State of California
Franchise Tax Board

SUMMARY OF FEDERAL INCOME TAX CHANGES — 1991

Laws Affected

Personal Income Tax
Bank & Corporation Tax

SUMMARY OF
FEDERAL INCOME TAX CHANGES
1991

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

Members of the Board:
State Controller
Chairman, State Board of Equalization
Director of Finance

Executive Officer:
Gerald H. Goldberg

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

Table of Contents

FEDERAL INCOME TAX CHANGES - 1991

Executive Summary

During 1991, the President signed the following Acts into law:

- TAX EXTENSION ACT OF 1991 (PL 102-227)
- EMERGENCY UNEMPLOYMENT COMPENSATION ACT OF 1991 (PL 102-164)
- TAXATION: TIME EXTENSION FOR INDIVIDUALS IN DESERT SHIELD OPERATIONS (PL 102-2)

Each of these Acts modified the federal Internal Revenue Code and the implications of those changes on California revenue is discussed in this report. With respect to the Act relating to the time extension for individuals in Desert Shield, California conformed to federal law, as amended by PL 102-2, in SB 830 (Ch. 91-479, Stats. 1991).

Changes to the federal rules for payment of estimated tax for individuals were used as the funding mechanism of the Emergency Unemployment Compensation Act of 1991 and changes in the corporate estimated tax were used to fund the Tax Extension Act of 1991. Thus, acceleration of the payment of the current year's tax liability for individuals was used to pay for the cost of providing additional jobless benefits, while the corporate estimate payment acceleration was used to fund the cost of extending the twelve tax provisions scheduled to expire at the end of 1991.

This report first discusses (beginning on Page 1) the twelve federal tax provisions which have been extended for six months. Next (beginning on Page 16), the two estimated tax acceleration provisions are explained. A summary of the Desert Shield provisions (to which California conformed in SB 830 (Ch. 91-479, Stats. 1991) begins on Page 20. Finally, two exhibits are included relating to expiring provisions and capital gains.

Exhibit A contains a list of expiring provisions in both state and federal law for the next four years.

As shown in Exhibit A, the following provisions expired on December 31, 1991:

<u>PROVISIONS AFFECTING INDIVIDUALS</u>

Tax Credit - Elderly and Disabled

Tax Credit - Public Employees who Retired Before 1984

Tax Credit - Persons Receiving Income From Military Service

Tax Credit - Political Contributions

Tax Credit - Low-Income Taxpayers

Tax Credit - Nondependent Who Qualifies Taxpayer as Head of Household

Tax Credit - Sale of Farm or Residential Rental Property

PROVISIONS AFFECTING BUSINESS (BOTH CORPORATE AND NON-CORPORATE)

Tax Credit - Start-up Costs for Employer Provided Child Care Center

Tax Credit - Employer Provided Child Care Plan

Tax Credit - Donation of Unspoiled Agricultural Products

Deduction - Self-Employed Health Insurance Premiums

Exhibit A also shows the provisions which will expire in 1992 without legislative action. These include the California counterparts to the twelve federal provisions which have been extended by federal through June 30, 1992 as well as the tax credit for child and dependent care which is permanent in federal law but expires on December 31, 1992 for state purposes.

Exhibit B includes a discussion of the President's capital gain tax proposal contained in his 1992 budget. That proposal is the same as previously proposed in S. 2071 (Packwood, Dole, and Roth), and H.R. 3772 (Archer) during 1990. Exhibit B is included in this report due to the continued support of the President for the proposal and the continuing economic debate taking place in Congress.

FEDERAL INCOME TAX CHANGES - 1991

PUBLIC LAW: TAX EXTENSION ACT OF 1991 (PL 102-227)

ACT SECTION: 101

SECTION TITLE: ALLOCATION OF RESEARCH AND EXPERIMENTAL EXPENDITURES

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

Since 1981, Congress has provided a series of statutory rules for the allocation of R & D expenses to U.S. source income. Under the Omnibus Budget Reconciliation Act of 1990 (OBRA 90) these rules were codified as Section 864(f) of the Internal Revenue Code and provided that for the first two taxable years beginning after August 1, 1989, and on or before August 1, 1991:

- 64 percent of U.S. incurred R & D expenses are allocated to U.S. source income;
- 64 percent of foreign-incurred R & D expenses are allocated to foreign source income; and
- the remainder of R & D expenses are allocated and apportioned either on the basis of sales or gross income, but subject to the condition that if income-based apportionment is used, the amount apportioned to foreign source income can be no less than 30 percent of the amount that would have been apportioned to foreign source income had the sales method been used.

Current California Law (Sec. None)

California has not directly conformed to the provisions relating to sourcing of R & D expenses between foreign and U.S. source income. Under California law the three factor formula apportionment method is used to determine the business income subject to California tax when a corporation (or group of corporations) does business both inside and outside of California. This has the effect of apportioning R & D expenses to California using the average of the sales, property and payroll factors. However, certain foreign corporations doing business in California, which have a water's-edge election in force, are subject to the federal rules used to determine U.S. source income, including Section 864(f) of the Internal Revenue Code.

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

The statutory allocation rule is extended to apply to R & D expenses paid or incurred during the taxpayer's third taxable year beginning after August 1, 1989, and on or before August 1, 1992. In the case of the taxpayer's first taxable year beginning after August 1, 1991, however, the statutory allocation rule would apply only to research expenses paid or incurred during the first six months of that year.

FEDERAL INCOME TAX CHANGES - 1991

Effective Date of New Federal Law

Applies to taxable years beginning after August 1, 1991.

Impact on California Revenue

Based on federal estimates and recognizing that this change would only affect corporations with a water's-edge election in force, it is estimated that the extension of the allocation rules would produce revenue losses in the $1-2 million range.

PUBLIC LAW: TAX EXTENSION ACT OF 1991 (PL 102-227)

ACT SECTION: 102

SECTION TITLE: RESEARCH CREDIT

Prior Federal Law (IRC Sec. 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.

A 20 percent tax credit also applies to the excess of (1) 100 percent of corporate cash expenditures (including grants or contributions) paid for university basic research over (2) the sum of (a) the greater of two fixed research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation.

Those credits did not apply to expenditures paid or incurred after December 31, 1991.

Current California Law (Sec. 17052.12 & 23609)

In SB 169 (Stats. 1991), California extended the availability of the state Research Credit to taxpayers for taxable years beginning prior to January 1, 1998.

New Federal Law (IRC Sec. 41)

The tax credit for qualified research expenditures (including university basic research payments) is extended for six months. It, thus, applies to qualified expenses paid or incurred through June 30, 1992.

Effective Date of New Federal Law

Applies to taxable years ending after December 31, 1991.

Impact on California Revenue

None. California extended its credit through 1997 in SB 169 (Stats. 1991).

PUBLIC LAW: TAX EXTENSION ACT OF 1991 (PL 102-227)

ACT SECTION: 103

SECTION TITLE: EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE

Prior Federal Law (IRC Sec. 127)

An employee's gross income and wages for income and employment tax purposes do not include amounts paid or incurred by the employer for educational assistance provided to the employee if such amounts are paid or incurred pursuant to an educational assistance program that meets certain requirements. This exclusion, which expires for taxable years beginning after December 31, 1991, is limited to $5,250 of educational assistance with respect to an individual during a calendar year.

Current California Law (Sec. 17151)

California is fully conformed to federal law with regard to the exclusion from income for employer-provided educational assistance. State law has no sunset date but instead provides that the exclusion is applicable for any period in which a similar exclusion is allowed under federal law.

New Federal Law (IRC Sec. 127)

The exclusion from income for employer-provided educational assistance is extended through June 30, 1992.

Effective Date of New Federal Law

The exclusion is available with respect to amounts paid on or before June 30, 1992.

Impact on California Revenue

The current law state revenue loss attributed to the six-month extension is $10 million.

FEDERAL INCOME TAX CHANGES - 1991

<u>PUBLIC LAW:</u> TAX EXTENSION ACT OF 1991 (PL 102-227)

<u>ACT SECTION:</u> 104

<u>SECTION TITLE:</u> EMPLOYER-PROVIDED GROUP LEGAL SERVICES PLANS

<u>Prior Federal Law (IRC Sec. 120)</u>

Certain 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 is limited to an annual premium value of $70.

The exclusion for group legal services benefits expires for taxable years beginning after December 31, 1991.

<u>Current California Law (Sec. 17157)</u>

California is fully conformed to federal law with regard to the exclusion from income for employer-provided group legal services plans. State law has no sunset date but instead provides that the exclusion is applicable for any period in which a similar exclusion is allowed under federal law.

<u>New Federal Law (IRC Sec. 120)</u>

The exclusion from income for employer-provided group legal services is extended through June 30, 1992.

<u>Effective Date of New Federal Law</u>

The exclusion would be available with respect to amounts paid by an employer before July 1, 1992, for coverage under a qualified group legal services plan for periods before July 1, 1992.

<u>Impact on California Revenue</u>

The current law state revenue loss attributed to the six-month extension is $3 million.

FEDERAL INCOME TAX CHANGES - 1991

PUBLIC LAW: TAX EXTENSION ACT OF 1991 (PL 102-227)

ACT SECTION: 105

SECTION TITLE: TARGETED JOBS CREDIT

Prior Federal Law (IRC Sec. 51)

The targeted jobs tax credit is available on an elective basis for hiring individuals from nine targeted groups. The targeted groups consist of individuals who are either recipients of payments under means-tested transfer programs, economically disadvantaged, or disabled.

The credit generally is equal to 40 percent of up to $6,000 of qualified first-year wages paid to a member of a targeted group. Thus, the maximum credit generally is $2,400 per individual. With respect to economically disadvantaged summer youth employees, however, the credit is equal to 40 percent of up to $3,000 of wages, for a maximum credit of $1,200.

The credit expires for individuals who begin work for an employer after December 31, 1991.

Current California Law (Sec. 17053.7 & 23621)

The state credit is significantly different than the federal credit. California allows a credit equal to 10 percent of wages paid by an employer to each employee certified as eligible by the Employment Development Department. Eligible wages are limited to $3,000 paid by the employer per year for the first 24 months but the maximum credit is $600 for each qualified employee.

The state credit expires for individuals who begin work for an employer after December 31, 1993.

New Federal Law (IRC Sec. 51)

The targeted jobs tax credit is extended for six months, so that it would be available with respect to wages paid for employees who begin work for an employer before July 1, 1992.

Effective Date of New Federal Law

Applies to individuals who begin work for the employer after December 31, 1991.

Impact on California Revenue

None. The state credit does not expire until the end of 1993 under current law.

PUBLIC LAW: TAX EXTENSION ACT OF 1991 (PL 102-227)

ACT SECTION: 106

SECTION TITLE: ENERGY INVESTMENT CREDIT FOR SOLAR AND GEOTHERMAL PROPERTY

Prior Federal Law (IRC Sec. 48)

Nonrefundable business energy tax credits are allowed for 10 percent of the cost of certain qualified solar and geothermal energy property. Solar energy property that qualifies for the credit includes any equipment which uses solar energy to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat. Qualifying geothermal property includes equipment which produces, distributes, or uses energy derived from a geothermal deposit, but, in the case of electricity generated by geothermal power, only up to (but not including) the electrical transmission stage.

The business energy tax credits are currently scheduled to expire with respect to property placed in service after December 31, 1991.

Current California Law (Sec. 17052.5 & 23601.5)

Under state law a commercial solar energy credit is available under both the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL) for taxable and income years beginning on or after January 1, 1990, and ending before January 1, 1994. The credit is available in the amount of 10 percent of the cost of a solar energy system that is installed on premises used for commercial purposes, which is located in California and which is owned by the taxpayer during the taxable/income year.

For solar energy systems with a generating capacity in excess of 30 megawatts, there is an additional restriction. These systems may only qualify for the state credit in years for which the Internal Revenue Code (IRC) allows at least a 10 percent federal tax credit which is equivalent in scope to the federal credit available under the IRC for the 1989 year.

New Federal Law (IRC Sec. 48)

The business energy tax credits are extended for property placed in service through June 30, 1992.

Effective Date of New Federal Law

Applies to property placed in service after December 31, 1991 and before July 1, 1992.

Impact on California Revenue

Although the California credit generally does not expire until the end of 1993, for solar energy systems with a generating capacity in excess of 30 megawatts, there is an additional restriction. These systems may only qualify for the state credit in years for which the Internal Revenue Code (IRC) allows at least a 10 percent federal tax credit which is equivalent in scope to the federal credit available under the IRC for the 1989 year. The six month federal extension, therefore, will allow those large systems to continue to qualify for the 10 percent state credit. The revenue loss from commercial solar systems is $25 million annually.

<u>PUBLIC LAW:</u> TAX EXTENSION ACT OF 1991 (PL 102-227)

<u>ACT SECTION:</u> 107

<u>SECTION TITLE:</u> LOW-INCOME HOUSING CREDIT

<u>Prior Federal Law (IRC Sec. 42)</u>

A tax credit is allowed in annual installments over ten years for qualifying newly constructed or substantially rehabilitated low-income rental housing. For most qualifying housing, the credit has a present value of 70 percent of the cost of low-income housing units. For housing receiving other Federal subsidies such as tax exempt bond financing and for the acquisition cost of existing housing (i.e. costs other than the required rehabilitation expenditures), the credit has a present value of 30 percent.

To qualify for the credit, a building owner generally must receive a low-income housing credit allocation from the appropriate State credit authority. The annual credit ceiling for each State is $1.25 per resident per year.

The low-income housing credit is scheduled to expire after December 31, 1991.

<u>Current California Law (Sec. 17058 & 23610.5)</u>

California generally conforms to federal law except that the state credit amount is 30 percent of the costs, is claimed over a four year period, and is limited to projects located in California.

To qualify for the credit, a taxpayer must receive an allocation of the credit from the Tax Credit Allocation Committee. The basic credit allocations allowed to be made by the Committee each year cannot exceed $35 million.

The California credit expiration date is tied to the expiration of the federal credit.

<u>New Federal Law (IRC Sec. 42)</u>

The low-income housing credit is extended through June 30, 1992. The credit ceiling for each State would be $1.25 per resident of the State for the period during 1992 for which the credit is extended.

<u>Effective Date of New Federal Law</u>

Applies to calendar years after 1991.

Impact on California Revenue

The current law credit allocation cannot exceed $35 million on an annual basis. Presumably, this six-month extension would authorize an additional allocation of $17.5 million in credits at the state level.

PUBLIC LAW: TAX EXTENSION ACT OF 1991 (PL 102-227)

ACT SECTION: 108

SECTION TITLE: QUALIFIED MORTGAGE BONDS AND MORTGAGE CREDIT CERTIFICATES

Prior Federal Law (IRC Sec. 25 & 143)

Qualified mortgage bonds (QMBs) are bonds the proceeds of which are used (net of costs of issuance and a reasonably required reserve fund) to finance the purchase, or qualifying rehabilitation or improvement, of single-family, owner-occupied residences located within the jurisdiction of the issuer of the bonds. The QMBs must meet purchase price, income eligibility limitations, and other restrictions.

Qualified governmental units may elect to exchange QMB authority for authority to issue mortgage credit certificates (MCCs) which entitle home buyers to nonrefundable income tax credits for a specified percentage of interest paid on mortgage loans on their principal residence. Once issued, an MCC remains in effect as long as the residence being financed continues to be the holder's principal residence.

Authority to issue QMBs and to elect to trade in QMB volume authority to issue MCCs expires after December 31, 1991.

Current California Law (None)

California has not conformed to providing a state tax credit for mortgage interest.

New Federal Law (IRC Sec. 25 & 143)

The authority of State and local governments to issue QMBs and to elect to trade in bond volume authority to issue MCCs is extended through June 30, 1992.

Effective Date of New Federal Law

Applies to bonds issued after December 31, 1991 and, with respect to mortgage credit certificates, to elections for periods after December 31, 1991.

Impact on California Revenue

Not applicable.

PUBLIC LAW: TAX EXTENSION ACT OF 1991 (PL 102-227)

ACT SECTION: 110

SECTION TITLE: HEALTH INSURANCE COSTS OF SELF-EMPLOYED INDIVIDUALS

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

An employer's contribution to a plan providing accident or health coverage is excluded from an employee's income. No equivalent exclusion is provided for self-employed individuals whether they are sole proprietors or partners in a partnership.

However, 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. This deduction is allowable in calculating adjusted gross income. 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 in any subsidized health plan maintained by any employer of the self-employed individual (or spouse).

The 25 percent deduction expires for taxable years beginning after December 31, 1991.

Current California Law (Sec. 17201 & 24343)

California is fully conformed to federal law.

The 25 percent deduction expires for taxable years beginning after December 31, 1991.

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

The 25 percent deduction for health insurance costs of self-employed individuals is extended through June 30, 1992. The deduction is available with respect to amounts paid before July 1, 1992, for insurance coverage for periods before July 1, 1992.

Effective Date of New Federal Law

Applies to taxable years beginning after December 31, 1991.

Impact on California Revenue

The current law state revenue loss attributed to the six-month extension is in the $8 million range.

FEDERAL INCOME TAX CHANGES - 1991

PUBLIC LAW: TAX EXTENSION ACT OF 1991 (PL 102-227)

ACT SECTION: 111

SECTION TITLE: EXPENSES FOR DRUGS FOR RARE CONDITIONS

Prior Federal Law (IRC Sec. 28)

A 50 percent nonrefundable tax credit is allowed for a taxpayer's qualified clinical testing expenses paid or incurred in the testing of certain drugs, generally referred to as orphan drugs, for rare diseases or conditions.

The federal credit does not apply to expenses incurred in years beginning after December 31, 1991.

Current California Law (Sec. 17057 & 23609.5)

California conforms to federal law except that, to qualify, the testing must take place in California and the amount of the credit equals 15 percent of the qualifying expenses.

The state credit does not apply to expenses incurred in years beginning after December 31, 1992.

New Federal Law (IRC Sec. 28)

Extends the orphan drug tax credit for six months (i.e., for qualified clinical testing expenses incurred through June 30, 1992).

Effective Date of New Federal Law

Applies to taxable years ending after December 31, 1991.

Impact on California Revenue

None. The state credit does not expire until the end of 1992. The revenue loss from this credit is minor, less than $250,000 annually.

PUBLIC LAW: TAX EXTENSION ACT OF 1991 (PL 102-227)

ACT SECTION: 112

SECTION TITLE: CHARITABLE CONTRIBUTIONS OF APPRECIATED PROPERTY

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

In computing taxable income, a taxpayer generally is allowed to deduct the fair market value of property contributed to a charitable organization. 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 the property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose.

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. However, in the case of any taxable year beginning in 1991, this rule does not apply to contributions of tangible personal property.

Current California Law (Sec. 17062 & 23457)

California did not conform to this federal provision.

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

The rule that charitable contributions of tangible personal property are not treated as a minimum tax preference item is extended for six months (i.e., for contributions made through June 30, 1992).

Effective Date of New Federal Law

Applies to taxable years beginning after December 31, 1991.

Impact on California Revenue

Not applicable, since California law contains a specific exception to the temporary suspension of this rule by Congress for the 1991 taxable year.

PUBLIC LAW: TAX EXTENSION ACT OF 1991 (PL 102-227)

ACT SECTION: 201

SECTION TITLE: TEMPORARY INCREASE IN AMOUNT OF CORPORATE ESTIMATED TAX PAYMENTS

Prior Federal Law (IRC Sec. 6655(d))

A corporation is subject to an addition to tax for any underpayment of estimated tax. A corporation does not have an underpayment of estimated tax if it makes four equal timely estimated tax payments that total at least 90 percent of the tax liability shown on the return for the current taxable year. In addition, a corporation may annualize its taxable income and make estimated tax payments based on 90 percent of the tax liability attributable to the annualized income.

A corporation that is not a "large corporation" generally may avoid the addition to tax if it makes four timely estimated tax payments each equal to at least 25 percent of its tax liability for the preceding taxable year (the "100 percent of last year's liability safe harbor"). A large corporation may use this rule with respect to its estimated tax payment for the first quarter of its current taxable year. A large corporation is one that had taxable income of $1 million or more for any of the three preceding taxable years.

Current California Law (Sec. 25951)

Although California is not conformed by reference to federal law, the rules for avoiding the addition to tax for underpayment of estimated tax are almost word for word with federal IRC Section 6655(d) and thus the "100 percent of last year's liability safe harbor" is available for corporations that are not "large corporations". A corporation that does not qualify for the "safe harbor" is subject to an addition to tax for any underpayment of estimated tax unless it makes four equal timely estimated tax payments that total at least 90 percent of the tax liability shown on the return for the current taxable year. However, a corporation may annualize its taxable income and make estimated tax payments based on 90 percent of the tax liability attributable to the annualized income. There are special California rules for situations where a unitary group of corporations includes income and apportionment factors of none or more banks or corporations that derive all of their income form sources outside the U.S. which are not subject to federal income tax.

New Federal Law (IRC Sec. 6655(d))

For 1992, a corporation that does not use the 100 percent of last year's liability safe harbor for its estimated tax payments would be required to base its estimated tax payments on 93 percent (rather than 90 percent) of its current year tax liability, whether the liability is determined on an actual or annualized basis. The applicable percentage would be 94 (rather than 93) percent in 1993, 94 percent in 1994, 95 percent in 1995, and 95 percent in 1996.

The provision does not change the availability of the 100 percent of last year's liability safe harbor for small corporations. In addition, as under current law, the first quarter's estimated tax payment for a large corporation may be based on 100 percent of the prior year's tax liability.

Effective Date of New Federal Law

Applies to estimated tax payments with respect to taxable years beginning after December 31, 1991, and before January 1, 1997.

Impact on California Revenue

Analysis pending.

PUBLIC LAW: EMERGENCY UNEMPLOYMENT COMPENSATION ACT OF 1991 (PL 102-164)

ACT SECTION: 403

SECTION TITLE: MODIFICATION TO INDIVIDUAL ESTIMATED TAX REQUIREMENTS

Prior Federal Law (IRC Sec. 6654(d))

A taxpayer may avoid an addition to tax for underpayment of estimated tax by making four timely estimated tax payments each equal to at least 25 percent of the lesser of 90 percent of the tax shown on the return for the current year or 100 percent of the tax liability for the preceding taxable year (the "100 percent of last year's liability safe harbor"). This "safe harbor" is allowed without regard to the amount of income taxable in the current year.

Current California Law (Sec. 18682)

California is conformed to federal law regarding the use of the lesser of 100 percent of last year's tax liability or a percentage of the tax shown on the return for the current year to determine the required estimate payments. The percentage, however, is 80 percent for California purposes rather than the 90 percent required under federal law. In addition California provides that a taxpayer may avoid the addition to tax for underpayment of estimated tax even when they would fail the "100 percent of last year's tax safe harbor" test if 80 percent or more of their income (either in the current year or the prior year) consists of wages subject to withholding.

New Federal Law (IRC Sec. 6654(d))

Does not allow the "100 percent of last year's tax safe harbor" for calculating estimated tax payments by non-corporate taxpayer's with an Adjusted Gross Income (AGI) which exceeds $75,000 ($37,500 in the case of a married individual filing a separate return) in the current year if the taxpayer was required to make estimated payments in any of the three preceding tax years. Thus, the estimate payments made must be based upon at least 90 percent of the current year's tax liability in order to avoid the addition to tax for underpayment of estimated tax.

This revised method only applies to this group of non-corporate taxpayer's if their modified AGI for the current year exceeds the amount of their AGI shown on the return for the preceding taxable year by more than $40,000 ($20,000 in the case of a separate return for the current year by a married individual).

To calculate the "modified AGI" for the current year, current year income is used, except for income from pass-thru entities in which the taxpayer is not a general partner or owns less than a 10 percent interest (in which case the amounts shown as pass-thru from last year's return are used), and gain from involuntary conversions of property or sales of a principal residence are disregarded.

All taxpayer's could continue to use the "100 percent safe harbor" for the first quarter of the year or for any quarter where the taxpayer's annualized AGI is estimated to be within the threshold amounts but the subsequent installment must be increased to make up the difference.

This provision would also apply to estates and trusts.

Effective Date of New Federal Law

Applies to estimated tax payments made with respect to taxable years beginning after December 31, 1991 and does not apply to estimated tax payments made with respect to taxable years beginning after December 31, 1996.

Impact on California Revenue

Analysis pending.

PUBLIC LAW: TAXATION: TIME EXTENSION FOR INDIVIDUALS IN DESERT SHIELD OPERATIONS (PL 102-2)

ACT SECTION: 1

SECTION TITLE: EXTENSION OF TIME FOR PERFORMING CERTAIN ACTS

Prior Federal Law (IRC Sec. 7508)

Military persons serving in a combat zone (the Persian Gulf was declared a combat zone as of January 17, 1990; Operation Desert Storm) are allowed a special extension of time to take certain income tax related actions that are required or permitted to be taken (e.g., file returns, claim refunds, file protests/appeals). Under this special extension, the period that the taxpayer is serving in the zone or hospitalized as a result of combat injuries, plus 180 days, is disregarded. During the special extension of time, interest and penalties are excused. These provisions did not cover Desert Shield or those hospitalized stateside as a result of military operations.

Current California Law (Sec. 18470.1)

California conformed to federal law, as amended by PL 102-2, in SB 830 (Ch. 91-479, Stats. 1991).

New Federal Law (IRC Sec. 7508)

To summarize the federal provisions, as amended by Public Law 102-2, those serving in the Persian Gulf on or after August 2, 1990 (Operation Desert Shield/Desert Storm), or hospitalized overseas and/or stateside as a result of serving in Desert Shield/Desert Storm are:

(1) eligible for the special extensions; and

(2) eligible to receive interest on overpayments from the original due date of the return if the return was due on or after August 2, 1990, and filed within the special extension of time.

In most cases, these federal provisions as they affect those serving in Operation Desert Shield and Desert Storm, will affect the filing of the 1990 returns; however, the provisions also affect other years (e.g., protests/appeals where the last date for filing the protest/appeal was on or after August 2, 1990; 1989 tax returns that were due on October 15, 1990 (under a six-month extension of time to file)).

Effective Date of New Federal Law

The amendments take effect on August 2, 1990.

Impact on California Revenue

California conformed to these federal provisions in SB 830 (Stats. 1991, Ch. 479) last year and, thus, there is no impact in the current year.

EXHIBIT A

EXPIRING TAX PROVISIONS

Section	Expiration	Section	Expiration	Section	Expiration		Description and Comments
22	Permanent	17052.9	12/31/91	N/A	N/A	a	Tax Credit - Elderly and Disabled.
28	6/30/92	17057	12/31/92	23609.5	12/31/92		Tax Credit - Orphan Drugs.
41	6/30/92	17052.12	12/31/97	23609	12/31/97		Tax Credit - Research.
42	6/30/92	17058	(Federal)	23610.5	(Federal)		Tax Credit - Low-Income Housing.
57	6/30/92	17062	N/A	23457	N/A		Alternative Minimum Tax - One Year Window for Certain Contributions of Appreciated Tangible Property
120	6/30/92	17157	(Federal)	N/A	N/A		Exclusion - Employer Provided Group Legal Services
127	6/30/92	17151	(Federal)	N/A	N/A		Exclusion - Employer Provided Education
162	6/30/92	17201	12/31/91	N/A	N/A	a	Deduction - Self-Employed Health Insurance Premiums
N/A	N/A	17052.9	12/31/91	N/A	N/A	c	Tax Credit - Public Employees who Retired Before 1984
N/A	N/A	17053.12	12/31/91	23608	12/31/91	c	Tax Credit - Donation of Unspoiled Agricultural Products
N/A	N/A	17053.13	12/31/91	N/A	N/A	b	Tax Credit - Persons Receiving Income From Military Service
N/A	N/A	17053.14	12/31/91	N/A	N/A	b	Tax Credit - Political Contributions
N/A	N/A	17054.6	12/31/91	N/A	N/A	c	Tax Credit - Nondependent Who Qualifies Taxpayer as Head of Household
N/A	N/A	17061.5	12/31/91	N/A	N/A	c	Tax Credit - Sale of Farm or Residential Rental Property
N/A	N/A	17069	12/31/91	N/A	N/A	b	Tax Credit - Low-Income Taxpayers
21	Permanent	17052.6	12/31/92	N/A	N/A	d	Tax Credit - Child and Dependent Care
51	6/30/92	17053.7	12/31/93	23621	12/31/93		Tax Credit - Targeted Jobs.

a New difference between state and federal law, effective 1/1/92.

b Repealed 1/1/92. Extension will require reenactment as a new credit.

Will be automatically repealed 12/1/92. Extension may be accomplished by amendment.

d Will be automatically repealed 12/1/93. Extension may be accomplished by amendment.

EXHIBIT A

EXPIRING TAX PROVISIONS

IRC Section	Federal Expiration	PITL Section	PITL Expiration	BCTL Section	BCTL Expiration	Description and Comments
N/A	N/A	17052.14	12/31/93	23612.5	12/31/93	Tax Credit - Recycling Equipment
N/A	N/A	17052.20	12/31/93	N/A	N/A	Tax Credit - Parent who Stays at Home to Care
N/A	N/A	17052.5	12/31/93	23601.5	12/31/93	Tax Credit - Solar Energy Systems
N/A	N/A	18042	12/31/93	24954	12/31/93	Sales of Stock to ESOP
N/A	N/A	18802.6	12/31/93	N/A	N/A	Cash Received - Action by Attorney General
170	12/31/94	17201	12/31/94	N/A	N/A	Deduction - Contributions of stock for which market quotations are readily available.
N/A	N/A	N/A	N/A	24357.8	12/31/94	Contributions - Technological Equipment to Schools
N/A	N/A	17052.11	12/31/94	23603	12/31/94	Tax Credit - Conversion of Vehicle to Use Alcohol Fuel
N/A	N/A	17052.17	12/31/94	23617	12/31/94	Tax Credit - Start-up Costs for Employer Provided Child Care Center
N/A	N/A	17052.18	12/31/94	23617.5	12/31/94	Tax Credit - Employer Provided Child Care Plan
68	12/31/95	17077	Permanent	N/A	N/A	Itemized Deductions (Phase-out)
151	12/31/95	17054	Permanent	N/A	N/A	Personal Exemptions (Phase-out)
N/A	N/A	17053	12/31/95	23605	12/31/95	Tax Credit - Employer Sponsored Ridesharing
N/A	N/A	17053.1	12/31/95	N/A	N/A	Tax Credit - Nonemployer Sponsored Vanpool
N/A	N/A	17053.5	12/31/95	N/A	N/A	Tax Credit - Renter's (Phase-out)
N/A	N/A	18504	12/31/95	N/A	N/A	Voluntary Contribution - Children's Trust Fund
N/A	N/A	18513	12/31/95	N/A	N/A	Voluntary Contribution - Senior Citizens
N/A	N/A	18516.3	12/31/95	N/A	N/A	Voluntary Contribution - Veterans
N/A	N/A	18525	12/31/95	N/A	N/A	Voluntary Contribution - Fish, Wildlife, & Plants
N/A	N/A	18545	12/31/95	N/A	N/A	Voluntary Contribution - Alzheimer's Disease
N/A	N/A	18765	12/31/95	N/A	N/A	Voluntary Contribution - Election Campaign Fund

EXHIBIT B

PRESIDENT'S CAPITAL GAIN PROPOSAL

PART I. A. Department of Treasury Table of Revenue Effects of the President's Capital Gain Proposal as of January, 1991

Fiscal Year ($ Billions)

	Item	1991	1992	1993	1994	1995	1996	1991-96
I.	Static effect of 30% exclusion	-1.7	-11.3	-13.0	-14.6	-16.2	-18.0	-74.7
II.	Effect of taxpayer behavior 1/	2.3	14.9	15.1	14.7	15.1	16.3	78.3
III.	Effect of the 3-year holding period	0.0	-0.1	-0.8	-0.8	0.3	0.3	-1.1
IV.	Effect of full depreciation recapture	0.0	-0.2	0.4	1.0	1.5	1.7	4.2
V.	Effect of treating excluded gains as a preference item for AMT purposes	-0.1	-0.5	0.1	0.8	1.2	1.4	2.7
VI.	Effective date of proposal 2/	0.0	0.3	0.0	0.0	0.0	0.0	0.3
VII.	Total revenue effect of proposal	0.4	3.0	1.7	0.9	1.8	1.7	9.5

Department of the Treasury
Office of Tax Analysis

January, 1991

Note: Details may not add to total due to rounding.

1/ This line reflects on estimate of the net effect of an increase in budget receipts attributable to taxpayer decisions to realize more capital gains, and a decrease in receipts resulting from conversion of ordinary income into capital gains and deferral of short-term gains as a result of lower tax rates.

2/ Lines I-V reflect January 1, 1991 effective date. Line VI represents an adjustment to these lines to reflect as assumed effective date of February 15, 1991.

B. Description of the President's Capital Gain Proposal

In January, 1991, the President submitted his 1992 Budget Proposal to Congress. Contained within this budget under the title "Receipt Proposals" was an item to "Enhance long-term investment". That item proposes to enhance long-term investment through expansion of a capital gains differential. Specifically, when fully phased in in 1993, gains from all capital assets held by individuals (other than collectibles) would qualify for an exclusion of 30 percent if held for more than 3 years, 20 percent if held for more than 2 years, and 10 percent if held for more than 1 year. This tax cut would be phased in over three years.

- <u>First Year</u> - 30 percent exclusion of taxable income from the sale of any capital asset that has been held for more than one year.

EXHIBIT B

PRESIDENT'S CAPITAL GAIN PROPOSAL

- Second Year - 30 percent exclusion of the taxable income from the sale of any capital asset held more than two years.

  20 percent exclusion of the taxable income from the sale of any capital asset held more than one year.

- Third year and thereafter - 30 percent exclusion of the taxable income from the sale of any capital asset held more than three years.

  20 percent exclusion of the taxable income from the sale of any capital asset held more than two years.

  10 percent exclusion of the taxable income from the sale of any capital asset held more than one year.

EXHIBIT B

PRESIDENT'S CAPITAL GAIN PROPOSAL

PART II. Treasury Department Tables Showing Distributional and Revenue Effects of The President's Capital Gains Proposal as Released December 17, 1991

President's Capital Gains Proposal (1)
(1991) Income Levels)

Family Economic Income Class (2) (000)	Families with Tax Change		Average Tax Change ($)	Total Tax Change	
	Number (millions)	Percent of All Families (%)		Amount ($M)	Percent Distribution (%)
Loss	(3)	N/A	N/A	145	16.1
0-10	(3)	N/A	N/A	-16	-1.8
10-20	0.4	2.3	-90	-39	-4.3
20-30	0.5	3.6	-233	-125	-14.0
30-50	1.6	8.0	-88	-145	-16.1
50-75	1.8	11.2	-13	-23	-2.5
75-100	1.3	15.8	-322	-429	-47.7
100-200	1.8	28.8	-142	-258	-28.7
200 & over	0.8	51.4	2,281	1,790	198.9
Total	8.4	8.2	108	900	100.0

Department of the Treasury
Office of tax Analysis

24-Oct-91

(1) This table reflects the total estimated change in tax liability due to the President's capital gains proposal, including both the reduction in tax on baseline gains (static effect) and the additional taxes attributable to induced realizations. The estimate of induced realizations is done at long-run (1996) levels.

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and under reported income: IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC: employer-provided fringe benefits: inside build-up on pensions, IRAs, Keoghs, and life insurance: tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

(3) Fewer than 50,000 families.

EXHIBIT B

PRESIDENT'S CAPITAL GAIN PROPOSAL

PART III. Statutory Language of the President's Capital Gains Proposal as Contained in HR 3138, The Economic Growth, Investment, and Job Creation Act, as Adopted by House Republican Conference November 22, 1991

TITLE I - DEDUCTION FOR CAPITAL GAINS

SEC. 101. CAPITAL GAINS DIFFERENTIAL.

(a) IN GENERAL. --Part I of subchapter P of chapter 1 (relating to treatment of capital gains) is amended by inserting after section 1201 the following new section:

"SEC. 1202. DEDUCTION FOR CAPITAL GAINS.

"(a) DEDUCTION ALLOWED. -- If for any taxable year a taxpayer other than a corporation has a net capital gain, there shall be allowed as a deduction from gross income an amount equal to the sum of --

"(1) 30 percent of the lesser of --
"(A) the net capital gain, or
"(B) the qualified 3-year net capital gain, plus
"(2) 20 percent of the excess (if any) of --
"(A) the net capital gain, over
"(B) the qualified 2-year net capital gain, reduced by the amount taken into account under paragraph (1), plus
"(3) 10 percent of the excess (if any) of --
"(A) the net capital gain, over
"(B) the amounts taken into account under paragraphs (1) and (2).

"(b) QUALIFIED NET CAPITAL GAIN. --For purposes of subsection (a) --

"(1) QUALIFIED 3-YEAR NET CAPITAL GAIN. --The term 'qualified 3-year net capital gain' means the amount of net capital gain which would be computed for any taxable year if, in determining net capital assets held by the taxpayer for at least 3 years at the time of the sale or exchange were taken into account.

"(2) QUALIFIED 2-YEAR NET CAPITAL GAIN. --The term 'qualified 2-year net capital gain' means the amount of net capital gain which would be computed for any taxable year if, in determining net capital assets held by the taxpayer for at least 2 years but less than 3 years at the time of the sale or exchange were taken into account.

"(c) ESTATES AND TRUSTS. --In the case of an estate or trust, the deduction under subsection (a) shall be computed by excluding the portion (if any) of the gains for the taxable year from sales or exchanges of capital assets which, under section 652 and 662 (relating to inclusions of amounts in gross income of beneficiaries of trusts), is includible by the income beneficiaries as gain derived from the sale or exchange of capital assets.

"(d) TRANSITIONAL PROVISIONS. --

"(1) SALES AND EXCHANGES DURING 1991. --In the case of sales and exchanges after September 30, 1991, and before January 1, 1992, subsection (a) shall be applied by substituting '30 percent' for each of the percentages contained in paragraphs (2) and (3) thereof.

"(2) SALES AND EXCHANGES DURING 1992. --In the case of sales and exchanges during 1992, subsection (a) shall be applied --

"(A) by substituting '30 percent' for '20 percent' in paragraph (2) thereof, and

"(B) by substituting '20 percent' for '10 percent' in paragraph (3) thereof.

(b) CAPITAL ASSETS NOT TO INCLUDE COLLECTIBLES. --Section 1221 is amended by --

(1) by striking the period at the end of paragraph (5) and inserting " ; and" and

(2) by inserting after paragraph (5) the following new paragraph:

"(6) any collectible (within the meaning of section 408(m)(2))."

(c) MINIMUM TAX. --Section 57(a) is amended by adding at the end thereof the following new paragraph:

"(8) CAPITAL GAINS. --In the case of a taxpayer other than a corporation, the deduction under section 1202 for the taxable year."

(d) CONFORMING AMENDMENTS. --

(1) Section 62(a) is amended by adding after paragraph (13) the following new paragraph:

"(14) LONG-TERM CAPITAL GAINS. --The deduction allowed by section 1202."

(2) Subparagraph (B) of section 170(e)(1) is amended by inserting "100 percent minus the percentage described in each of the paragraphs of section 1201(a), whichever is applicable, of" before "the amount of gain".

(3) Section 172(d)(2) (relating to modifications with respect to net operating loss deduction) is amended to read as follows:

"(2) CAPITAL GAINS AND LOSSES OF TAXPAYERS OTHER THAN CORPORATIONS. --In the case of a taxpayer other than a corporation --

"(A) the amount deductible on account of losses from sales or exchanges of capital assets shall not exceed the amount includible on account of gains from sales or exchanges of capital assets, and

"(B) the deduction for long-term capital gains provided by section 1202 shall not be allowed."

(4) Subparagraph (B) of section 172(d)(4) is amended by inserting ", (2)(B)," after "paragraph (1)".

(5)(A) Section 220 (relating to cross reference) is amended to read as follows:

"SEC. 220. CROSS REFERENCES.

"(1) For deduction for long-term capital gains in the case of a taxpayer other than a corporation, see section 1202.

"(2) For deductions in respect of a decedent, see section 691."

(B) The table of sections for part VII of subchapter 3 of chapter 1 is amended by striking "reference" in the item relating to section 220 and inserting "references".

(6) Paragraph (4) of section 642(c) is amended to read as follows:

"(4) ADJUSTMENTS. --To the extent that the amount otherwise allowable as a deduction under this subsection consists of gain from the sale or exchange of capital assets held for more than 1 year, proper adjustment shall be made for any deduction allowable to the estate or trust under section 1202 (relating to deduction for excess of capital gains over capital losses). In the case of a trust, the deduction allowed by this subsection shall be subject to section 681 (relating to unrelated business income)."

(7) Paragraph (3) of section 643(a) is amended by adding at the end thereof the following new sentence:

"The deduction under section 1202 (relating to deduction for excess of capital gains over capital losses) shall not be taken into account."

(8) Paragraph (4) of section 691(c) is amended by striking "1(h), 1201, and 1211" and inserting "1(h), 1201, 1202, and 1211, and for purposes of section 57(a)(8)".

(9) Clause (iii) of section 852(b)(3)(D) is amended by striking "66 percent" and inserting "the rate differential portion (within the meaning of section 904(b)(3)(E))".

(10) The second sentence of paragraph (2) of section 871(a) is amended by inserting "such gains and losses shall be determined without regard to section 1202 (relating to deduction for excess of capital gains over capital losses) and" after "except that".

(11) Section 1402(i)(1) is amended to read as follows:

"(1) IN GENERAL. --In determining the net earnings from self-employment of any options dealer or commodities dealer --

"(A) notwithstanding subsection (a)(3)(A), there shall not be excluded any gain or loss (in the normal course of the taxpayer's activity of dealing in or trading section 1256 contracts) from section 1256 contracts or property related to such contracts, and

EXHIBIT B

PRESIDENT'S CAPITAL GAIN PROPOSAL

"(B) the deduction provided by section 1202 shall not apply."

(12) Section 1445(e)(1) is amended by striking "34 percent (or, to the extent provided in regulations, 28 percent)" and inserting "34 percent (or, to the extent provided in regulations, the alternative tax rate determined under section 904(b)(3)(E)(iii))".

(e) EFFECTIVE DATE. --The amendments made by this section shall apply to sales and exchanges after September 30, 1991.

EXHIBIT B

PRESIDENT'S CAPITAL GAIN PROPOSAL

PART IV. CALIFORNIA REVENUE IMPACT

If the President's capital gain tax proposal of 1991 (which is virtually identical to the 1990 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 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.

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. However, taxpayers generally alter behavior in response to changes in capital gain tax rates.

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. 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 developed in 1990. Treasury estimated that the President's proposal would result in revenue gains in the

EXHIBIT B

PRESIDENT'S CAPITAL GAIN PROPOSAL

first six years amounting to $12.5 billion. JCT estimated 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, prorated these national estimates to provide an indication of what the California impacts of conforming to the President's proposal might be over an initial six year period. The state impacts include the effect of additional base line revenues from induced realizations attributable to the federal 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. Estimates include change in base line realizations due to federal proposal.