201	24354	Elimination of expired provisions in Section 167.
11812(a)(1)	167(j)	17201	24354.1	Elimination of expired provisions in Section 167.
11812(a)(1)	167(k)	17201	24354.2	Elimination of expired provisions in Section 167.
11812(a)(1)	167(l)	17201	N/C	Elimination of expired provisions in Section 167.
11812(a)(1)	167(m)	17201	N/C	Elimination of expired provisions in Section 167.
11812(a)(1)	167(p)	17201	24354.3	Elimination of expired provisions in Section 167.
11812(a)(1)	167(q)	17201	24354.4	Elimination of expired provisions in Section 167.
11812(a)(1)	167(r)	17201	24368.1	Elimination of expired provisions in Section 167.
11812(a)(1)	167(s)	17201	N/C	Elimination of expired provisions in Section 167.
11812(b)(01)	167(e)	17201	24352.1	Elimination of expired provisions in Section 167.
11812(b)(02)	168(i)	17201	23802	Elimination of expired provisions in Section 167.
11812(b)(02)A	168(e)	17201	23802	Elimination of expired provisions in Section 167.
11812(b)(02)C	168(f)(2)	17201	23802	Elimination of expired provisions in Section 167.
11812(b)(03)	42	17058	23610.5	Elimination of expired provisions in Section 167.
11812(b)(04)	56	17062	23400	Elimination of expired provisions in Section 167.
11812(b)(05)	312	17321	24484	Elimination of expired provisions in Section 167.
11812(b)(06)	381	17321	24591	Elimination of expired provisions in Section 167.
11812(b)(07)	404	17501	24601	Elimination of expired provisions in Section 167.
11812(b)(08)	460	17551	24673.2	Elimination of expired provisions in Section 167.
11812(b)(08)	460	17551	24673.2	Elimination of expired provisions in Section 167.
11812(b)(09)	642(e)	17731	N/A	Elimination of expired provisions in Section 167.
11812(b)(10)	1016(a)	18031	24916.2	Elimination of expired provisions in Section 167.
11812(b)(11)	1250	18151	24990	Elimination of expired provisions in Section 167.

REVENUE RECONCILIATION ACT OF 1990

Exhibit B

Repeal of Expired or Obsolete Provisions

Act Section	IRC Section	PIT Section	BCT Section	Description of Act Provision
11812(b)(12)	1250	18151	24990	Elimination of expired provisions in Section 167.
11812(b)(13)	7701(e)	17020.8	23047	Elimination of expired provisions in Section 167.
11812-13	168	17201	23802	
11812-13	168	17201	24349	
11813(b)	108	17131	24307	Elimination of expired or obsolete investment tax credit provisions.
11813(b)(03)	42	17058	23610.5	Elimination of expired or obsolete investment tax credit provisions.
11813(b)(04)	51 -52	17053.7	23621	Elimination of expired or obsolete investment tax credit provisions.
11813(b)(05)	55	17062	23455	Elimination of expired or obsolete investment tax credit provisions.
11813(b)(09)	168(e)	17201	23802	Elimination of expired or obsolete investment tax credit provisions.
11813(b)(09)B	168(i)	17201	23802	Elimination of expired or obsolete investment tax credit provisions.
11813(b)(09)C	168(g)(4)	17201	23802	Elimination of expired or obsolete investment tax credit provisions.
11813(b)(10)	170(h)(4)(B	17201	24357.7	Elimination of expired or obsolete investment tax credit provisions.
11813(b)(11)	179	17201	24356.3	Elimination of expired or obsolete investment tax credit provisions.
11813(b)(11)	179	17201	24356.2	Elimination of expired or obsolete investment tax credit provisions.
11813(b)(11)	179	17201	23802	Elimination of expired or obsolete investment tax credit provisions.
11813(b)(12)	196	17201	N/A	Elimination of expired or obsolete investment tax credit provisions.
11813(b)(13)	280F	17201	24349.1	Elimination of expired or obsolete investment tax credit provisions.
11813(b)(14)	312(k)	17321	24484	Elimination of expired or obsolete investment tax credit provisions.
11813(b)(15)	465	17551	24691	Elimination of expired or obsolete investment tax credit provisions.
11813(b)(16)	469	17551	24692	Elimination of expired or obsolete investment tax credit provisions.
11813(b)(19)	1016(a)	18031	24916.2	Elimination of expired or obsolete investment tax credit provisions.
11813(b)(20)	1033(g)	18031	24949.2	Elimination of expired or obsolete investment tax credit provisions.
11813(b)(21)	1245(a)(3)(D	18151	24990	Elimination of expired or obsolete investment tax credit provisions.
11813(b)(22)	1274A	18151	24990	Elimination of expired or obsolete investment tax credit provisions.
11813(b)(23)	1371	17087.5	23800	Elimination of expired or obsolete investment tax credit provisions.
11813(b)(24)	1388	N/A	N/A	Elimination of expired or obsolete investment tax credit provisions.
11813(b)(25)	1503(e)(3)(B	N/A	N/A	Elimination of expired or obsolete investment tax credit provisions.
11814	243	N/A	N/A	Elimination of obsolete provisions in Section 243(b).
11814(b)	1504	N/A	23361	Elimination of obsolete provisions in Section 243(b).
11815(a)	613A(c)	17683	24833	Elimination of expired provisions in percentage depletion.
11815(b)	613(e)	17682	24832	Elimination of expired provisions in percentage depletion.
11815(b)(3)	57	17062	24357	Elimination of expired provisions in percentage depletion.
11815(b)(3)	263(c)	17201	24423(a)	Elimination of expired provisions in percentage depletion.
11815(b)(3)	465	17551	24691	Elimination of expired provisions in percentage depletion.
11816	29	N/A	N/A	Elimination of expired provisions in Section 29.

REVENUE RECONCILIATION ACT OF 1990

Exhibit B

Repeal of Expired or Obsolete Provisions

Act Section	IRC Section	PIT Section	BCT Section	Description of Act Provision
11821	*	N/A	N/A	Effective date.

EXHIBIT C

CAPITAL GAINS STUDY

This exhibit includes a California estimate of the impact of the president's capital gain tax proposal as contained in S. 2071 (Packwood, Dole, and Roth), and H.R. 3772 (Archer) during 1990. It also includes a copy of Proposals and Issues Relating to Taxation of Capital Gains and Losses, as prepared by the staff of the Joint Committee on Taxation.

Revenue Estimate:

If the President's capital gain tax proposal had become law, base line projected California revenue would have increased. This is because a reduction in the effective federal tax rate on capital gains would generally increase capital gain realizations for federal purposes. Without changing California law, the result would be increased taxable income for state purposes. Thus, by not conforming to a change in federal law such as the President's capital gain tax proposal, California would gain revenue. By conforming to the proposal, compared to the base line revenue expected from not conforming, California would unambiguously lose revenue in every period. As the measures that would have implemented the President's capital gain proposal were not successful, the state revenue implications were not thoroughly examined by this department. Thus, although base line revenue would increase without conformity, no attempt has been made to quantify the magnitude. In addition, although there would be a revenue loss from the new (unknown) base with conformity, no attempt has been made to quantify the magnitude. The following pages offer a general discussion of the interaction of capital gain tax changes and their impacts on revenue. Finally, the following offers a revenue estimate of conformity vis a vis the current base line.

The revenue impacts of proposed changes in capital gain taxation are speculative by nature and consequently have historically been among the most hotly debated. The controversial nature of capital gain revenue estimates is primarily a result of the control taxpayers have with respect to the timing of capital gain realizations. Unlike virtually all other forms of income; wages, interest, and dividends which are distributed at the payor's discretion; income from capital gains is realized, in large part, at the recipient's discretion. As a result, the amount of capital gain realized in any given period is very sensitive to taxpayers' expectations of the tax consequences of realizing gain in that period versus other periods.

If the effective tax rate on capital gains were reduced, and if nothing else changed, there would be a directly corresponding reduction in tax revenue. Applying the President's proposal to national capital gain realizations projected under current law, the Joint Committee on Taxation (JCT) estimates federal fiscal year revenue losses of about $20 billion in 1989-90 increasing to almost $29 billion in 1994-95. However, taxpayers generally alter behavior in response to changes in capital gain tax rates.

EXHIBIT C

Reducing the tax rate on capital gains tends to affect taxpayer behavior in two ways. First, taxpayers will increase their sales of capital assets, especially if the rate reduction is perceived to be temporary. Secondly, taxpayers will, whenever possible, convert some of their otherwise ordinary income sources into capital assets. These two behavioral responses result in revenue increases as more capital gain income is realized than would otherwise be the case. JCT estimates that if nothing else changed, i.e. looking at the expected changes in capital gain realizations but applying current tax law to them, the behavioral effects would result in revenue increases of about $21 billion in 1989-90 decreasing to about $17 billion in 1994-95.

Thus, as can be seen from the preceding, the net revenue impact of a capital gain rate reduction depends on small differences between relatively large numbers. As a result, slight changes in assumptions or projections can exert significant differences in the estimated net impact. This sensitive aspect of capital gain revenue estimation is dramatically illustrated by the differences between JCT and Treasury's revenue estimates.

Treasury estimates that the President's proposal would result in revenue gains in the first six years amounting to $12.5 billion. JCT estimates that the proposal would result in revenue gains in the first two years and produce revenue losses for the next four years for an overall loss of $11.4 billion over the first six years.

Congress primarily relies on final JCT estimates for deliberating federal legislation. We, therefore, have prorated these national estimates to approximate California impacts of conforming to the President's proposal.

APPROXIMATE CALIFORNIA REVENUE IMPACT OF CONFORMING TO THE PRESIDENT'S CAPITAL GAIN PROPOSAL ($000,000).

Fiscal Yr Ending	JCT Est. National	California Proration*	California Rev. Impact
1990	$700	6.3%	$23**
1991	$3,200	6.3%	$201
1992	($4,300)	6.3%	($270)
1993	($3,600)	6.3%	($226)
1994	($4,300)	6.3%	($270)
1995	($3,100)	6.3%	($195)

* Calculated from CA capital gain as a % of U.S. (18.9%) and CA top inc tax rate/US top individual inc tax rate of 1/3.
** Effective date of March 15, 1990.

EXHIBIT C

[JOINT COMMITTEE PRINT]

PROPOSALS AND ISSUES RELATING TO TAXATION OF CAPITAL GAINS AND LOSSES

SCHEDULED FOR A HEARING

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON MARCH 28, 1990

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

MARCH 23, 1990

U.S. GOVERNMENT PRINTING OFFICE
27-888 WASHINGTON : 1990 JCS-10-90

EXHIBIT C

JOINT COMMITTEE ON TAXATION

101st Congress, 2d Session

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CONTENTS

EXHIBIT C

I. PRESENT LAW

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On disposition of a capital asset, long-term capital gain is currently taxed at the same rate as ordinary income. Long-term capital loss is deductible against capital gain, but not against ordinary income except to a limited extent. For depreciable property used in a trade or business and not held for sale to customers, and for certain other noncapital assets, net gain can be treated as capital gain, while net loss is an ordinary loss.

A complex set of statutory provisions attempts to limit the ability of taxpayers to recharacterize ordinary income assets as assets eligible for capital gain treatment, and also requires recharacterization of capital gain as ordinary income to the extent of certain prior deductions from ordinary income. In addition, certain judicial interpretations of the statutory provisions require gain or loss to be characterized as ordinary, rather than capital, in certain circumstances.

As a result of the changes made by the Tax Reform Act of 1986, taxing capital gains at the same rate as ordinary income, many of these rules now affect only the determination of the deductibility of capital losses.

The Tax Reform Act of 1986 provided that the maximum rate for capital gains would not exceed the maximum ordinary income rates specified in the Act. (See Code sections 1(j) and 1201.) The various rules relating to the recharacterization of gains as capital rather than ordinary were retained in the Code to facilitate the reinstatement of a capital gains rate differential if there is a future tax rate increase.[4]

A. Statutory Provisions

Capital gains

Long-term capital gain is defined as gain from the sale or exchange of a capital asset held for more than one year. Net long-term capital gain is the excess of long-term capital gains over long-term capital losses.

Capital losses

Capital losses of noncorporate taxpayers are generally deductible in full against capital gains.[5] In addition, such losses may be de-

[4] H. Rept. 99-841, p. II-106, Conference Report on H.R. 3838.

[5] However, section 165 generally denies individuals a deduction for losses not incurred in a trade or business unless such losses are incurred in a transaction entered into for profit or qualify as deductible casualty losses. *See also* section 267 (disallowance of deduction for certain losses from sale or exchange of property between related persons) and section 1092 (limitation on current deductibility of losses in the case of straddles).

ducted against a maximum of $3,000 of ordinary income in each year. Capital losses in excess of these limitations may be carried over to future years indefinitely, but may not be carried back to prior years.

Capital assets

A "capital asset" generally means any property held by the taxpayer except certain specified classes. Capital assets generally do not include (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, or (5) certain U.S. publications.

Certain depreciable property, nondepreciable business property, and special assets (sec. 1231)

A special rule (sec. 1231) applies to gains and losses on the sale, exchange, or involuntary conversion of certain noncapital assets. Net gains from such assets (in excess of depreciation recapture) are treated as long-term capital gains but net losses are treated as ordinary losses. However, net gain from such property is recharacterized as ordinary income to the extent net losses from such property in the previous 5 years were treated as ordinary losses. The assets eligible for this treatment include depreciable property or land held for more than one year and used in a trade or business (if not includible in inventory and not held primarily for sale to customers in the ordinary course of business). Also included are certain special assets including interests in timber, coal, domestic iron ore, certain livestock and certain unharvested crops.

Patents

Under certain circumstances, the creator of a patented invention may transfer his or her rights to the patent and treat amounts received as proceeds from the sale of a capital asset, whether or not the proceeds are contingent on the use or productivity of the patent (sec. 1235).

Regulated futures contracts

Under present law, unlike most assets (with respect to which no gain or loss is realized until a disposition), regulated futures contracts, foreign currency contracts, nonequity options and dealer equity options are "marked-to-market" as gain or loss accrues (sec. 1256). Forty percent of the gain or loss is short-term gain or loss and 60 percent of the gain or loss is long-term gain or loss. Prior to the Tax Reform Act of 1986, this resulted in a maximum tax rate of 32 percent. Individuals who have a net loss regarding such contracts may elect to carry it back three years against prior net gain regarding such contracts.

Losses on small business stock

An individual may deduct as an ordinary loss up to $50,000 ($100,000 in the case of a joint return) on the loss from the disposition of small business corporation stock (section 1244 stock) originally issued to the individual (or to a partnership having the individual as a partner), without regard to the $3,000 limit generally applicable to losses. A small business corporation is a corporation engaged in the active conduct of a trade or business whose equity capital does not exceed $1,000,000.

Certain foreign corporate stock

Special rules recharacterize as ordinary income a portion of gain on the sale or exchange of certain foreign corporate stock, to compensate for the deferral of U.S. tax on corporate earnings and profits accumulated abroad (sec. 1248).

Collapsible property

The distinction between capital gains and ordinary income has led to numerous taxpayer attempts to realize the value of an anticipated future ordinary income stream through the sale of a "capital" asset, such as stock in a corporation, or an interest in a partnership, that holds the income-producing asset.

Present law contains statutory rules intended to prevent such use of partnerships and corporations to convert what otherwise would be ordinary income into capital gains from the disposition of stock or a partnership interest. These provisions (secs. 341 and 751) known as the "collapsible" corporation and "collapsible" partnership provisions, are among the most complex provisions of the Internal Revenue Code and have been criticized by some for apparent inconsistencies in application and for limited effectiveness in some circumstances.

Similarly, certain partnership rules relating to basis allocations (secs. 732(c) and 755) attempt to prevent conversion of ordinary income to capital gain by preventing allocations of basis from capital assets to ordinary income assets in certain partnership transactions. These rules have also been criticized by some as having limited effectiveness in certain situations.

Recapture provisions

Depreciation recapture rules recharacterize as ordinary income a portion of gain upon dispositions of depreciable property. These rules vary with respect to the type of depreciable property. Under ACRS, for personal property, previously allowed depreciation (up to the amount of realized gain) is generally recaptured as ordinary income. In the case of real property using the straight-line method of depreciation (the only method generally permitted for real property placed in service under present-law ACRS), there is no depreciation recapture upon disposition if the asset is held more than one year. For real property to which the present-law ACRS does not apply, generally, the excess of depreciation deductions over the straight-line method is recaptured as ordinary income. Special rules apply to certain non-residential property and to certain low-income housing.

Similar recapture rules apply to dispositions of oil, gas, geothermal or other mineral property. These rules require ordinary income recapture (up to the amount of realized gain) of previously deducted intangible drilling and development costs, mining expenses, and depletion.

The recapture rules require the recognition of ordinary income in some situations that are otherwise tax-free or tax-deferred. For example, although recognition of gain on an installment sale is otherwise deferred, recaptured ordinary income with respect to depreciated real or personal property is recognized in the year of the sale.

Recapture is imputed to a partner who sells a partnership interest if recapture would have been imposed upon the disposition by the partnership of the recapture property. Except in the case of certain previously deducted depletion, intangible drilling and development and mining exploration costs, there is no comparable imputation to a shareholder of an S corporation who sells his or her stock.

Realization events

In general, property appreciation is not taxed until the property is disposed of in a taxable transaction. There are certain exceptions to this rule. For example, regulated futures contracts and certain other items must be "marked to market" as gain or loss accrues even though there has been no disposition of the asset.

Nonrecognition events

Under various nonrecognition provisions, realized gains and losses in certain transactions are deferred for tax purposes. Examples of such nonrecognition transactions include certain corporate reorganizations, certain like-kind exchanges or property, involuntary conversions followed by an acquisition of replacement property, and the sale of a principal residence within two years of the acquisition of a new principal residence. Generally, nonrecognition treatment defers gain or loss for tax purposes by providing a carryover basis from the old holder to the new holder or a substitution of basis from the old property to the new property.

Certain exemptions

Present law effectively forgives income tax on accrued appreciation on the occurrence of certain events. For example:

Basis step-up at death.—At death, income tax on unrealized capital gains on an individual taxpayer's assets is forgiven, due to the step-up in basis such assets receive.[6]

Sale of principal residence.—$125,000 of gain on the sale of a principal residence by a taxpayer age 55 or over is exempt from tax if, during the 5-year period ending with the date of the sale, the property was owned and used as the taxpayer's principal residence for at least an aggregate of 3 years.

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[6] Such appreciation might give rise to Federal estate and gift tax. In many instances, however, opportunities for deferral and the rate structure under the Federal estate and gift tax may result in significantly less tax than would be imposed under the income tax. The value of stock or other assets held at death would be included in the decedent's gross estate and, if not passing to a surviving spouse or to charity, the decedent's taxable estate as well.

The extent to which such inclusion gives rise to Federal estate and gift tax depends on the value of the decedent's taxable transfers. The Federal estate and gift tax depends on the value of the decedent's taxable transfers. The Federal estate and gift tax rates begin at 18 percent on the first $10,000 of taxable transfers and reach 55 percent (50 percent for descendents dying after 1992) on taxable transfers over $3 million. A unified credit in effect exempts the first $600,000 from estate and gift tax. The graduated rates and unified credit are phased out for estates in excess of $10 million.

B. Statutory Interpretations

The statutory provisions described above have led to numerous disputes about the characterization of gain or loss as capital or ordinary. Literally hundreds of cases have been litigated involving capital gains issues; and the varying results of the cases can encourage taxpayers to take aggressive positions on tax returns. The issues that have been litigated and the principles asserted in particular cases include the following.

Property held primarily for sale to customers

Inventory and property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business are excluded from the definition of a capital asset. The object of this exclusion is to preclude capital gains treatment for receipts obtained in the routine conduct of the taxpayer's enterprises.

A host of cases have been litigated over whether gain realized by a taxpayer was attributable to the sale of property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. The majority of these cases has involved real estate sales, and the sale of equipment held for rental (or for rental and then sale). In both instances, the litigation generally revolves around the question of the "primary" purpose for which the property was held. *Cf. Malat v. Riddell*, 383 U.S. 569 (1966). The resolution of this question, in turn, has generated an intricate web of subordinate rules and exceptions relating to (1) the existence of business (ordinary income) and investment (capital gain) purposes and (2) the acquisition of property for one purpose and its disposition for another purpose. Factual issues include the extent to which the taxpayer advertised the property, the frequency of sales, and whether unusual circumstances led to the sale. *See, e.g., The Municipal Bond Corporation v. Commissioner*, 341 F.2d 683 (8th Cir. 1965), *on remand*, 46 T.C. 219 (1966). In many situations, the taxpayer may have a considerable degree of flexibility in adopting those advertising or sales practices that are the most likely to support the desired result.

Sale or exchange treatment

Many cases have involved the issue whether a transfer is a sale or exchange, thus qualifying for capital gains treatment, or a transfer more properly characterized as a lease or other transfer producing ordinary income. This issue arises, for example, where the transferor has the right to receive contingent payments based on future sales or profits, or retains certain elements of control over the property. *See, e.g., Nassau Suffolk Lumber & Supply Corp. v. Commissioner*, 53 T.C. 280 (1969) (Acq. 1970-2 C.B. xx). Statutory provisions have been enacted to deal with certain types of transfers (*e.g.*, sec. 1235, providing capital gain treatment for certain transfers of patents for future periodic or contingent payments; sec.1253, providing ordinary income treatment when certain rights to control the use of specified intangibles are retained). However, where these provisions do not apply, the issue remains.

Another issue that arises is whether there is a difference in sale or exchange characterization between the termination or expiration of certain instruments or contract rights and the assignment of such rights to a third party prior to expiration.[7] There is some authority that in certain situations if an instrument or right is held to maturity or expiration, the expiration is not a sale or exchange and the resulting gain or loss is ordinary; but if the instrument or right is sold prior to expiration, gain or loss on the sale is capital. *See, e.g., International Flavors and Fragrances v. Commissioner*, T.C. Memo 1977-58, 36 T.C.M. 260 (1977). Various statutory provisions attempt to specify the outcome in the case of particular instruments or rights (*e.g.*, sec. 988, generally requiring ordinary rather than capital treatment for certain foreign currency related transactions; sec. 1271 and related provisions, dealing with certain debt instruments).

Holding period

Numerous cases have involved the issue whether the taxpayer satisfied the required holding period for capital gains treatment. Taxpayers may utilize various arrangements in attempts to shift ownership of assets prior to the expiration of the required holding period while still appearing to meet the holding period requirement. For example, taxpayers may attempt to transfer short-term assets in a tax-free transaction to another entity controlled by the taxpayer that has been held for the required period of time, and then dispose of that entity under circumstances where the various collapsibility or recapture rules may be vulnerable or inadequate.

Taxpayers may also attempt to enter transactions that effectively shift the risk of gain or loss to another taxpayer prior to expiration of the holding period, but that do not in form provide for a sale until after the holding period expires.

Allocation of gain to capital assets

Numerous cases have involved the proper allocation of purchase price among assets. When a taxpayer sells a combination of assets some of which are eligible for capital gains treatment and some of which are not, it is necessary to allocate the purchase price and the taxpayer's resulting gain among the assets. *Williams V. McGowan*, 152 F. 2d 570 (2d Cir. 1945). Under the prior law differential between capital gains and ordinary income, the seller of property had an incentive to allocate more of his gain to capital assets. As one example, under the prior law differential for capital gains, on the sale of a building and land under circumstances where there would be recapture of accelerated depreciation on the building, the seller had an incentive to allocate more of the gain to the land, thus reducing the potential recapture. Because the building is depreciable and the land is not, the buyer has an incentive on the contrary to allocate more of the price to the building. In some cases, this tension between the parties might limit the degree to which the government would be whipsawed by parties taking inconsistent positions. In general, if the parties did specify an allocation in their contract with appropriate regard to value, they are bound by it for tax purposes; and if they have adverse tax interests the courts and

[7] *See also* discussion of "Other capital asset definitional issues," *infra*.

the Internal Revenue Service will generally accept the allocation. *See, e.g., Ullman v. Commissioner*, 264 F. 2d 305 (2d Cir. 1959); *Commissioner v. Danielson*, 378 F. 2d 771 (3d Cir.), *cert. denied*, 389 U.S. 858 (1967). However, it is not clear whether taxpayers will always specify an allocation in a contract or take consistent positions.

Another example of the same issue arises on the sale of a business, where the seller would have an incentive to allocate more of the price to goodwill or other assets eligible for capital gains treatment, while the buyer would prefer to allocate more of the price to depreciable assets. Under prior law, many intangible assets depreciable by the buyer were eligible for capital gains treatment by the seller, thus eliminating any tension between the parties.

The Tax Reform Act of 1986 added section 1060 to the Code. This section generally applies to sales of trade or business assets. It specifies a residual method of allocating price to nondepreciable goodwill and going concern value, generally adopting the method specified in Treasury Regulations dealing with certain sales of corporate stock that are treated as sales of the underlying assets (Prop. and Temp. Reg. sec. 1.338(b)–2T). It also authorizes the Internal Revenue Service to require the parties to report their respective allocations of purchase price, thus assisting the Internal Revenue Service in identifying inconsistent positions for audit. Some commentators have observed that the section does not strictly require consistent allocations and it is unclear to what extent the government would still be exposed to whipsaw due to inconsistent positions taken by the parties during periods of a capital gains rate differential.

Corn Products doctrine

In *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955), the Supreme Court addressed a taxpayer claim that gain on the disposition of corn futures was capital gain. The taxpayer was a manufacturer of products made from grain corn and had acquired the corn futures to assure the needed supply of corn at a fixed price. The Supreme Court held that the disposition of the futures produced ordinary income, even though the futures were not literally inventory or other property specifically excluded by statute from the definition of a capital asset. The Court held that gain on this type of hedging transaction was ordinary income, and stated that Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss. Numerous subsequent lower court decisions interpreted the *Corn Products* decision to mean that property otherwise within the definition of a capital asset may have such an important and integral relationship to the ordinary conduct of the taxpayer's business that it loses its identity as a capital asset. In 1975, the Internal Revenue Service stated that if a taxpayer acquired and held property with a "predominant" business (as opposed to investment) purpose, gain or loss on disposition would be ordinary; conversely, a "predominant" investment purpose would cause gain or loss to be capital. (Rev. Rul. 75–13, 1975-1 C.B. 67.) Later, following several

Tax Court decisions,[8] the Internal Revenue Service took the position that even a "predominant" business motive cannot preclude capital gain or loss treatment, as long as there was a "substantial" investment motive for acquiring or holding the property. (Rev. Rul. 78-94, 1978-1 C.B. 58). Of course, it is to the taxpayer's advantage to have gains characterized as capital, and losses as ordinary.

In *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988), the Supreme Court rejected a taxpayer claim for ordinary loss treatment on the sale of stock of a bank that had been 65 percent owned by the taxpayer's holding company. The Supreme Court stated that *Corn Products* is properly interpreted as standing for the narrow proposition that hedging transactions that are an integral part of a business' inventory-purchase system fall within the inventory exclusion of the Code. There is considerable uncertainty about the scope of the *Arkansas Best* decision and its impact on lower court decisions and Internal Revenue Service positions interpreting *Corn Products.*

Arrowsmith doctrine

In *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), the Supreme Court held that amounts paid by former corporate shareholders (as the transferees of corporate assets received in a prior year corporate liquidation) to satisfy liabilities of the liquidated corporation were capital, rather than ordinary losses. The Court related the payments to the earlier receipt (at capital gains rates) of corporate assets in the liquidation. Pursuant to *Arrowsmith*, the characterization of a transaction in one year may depend upon its relationship to another transaction in a prior year.

Other capital asset definitional issues

A number of cases have addressed the question of the extent to which a taxpayer may obtain capital rather than ordinary treatment by assigning various contract rights that, if held to maturity, would have produced ordinary income. In certain circumstances, this ability has been limited by a court's conclusion that the asset assigned is not a capital asset but rather a substitute for ordinary income. *See, e.g., Commissioner v. Ferrer*, 304 F. 2d 125 (2d Cir. 1962); *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958). On the other hand, in many situations the assignment of all rights to a lease or to a business interest that would produce ordinary income in the future can be treated as capital gain.

Tax benefit rule

The Internal Revenue Service has occasionally asserted the "tax benefit rule" in attempts to recharacterize as ordinary income a portion of the gain from the disposition of property otherwise entitled to capital gain treatment. The amount to be recharacterized reflects the extent to which the basis of such property was reduced by deductions taken from ordinary income, to which no specific

[8] *W. W. Windle Co. v. Commissioner*, 65 T.C. 694 (1976), *aff'd on other grounds*, 550 F.2d 43 (1st Cir. 1977), *cert. denied*, 431 U.S. 966 (1977); *Bell Fibre Products Corp. v. Commissioner*, 36 T.C.M. (CCH) 182 (1977). *Compare Union Pacific Railroad Co., Inc. v. United States*, 524 F.2d 1343 (Ct.Cl. 1975), *cert. denied*, 429 U.S. 827 (1976).

statutory recapture provision applies on disposition of the property. For example, in *First National Bank of Lawrence County v. Commissioner,* 16 T.C. 147 (1951), the Internal Revenue Service successfully asserted that net proceeds received on the retirement of certain bonds that had previously been written off by a bank against ordinary income as worthless were taxable as ordinary income rather than as capital gain.

The scope of the tax benefit rule is uncertain [9] and the Internal Revenue Service does not contend that all items deducted from ordinary income are automatically subject to recapture on the sale of property otherwise eligible for capital gains treatment. For example, the Internal Revenue Service has ruled under section 174 that deductions previously taken for research and experimental expenditures under that section are not recaptured on disposition of the developed property.[10]

[9] *See Hillsboro National Bank v. Commissioner,* 460 U.S. 370 (1983), for Supreme Court discussion of the rule.

[10] Rev. Rul. 85-186, 1985-2 C.B. 84. Prior to the issuance of this ruling, the Internal Revenue Service had taken a different position and indicated in a revenue ruling and in a technical advice memorandum that it might assert tax benefit rule recapture of research and experimental deductions taken under section 174 of the Code on the disposition of patents or technology otherwise eligible for capital gains treatment under the special rules applicable to patents or under other provisions (Rev. Rul. 72-528, 1972-2 C.B. 481; TAM 8409009 (1983)).

II. LEGISLATIVE BACKGROUND

Reduced tax rate for capital gains

Noncorporate capital gains were taxable at reduced rates from 1921 through 1987.

The Revenue Act of 1921 provided for a maximum 12.5 percent tax on gain on property held for profit or investment for more than 2 years (excluding inventory or property held for personal use). Because of the relatively low tax rates on ordinary income during the 1920's and 1930's, this provision benefited only higher bracket taxpayers.

The system of capital gains taxation in effect prior to the Tax Reform Act of 1986 dated largely from the Revenue Act of 1942. The 1942 Act provided for a 50-percent exclusion for noncorporate capital gains or losses on property held for more than 6 months. The Act also included alternative maximum rates on capital gains taxes for noncorporate and corporate taxpayers. The basic structure of the 1942 Act was retained under the Internal Revenue Code of 1954.

The Revenue Act of 1978 increased the exclusion for noncorporate long-term capital gains from 50 to 60 percent. Together with concurrent changes in the noncorporate minimum tax, this had the effect of reducing the highest effective rate on noncorporate capital gains from approximately 49 percent [11] to 28 percent. The reduction in the maximum individual rate from 70 to 50 percent under the Economic Recovery Act of 1981 (ERTA) reduced the maximum effective capital gains rate from 28 percent to 20 percent.

The Tax Reform Act of 1986 repealed the provisions granting reduced rates for capital gains, fully effective beginning in 1988.

The Internal Revenue Code of 1954 as originally enacted provided for an alternative tax rate of 25 percent on corporate capital gains. The Tax Reform Act of 1969 raised this rate to 30 percent. The Revenue Act of 1978 reduced the rate to 28 percent. Finally, the Tax Reform Act of 1986 repealed the alternative rate.

Holding period

Under the Revenue Act of 1921, the alternative maximum rate for capital gains applied to property held for more than 2 years. Since that time, Congress has, on several occasions, adjusted the holding period required for reduced capital gains taxation.

The Revenue Act of 1934 provided for exclusion of varying percentages of capital gains and losses depending upon the period for which an asset was held. Under that Act, 20 percent of capital gains was excludible if an asset was held for 1 to 2 years, 40 per-

[11] The 49-percent rate resulted in certain cases where the taxpayer was subject to the individual "add-on" minimum tax and the maximum tax "earned income" limitation.

cent if an asset was held for 2 to 5 years, and 60 percent if the asset was held for between 5 and 10 years. Where an asset had been held for more than 10 years, 70 percent of capital gains was excluded.

The Revenue Act of 1938 provided for two classes of long-term capital gains. For assets held for 18 months to 2 years, a 33-percent exclusion was allowed. Where assets were held for more than 2 years, a 50-percent exclusion was provided. No exclusion was allowed for assets held for 18 months or less. The 1938 Act also provided alternative ceiling rates applicable to the same holding periods as the capital gains exclusions.

In the Revenue Act of 1942, Congress eliminated the intermediate holding period for capital gains purposes. The 1942 Act provided for two categories of capital assets: assets held for more than 6 months (long-term capital assets), for which a 50-percent exclusion was allowed; and assets held for 6 months or less (short-term capital assets) for which no exclusion was provided. The alternative tax rates on individual and corporate net capital gains (i.e., the excess of net long-term capital gains over short-term capital losses) were based upon the same 6-month holding period.

A 6-month holding period for long-term capital gains treatment remained in effect from 1942 through 1976. The Tax Reform Act of 1976 increased the holding period to 9 months for 1977 and one year for 1978 and all subsequent years. The Deficit Reduction Act of 1984 reduced the holding period to 6 months for property acquired after June 22, 1984 and before 1988.

Treatment of gain and loss on depreciable assets and land used in trade or business

Depreciable property used in a trade or business was excluded from the definition of a capital asset by the Revenue Act of 1938, principally because of the limitation on deductibility of losses imposed by the Revenue Act of 1934. This step was motivated in part by the desire to remove possible tax deterrents to the replacement of antiquated or obsolete assets such as equipment, where depreciation would be fully deductible against ordinary income if the asset were retained, but loss would be subject to the capital loss limitations if the asset were sold.

The availability of capital gain treatment for gains from sales of depreciable assets stems from the implementation of excess profits taxes during World War II. Many depreciable assets, including manufacturing plants and transportation equipment, had appreciated substantially in value when they became subject to condemnation or requisition for military use. Congress determined that it was unfair to tax the entire appreciation at the high rates applicable to wartime profits. Accordingly, in the Revenue Act of 1942, gains from wartime involuntary conversions were taxed as capital gains. The provision was extended to voluntary dispositions of assets since it was not practical to distinguish condemnations and involuntary dispositions from sales forced upon taxpayers by the implicit threat of condemnation or wartime shortages and restrictions.

The Revenue Act of 1938 did not exclude land used in a trade or business from the capital asset definition. Since basis would have to be allocated between land and other property for purposes of depreciation in any event, the differing treatment of land used in a trade or business and depreciable property used in a trade or business was not viewed as creating serious allocation difficulties.

However, in the Revenue Act of 1942, Congress excluded land used in a trade or business from the definition of a capital asset and extended to such property the same special capital gain/ordinary loss treatment afforded to depreciable trade or business property.

In 1962, Congress required that depreciation on section 1245 property (generally, personal property) be recaptured as ordinary income on the disposition of the property. In 1964, Congress required that a portion of the accelerated depreciation on section 1250 property (generally, real property) be recaptured as ordinary income. Subsequent amendments have required that the entire amount of accelerated depreciation on section 1250 property be recaptured as ordinary income. However, any depreciation taken to the extent allowable under the straight-line method is generally not recaptured as ordinary income, but rather creates capital gain.

Noncorporate capital losses

In the early years of the income tax, losses from investments not connected with a trade or business were not deductible even against gains from similar transactions. This rule was changed in 1916 to allow deductions for transactions entered into for profit (but only to the extent of gains from similar transactions). The rule was further adjusted by the Revenue Act of 1918.

The Revenue Act of 1921 provided that net capital losses were deductible in full against capital gains or ordinary income. Because capital gains at this time were taxable at a maximum 12.5-percent rate, but capital losses could be used to offset income taxable at higher rates, this rule resulted in substantial revenue loss. Accordingly, the rule was amended by the Revenue Act of 1924 to limit the tax benefit from capital losses to 12.5 percent of the amount of such losses. The 1924 Act also repealed the previously existing carryforward for excess capital losses.

Under the Revenue Act of 1934, the percentage exclusion for net capital gains was made dependent upon the length of time for which the property was held. In conjunction with this change, the Act allowed equivalent percentages of capital losses to be deducted against capital gains and, in the event of any excess, against $2,000 of ordinary income. The $2,000 limit on the amount of ordinary income against which capital losses could be deducted was motivated by the fact that some very wealthy investors had been able to eliminate all their income tax liability by deducting losses incurred in the stock market crash against ordinary income.

Under the Revenue Act of 1942, capital losses could offset up to $1,000 of ordinary income with a carryforward of unused losses. The Tax Reform Act of 1976 increased this amount to $3,000. Between 1970 and 1986, only one-half of the net long-term loss could be carried forward.

business corporation as an ordinary loss. These limitations were doubled in 1978.

In 1958, individuals were allowed to deduct up to $25,000 ($50,000 on a joint return) of loss from the disposition of stock in a small

III. PRESIDENT'S BUDGET PROPOSAL

Description of Proposal

The President's fiscal year 1991 budget proposal [12] would allow individuals an exclusion of a percentage of the gain realized upon the disposition of qualified capital assets. Assets held 3 years or more would qualify for a 30-percent exclusion; assets held at least 2 years but less than 3 years would qualify for a 20-percent exclusion; and assets held at least one year but less than 2 years would qualify for a 10-percent exclusion. For a taxpayer in the 28-percent tax bracket, this would result in a regular tax rate of 19.6 percent for assets held 3 years or more, 22.4 percent for assets held between 2 and 3 years and 25.2 percent for assets held between one and 2 years.

Qualified capital assets generally would be capital assets as defined under present law, except that collectibles would be excluded. In addition, all depreciation would be recaptured in full as ordinary income.

The capital gains exclusion would be a preference for purposes of the alternative minimum tax. The amount treated as investment income for purposes of the investment interest limitation would be reduced by the capital gains exclusion attributable to investment assets.

The provision would apply to dispositions (and installment payments received) after the date of enactment. For the portion of 1990 to which the proposal applies, a 30-percent exclusion would apply for all assets held one year or more. For 1991, the exclusion would be 20 percent for assets held between one and 2 years and 30 percent for assets held at least 2 years. After 1991, the staggered exclusion described above would apply.

Revenue Effects

Table 1 provides the Joint Committee on Taxation staff's estimate of the net budgetary effects of the Administration's capital gains proposal for fiscal years 1990 through 1995.[13]

[12] The proposal was introduced by Senators Packwood, Dole and Roth as S. 2071. A companion bill, H. R. 3772, was introduced in the House of Representatives by Mr. Archer. The effective date of these bills is March 15, 1990.

[13] The Treasury Department's estimate of the revenue effects for the same period is a revenue gain of $0.5 billion in fiscal 1990, a revenue gain of $4.9 billion in fiscal 1991, a revenue gain of $2.8 billion in fiscal 1992, a revenue gain of $1.2 billion in fiscal 1993, a revenue gain of $1.7 billion in fiscal 1994, and a revenue gain of $1.4 billion in fiscal 1995, for a six-year total gain of $12.5 billion.

EXHIBIT C

Table 1.—Revenue Estimates of the Administration's Capital Gains Proposal, Fiscal Years 1990–1995

[Fiscal year; billions of dollars]

	1990	1991	1992	1993	1994	1995	1990–95
Revenue Effect.........	0.7	3.2	−4.3	−3.6	−4.3	−3.1	−11.4

Source: Joint Committee on Taxation.

IV. OTHER LEGISLATIVE PROPOSALS

1. S. 1771 (Senator Packwood and others)

S. 1771, introduced by Senator Packwood and others on October 19, 1989, would allow individuals an exclusion of a percentage of the gain realized upon the disposition of qualified capital assets. Assets held 7 years or more would qualify for a 35-percent exclusion; assets held more than one year but less than 7 years would be allowed an exclusion equal to 5 percent for each full year the asset was held. This gain would not be taken into account under the phase-out of the 15-percent rate and personal exemptions.

In addition, corporations would pay tax at a lower rate on the gain realized upon the disposition of qualified capital assets. Assets held more than 15 years would be taxed at a 29-percent rate. Assets held more than 3 years but less than 15 years would be taxed at a rate equal to one percentage point below the regular tax rate of 34 percent for each three full years the asset was held.

Qualified capital assets generally would be capital assets as defined under present law, except that collectibles would be excluded. In addition, all depreciation would be recaptured in full as ordinary income.

The capital gains exclusion would be a preference for purposes of the alternative minimum tax. The amount treated as investment income for purposes of the investment interest limitation would be reduced by the capital gains exclusion attributable to investment assets.

An individual could elect to index the basis of certain assets held more than two years for inflation occurring after 1990 for purposes of determining gain upon a taxable sale, rather than to exclude a portion of the capital gains for that year. Under the bill, the assets generally eligible for indexing would be common stock, tangible personal property and real property, provided such assets are either capital assets or assets used in a trade or business and were held for more than two years.

The bill contains numerous exceptions and other provisions dealing with an array of issues. These issues include the denial of indexing for debt instruments,[14] the differentiation of common stock eligible for indexing from preferred stock (considered more like non-indexable debt); possible abuses such as incorporation of non-indexed assets to obtain indexing with respect to stock; depreciation recapture, problems regarding the appropriate treatment of in-

[14] The legislative history of prior Congressional proposals to index for inflation have disallowed indexing for debt instruments. Indexing debt was viewed as producing complex adjustments that would not produce additional revenues where both the borrower and the lender have the same marginal tax rate. The legislative history (apparently still addressing the situation in which a borrower and a lender have the same marginal rate) suggested that to the extent inflation is anticipated correctly and interest rates are free to rise, interest rates would tend to rise to a rate that would compensate for inflation on an after-tax basis.

terests in different types of flow-through entities (such as regulated investment companies, real estate investment trusts, partnerships and subchapter S corporations); and concerns related to application of the short sale provisions of existing law.[15]

The bill would apply to sales and exchanges after October 1, 1989.

2. S. 1938 (Senator Graham and others)

S. 1938, introduced by Senator Graham and others on November 20, 1989, would allow individuals an exclusion of a percentage of the gain realized upon the disposition of qualified capital assets. Assets held 10 years or more would qualify for a 50-percent exclusion; assets held more than one year but less than 10 years would be allowed an exclusion equal to 5 percent for each full year the asset was held. For assets held before October 14, 1989, the exclusion would be one-half of these amounts (but, for this purpose, in no event shall an asset be treated as acquired before October 19, 1983). Qualified venture capital stock would be allowed an exclusion of 40 percent for stock held between 4 and 6 years and 50 percent for stock held more than 6 years.

In addition, corporations would pay tax at a lower rate on the gain realized upon the disposition of qualified capital assets. Assets held more than 10 years would be taxed at a 25.5-percent rate. Assets held more than 2 years but less than 10 years would be taxed at a rate equal to .85 percent below the regular tax rate of 34 percent for each full year the asset was held. Qualified venture capital stock would be taxed at a rate of 20.4 percent if held between 4 and 6 years and 17 percent if held more than 6 years.

Qualified capital assets generally would be capital assets as defined under present law, except that collectibles would be excluded. In addition, all depreciation would be recaptured in full as ordinary income.

Qualified venture capital stock means stock in a qualified venture capital corporation issued after October 18, 1989, originally issued to the taxpayer. A qualified venture capital corporation means a corporation with a paid-in capital of less than $20 million (on the date of issuance) engaged in the active conduct of a trade or business. Personal service corporations are excluded.

The capital gains deduction is not allowed for purposes of the minimum tax to the extent it exceeds one-half of the deduction allowed with respect to qualified venture capital stock net capital gain. The amount treated as investment income for purposes of the investment interest limitation would be reduced by the capital gains exclusion attributable to investment assets.

The bill would apply to sales and exchanges after October 18, 1989.

3. S. 348 (Senator Bumpers and others)

S. 348, introduced by Senator Bumpers and others on February 7, 1989, would provide a capital gains exclusion for certain small busi-

[15] A similar proposal for indexing passed the Senate in 1982 (as a floor amendment to the Tax Equity and Fiscal Responsibility Act of 1982), but was not enacted. Likewise, a similar proposal passed the House of Representatives in 1978 but was not enacted.

ness stock. Specifically, taxpayers other than corporations would be able to deduct from gross income 25 percent of net capital gain from the disposition of "qualified small business stock" that was held for at least 4 years at the time of the disposition. A maximum tax rate of 21 percent would apply. In addition, the deduction would be treated as a preference for purposes of the alternative minimum tax.

"Qualified small business stock" means stock which is (1) issued by a "qualified small business" more than 6 months after the date of enactment, (2) first acquired by the taxpayer (directly or through an underwriter), and (3) not issued in redemption of (or otherwise exchanged for) stock that was issued prior to the effective date.

A "qualified small business" means a corporation that: (1) has paid-up capital of $100 million or less immediately after the issuance; (2) was engaged in an active trade or business for at least 5 years prior to the issuance (or, if shorter, its period of existence); (3) is engaged in an active trade or business immediately after the issuance; and (4) is not a personal service corporation.

4. Other bills introduced in the Senate

Other bills introduced in the Senate relating to capital gains include S. 171, introduced by Senator Kasten and others, to provide a variable capital gains tax differential for certain capital gains and to index the basis of capital assets; S. 182, introduced by Senator Heinz, to provide for indexing of certain assets; S. 411, introduced by Senator Boschwitz and others, to restore a capital gains tax differential; S. 551, introduced by Senator Cranston and Senator Boschwitz, to restore a capital gains differential; S. 645, introduced by Senator Boschwitz, to provide for the indexing of certain assets and to increase the holding period for capital assets from one year to three years; S. 664, introduced by Senator Armstrong and others, to provide for the indexing of certain assets; S. 869, introduced by Senator DeConcini, to restore the deduction for capital gains of individuals and to ensure that the tax-rate on long-term capital gains of individuals does not exceed 21 percent; S. 1238, introduced by Senator Fowler, to restore the capital gains treatment for timber; S. 1286, introduced by Senator Kasten, to provide a maximum long-term capital gains rate of 15 percent and indexing of certain capital assets; S. 1311, introduced by Senator Armstrong and others, to provide a maximum rate of 15 percent on capital gains before 1991, to provide indexing of the bases of certain capital assets after 1990, and to provide a 20-percent maximum rate on capital gains from qualified small business stock held for 4 years or more; and S. 1541, introduced by Senator Kerry, to restore a capital gains tax differential for small and high-risk business stock held for 5 years or more (with lower rates on gains from such stock held for 10 years or more).

5. H. R. 3299 and H.R. 3628 as passed by the House

The Omnibus Budget Reconciliation Act of 1989 (H.R. 3299)[16] as passed by the House of Representatives on October 5, 1989, would

[16] For a description of the provisions, see H. Rept. 101-247, September 20, 1989, pp. 1474-1480.

have allowed individuals a temporary exclusion of 30 percent of the gain realized upon the disposition of qualified capital assets held more than one year. The capital gains provision in H.R. 3299 were deleted in conference. The identical provisions also passed the House as H.R. 3628 on November 9, 1989.

Qualified capital assets generally would have been capital assets as defined under present law, except that collectibles would be excluded. In addition, all depreciation would have been recaptured in full as ordinary income.

The capital gains exclusion would have been a preference for purposes of the alternative minimum tax. The amount treated as investment income for purposes of the investment interest limitation would have been reduced by the capital gains exclusion attributable to investment assets.

The exclusion would have applied to sales and exchanges on or after September 14, 1989 and before January 1, 1992.

In addition, the bill provided that gains from the sale or exchange of qualified capital assets on or after September 14, 1989, were not taken into account in computing the additional 5-percent tax imposed by reason of the phaseout of the 15-percent bracket and personal exemptions.

Finally, the bill provided for indexing the basis of certain assets acquired after 1991 for inflation.

EXHIBIT C

V. ANALYSIS OF ISSUES

A. Issues Relating to a Reduced Tax on Capital Gains

1. Arguments for reduced tax on capital gains

Lock-in.—Many argue that higher tax rates discourage sales of assets. For individual taxpayers, this lock-in effect is exacerbated by the rules which allow a step-up in basis at death and defer or exempt certain gains on sales of homes. The legislative history suggests that this lock-in effect was an important consideration in Congress' decision to lower capital gains taxes in 1978. As an example of what is meant by the lock-in effect, suppose a taxpayer paid $500 for a stock which now is worth $1,000, and that the stock's value will grow by an additional 10 percent over the next year with no prospect of further gain thereafter. Assuming a 28-percent tax rate, if the taxpayer sells the stock one year or more from now, he or she will receive $932 after payment of $168 tax on the gain of $600. With a tax rate on gain of 28 percent, if the taxpayer sold this stock today, he or she would have, after tax of $140 on the gain of $500, $860 available to reinvest. The taxpayer would not find it profitable to switch to an alternative investment unless that alternative investment would earn a total pre-tax return in excess of 11.6 percent. Preferential tax rates impose a smaller tax on redirecting monies from older investments to projects with better prospects, in that way contributing to a more efficient allocation of capital.

A preferential tax rate on capital gains would both lower the tax imposed when removing monies from old investments and increase the after-tax return to redirecting those monies to new investments. Some have suggested that the lock-in effect could be reduced without lowering taxes on old investments. For example, eliminating the step-up in basis upon death would reduce lock-in. Alternatively, preferential tax rates only for gains on newly acquired assets would increase the after-tax return to new investments, thereby making reallocation of investment funds more attractive than currently is the case. On the other hand, taxpayers would not necessarily redirect their funds to new investments when their monies in older investments are unlocked. Taxpayers might instead choose to consume the proceeds.[17]

Some have argued that the lock-in effect should not be as strong for capital gains accurred on assets held by corporations as on assets held by individual taxpayers, because corporations do not re-

[17] One recent study argues that second mortgages permit taxpayers to "realize" accrued capital gains on their personal residences without paying tax. The study presents data which indicate that taxpayers use their accrued gains to finance increased consumption more often than re-investment. Such behavior would reduce personal saving and investment. *See* Joyce M. Manchester and James M. Poterba, "Second Mortgages and Household Saving," *Regional Science and Urban Economics*, vol. 19, May 1989.

ceive the benefit of step-up in basis. They also observe that most corporate assets do not represent portfolio investments, but rather are held in furtherance of the corporation's business activity. Therefore, there is likely to be less discretion in timing of realization of corporate assets. Proponents of a preferential tax rate on corporate capital gains counter that lock-in occurs because of the ability to defer realization and that consequently corporations can be subject to substantial lock-in effects.

Incentives for equity investments.—A second argument for preferential capital gains tax rates is that they encourage investors to buy corporate stock, and especially to provide venture capital for new companies, stimulating investment in productive business activities. This argument was important in the 1978 debate over capital gains taxes, and there has been a large growth in the availability of venture capital since 1978. Proponents argue that the preference provides an incentive for investment and capital formation, with particular mention of venture capital and high technology projects.

Others argue that the capital gains preference may be an inefficient mechanism to promote the desired capital formation. They argue that a preferential capital gains tax rate is not targeted toward any particular type of equity investment although promotion of high technology venture capital is apparently a goal. Furthermore, a broad capital gains preference affords capital gains treatment to non-equity investments such as gains on municipal bonds and certain other financial instruments.

To the extent that potential sources of venture capital or other equity investment, or secondary purchasers of corporate stock, are tax-exempt or partially tax-exempt (for example, pension funds and certain insurance companies and foreign investors), a tax preference could have a small incentive effect on investment. Since 1978, tax-exempt entities (pension funds and non-profit institutions) have constituted the fastest growing source of new venture capital funds.[18] On the other hand, proponents argue that capital gains treatment for venture capitalists who are taxable has importance. They argue that this is particularly acute for the entrepreneur who often contributes more in time and effort than in capital.

Opponents of a capital gains preference argue that creating a preference for capital gains could encourage the growth of debt and the reduction of equity throughout the economy. When debt is used in a share repurchase program or leveraged buyout transaction the taxpayers who hold the original equity securities must realize any gain that they might have. A lower tax rate on gains could make holders of equity more likely to tender their shares in a leveraged buyout transaction or share repurchase program.[19]

Competitiveness.—Related to the argument that preferential capital gains tax rates encourage investment is the argument that a lower capital gains tax rate will improve the international competitive position of the United States. Proponents of a reduction in cap-

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[18] *See* James M. Poterba, "Venture Capital and Capital Gains Taxation," in Lawrence H. Summers (ed.), *Tax Policy and the Economy*, (Cambridge: MIT Press), 1989.

[19] Jane Gravelle, "Tax Aspects of Leveraged Buyouts," CRS Report to Congress, 89-142 RCO, March 2, 1989.

ital gain tax rates observe that many of our major trading partners have lower marginal tax rates on the realization of capital gains than does the United States. For example, prior to this year, all gains on stocks, bonds, and unit trusts were exempt from tax in Japan. The recent Japanese tax reform imposes a tax at the taxpayer's discretion of either one percent of the gross proceeds or 20 percent of the gain, a rate still below the maximum U.S. rate. In West Germany, all long-term gains are exempt from tax.

Others point out that the issue of the effect of capital gains taxes on international competitiveness is really one of the cost of capital of domestic firms compared to that of their competitors. Corporate income taxes, individual income taxes on interest and dividends, net wealth taxes,[20] as well as taxes on capital gains, all may affect the cost of capital. Opponents of a capital gains preference argue that the fact that marginal tax rates on capital gains are higher in the United States than in other countries does not imply automatically that American firms are at a competitive disadvantage. Moreover, because of the ability to defer gains, to receive step-up at death, and because of substantial holding of corporate equity by tax-exempt institutions, the effective tax rate on gains, which helps determine the cost of capital, may be substantially below the statutory rate. For example, one recent study calculated that prior to 1987 the effective marginal tax rate on capital gains, including State taxes, was less than 6 percent.[21]

On the other hand, proponents of a capital gains tax reduction contend that any reduction in a tax on capital may reduce the cost of capital.

Bunching.—Because capital gain is generally not taxed until a disposition, taxpayers can face large jumps in taxable income when the gain is realized. With graduated tax rates, such bunching could lead to a higher tax burden than if the gain were taxed as it accrued. If the benefit of deferral is not enough to compensate for the extra tax in some of those cases, then the additional benefit of a preferential tax rate helps to achieve parity (although its availability is not limited to such cases).

Some analysts have argued that the flattened marginal tax rate schedule of present law diminishes the amount of bunching and so, presumably, reduces the need for a preferential tax rate as a remedy for it. These analysts have stated that the most significant bunching problems under present law would now befall those taxpayers in the 15-percent marginal tax bracket whose gains could push them into the 28-percent bracket. However, they point out that relatively few taxpayers who realize gains are in these circumstances.

Inflation.—Another argument for preferential tax treatment of capital gain is that part of the gain represents the effects of inflation and does not constitute real income. This argument was also

[20] While the United States does not impose on annual tax on an individual's net wealth, several of our trading partners do, for example, West Germany, the Netherlands, Spain, and Switzerland. *See* OECD, *Taxation of Net Wealth, Capital Transfers and Capital Gains of Individuals*, Paris, 1988.

[21] Don Fullerton, "The Indexation of Interest, Depreciation, and Capital Gains and Tax Reform in the United States," *Journal of Public Economics*, 32, February 1987, pp. 25–51.

important in 1978. Proponents observe that the preference may provide to taxpayers some rough compensation for inflation.

Others claim that a preferential tax rate is a very crude adjustment for inflation. For example, since 1978 the price level approximately has doubled. Thus, an asset purchased in 1978 for $1,000 and sold today for $2,000 would have a purely inflationary gain. Even with a preferential rate, this gain would be taxed. On the other hand, for an individual who purchased an asset in 1986 for $1,000 and sold it today for $2,000, a reduction in the tax rate from 28 percent to 19.6 percent would more than offset the effects of inflation over the past three years. A preferential rate also does not account for the impact of inflation on debt-financed assets, where inflation reduces the cost of repaying the debt.

Double taxation of corporate earnings.—Theorists have suggested that capital gains treatment on a disposition of corporate stock might be viewed as ameliorating the double taxation of corporate earnings. The first step of double taxation occurs at the corporate level; the second step occurs at the shareholder level as dividends are paid or as shares which have presumably increased in value by retained earnings are sold. However, other theorists have argued that preferential capital gains treatment is a very inexact means of accomplishing any such benefit. Among other things, the capital gains holding period requirement is unrelated to earnings. Also, any relief that a capital gains preference provides from the burden of double taxation applies only to retained corporate earnings. Distributed earnings would be still generally subject to double taxation.

2. Arguments against reduced tax on capital gains

Measurement of income.—Opponents of reduced tax on capital gains argue that appreciating assets already enjoy a tax benefit from the deferral of tax on accrued appreciation until the asset is sold, which benefit reduces in whole or in part any bunching or inflationary effects.[22] In addition, if capital assets are debt-financed, inflation will reduce the real cost of borrowing to the extent interest rates do not rise to compensate for the reduced value of principal repayments and interest is deductible. Thus, debt financing may further tend to offset any adverse impact of inflation. Some opponents of the preference have contended that a direct basis adjustment by indexing for inflation would be more accurate and would reduce uncertainty regarding the eventual effective rate of tax on investments that might impair capital formation.[23]

On the other hand, proponents of a preference for capital gains contend that the benefit of deferral is insufficient to make up for more than very modest inflation. Moreover, they argue that indexing may be viewed as too complex to implement.

Neutrality.—To the extent that preferential rates may encourage investments in stock, opponents have argued that the preference tilts investment decisions toward assets that offer a return in the

[22] *See* Roger Brinner, "Inflation, Deferral and the Neutral Taxation of Capital Gains," *National Tax Journal*, vol. 46, December 1973.

[23] A more detailed discussion of issues relating to indexation of capital gains is below (D. "Indexing").

form of asset appreciation rather than current income such as dividends or interest. Furthermore, because the individual capital gains preference is accomplished by a deduction (or exclusion) from income, it provides a greater benefit to high-income than to middle- or low-income taxpayers. On the other hand, it is argued that neutrality is not an appropriate goal because risky investments that produce a high proportion of their income in the form of capital gains may provide a social benefit not adequately recognized by investors in the marketplace.

Reduction of "conversion" opportunities.—Opponents of the preferential capital gains rate contend that it not only provides a reduced tax rate on gains from the preferred assets but also encourages taxpayers to enter transactions designed to convert other, ordinary, income to capital gains.

Conversion can also occur through debt-financing the cost of assets eligible for capital gains rates. For example, if a taxpayer borrows $100 at 10 percent annual interest to acquire a capital asset that is sold for $110 a year later, and repays the borrowing with sales proceeds, the taxpayer has an interest deduction of $10 that can reduce ordinary income [24] and a capital gain of $10 subject to preferential rates. The taxpayer thus has a net after-tax positive cash flow even though on a pre-tax basis the transaction was not profitable.

On the other hand, it is argued that such "conversion" opportunities are simply an additional tax incentive for types of investments the capital gains preference is intended to encourage. In addition, it is argued that the passive loss limitations of present law limit taxpayers' ability to "convert" ordinary income to capital gains.

Simplification and consistent treatment of taxpayers.—Opponents of the preferential capital gains rate point out that the application of different tax rates to different sources of income inevitably creates disputes over which assets are entitled to the preferential rate and encourages taxpayers to mischaracterize their income as derived from the preferred source. Litigation involving holding period, sale or exchange treatment, asset allocation, and many other issues has been extensive in the past. A significant body of law, based both in the tax code and in judicial rules, has developed in response to conflicting taxpayer and Internal Revenue Service positions in particular cases. Its principles are complicated in concept and application, typically requiring careful scrutiny of the facts in each case and leaving opportunities for taxpayers to take aggressive tax return positions. It has been argued that the results derived in particular cases lack even rough consistency, notwithstanding the substantial resources consumed in this process by taxpayers and the Internal Revenue Service. Elimination of the preferential rates on capital gains has obviated the incentive for many such disputes. It has also obviated the need for such complex provisions as the collapsible corporation and collapsible partnership rules, which have been criticized for apparent inconsistencies in ap-

[24] Even if an interest deduction is subject to present law investment interest limitations, it can be offset against investment income that is ordinary income.

plication, and certain aspects of the varying recapture provisions for different types of assets.

On the other hand, it is argued that so long as a limitation on deductions of capital or investment loss is retained, some areas of uncertainty and dispute continue to exist (for example, whether property was held primarily for sale to customers in the ordinary course of business, and the application of the *Corn Products* and related doctrines). Since (as discussed further below) limitations on the deductibility of capital or investment losses may be desirable to limit the selective realization of losses without realization of gains, the amount of simplification and consistency that has occurred as a result of eliminating the preference for long term capital gains has been limited somewhat.

B. Issues Specific to the Administration's Proposal

1. Holding period

Some argue that taxpayers do not plan their investments with sufficiently long time horizons. They argue that because some taxpayers realize their gains after holding the investment for short periods, managers of enterprises plan their enterprise's investment with a view to the short run, forsaking profitable long-term investments. Others argue that there is no evidence that managers ignore potentially profitable long-term investments at the expense of short-term investments and that there is no evidence of a causal link between stockholder holding period and management behavior.

Establishing a holding period requirement of 36 months to qualify for preferential capital gain treatment would create incentives for some of those taxpayers who would otherwise realize their gains in less than 36 months to defer some of those gains until they had been held for at least 36 months.[25] The holding period requirement would not be expected to have any effect on the timing of the realization of gains which taxpayers would have realized after 36 months in the absence of the holding period requirement.

Two studies, which specifically examined the effect of the holding period requirement of prior law, concluded that the holding period requirement did affect individual taxpayers' decisions as to when to realize gains.[26] If the tax rate varies by holding period, the taxpayer's decision to realize a gain now or later involves a comparison of the current after-tax yield from realization to the expected future after-tax yield from realization. While a tax rate which is lower the longer an asset has been held would increase

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[25] Under the proposal, it may be necessary to develop rules to prevent a taxpayer from first contributing assets with a short holding period to an entity, such as a partnership or S corporation, in which the taxpayer's equity interest has a longer holding period, and then selling the equity interest, in order to obtain the benefits of the longer holding period.

[26] *See* J. Eric Fredland, John A. Gray, and Emil M. Sunley, Jr., "The Six Month Holding Period for Capital Gains: An Empirical Analysis of Its Effect on the Timing of Gains," *National Tax Journal*, vol. 21, December 1968, and Steven Kaplan, "The Holding Period Distinction of the Capital Gains Tax," National Bureau of Economic Research Working Paper Number 762, September 1981.

An earlier study, *see* Lawrence H. Seltzer, *The Nature and Tax Treatment of Capital Gains and Losses* (National Bureau of Economic Research) 1951, had concluded that the five graduated holding periods which were part of the Code from 1934 to 1937 reduced the turnover of capital assets.

the after-tax yield to waiting, the taxpayer is uncertain as to whether his pre-tax gain will be larger or smaller if he waits. The taxpayer must decide whether the gain in tax reduction offsets the uncertainty about the size of the gain. Under prior law, the reward to waiting was more substantial than that offered by the Administration's current proposal. For example, if a taxpayer had accrued $100 in gain, under prior law if it was classified as short term, the net would be $50 (assuming the 50-percent marginal tax rate). If the gain was classified as long-term, the net would be $80 (assuming the 60-percent exclusion of prior law). Under the Administration's proposal, the net return on a $100 gain to a taxpayer in the 28-percent tax bracket would be $72 if the asset had been held less than one year, $74.80 if the asset had been held between 12 and 24 months, $77.60 if the asset had been held between 24 and 36 months, and $80.40 if the asset had been held 36 months or longer.

Lengthening the holding period should, by itself, increase taxpayers' average holding periods for all assets in their portfolios. However, taxpayers' average holding periods probably are affected by more than the holding period requirement. If a reduction in the tax rate on capital gains induces taxpayers to realize gains in their portfolios more frequently and to realize gains which they otherwise would have held, unrealized, until death, then taxpayers' average holding periods for all assets in their portfolios may decline. Consequently, while the Administration's proposal may cause fewer taxpayers to realize gains within 36 months, it may also cause the average holding period to fall.

2. Capital losses

Deductibility against ordinary income.—The present limits on the deductibility of capital losses against ordinary income are intended to address problems that arise from the high degree of taxpayer discretion over when to sell certain types of assets. If capital losses were fully deductible against ordinary income, as was the case between 1921 and 1934, a taxpayer owning many assets could selectively sell only those assets with losses and thereby wipe out the tax on ordinary income even if those losses were offset by unrealized capital gains in the taxpayer's portfolio. This concern would support retention of a limitation on the deduction of capital or investment losses, even if capital or investment gains were not subject to preferential tax treatment and even though tax distinctions between investment and non-investment assets tend to generate disputes over the proper characterization of particular assets. Some have suggested a marked-to-market system (parallel to present-law treatment of regulated futures contracts) for both gains and losses, at least in the case of publicly traded stock and securities or other readily valued assets. Others contend that limitation of such a system to these types of assets would retain possibilities for taxpayer manipulation.

Limits on the deductibility of capital losses may be unfair to taxpayers who have losses in excess of unrealized gains, since they may never get to deduct legitimate losses. Or, even if, over a period of years, the taxpayer can deduct his full loss, the present value of the deduction is reduced by deferral of the loss deduction. The reduction in the value of the loss deduction creates an asymmetric treatment of gains and losses. This relative penalty on loss deduction may discourage taxpayers from undertaking risky investments. However, the ability of the taxpayer to defer realization of his gains at his discretion creates incentives to undertake such investments.

The present system—allowing the deduction of losses against up to $3,000 of ordinary income—is a compromise between the desire to be fair to taxpayers with net losses and the need to protect the tax base from selective realization of losses. In effect, small investors, who are presumed not to have large portfolios with unrealized gains, are allowed to deduct capital losses against ordinary income, and large investors, for whom $3,000 is not significant, are not. Arguably, however, large investors may have larger portfolios and lower transactional costs, making it easier selectively to realize accrued gains to offset losses and reduce the adverse impact of the $3,000 limit.

Reduction of long-term capital loss carryovers.—The prior law rule requiring that long-term losses be reduced by 50 percent when deducted against ordinary income (up to the $3,000 limit) was also a compromise between the need to protect the tax base and equity to investors with net capital losses. If long-term losses were fully deductible against ordinary income, as was the case before 1969, taxpayers with both long-term gains and losses could realize the gains and losses in alternate years, paying tax on only 40 percent of the gains and fully deducting the losses. Under prior law, a taxpayer who took care to realize losses before they became long-term could, of course, achieve this result despite the 50-percent reduction. To compensate for the loss limitation, Congress retained a 50-percent cutback, instead of increasing it to 60 percent, when the capital gains exclusion percentage was increased from 50 to 60 percent in 1978.

The Administration's proposal does not reduce long-term losses deducted against ordinary income. The proposal treats all long-term loss carryovers as losses from the sale or exchange of property held between one and two years.

3. Treatment of taxpayer with both gains and losses from the sale of capital assets

In general.—Under the law prior to the Tax Reform Act of 1986, the amount of gain that was entitled to the 60-percent capital gains exclusion was the excess of net long-term capital gain over net short-term capital loss for the year. Thus, in determining the amount eligible for the exclusion, the amount of gain from the sale or exchange of capital assets held more than six months was reduced, first, by the amount of losses from the sale or exchange of capital assets held more than six months and then was further reduced by the excess of short-term capital losses for the year over short-term capital gains for the year.

If a capital gains structure is adopted with multiple holding periods providing a larger exclusion for longer-held gains, rules must be adopted to provide the manner in which a taxpayer's capital losses for any taxable year offset capital gains for that year. Rules also must be adopted to prescribe the treatment of the carryover of long-term capital losses.

Administration proposal.—The Administration proposal would, in effect, treat all long-term capital losses as losses arising from the sale of assets held between one and two years, notwithstanding the actual holding period of the asset sold. This would result in long-term capital losses first offsetting capital gains with a holding period of between one and two years, with any excess next offsetting capital gains with a holding period of between two and three years, and with any further excess then offsetting capital gains from assets held more than three years.

Assume, for example, a taxpayer has a $100 gain from the sale of a capital asset held between one and two years, a $50 gain from the sale of a capital asset held more than three years and a $100 loss from the sale of an asset held more than three years. Under the Administration proposal (when fully effective in 1992), the $100 loss from the asset held more than three years would offset the $100 gain from the asset held between one and two years. The taxpayer would then be entitled to exclude $15 of gain (30 percent of the $50 gain attributable to the asset held more than three years), resulting in $35 of net gain being subject to tax.

Principles set forth in S. 1771 and S. 1938.—Under these bills, gains and losses within each category of gains and losses are first netted against each other. Next, the net loss from any category is then netted against the net gain from other categories in a prescribed order. Under these bills, the carryover of any long-term capital loss is treated as loss from the sale or exchange of an asset with a holding period of between one and two years. This carryover rule is intended to simplify the calculation of the loss carryovers.

Assume the facts in the example set forth above under the discussion of the Administration proposal. Under the principles set forth in each of these bills (but using the holding periods and exclusion amounts set forth in the Administration proposal), $50 of the loss from the asset held more than three years would first offset the $50 of gain from the asset held more than three years. The remaining $50 loss would then offset the gain from the asset held between one and two years. The taxpayer would then be entitled to exclude $5 of gain (10 percent of the $50 gain attributable to the asset held between one and two years), resulting in $45 of net gain being subject to tax.

Principles used under prior law when multiple holding periods were in effect.—When multiple holding periods for long-term capital gains were in effect before World War II, netting of gains and losses between categories of gains and losses (either short-term and long-term) did not occur. The applicable portion of the net gain from each category of long-term gain was excluded from income and the allowable loss from any category of asset with a net long-term loss was reduced by the applicable portion of the loss. Under this system, any capital loss carryover (after proper reduction in the current year) would be carried over in full.

Again assume the facts in the prior example. Applying these principles to the holding periods and exclusion amounts set forth in the Administration proposal, 10 percent of the $100 gain (i.e., $10) from the asset held between one and two years would be excluded from income. In addition, the $50 gain and $100 loss from the sale of capital assets held more than three years would be netted, resulting in a net loss of $50. However, the taxpayer would be allowed to deduct only 70 percent of the $50 net loss (i.e., $35) from the assets held more than three years. The net amount of capital gain included in taxable income would thus be $55 ($90 gain reduced by $35 allowable loss).

4. Definition of qualified assets

The Administration proposal generally would apply to all assets which were eligible for the long-term capital gain exclusion of prior law. The proposal, however, would deny the proposed exclusions to collectibles. The proposal, however, Proponents of the proposal argue that denying the exclusion to collectibles targets the proposal towards those assets which are most directly responsible for future growth, such as investments in plant and equipment. On the other hand, economic neutrality argues for not artificially biasing taxpayer's choices of the form of their investments.

A preference which applies to corporate stock but not to collectibles, or some other class of assets, may make tax administration and compliance more difficult. Taxpayers may attempt to obtain the capital gains preference for sales of collectibles by contributing these assets to a C corporation and selling the stock of that entity. Certain disadvantages to holding such property in corporate form, such as the imposition of a corporate-level tax if the collectibles themselves are later sold or distributed by the corporation, would tend to discourage such activity.[27]

C. Distributional Effects of a Reduction in Capital Gains Taxes

Table 2 below presents the Joint Committee on Taxation staff's estimate of the distributional effect of the Administration's proposal. The second column in the table below estimates the number of returns in each income class which will benefit from the proposed capital gains rate reduction. The third column reports the aggregate tax reduction which accrues to each income class. The fourth column calculates the average dollar tax reduction per return. The last column calculates the percentage of the aggregate tax change which accrues to each income class.

[27] The Administration proposal, S. 1771, and S. 1938 each would deny long-term capital gains treatment to the sale of S corporation stock or a partnership interest to the extent the gain is attributable to the gain from collectibles held by the S corporation or partnership.

Table 2.—Distributional Effect of the Administration's Capital Gains Proposal

[1990 income levels]

Income class [1]	Number of returns with tax change (Thousands)	Aggregate tax change (Millions of dollars)	Average tax reduction [2] (Dollars)	Percent distribution of aggregate tax change
Less than $10,000	59	−$4	$68	[3]
$10,000 to $20,000	638	−56	88	0.4
$20,000 to $30,000	1,360	−136	100	.9
$30,000 to $40,000	1,811	−297	164	1.9
$40,000 to $50,000	1,502	−415	276	2.6
$50,000 to $75,000	2,423	−1,004	414	6.3
$75,000 to $100,000	984	−785	798	4.9
$100,000 to $200,000	1,299	−2,709	2,085	17.0
$200,000 and above	681	−10,522	15,454	66.1
Total	**10,756**	**−15,928**	**1,481**	**100.0**

[1] The income concept used to place tax returns into income classes equals adjusted gross income plus: (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) inside buildup on life insurance, (4) worker's compensation, (5) nontaxable social security benefits, (6) deductible contributions to individual retirement accounts, (7) the minimum tax preferences, and (8) net losses in excess of minimum tax preferences from passive business activities.

[2] The tax reduction reported here assumes no change in taxpayer behavior. Thus, this measure understates the tax benefit received by certain taxpayers.

[3] Negligible.

Note.—Details may not add to totals due to rounding.

Source: Committee on Taxation.

The table above calculates the benefit from the proposed rate reduction which taxpayers would receive if they realized the same amount of gains that they would have realized in the absence of a rate reduction. In other words, this calculation measures only the benefit the taxpayer receives if he or she does not alter behavior. This is a conservative estimate of the actual benefit, because it does not assume a behavioral response. If taxpayers respond by realizing additional gains they will obtain even more benefit from the change, since taxpayers change their behavior only if the change makes them even better off. Thus, this calculation understates the benefit received by higher income taxpayers.

In other words, Table 2 reports the distribution of the tax burden rather than the distribution of taxes paid. If a reduction in capital gains tax rates leads to greater realizations and tax revenue paid by high-income taxpayers, the distribution of taxes paid will have shifted more onto high-income taxpayers. However, an increase in the distribution of taxes paid does not imply that the tax burden on high-income taxpayers has increased, because, as noted above, any additional tax paid in response to a capital gains rate cut results only from changed behavior.[28]

D. Indexing

Proponents of indexing contend that indexing would accomplish the goals of capital gains taxation while producing a more accurate measurement of economic income with greater neutrality.

Opponents contend that indexing is complex, should not be significant if efforts to control inflation are successful, and would erode revenues if such efforts are not successful.

1. Issues related to partial indexing

The 1989 House-passed reconciliation bill (H.R. 3299) and S. 1771 would provide indexing of basis but would not generally index costs of financing property.

Where some but not all assets are indexed, several issues arise. To the extent that the basis of certain assets is indexed but debt-financing of those assets is not, the adjustment for inflation may be overstated. An overadjustment in favor of the taxpayer who finances assets can occur even if it is assumed that interest rates correctly anticipate inflation and rise in the marketplace to reflect the effect of inflation on borrower and lender. For example, suppose a taxpayer acquires an asset for $100 (fully financed) and sells it one year later for $115. Inflation over the year is 5 percent. The lender and the taxpayer are each in a 28-percent tax bracket. The lender, seeking a 10 percent pre-tax rate of interest and anticipating 5-percent inflation, charges 15 percent interest for the year. On a pre-tax basis, the taxpayer receives $115 in return of basis and gain on the sale, but pays the lender $115 in interest and principal, producing no net cash flow.

If there is no indexing and no capital gains preference, the after-tax result is the same as the pre-tax economic result—the taxpayer receives $15 of income taxable at 28 percent and pays $15 of offsetting, deductible interest, producing no after-tax net cash flow. If both the basis of the asset and the interest on the financing are indexed (assuming an accurate indexing factor has been identified and applied) the taxpayer again has $10 of gain and $10 of offsetting deductible interest, producing no after-tax net cash flow. However, if the basis of the asset is indexed for inflation but the financing is not indexed, then the taxpayer has $10 of gain (taxed at 28 percent) but a $15 deduction, producing an after-tax positive net cash flow of $1.40, assuming the deduction can be used in full to offset other income in the 28-percent bracket.[29]

If some but not all assets are indexed, additional consideration would have to be given to provisions designed to accomplish the desired results in certain special situations. For example, if stock but

[28] For further discussion on the appropriate methodology for assessing distributional effects, *see* Jane G. Gravelle and Lawrence B. Lindsey, "Capital Gains," *Tax Notes*, 38, January 25, 1988, pp. 397–405.

[29] Indexing the basis of assets without indexing debt-financing of such assets also overcompensates the borrower if interest rates do not rise enough to compensate for inflation on an after-tax basis. Thus, if the stated interest payment in the example is only $10 (rather than $15), interest is not indexed, and there is no capital gains preference, the taxpayer will have a pre-tax positive net cash flow of $5 and an after-tax positive net cash flow of $3.60.

not debt is indexed, (or if debt is indexed in a different manner than stock—for example, by interest adjustments rather than basis adjustments) the question arises whether some types of assets, such as preferred stock or convertible debt, should be classified as stock or as debt for this purpose.

If some assets are not indexed or are only indexed at the option of the holder, it would be necessary to provide for the appropriate treatment of various types of flow-through entities that may hold indexed assets but whose stock or interests may or may not be indexed. Conversely, if an interest in an entity is eligible for indexing but the entity may hold substantial non-indexable assets, consideration could be given to provisions designed to prevent taxpayers from indirectly obtaining indexing for nonqualified assets.

The question also arises whether indexing of an otherwise capital asset is appropriate in situations such as the disposition of stock in a controlled foreign corporation or foreign investment company, where present law requires ordinary income treatment to account for prior income deferral.

In the case of depreciable assets, rules are necessary to prevent the churning of assets in order for the buyer to obtain a higher basis for depreciation than the seller's basis, where the seller's gain is not taxed as a result of indexing. H.R. 3299 provided that indexing did not apply to the extent of depreciation recapture.

Finally, if capital gains treatment is reinstated for some types of assets (as would the case under H.R. 3299) then, depending upon the rate of inflation, taxpayers may continue to have an incentive to engage in transactions designed to convert ordinary income to capital gains income. Because of this possibility, the complex provisions of present law dealing with situations in which capital gains treatment is available (for example, the collapsible partnership rules) presumably could not be eliminated.

2. Other indexing considerations

"Lock-in".—It is possible that indexing might not relieve "lock-in" problems, because a taxpayer whose after-tax economic gain is protected against future inflation may decide to continue to hold an asset to obtain the benefits of tax deferral, or the benefits of tax exemption if the asset is held until death. Others contend that indexing alleviates "lock-in" by removing the burden of taxing nominal gains arising from inflation.

Complexity.—Indexing would involve a significant amount of recordkeeping. Records of the cost of property and of improvements are generally maintained under present law. However, records of the dates such costs are incurred may not be retained under present law, since the acquisition date is generally not relevant to the determination of tax liability.

Indexing would substantially increase the volume of calculations necessary to calculate taxable gain for many common transactions. For example, consider an individual who sells stock which was purchased 10 years before the sale and who has reinvested the quarterly dividends in additional stock during this entire period. Under present law, if all the stock is sold at once, the individual can add the original cost and the dollar amounts of each of the 40 reinvested dividend payments in order to obtain the stock's basis, which is subtracted from the sales proceeds in order to determine taxable gain. Under indexing, each of the 41 components of basis (the original purchase plus the 40 dividend payments) would be multiplied separately by indexing factors based on the full number of years that had elapsed since the dividend was reinvested in order to compute the inflation-adjusted value of that component and determine the basis of stock.

The interaction of indexing rules with other Code provisions would raise further issues. For example, the basis of a partnership interest or S corporation stock in the hands of a partner or shareholder is affected by numerous transactions, including distributions, that could complicate accurate indexing of such interests. Another example is the appropriate interaction with the short sale provisions of the Code. Theoretically, it can be argued that any inflation adjustment for a short sale should require the short seller to report a capital gain to the extent of inflation. If such a requirement were not imposed, it may not be appropriate to allow a shareholder who sells short "against the box" (i.e., while he or she owns shares of stock for which the short sale is made) to receive an inflation adjustment for the stock owned during the period of the short sale.

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EXHIBIT D

EXPIRING PROVISIONS

IRC Section	Federal Expiration	PITL Section	PITL Expiration	BCTL Section	BCTL Expiration	Description and Comments
25	12/31/91	N/C		N/A		Tax Credit - Mortgage Credit Certificate Program. President's Budget Proposal Would NOT Extend.
28	12/31/91	17057	12/31/92	23609.5	12/31/92	Tax Credit - Orphan Drugs. President's Budget Proposal Would NOT Extend.
41	12/31/91	17052.12	12/31/92	23609	12/31/92	Tax Credit - Research. President's Budget Proposal WOULD Extend.
42	12/31/91	17058	(Federal)	23610.5	(Federal)	Tax Credit - Low-Income Housing. President's Budget Proposal WOULD Extend.
46	12/31/91	N/C		N/C		Tax Credit - Investments. President's Budget Proposal Would NOT Extend.
51	12/31/91	17053.7	12/31/93	23621	12/31/93	Tax Credit - Targeted Jobs. President's Budget Proposal WOULD Extend.
57	12/31/91	17062	(Federal)	23400	(Federal)	AMT - Contribution of Appreciated Tangible Property. President's Budget Proposal Would NOT Extend.
120	12/31/91	17151	(Federal)	N/A		Exclusion - Educational Assistance Provided by Employer. President's Budget Proposal Would NOT Extend.
127	12/31/91	17157	(Federal)	N/A		Exclusion - Group Legal Benefits. President's Budget Proposal Would NOT Extend.
144	12/31/91	N/A		N/A		Exclusion - Qualified Small Issue Bonds. President's Budget Proposal Would NOT Extend.
162	12/31/91	17201	Pending	N/A		Deduction - Health Insurance for Self-Employed Persons. President's Budget Proposal WOULD Extend.
864	12/31/91	N/A		N/A		Definitions and Rules for Sourcing of Income. President's Budget Proposal WOULD Extend.
None		17052.17	12/31/91	23617	12/31/91	Credit - Start-up Costs for Employer Provided Child Care Center
None		17052.18	12/31/91	23617.5	12/31/91	Credit - Employer Provided Child Care Plan

EXHIBIT D

EXPIRING PROVISIONS

IRC Section	Federal Expiration	PITL Section	PITL Expiration	BCTL Section	BCTL Expiration	Description and Comments
None		17052.9	12/31/91	N/A		Credit - Public Employees who Retired Before 1984
None		17053.12	12/31/91	23608	12/31/91	Credit - Donation of Unspoiled Agricultural Products
None		17053.13	12/31/91	N/A		Credit - Persons Receiving Income From Military Service
None		17053.14	12/31/91	None		Credit - Political Contributions
None		17061.5	12/31/91	None		Credit - Sale of Farm or Residential Rental Property
172	Permanent	17276	12/31/91	24416	12/31/91	Deduction - Net Operating Losses
None		18500	12/31/90	N/A		Voluntary Contributions - State Children's Trust Fund
None		18510	12/31/90	N/A		Voluntary Contributions - California Fund for Senior Citizens
None		18515	12/31/90	N/A		Voluntary Contributions - Vietnam Veterans Memorial Fund
None		18520	12/31/90	N/A		Voluntary Contributions - Endangered Wildlife
None		18530	12/31/90	N/A		Voluntary Contributions - U.S. Olympic Committee
None		18540	12/31/90	N/A		Voluntary Contributions - Alzheimer's Disease
None		18700	12/31/90	N/A		Voluntary Contributions - California Election Campaign
None		18838	12/31/91	26255	12/31/91	Enforcement - Allows Collection of Taxes by Private Collection Agencies
21	Permanent	17052.6	12/31/92	N/A		Credit - Child and Dependent Care
None		17052.14	12/31/93	23612.5	12/31/93	Credit - Recycling Equipment
None		17052.20	12/31/93	N/A		Credit - Parent who Stays at Home to Care for Infant

EXHIBIT D

EXPIRING PROVISIONS

IRC Section	Federal Expiration	PITL Section	PITL Expiration	BCTL Section	BCTL Expiration	Description and Comments
None		17052.5	12/31/93	23601.5	12/31/93	Credit - Solar Energy Systems
170	12/31/94	17201	(Federal)	N/C		Deduction - Special Rule for Contribution of Stock for Which Market Quotations are Readily Available
None		17052.11	12/31/94	23603	12/31/94	Credit - Conversion of Vehicle to Use Alcohol Fuel
133	Permanent	17131	Permanent	24306	12/31/94	Exclusion - Interest on Loans Used to Acquire Employer Securities (ESOP)
1042	Permanent	18042	12/31/94	24954	12/31/94	Nonrecognition of Gain - Sales of Stock to ESOP
59A	12/31/95	N/A		N/C		Environmental Tax
68	12/31/95	Pending	Pending	N/A		Deductions - Maximum Limitation on Itemized Deductions
151	12/31/95	Pending	Pending	N/A		Exemptions - Phase-out for High Income Persons
None		17053	12/31/95	23605	12/31/95	Credit - Ridesharing
40	12/31/00	N/C		N/C		Credit - Alcohol Used as Fuel