California
Franchise
Tax
Board

SUMMARY OF FEDERAL INCOME TAX CHANGES — 1996

Laws Affected:

Personal Income Tax
Bank and Corporation Tax
Administration of Franchise and Income Tax Laws

SUMMARY OF

FEDERAL INCOME TAX CHANGES

1996

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

This report is submitted in fulfillment of the requirement in Revenue and Taxation Code Section 19522.

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Executive Summary

During 1996, the Internal Revenue Code was changed by:

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This report examines the changes made by these Acts by explaining the new federal law along with its effective date, corresponding California law (if any) including an explanation of any changes made in response to the new federal law along with its effective date and the impact on California revenue were California to conform to the change in federal law. The explanations also contain citations to the section numbers of the Public Law as well as the Internal Revenue Code and California Revenue and Taxation Code sections impacted by the change.

Exhibit A contains a list of expiring provisions in both California and federal law for the years 1996 through 2004. As shown in Exhibit A, the following California provisions expired or became inoperative at the end of 1996 and will not apply to taxable or income years beginning in 1997:

Credit	-	Renters (no credit for 1996 but credit resumes in 1997 without any limitation based upon AGI)
Estimated Tax Penalty	-	Limitation on the use of preceding year's tax safe harbor.

The 1996 tax return is the last tax return upon which the following voluntary contributions will appear.

Voluntary Contribution	-	California Election Campaign Fund
Voluntary Contribution	-	Children's Trust Fund for the Prevention of Child Abuse
Voluntary Contribution	-	Veterans' Memorial Account
Voluntary Contribution	-	Rare and Endangered Species Preservation Program

LIMITATION ON STATE INCOME TAXATION OF CERTAIN PENSION INCOME (PL 104-95)

Act Section: 1

Section Title: LIMITATION ON STATE INCOME TAXATION OF CERTAIN PENSION INCOME

New Federal Law (Chapter 4 of Title 4 Sec. 114)

The Act amends title 4 of the United States Code (entitled "Flag and Seal, Seat of Government, and the States"), to prohibit any State, including any political subdivision of a State, the District of Columbia, and the possessions of the United States, from imposing income tax on any retirement income, received after December 31, 1995, of any individual who is not a resident or domiciliary of the State.

For this purpose, "retirement income" includes any income from a qualified retirement or annuity plan, a simplified employee pension, a tax-sheltered annuity plan, an eligible deferred compensation plan of a tax-exempt or State and local government, an individual retirement arrangement, a governmental plan, a trust created before June 25, 1959, and that is part of a plan funded only by employee contributions, and certain retired or retainer pay of a member or former member of the uniformed services.

The term "retirement income" also includes income from a nonqualified deferred compensation plan, provided such income is:

(1) part of a series of substantially equal periodic payments made over

(a) the life or life expectancy of the recipient (or the joint lives or life expectancies of the recipient and the recipient's beneficiary), or

(b) a period not less than 10 years, or

(2) a payment received after termination of employment under a plan, program, or arrangement (called a "mirror plan") maintained solely for the purpose of providing benefits in excess of limitations on contributions or benefits in the Internal Revenue Code on qualified retirement plans.

The provision has no effect on the application of the provision in the Employee Retirement Income Security Act of 1974 ("ERISA") that generally preempts State laws.

LIMITATION ON STATE INCOME TAXATION OF CERTAIN PENSION INCOME (PL 104-95)

California Law (Sec. 17041 & 17951)

Starting in 1996, AB 850 incorporates the federal preemption regarding the taxation of nonresident pension income (Public Law 104-95) into California law. Part-year residents are taxed on the retirement income received during the part of the taxable year they were California residents. If the pension distribution is made before 1996, this tax-deferred income remains taxable by California at the time of its distribution, regardless of the recipient's state of residency at the time of the distribution. Similarly, when pension or annuity benefits originally earned in California are transferred to a surviving beneficiary, they remain taxable by California if the transfer is made before 1996, regardless of the beneficiary's residence.

Effective Date

Under both federal and state law this provision applies to payments received after December 31, 1995.

Impact on California Revenue

AB 850 has no impact on state revenues. However, based on tax return data and assumptions discussed below, the estimate of the revenue impact of Public Law 104-95 is as follows:

Estimated Revenue Impact of PL 104-95
Effective for Retirement Income Received After 12/31/95
Enacted January 1996
[$ In Millions]

Taxable Years	1996	1997	1998	1999
	$ (25)	$ (26)	$ (28)	$ (29)
Fiscal Years	**95-96**	**96-97**	**97-98**	**98-99**
	$ (10)	$ (26)	$ (27)	$ (28)

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

LIMITATION ON STATE INCOME TAXATION OF CERTAIN PENSION INCOME (PL 104-95)

Tax Revenue Discussion

The estimate of the impact of the federal legislation is based on nonresident tax return data. Distributions from retirement plans which constitute income from California sources are reported on the Schedule CA (Form 540 NR) as either IRA distributions or pensions and annuities. IRA distributions would include distributions from regular and rollover IRAs, and distributions from Simplified Employee Pensions (SEPs). (A rollover IRA is established in those cases where participation in certain types of plans has been terminated and the vested interest rolled over to an IRA.)

The revenue estimate was derived by using the department's personal income tax sample (1993 base). Reported taxable pension and/or IRA distributions were excluded from tax returns of full-year nonresidents and part-year residents leaving California. Tax liabilities were recalculated for those receiving a tax benefit from the exclusion. For subsequent years, revenue losses were grown annually by an assumed 5% growth in retirement income.

TAX BENEFITS FOR SERVICEMEN IN BOSNIA AND HERZEGOVINA (PL 104-117)

Act Section: 1

Section Title: TREATMENT OF CERTAIN INDIVIDUALS PERFORMING SERVICES IN CERTAIN HAZARDOUS DUTY AREAS

New Federal Law (Sec. 112)

Public Law 104-117 provides that (1) certain hazardous duty areas (Bosnia and Herzegovina, Croatia or Macedonia) are to be treated in the same manner as if that area were a combat zone; (2) the combat zone pay exclusion for officers is increased from $500 per month (established in 1966) to equal the maximum enlisted amount, which is currently $4,254.80 per month; and (3) the exclusion of combat pay from wage withholding is limited to the amount excludable from gross income.

California Law (Sec. 17142.5)

AB 1626 conforms California law to the new federal law which provides that certain hazardous duty areas are to be treated in the same manner as if that area were a combat zone and the combat zone pay exclusion for officers is increased to equal the maximum enlisted amount of $4,254.80 per month.

In addition, AB 1626 provides that for purposes of applying wage withholding requirements, the revision to the combat pay exclusion amount to include a hazardous duty area, as defined, applies to remuneration paid after March 20, 1996 (the same date the corresponding federal withholding provision is applicable).

Effective Date

For both federal and state law he changes to withholding apply to remuneration paid after March 20, 1996, while all other provisions take effect on November 21, 1995.

Impact on California Revenue

The following estimate is the total impact from the various provisions of AB 1626:

Estimated Revenue Loss Beginning November 21, 1995 Enacted after June 30, 1996		
1996/97	1997/98	1998/99
Minor *	Minor *	Minor *

* Loss less than $75,000 .

TAX BENEFITS FOR SERVICEMEN IN BOSNIA AND HERZEGOVINA (PL 104-117)

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

Contact was made with the Pentagon and the following information was provided:

Qualifying Bosnia and Herzegovina, Croatia, and Macedonia for combat zone tax relief provisions.

Based on a report of 40,162 participants with various home of record states and duty location states for active duty components, 2,726 participants (6.8%) are California-domiciled of which 1.27% (35) are from California duty stations.

Approximately 12.5% (5) of the 35 California participants are officers, with the remaining 30 being enlisted.

The average pay for officers is approximately $3,000 per month ($36,000 annually). Applying an average tax rate of 4%, the annual revenue loss attributed to the five officers would be $7,200.

For the enlisted personnel, the average pay is approximately $1,500 ($18,000 annually). Applying an average tax rate of 2%, the annual revenue loss attributed to the 30 enlisted participants would be $10,800.

Increasing maximum officers combat pay exclusion from $500 to $4,254.80

Approximately 3,300 officers are in existing combat zones. It is not known how many are California-domiciled. Even if all of them are California-domiciled and using the 1.27% ratio determined for Bosnia, the total number of officers from California duty stations would be only 42. The revenue impact from increasing the pay exclusion from $500 to $4,254.80 would be, at the maximum, $50,400 annually ($3,000 average pay minus $500 current exclusion x 12 months x 4% average tax rate x 42 officers).

In total, the revenue loss from the provisions of this bill is estimated to be minor, less than $75,000 annually.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 101

Section Title: ESTABLISHMENT OF POSITION OF TAXPAYER ADVOCATE WITHIN THE INTERNAL REVENUE SERVICE

New Federal Law (Sec. 7802)

The Act establishes the Office of the Taxpayer Advocate to replace the Ombudsman. The Taxpayer Advocate is required to report directly to the IRS Commissioner. The Advocate is required to report to congressional fiscal committees a detailed analysis of various actions taken by the Advocate, including actions with respect to Taxpayer Assistance Orders.

California Law (R&T Sec. 21004 & 21006)

In accordance with California law the Franchise Tax Board (FTB) has established the position of the Taxpayer's Rights Advocate, who reports to the executive officer. The Taxpayer's Rights Advocate is responsible, among other things, for coordinating resolution of taxpayer complaints and problems, as well as implementing an educational program which includes communication with taxpayers or industry group regarding common errors. The FTB is required to report to the Legislature areas of recurrent taxpayer noncompliance and include in its annual report any recommendations for improving taxpayer compliance.

Effective Date

The federal provision is effective August 1, 1996. The first annual reports of the Taxpayer Advocate are due in June and December, 1996.

Impact on California Revenue

The revenue impact under conformity of Sections 101-1314 is estimated to be minor indirect losses. These provisions do not directly affect the collection of PITL and B&CTL liabilities. To the extent that some penalties and/or interest charges might be reduced or the timing of remittances may be delayed or the FTB could be liable for additional court costs, these provisions could result in revenue losses. The nature and extent of such losses is conjectural, however, such costs would be minor (less than $1 million).

This estimate does not account for any change in employment, personal income, or gross state product that might result from the provisions.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 102

Section Title: EXPANSION OF AUTHORITY TO ISSUE TAXPAYER ASSISTANCE ORDERS

New Federal Law (Sec. 7811)

The Act provides the Taxpayer Advocate with broader authority over actions of the Internal Revenue Service (IRS) through the use of Taxpayer Assistance Orders.

California Law (R&T Sec. 21004)

Under California law, there are no provisions for issuing Taxpayer Assistance Orders. The Taxpayers' Rights Advocate resolves taxpayer complaints and works with FTB program staff without the need to issue formal orders.

Effective Date

The federal provision is effective August 1, 1996.

Impact on California Revenue

Included under Act Section 101.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 201

Section Title: NOTIFICATION OF TERMINATION OF INSTALLMENT AGREEMENTS

New Federal Law (Sec. 6159)

A termination of an installment agreement because of changes in the taxpayer's financial conditions required the that taxpayer be provided a notice of and reason for the action 30 days before the action is taken.

The Act extends this notification requirement to installment agreements altered, modified or terminated for any reason, including the taxpayer's failure to make timely installment payments or pay any other tax liability when due. This notification requirement does not apply if the IRS determines collection is in jeopardy.

California Law (R&T Sec. 19008)

Under state law, if the taxpayer does not comply with the terms of an installment payment agreement (defaults), the agreement is null and void, unless the default was due to a reasonable cause.

Current practice provides that before an installment arrangement can be considered, all delinquent returns must be filed. All installment agreements require that all installment payments be timely made and all subsequent returns be timely filed and fully paid.

In the event the taxpayer defaults on the installment agreement, the taxpayer is sent a notice of default indicating that the agreement is null and void. Generally, the taxpayer has between 10 and 20 days to provide reasonable cause. In the event of changes in the taxpayer's financial condition or other situations, the taxpayer and FTB may mutually agree to terminate the existing agreement by altering or modifying the terms of the agreement accordingly.

Effective Date

This federal provision is operative January 30, 1997.

Impact on California Revenue

Included under Act Section 101.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 202

Section Title: ADMINISTRATIVE REVIEW OF TERMINATIONS

New Federal Law (Sec. 6159)

The Act requires the Secretary of the Treasury to establish procedures for an independent departmental review for terminated agreements in the event the taxpayer requests such a review.

California Law (R&T Sec. 19008)

Under state law or practice, there is no review process relative to the termination even if the taxpayer disagrees with staff's adverse determination.

Effective Date

The establishment of the review procedures is operative on January 1, 1997.

Impact on California Revenue

Included under Act Section 101.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 301 ~~970~~

301
~~Section Title:~~ ABATE INTEREST FOR UNREASONABLE ERRORS AND DELAYS DUE TO MINISTERIAL OR MANAGERIAL ACTS

New Federal Law (Sec. 6404)

Under prior federal law, the IRS could abate interest attributable to errors or delays caused by an officer or employee performing a ministerial act. The errors or delays were not specifically limited to those that are unreasonable.

The Act limits the errors or delays to those that are unreasonable and expands the abatement authority to managerial acts.

"Unreasonable" and "managerial" are undefined. The Committee report states that "[T]his would include extensive delays resulting from managerial acts such as: the loss of records by the IRS, IRS personnel transfers, extended illnesses, extended personnel training, or extended leave. On the other hand, interest would not be abated for delays resulting from general administrative decisions. For example, the taxpayer could not claim that the IRS's decision on how to organize the processing of tax returns or its delay in implementing an improved computer system resulted in unreasonable delay in the Service's action on the taxpayer's tax return, and so the interest on any subsequent deficiency should be waived."

California Law (R&T Sec. 19104)

Under California law, which generally conforms to the federal law before the Act's changes, the FTB may abate interest attributable to errors or delays caused by an officer or employee performing a ministerial act.

The errors or delays are not specifically limited to those that are unreasonable. Under current procedures, requests for the abatement of interest due to ministerial acts are submitted to an internally established interest abatement team that determines whether the abatement of interest is appropriate. Because the current interest abatement provision conforms to a federal provision, the federal regulations and rulings are used to define "ministerial act." Upon FTB's determination with respect to the abatement of interest, a notice of determination is mailed to the taxpayer.

Effective Date

The federal provision applies to interest accruing with respect to deficiencies or payments for taxable years beginning on or after July 30, 1996.

Impact on California Revenue

Included under Act Section 101.

ct Section: 302

Section Title: REVIEW OF IRS FAILURE TO ABATE INTEREST

New Federal Law (Sec. 6404)

The Act gives the Tax Court jurisdiction over adverse determinations by the IRS with respect to abatements of interest due to ministerial or managerial acts. The action may be brought within 180 days after the IRS mails notice of its determination not to abate interest.

California Law (R&T Sec. None)

The State Board Of Equalization (SBE) has jurisdiction over adverse determinations by FTB with respect to tax assessments and the related interest and penalties, but not abatements of interest due to ministerial acts.

Effective Date

This federal provision is operative for requests for abatement after July 30, 1996.

Impact on California Revenue

Included under Act Section 101.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 303

Section Title: EXTENSION OF INTEREST-FREE PERIOD AFTER NOTICE AND DEMAND AND EXTENSION OF TAXPAYERS' TIME TO PAY AFTER NOTICE AND DEMAND

New Federal Law (Sec. 6601 & 6651)

Under the Act, taxpayers are allowed additional days to pay the amount due, depending upon the size of the amount due, without accruing additional interest and to pay the amount required to be shown on a tax return before being subjected to an underpayment penalty. The additional days are as follows:

(1) If less than $100,000 is due, eleven additional calendar days (21 calendar days instead of the 10 calendar days previous allowed) are allowed.

(2) If $100,000 or more is due, the window is 10 business days instead of the 10 calendar days previously allowed.

California Law (R&T Sec. 19049, 19111, 19132, 19280, & 19290)

Under California law, taxpayers are allowed 10 calendar days after notice and demand to pay amounts due without accruing additional interest. For court-ordered debts and Department of Industrial Relation's delinquencies collected by FTB, if the debts accrue interest at the rate provided under specified provisions of the Revenue and Taxation Code, the 10 day rule is applied. In addition, (1) deficiency assessments are due and payable 10 calendar days after notice and demand for payment and (2) underpayment penalties are imposed if the amount required to be shown on the return is not paid within 10 calendar days after notice and demand for payment.

Effective Date

These federal provisions are operative for notices issued after December 31, 1996.

Impact on California Revenue

Included under Act Section 101.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

ct Section: 304

Section Title: ABATEMENT OF PENALTY FOR FAILURE TO MAKE REQUIRED DEPOSITS OF PAYROLL TAXES IN CERTAIN CASES

New Federal Law (Sec. 6656)

The Act provides that the Secretary may waive this penalty with respect to an inadvertent failure to deposit any employment tax if: (a) the depositing entity meets the net worth requirements applicable for awards of attorney's fees; (b) the failure to deposit occurs during the first quarter that the depositing entity was required to deposit any employment tax; and (c) the return for the employment tax was filed on or before the due date.

The Act also provides that the Secretary may abate any penalty for failure to make deposits for the first time a depositing entity makes a deposit if it inadvertently sends the deposit to the Secretary instead of to the required government depository.

California Law

Employment taxes are administered by the Employment Development Department (EDD). Defer to EDD.

Effective Date

The provision is effective on July 30, 1996.

Impact on California Revenue

Defer to EDD.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 401

Section Title: STUDIES OF JOINT RETURN-RELATED ISSUES

New Federal Law

The Act requires the IRS and the Comptroller to each conduct a separate study of the following joint return-related issues: the effects of changing the liability on a joint return from several to being proportionate to the tax attributable to each spouse; collection in accordance with the terms of a divorce decree; whether the innocent spouse provisions provide appropriate intended relief; and effect of certain treatment of community income for purposes of levies.

California Law

Currently, the FTB conducts studies as it finds necessary to administer the Personal Income Tax Law (PITL) and the Bank & Corporation Tax Law (B&CTL). The law does not specifically preclude the FTB from doing any study. The FTB can use any relevant federal data from federal studies for this purpose.

Effective Date

The federal provision requires the reports to be submitted to the tax writing committees of congress within 6 months of July 30, 1996.

Impact on California Revenue

Not applicable.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 402

Section Title: JOINT RETURN FILED AFTER SEPARATE RETURN

New Federal Law (Sec. 6013)

Under the Act, taxpayers who file separate returns for a given year are no longer precluded from filing a joint tax return for that same year even though they cannot pay the tax reflected on the joint return.

California Law (R&T Sec. 18521, 18522 & 18525)

Under state law, in general, the filing status used under federal law must be used under state law. However, taxpayers who for federal purposes file a separate return and for the same year file an amended return changing their filing status to a joint return are precluded from filing a California joint return unless all previous separate personal income tax liabilities for that taxable year are paid.

Effective Date

The federal provision applies to taxable years beginning after July 30, 1996.

Impact on California Revenue

Included under Act Section 101.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 403

Section Title: DISCLOSURE OF COLLECTION INFORMATION

New Federal Law (Sec. 6103)

The Act authorizes the disclosure of collection activity, if a couple files a joint return for which an amount is due and the taxpayers are no longer married or living in the same household. Either taxpayer can request in writing, and the IRS shall disclose to that person, whether the IRS has attempted to collect the delinquency from the other taxpayer, the general nature of the collection activities and the amount collected.

California Law (R&T Sec. 19542)

Under California law, tax return information is confidential and cannot be disclosed to anyone other than the taxpayer or the taxpayer's representative unless disclosure is specifically authorized by law. There is no authority to disclose collection activity.

Effective Date

This federal provision is effective for requests made after July 30, 1996.

Impact on California Revenue

Included under Act Section 101.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Section: 501

Section Title: MODIFICATION TO LIEN AND LEVY PROVISIONS

New Federal Law (Sec. 6323, 6343,)

1. Liens

Under federal law, the IRS can release liens only as provided by law.

The Act provides that under the following circumstances a lien may be released as though it had not been filed:

- the filing of the lien was premature or otherwise not in accordance with the administrative procedures of the IRS,
- the taxpayer has entered into an installment agreement for the tax with respect to which the lien was filed,
- the withdrawal of the lien will facilitate collection of the tax liability; or
- the withdrawal will be in the best interest of the taxpayer and the Government.

  Under these circumstances, a copy of the notice of withdrawal must be sent to the taxpayer and upon request of the taxpayer, the IRS must make a reasonable effort to give notice to third parties.

2. Levies

Under federal law, the IRS is allowed to release levies only in situations specifically provided by law. The IRS can return property only if the property was wrongfully levied upon under circumstances specified by law.

The Act generally treats the additional following circumstances as a wrongful levy:

- the levy was premature or otherwise not in accordance with administrative procedures,
- the taxpayer has entered into an installment agreement to satisfy the tax liability for which the levy was imposed, unless the agreement provides otherwise,
- the return of the property will facilitate the collection of the tax liability, or
- with the consent of the taxpayer or Taxpayer Advocate, the return of such property would be in the best interest of the taxpayer (as determined by the Taxpayer Advocate) and the United States.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

California Law (R&T Sec. 19221, 21016, 21018 & 21019)

1. Liens

Under California law, FTB can record or file a lien on any amount due and payable under the PITL and B&CTL and can release liens as appropriate. In the event a lien is recorded or filed in error, the FTB is required to follow specified procedures for releasing such liens. Pursuant to the Government Code, if a lien is recorded or filed in error, the usual service fee is not charged. Under current practice, if a lien is recorded or filed in violation of FTB's administrative procedures, the lien is treated as though it were filed in error.

Typically, one term of an installment agreement is that FTB will record a lien to secure payment of the balance due. If, however, the installment agreement did not provide for the lien, the FTB is not precluded by law from recording or filing a lien. Any release thereof is not treated as release of a lien filed in error.

Nothing precludes FTB from releasing a lien if it determines that a release of the lien will facilitate the collection of the tax liability or will be in the best interest of the taxpayer and the state. In this event, it may mail a release to the taxpayer and the recording entity or take other actions as appropriate.

2. Levies

Under state law, the FTB can release any levy as appropriate. In certain instances the law requires the release of levies. If a levy is released after the property has been transmitted to the FTB, the FTB returns the property to whom it belongs. If a levy is erroneously issued on a bank account and bank charges result, a taxpayer may file a claim with the FTB for reimbursement of those bank charges.

Under current practice, if a levy is issued in violation of FTB's administrative procedures, the levy is treated as though it were filed in error.

Typically, an installment agreement stays the issuance of levies. If a levy is issued on the taxpayer's bank in disregard of the installment agreement, the taxpayer is eligible for reimbursement of bank charges.

Nothing precludes the FTB from releasing a levy if it determines that a release of the levy will facilitate the collection of the tax liability or will be in the best interest of the taxpayer and the state.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

_ffective Date

These federal provisions take effect on July 30, 1996.

Impact on California Revenue

Included under Act Section 101.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 502

Section Title: MODIFICATIONS TO CERTAIN LEVY EXEMPTION AMOUNTS

New Federal Law (Sec. 6334)

The Act increases the household furnishings or personal effects exemption amount from $1,650 to $2,500 and books or tools of trade from $1,100 to $1,250. The exemption amounts are subject to and inflation adjustment.

California Law (R&T Sec. 21016-21017 & Civil Code Sec. 703.010)

For purposes of seizing and selling property under the PITL and B&CTL, the Code of Civil Procedure is used to determine the amounts exempt from levy. These are the same exemptions used by judgment creditors. For household furnishings or personal effects, any amount that is ordinarily or reasonably necessary to the family is exempt from levy. For books or tools of trade, the exemption is $5,000 per taxpayer in the trade. For tax purposes, California law requires an inflation adjustment.

Effective Date

The federal provisions take effect with respect to levies issued after December 31, 1996.

Impact on California Revenue

Included under Act Section 101.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Section: 503

Section Title: OFFERS IN COMPROMISE

New Federal Law (Sec. 7122)

Under federal law, offers-in-compromise are accepted and approved administratively and a statement as to the compromise is on file. Prior to the Act, the statement was required where the amount that was compromised was less than $500. Under the Act, a statement is required only if the compromise is $50,000 or more.

California Law

The FTB does not have the ability to administratively approve an offer-in-compromise. Such actions are taken through a summary judgment process in superior court.

Effective Date

The federal provision take effect on July 30, 1996.

Impact on California Revenue

...cluded under Act Section 101.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 601

Section Title: CIVIL DAMAGES FOR FRAUDULENT FILING OF INFORMATION RETURNS

New Federal Law (Sec. 7434 new)

The Act specifically authorizes that a civil action can be brought by the taxpayer against another person who willfully files a fraudulent information return.

California Law

Under California law, a civil action may be brought against another person for damages. There is nothing specific with respect to the willful filing of a fraudulent information return.

Effective Date

This provision applies to fraudulent information returns filed after July 30, 1996.

Impact on California Revenue

Included under Act Section 101.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 602

Section Title: REQUIREMENT TO CONDUCT REASONABLE INVESTIGATIONS OF INFORMATION RETURN

Background

Under federal law, third-parties are required to furnish a taxpayer with information returns that report items of income attributable to the particular taxpayer and file a copy of the information return with the IRS. Certain of these returns are detailed and comprehensive information returns (e.g., partnership and limited liability information), while others are not (e.g. interest, dividend and wage information returns).

Prior to the Act, the general rule was that the information return is presumed correct. In the event the taxpayer disputes a reported income item, the taxpayer may file a protest but has the burden of proving that the information reported on the information return is not correct. The taxpayer may appeal adverse IRS actions to the tax court.

New Federal Law (Sec. 6201)

Under the Act, effective July 30, 1996, the burden of proof may shift to the IRS in a court proceeding in the case of deficiencies resulting from certain information returns. If a taxpayer asserts a reasonable dispute with respect to reported income items on an information return filed by a third party and the taxpayer has fully cooperated with the IRS, Government has the burden of producing reasonable and probative information concerning the deficiency (in addition to the information return itself).

The following information returns are some to which the presumption of correctness may not be applied:

- Payments of remuneration for services and direct sales;
- Payments of dividends and corporate earnings and profits;
- Patronage dividends;
- Broker's customers;
- Payments of interest;
- State and local income tax refunds;
- Mortgage interest received in trade or business from individuals;
- Payment of royalties;
- Receipts of employees (wages); or
- Reporting of tips.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

This provision does not affect information returns of the following third-parties:

- Partnerships;
- Limited liability companies;
- S corporations;
- Tax shelter promoters; or
- Charitable trusts.

California Law (R&T Sec. 18631-18648)

California law, in general, conforms to federal provisions regarding the items of income subject to tax. The state generally allows third-parties to fulfill their California information return reporting requirements by filing with the FTB a copy of the federal information return. With respect to wage information, the FTB also receives information relating to wage withholding from the EDD.

Where a third party is not required to file a federal information return or California's laws are such that a federal information return would not provide sufficient information, the FTB may prescribe in certain circumstances a California information return.

Like federal law, certain of these information returns are detailed and comprehensive (e.g., partnership and limited liability information), while others are not. Like federal law, income items reported by third parties, including wage reporting, are presumed to be correct.

Under current practice, if the taxpayer asserts a reasonable dispute as to the amount that the FTB has determined to be correct, staff will make a reasonable attempt to resolve the matter. However, the burden is on taxpayers to substantiate that the income item is not theirs. If the matter cannot be resolved, the taxpayer may file a protest. In the event the protested assessment is affirmed by FTB staff, the taxpayer may appeal the FTB's action to the SBE.

Effective Date

The federal provision is effective July 30, 1996.

Impact on California Revenue

Included under Act Section 101.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 701

Section Title: UNITED STATES MUST ESTABLISH THAT ITS POSITION IN PROCEEDING WAS SUBSTANTIALLY JUSTIFIED

Background

Under federal law taxpayers petition the tax court to protest an adverse IRS action with respect to deficiency assessments. Taxpayers may be entitled to reimbursement of expenses to represent themselves before the court. To be entitled to reimbursement, the taxpayer must exhaust all administrative remedies. Prior to the Act, the taxpayer was required to establish that IRS was not justified in its position in the proceeding.

New Federal Law (Sec. 7430)

Under the Act, the burden of establishing whether the position of the IRS was substantially justified shifts from the taxpayer to the IRS. The position of the IRS is presumed not to be substantially justified if the IRS did not follow its applicable published guidance, as defined.

California Law (R&T Sec. 19717 & 21013)

Under California law, taxpayers appeal adverse FTB actions on protests of deficiency assessments to the SBE. In the event of an adverse determination by the SBE, the taxpayer pays the amount due and may bring an action against FTB in superior court.

In conformity with prior federal law, taxpayers may be reimbursed for expenses (i.e., costs, fees or other expenses) to represent themselves before the SBE or superior court. For both litigation and SBE hearing expenses, the taxpayer must establish that FTB was not substantially justified in its position. To be entitled to litigation expenses, the taxpayer must exhaust all administrative remedies and prevail.

Effective Date

The federal provision is effective for proceedings commenced after July 30, 1996.

Impact on California Revenue

Included under Act Section 101.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 702

Section Title: INCREASED LIMIT ON ATTORNEY FEES

New Federal Law (Sec. 7430)

Under the Act, reasonable attorney fees were increased to $110 per hour (formerly $75 per hour) and are indexed for inflation beginning after 1996.

California Law (R&T Sec. 19717 & 21013)

Under California law reimbursement of reasonable attorney fees in litigation cases is limited to $75 per hour. However, for awards in a SBE hearing, there is no limit on the amount of reasonable expenses that may be awarded.

Effective Date

The federal provision is effective for proceedings commenced after July 30, 1996.

Impact on California Revenue

Included under Act Section 101.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 703

Section Title: FAILURE TO AGREE TO EXTENSION NOT TAKEN INTO ACCOUNT

New Federal Law (Sec. 7430)

Under the Act, in determining whether the taxpayer exhausted all administrative remedies, the taxpayers failure to agree to an extension of the statute of limitations specifically cannot be taken into consideration.

California Law (R&T Sec. 19717 & 21013)

For California purposes, to determine whether the taxpayer exhausted all administrative remedies, it is not generally an issue whether the taxpayer has agreed to extend a statute of limitations.

Effective Date

This provision is effective for proceedings commencing after July 30, 1996.

Impact on California Revenue

Included under Act Section 101.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 704

Section Title: AWARD OF LITIGATION COSTS PERMITTED IN DECLARATORY JUDGEMENT PROCEEDINGS

New Federal Law (Sec. 7430)

Under the Act, taxpayers are no longer precluded from being awarded reimbursement of reasonable litigation expenses in declaratory judgment proceedings.

California Law (R&T Sec. 19717)

California conforms to the prior federal law, and provides that taxpayers are not entitled to reimbursement in declaratory judgment proceedings, except in certain cases involving revocations of a charitable organization's tax exempt status.

Effective Date

This provision is effective for proceedings commencing after July 30, 1996.

Impact on California Revenue

Included under Act Section 101.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Section: 801

Section Title: INCREASE LIMIT ON RECOVERY OF CIVIL DAMAGES FOR UNAUTHORIZED COLLECTION ACTIONS

New Federal Law (Sec. 7433)

Prior to the Act, the dollar amount of damages that could be awarded if an employee or officer of the IRS recklessly or intentionally disregards the law in connection with collection was limited to $100,000.

The Act increases the dollar limit to $1,000,000.

California Law (R&T Sec. 21021)

Under California law, a taxpayer may be awarded damages if an employee or officer recklessly disregards board published procedures. However, there is no dollar limit on the amount of actual or direct monetary damages that may be award.

Effective Date

The federal provision is effective for actions by officers or employees of the IRS after July 30, 1996.

Impact on California Revenue

Included under Act Section 101.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 802

Section Title: COURT DISCRETION TO REDUCE AWARD FOR LITIGATION COSTS FOR FAILURE TO EXHAUST ADMINISTRATIVE REMEDIES

New Federal Law (Sec. 7433)

Under federal law, prior to the Act, a taxpayer had to exhaust all administrative remedies as a preliminary to being awarded damages with respect to IRS employees or officers who recklessly or intentionally disregarded the law in connection with collection.

The Act allows the court the discretion to reduce the amount of damages if the plaintiff has not exhausted all administrative remedies available to the plaintiff.

California Law (R&T Sec. None)

California law does not require that all administrative remedies be exhausted as a preliminary to being awarded damages because an FTB employee or officer recklessly disregarded FTB's published procedures.

Effective Date

The provision is effective for proceedings commenced after July 30, 1996.

Impact on California Revenue

Not applicable.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

ct Section: 901-904

Section Title: MODIFICATIONS TO PENALTY FOR FAILURE TO COLLECT AND PAY OVER TAX

New Federal Law (Sec. 6103 & 6672)

A "responsible person" is subject to a penalty equal to the amount of trust fund taxes that are not collected or paid to the government on a timely basis. An individual the IRS has identified as a "responsible person" is permitted an administrative appeal on the question of responsibility.

This "responsible person" may be an employee or officer of an entity with trust fund liabilities and in the case of tax-exempt organizations may include individuals who serve on the board on a voluntary or honorary basis and have no day-to-day involvement in the operations and financial decisions of the organization.

The Act modifies the penalty to provide: (a) preliminary notice to the individual the IRS determined to be a "responsible person;" (b) disclosure by the IRS, if requested by the "responsible person," of the name of any other person the IRS has determined to be a "responsible person" with respect to the tax liability; (c) a new federal cause of action (entirely separate from the IRS penalty collection) allowing each person who paid the penalty to recover from other persons who are liable for the penalty their share of the penalty; (d) that the "responsible person" penalty is not to be imposed on volunteer, unpaid members of any board of trustees or directors of a tax-exempt organization to the extent such members are solely serving in an honorary capacity, do not participate in the day-to-day or financial activities of the organization and do not have actual knowledge of the failure.

California Law

Employment taxes and wage withholding are administered by the Employment Development Department (EDD). Defer to EDD.

Effective Date

The federal provision is effective on July 30, 1996.

Impact on California Revenue

Defer to EDD.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 1001-1003

Section Title: MODIFICATION OF RULES RELATING TO SUMMONSES

New Federal Law (Sec. 7609)

Under federal law, the IRS may use summonses to obtain taxpayer information from third-parties, including recordkeepers.

1. Enrolled Agents Included as Third-party Recordkeepers

Under the Act, an enrolled agent is included in the definition of a third-party recordkeeper, which previously was limited to an attorney or accountant.

2. Safeguards relating to Designated Summonses

The Act requires high level IRS review before issuance of a summons and limits the use of a designated summons to corporations that are being examined as part of the Coordinated Examination Program (CEP) or its successor.

3. Annual Report to Congress Concerning Designated Summonses

The Act requires the Secretary of the Treasury to report to the tax writing committees of Congress by December 31 of each year after 1995, on the number of designated summonses which were issued during the preceding 12 months.

California Law (R&T Sec. 19504)

Under California law, the FTB does not issue summonses but instead may issue subpoenas to third-parties, including recordkeepers, to obtain taxpayer information. If the FTB serves a subpoena on a third-party recordkeeper, as defined by federal law (as it read January 1, 1993), and resolution is not forthcoming, certain statutes of limitation are suspended for a specified time, with respect to the person whose liability the subpoena is issued.

Effective Date

The federal provisions apply to summonses issued after July 30, 1996.

Impact on California Revenue

Not applicable.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 1101

Section Title: RELIEF FROM RETROACTIVE APPLICATION OF TREASURY DEPARTMENT REGULATIONS

New Federal Law (Sec. 7805)

The Department of the Treasury may issue temporary or proposed regulations, in addition to final regulations. Prior to the Act, the Department of the Treasury may prescribe the extent (if any) to which regulations shall be applied without retroactive effect. Thus, regulations were generally applied retroactively.

Under the Act a regulation can be applied retroactive only in the following instances:

- if it is filed or issued within 18 months of the date of the enactment of the underlying law
- to prevent abuse;
- if it corrects a procedural defect in the issuance of prior regulations;
- if it relates to the internal Treasury's policies, practices, or procedures.
- if the legislative grants the authority for retroactive application; or
- if the taxpayer elects retroactive application.

Otherwise, the regulation is applicable the earlier of:

- the date the regulation is filed with the Federal Register,
- in the case of a final regulation, the date the proposed or temporary regulation was filed with the Federal Register, or
- the date notice substantially describing the expected contents of any temporary, proposed or final regulation is issued to the public.

IRS rulings continue to apply retroactively unless the Department of the Treasury provides otherwise.

California Law (R&T Sec. 19503)

Under California law, the FTB's regulations process is governed by the Administrative Procedures Act (APA). As such, the FTB must provide notice to the public of its intent to issue a particular regulation and provide a public hearing.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Under FTB's practice, preliminary to the public notification under the APA, staff conducts symposia with the affected industries to resolve controversial issues and brings the matter of proposed regulations to the board, itself. Under the APA, FTB regulations are reviewed and approved by the Office of Administrative Law. When the regulation is approved, it is filed with the Secretary of State and is effective 30 days thereafter. Regulations, as well as rulings, are applied retroactively unless FTB prescribes otherwise.

If California conforms to a federal law for which federal regulations are adopted, California automatically conforms to that federal regulation unless it adopts a California regulation.

It is a fundamental principle that a regulation apply retroactively. State law allows the FTB to prescribe the extent that a regulation is applied without retroactive effect.

<u>Effective Date</u>

The federal change applies to regulations relating to federal laws enacted on or after July 30, 1996.

<u>Impact on California Revenue</u>

Included under Act Section 101.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 1201

Section Title: PHONE NUMBER OF PERSON PROVIDING PAYEE STATEMENTS REQUIRED TO BE SHOWN ON SUCH STATEMENTS

New Federal Law (Sec. 6041, 6042, 6044, 6045, 6049, 6050B, 6050H, 6050J, 6050K & 6050N)

Third parties issue information returns to taxpayers and a copy is filed with the government.

Under federal law, the third-party's name and address is required to be included on 11 types of information returns filed with the IRS

Under the Act, these third-parties also must include the telephone number of the information contact on these information returns.

California Law (R&T Sec. 18640 & 18648)

In general, since the filing requirement for the state and federal government is the same, California law generally requires the third-party to send a copy of the federal information return to the taxpayer and a copy to the FTB. For certain income items, however, the FTB requires the third-party to file a FTB form instead of the federal copy.

The FTB prefers that information returns be filed on magnetic media. For third-parties filing large numbers of information returns with FTB, magnetic media is required. The FTB uses information returns for tax enforcement purposes. Only certain FTB information returns are required to include the name and address of the person reporting the information.

Effective Date

This provision applies to statements required to be filed after December 31, 1996.

Impact on California Revenue

Included under Act Section 101.

prosecution pending with respect to a taxpayer. At the time charges are brought by FTB, the charges become public information, subject to disclosure by FTB.

Effective Date

The federal provision apply to actions after July 30, 1996.

Impact on California Revenue

Included under Act Section 101.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

:t Section: 1204

Section Title: ANNUAL REMINDERS TO TAXPAYERS WITH OUTSTANDING DELINQUENT ACCOUNTS

New Federal Law (Sec. 7524 new)

Under the Act, each taxpayer must be sent an annual written notice as to the amount delinquent. The Committee report states that "The IRS pursues larger delinquencies first, and then it pursues small deficiencies. Because of the limited amount of IRS resources to work collection cases, cases with smaller deficiencies may not be addressed for years. In the meantime, the taxpayer may come to believe that the apparent lack of IRS collection activities means that it has abandoned its claim against the taxpayer. The taxpayer may be surprised when the IRS resumes collection action years later, when the 10-year statute of limitations on collections is close to expiring."

California Law (R&T Sec. 19031-19067)

Under current FTB practice, through an automated billing cycle delinquent accounts receive a series of notices that range from notices of taxes due, to tax liens to tax levies. Liens are filed on all PIT delinquencies over $100, and the lien is subject to renewal.

Depending upon the amount of delinquency, the FTB may not continue to automatically pursue collection of delinquent accounts (inactive accounts), if there is no asset information, subsequent tax returns filed, or subsequent delinquencies. However, these accounts remain on the accounts receivable file. Certain of these inactive accounts exist because the FTB notices were returned as undeliverable by the postal service and a correct address has not been located. In addition, for certain accounts, collection may have been determined to be so remote that the account is discharged from accountability pursuant to the Government Code. Under certain criteria, accounts may be referred for manual resolution, in which various actions may be taken. There is no statute of limitation on the collection of a PITL or B&CTL debt.

Effective Date

The federal provision is operative for calendar years after 1996.

Impact on California Revenue

Included under Act Section 101.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 1205

Section Title: 5-YEAR EXTENSION OF AUTHORITY FOR UNDERCOVER OPERATIONS

New Federal Law (Sec. 7608)

Under the Anti-Drug Abuse Act of 1988, IRS undercover operations were exempted from otherwise applicable statutory restrictions controlling the use of Government funds and, thus, the IRS was permitted to "churn" the income earned by these operations. That exemption expired at the end of 1991.

The Act reinstates this exemption from July 30, 1996 until January 1, 2001. The Act also requires an annual report from the IRS containing specified information.

California Law

California has no comparable provision.

Effective Date

The federal provision is effective on July 30, 1996.

Impact on California Revenue

Not applicable.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 1206

Section Title: DISCLOSURE OF FORM 8300 INFORMATION ON CASH TRANSACTIONS

New Federal Law (Sec. 6103)

The Act allows the disclosure of certain cash transaction reports to local and state agencies for law enforcement purposes. Under the Act, the California's Attorney General (AG) will be able to obtain a copy of IRS' form 8300. This provision does not impact the use of the form for tax purposes.

California Law (R&T Sec. 18645)

Under California law, the FTB may disclose to the AG its copy of the Form 8300 for law enforcement purposes.

Effective Date

The federal provision is effective on July 30, 1996.

Impact on California Revenue

Included under Act Section 101.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 1207

Section Title: DISCLOSURE OF RETURNS AND RETURN INFORMATION TO DESIGNEE OF TAXPAYER

New Federal Law (Sec. 6103)

Under the Act, the IRS is no longer required to receive written consent from the taxpayer to disclose taxpayer information to a designated third party.

California Law (R&T Sec. 19543-19555)

Under California law, the FTB may receive written or verbal consent from the taxpayer before disclosing the taxpayers information to a designated third party.

Effective Date

The federal provision is effective on July 30, 1996.

Impact on California Revenue

Included under Act Section 101.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 1208

Section Title: STUDY OF NETTING OF INTEREST ON OVERPAYMENTS AND LIABILITIES

Background

The Tax Reform Act of 1986 first implemented an interest rate differential. The underpayment rate was set 1 percent higher than the overpayment rate. The OBRA of 1990, increased the underpayment rate on certain large corporate underpayments to 3 percent higher than the overpayment rate. The GATT reduced the overpayment rate on certain corporate tax refunds.

New Federal Law

The Act requires the Secretary of the Treasury to conduct a study of the manner in which the IRS has implemented the netting of interest on overpayments and underpayments and the policy and administrative implications of global netting. The Treasury is required to hold a public hearing to receive comments from any interested party prior to submitting the report of its study to the tax writing committees.

California Law (R&T Sec. 19101, 19340 & 19521)

California has not conformed to the federal law interest rate differential. Under state law, the interest rate is the same for underpayments and overpayments.

Effective Date

The federal report is due within six months of July 30, 1996.

Impact on California Revenue

Not applicable.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 1209

Section Title: EXPENSES OF DETECTION OF UNDERPAYMENTS AND FRAUD, ETC.

New Federal Law (Sec. 7623)

The Act clarifies that rewards paid for informant information relative to tax law violations, may be paid out of the money collected as a result of the informant information.

California Law (R&T Sec. 19525)

Under California law an information reward program could be established by regulations; however, to date there has been no appropriation provided by the Legislature for the program.

Effective Date

The federal provision is effective January 31, 1997.

Impact on California Revenue

Included under Act Section 101.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 1210

Section Title: USE OF PRIVATE DELIVERY SERVICES FOR TIMELY-MAILING-AS-TIMELY-FILING RULE

New Federal Law (Sec. 7502)

Under the Act, the IRS is required to treat items delivered by a private service as though they were mailed with the United States postal service. For purposes of administering the tax laws, the date items are recorded or marked by a designated delivery service are treated as being postmarked by the postal service.

California Law

California law does not conform to federal law to require the postmark of the United States postal service as the only proof of the date of delivery.

Effective Date

The federal provision is effective July 30, 1996.

Impact on California Revenue

Not applicable.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 1211

Section Title: REPORTS ON MISCONDUCT OF IRS' EMPLOYEES

New Federal Law

Under the Act, beginning June 1, 1997, and annually thereafter, the IRS must report to the fiscal committees of Congress all categories of instances of IRS employee misconduct (which is undefined) and the dispositions of the instances. The Committee report states that the reason for the change is that criminal matters are a matter of public record but "administrative disciplinary actions are generally not available, which may lead to a public perception that allegations of misconduct by IRS employees are not investigated or that misconduct goes unpunished." The Committee report states that the report would include, for instance, "the number of employees reprimanded, terminated, or prosecuted; instances dismissed because of a finding that proper procedures were followed and those initiated but not resolved."

California Law

Under the California Government Code, adverse actions may be brought by a state employer against an employee for 24 causes listed under Section 19572 of the Government Code (e.g., fraud in securing appointment, incompetence, inefficiency, inexcusable neglect of duty). Generally, notices of these adverse actions are public record available from the State Personnel Board. The FTB takes approximately 200 adverse actions a year.

Effective Date

The first federal report is due by June 1, 1997.

Impact on California Revenue

Included under Act Section 101.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 1211

Section Title: APPLICATION OF FAILURE TO PAY PENALTY TO SUBSTITUTE RETURNS

New Federal Law (Sec. 6651)

Under federal law if a taxpayer does not file a required return, the IRS may file a substitute return for the taxpayer.

The Act applies the failure to pay penalty to substitute returns in the same manner as the penalty applies to delinquent filers.

California Law

California law has no provision for substitute returns.

Effective Date

The federal provision applies in the case of any return the due date for which (determined without regard to extensions) is after July 30, 1996.

Impact on California Revenue

Included under Act Section 101.

TAXPAYER BILL OF RIGHTS 2
(PL 104-168)

Act Section: 1311-1314

Section Title: EXCISE TAXES ON AMOUNTS OF PRIVATE EXCESS BENEFITS

New Federal Law (Sec. 4958 new, 6033, 6104,6652)

The Act provides "intermediate sanctions" in the form of penalty excise taxes imposed when nonprofit organizations engage in transactions with certain insiders that result in private inurement. Initially the penalty excise tax imposed is 25% of the excess benefit and then, if the excess benefit is not corrected within the taxable period, it becomes 200% of the excess benefit. Previously, the revocation of tax-exempt status was the only remedy. In addition, the Act provides additional reporting of information by nonprofit organizations to the IRS and increased public access to documents filed by such organizations as well as penalties for failure to comply with these new requirements.

California Law

California, in general, does not impose penalty excise taxes at the state level in addition to those imposed at the federal level on these transactions.

Effective Date

The federal provision generally applies to excess benefit transactions occurring on or after September 14, 1995, subject to a binding contract exception.

Impact on California Revenue

Not applicable.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1111

Section Title: INCREASE IN EXPENSE TREATMENT FOR SMALL BUSINESS

New Federal Law (Sec. 179)

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $17,500 of the cost of qualifying property placed in service a taxable year beginning after December 31, 1992 (increased from $10,000 by the Revenue Reconciliation Act of 1993).

The Act increases the $17,500 amount allowed to be expensed under Code section 179 to $25,000. The increase is phased in as follows:

Taxable year beginning in-	Maximum expensing
1997	$18,000
1998	$18,500
1999	$19,000
2000	$20,000
2001	$24,000
2002	$24,000
2003 and thereafter	$25,000

California Law (R&T Sec. 17209 & 24356)

Under the Personal Income Tax Law California conforms to federal law as it read January 1, 1993, (prior to the passage of the Revenue Reconciliation Act of 1993) and thus provides that in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $10,000 of the cost of qualifying property placed in service for the taxable year.

In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $10,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In addition, the amount eligible to be expensed for a taxable year may not exceed the taxable income of the taxpayer for the year that is derived from the active conduct of any trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Under the Bank and Corporation Tax Law California does not conform to federal law but instead allows "additional first-year depreciation" of 20 percent of the cost of qualifying property, up to a maximum of $10,000 per year.

Effective Date

The federal change is effective for property placed in service in taxable years beginning after December 31, 1996, subject to the phase-in schedule set forth above.

Impact on California Revenue

Revenue losses from this provision are projected to be as follows:

Personal Income Tax Estimated Revenue Impact Beginning January 1, 1997 Enactment After June 30, 1997 (in millions)		
Fiscal Years		
1997-8	1998-9	1999-0
($22)	($5)	($5)

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion:

Revenue losses from this proposal will depend on the amount of additional expensing deductions reported by small businesses rather than depreciation.

Estimates have been developed previously for increasing state expensing allowances which have been based on federal projections for the Budget Reconciliation Act of 1993 and updated for the additional changes made in the Small Business Job Protection Act (P.L.104-188).

In general, revenue losses average around $3.5 million for every $1,000 expensing increase up to $18,000, and $1.5 million per $1,000 increase thereafter. Offsets to revenue losses in subsequent years will occur due to depreciation deductions that would no longer be taken.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1112

Section Title: TREATMENT OF EMPLOYEE TIPS

New Federal Law (Sec. 45B)

Employee tip income is treated as employer-provided wages for purposes of the Federal Insurance Contributions Act (`FICA'). Employees are required to report to the employer the amount of tips received. The Omnibus Budget Reconciliation Act of 1993 (`OBRA 1993') provided a business tax credit with respect to certain employer FICA taxes paid with respect to tips treated as paid by the employer.

The Act clarifies the credit with respect to employer FICA taxes paid on tips by providing that the credit is (1) available whether or not the employee reported the tips on which the employer FICA taxes were paid, and (2) effective with respect to taxes paid after December 31, 1993, regardless of when the services with respect to which the tips are received were performed.

The provision also modifies the credit so that it applies with respect to tips received from customers in connection with the delivery or serving of food or beverages, regardless of whether the food or beverages are for consumption on the premises of the establishment.

Current California Law (None)

California does not impose a tax similar to the FICA tax.

Effective Date

The clarifications relating to the effective date and nonreported tips are effective as if included in OBRA 1993. The provision expanding the tip credit to the provision of food or beverages not for consumption on the premises of the establishment is effective with respect to FICA taxes paid on tips received with respect to services performed after December 31, 1996.

Impact on California Revenue

Not applicable.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1113

Section Title: TREATMENT OF STORAGE OF PRODUCT SAMPLES

Background

A taxpayer's business use of his or her home may give rise to a deduction for the business portion of expenses related to operating the home (e.g., a portion of rent or depreciation and repairs). Business deductions generally are allowed only with respect to a portion of a home that is used exclusively and regularly in one of the following ways: (1) as the principal place of business for a trade or business; (2) as a place of business used to meet with patients, clients, or customers in the normal course of the taxpayer's trade or business; or (3) in connection with the taxpayer's trade or business, if the portion so used constitutes a separate structure not attached to the dwelling unit. In the case of an employee, the law further requires that the business use of the home must be for the convenience of the employer. These rules apply to houses, apartments, condominiums, mobile homes, boats, and other similar property used as the taxpayer's home.

Home office deductions may not be claimed if they create (or increase) a net loss from a business activity, although such deductions may be carried over to subsequent taxable years.

New Federal Law (Sec. 280A)

The Act expands the special rule contained in present-law to permit deductions for expenses related to a storage unit in a taxpayer's home regularly used for inventory or product samples (or both) of the taxpayer's trade or business of selling products at retail or wholesale, provided that the home is the sole fixed location of such trade or business.

Current California Law (R&T Sec. 17201)

California is conformed to this federal provision as it read January 1, 1993, which includes a special rule that allows a home office deduction for business expenses related to a space within a home that is used on a regular (even if not exclusive) basis as a storage unit for the inventory of the taxpayer's trade or business of selling products at retail or wholesale, but only if the home is the sole fixed location of such trade or business.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Effective Date

The federal provision applies to taxable years beginning after December 31, 1995.

Impact on California Revenue

Revenue losses from this provision are estimated as follows:

Estimated Revenue Impact Beginning January 1, 1997 Enactment After June 30, 1997 (In Thousands)		
Fiscal Years		
1997-8	1998-9	1999-0
* Minor	* Minor	* Minor

* Losses Less than $50 thousand

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion:

Revenue losses from this proposal would depend on the amount of additional deductions taken for home office expenses related to storage of product samples.

Revenue estimates above were based on federal projections for this provision in HR 3448. A proration factor of 3.1% was used based on state-to-nation comparisons of the labor-force population of the wholesale and retail trade industries (10.8%) and average marginal tax rates (28.6%).

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1114

Section Title: TREATMENT OF CERTAIN CHARITABLE RISK POOLS

Background

Charities generally are exempt from Federal income tax and are eligible to receive tax-deductible contributions and to use the proceeds of tax-exempt financing. Federal law requires that an organization be organized and operated exclusively for a charitable or other specifically enumerated exempt purpose in order to qualify for tax-exempt status under that section. Federal law did not specifically accord tax-exempt status to an organization that pools insurable risks of a group of tax-exempt charities.

New Federal Law (Sec. 501)

Under the Act, a qualified charitable risk pool is treated as organized and operated exclusively for charitable purposes. The provision make inapplicable to a qualified charitable risk pool the present-law rule that a charitable organization is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance.

The Act defines a qualified charitable risk pool as an organization organized and operated solely to pool insurable risks of its members (other than medical malpractice risks) and to provide information to its members with respect to loss control and risk management. Because a qualified charitable risk pool must be organized and operated solely to pool insurable risks of its members and to provide information to members with respect to loss control and risk management, no profit may be accorded to any member of the organization other than through providing members with insurance coverage below the cost of comparable commercial coverage and through providing members with loss control and risk management information. Only charitable tax-exempt organizations may be members of a qualified charitable risk pool.

The Act further requires that a qualified risk pool is required to (1) be organized as a nonprofit organization under State law authorizing risk pooling for charitable organizations; (2) be exempt from State income tax; (3) obtain at least $1 million in startup capital from nonmember charitable organizations; (4) be controlled by a board of directors elected by its members; and (5) provide in its organizational documents that members must be tax-exempt charitable organizations at all times, and if a member loses that status it must immediately notify the organization, and that no insurance coverage applies to a member after the date of any final determination that the member no longer qualifies as a tax-exempt charitable organization.

To be entitled to tax-exempt status, a qualified charitable risk pool described in the provision also must satisfy the other requirements of that section (i.e., the private inurement test and the prohibition of political campaign activities and substantial lobbying).

Current California Law (R&T Sec. 23701z)

The Corporations Code governs the formation of corporations in California. A corporation may be incorporated as a "for profit" (stock) corporation or a "nonprofit" (no stock) corporation. "For profit" corporations do not qualify for tax-exempt status. California nonprofit corporations are either public benefit corporations, mutual benefit corporations or religious corporations. Though nonprofit corporations are not automatically tax-exempt, a nonprofit corporation may apply for tax-exempt status with the FTB. A tax-exempt corporation, which has taxable business income unrelated to its exempt purpose, may incur tax liability under the B&CTL.

Under California law, insurance companies are generally not subject to the income or franchise tax. Instead, insurers pay a tax based generally on premiums received the year on business done in California. The gross premiums tax rate is set each year by the State Board of Equalization. Since 1990, the tax rate has been set at 2.35%.

Since 1990, the California Corporations Code has specified that an "authorized corporation" involved in a pooling arrangement with two or more other authorized corporations for self-insured claims and losses is not subject to regulation under the Insurance Code when it provides insurance for the following:

- itself against any tort liability;
- any employee of the corporation against liability for injury resulting from an omission in the scope of employment;
- any board member, officer, or volunteer of the corporation against any liability that may arise from any act or omission in the scope of participation with the corporation; and
- any loss arising from physical damage to motor vehicles owned or operated by the corporation;

For an "authorized corporation" to qualify under this Corporations Code provision, the corporation must be exempt from income tax under federal law as a charitable organization under Section 501(c)(3) of the IRC at the time the pooling arrangement is formed.

For income years beginning on or after January 1, 1996, SB 38 provides that organizations, which are pooling arrangements authorized under the Corporations Code, may be granted state exempt status under the B&CTL. However, such state exempt status would be conditioned on the member corporations receiving federal tax exempt status under Section 501(c)(3) of the IRC. This exemption applies to organizations formed by three or more exempt charitable organizations joined together for the purpose of self-insurance.

Pooling organizations addressed by this provision would be exempt from both the California gross premiums tax and tax under the B&CTL. Such organizations could provide insurance only to members of the pooling arrangement.

Effective Date

The federal provision applies to taxable years beginning after August 20, 1996.

The state provision applies to income years beginning on or after January 1, 1996.

Impact on California Revenue

In SB 38 this provision was estimated to result in revenue losses of $300,000 in fiscal year 1996-97 and $200,000 per fiscal year for 1997-98 and 1998-99.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1115

Section Title: TREATMENT OF DUES PAID TO AGRICULTURAL OR HORTICULTURAL ORGANIZATIONS

Background

Tax-exempt organizations generally are subject to the unrelated business income tax ('UBIT') on income derived from a trade or business regularly carried on that is not substantially related to the performance of the organization's tax-exempt functions (secs. 511-514). Dues payments made to a membership organization generally are not subject to the UBIT. However, several courts have held that, with respect to postal labor organizations, dues payments were subject to the UBIT when received from individuals who were not postal workers, but who became 'associate' members for the purpose of obtaining health insurance available to members of the organization. See *National League of Postmasters of the United States v. Commissioner,* No. 95-2646 (4th Cir. 1996), *American Postal Workers Union, AFL-CIO v. United States,* 925 F.2d 480 (D.C. Cir. 1991), *National Association of Postal Supervisors v. United States,* 944 F.2d 859 (Fed. Cir. 1991).

In Rev. Proc. 95-21 (issued March 23, 1995), the IRS set forth its position regarding when associate member dues payments received by an organization described in section 501(c)(5) will be treated as subject to the UBIT. The IRS stated that dues payments from associate members will not be treated as subject to UBIT unless, for the relevant period, 'the associate member category has been formed or availed of for the principal purpose of producing unrelated business income.' Thus, under Rev. Proc. 95-21, the focus of the inquiry is upon the organization's purposes in forming the associate member category (and whether the purposes of that category of membership are substantially related to the organization's exempt purposes other than through the production of income) rather than upon the motive of the individuals who join as associate members.

New Federal Law (Sec. 512)

Under the Act, a new retroactive subsection provides that if an agricultural or horticultural organization requires annual dues not exceeding $100 to be paid in order to be a member of that organization, then in no event will any portion of those dues be subject to the UBIT by reason of any benefits or privileges to which members of such organization are entitled. For taxable years beginning after 1995, the $100 amount will be indexed for inflation. The term 'dues' is defined as "any payment required to be made in order to be recognized by the organization as a member of the organization." Thus, if a person is recognized as a member of an organization by virtue of having paid annual dues for his or her membership, then any subsequent payments made by that person during the year to purchase another membership in the same organization (covering the same period) would not be within the scope of the provision.

Current California Law (R&T Sec. 17651 & 23732)

In general, California conforms to the federal rules for UBIT as those rules read on January 1, 1993, but substitutes references to state law sections describing tax-exempt organizations in-lieu federal references. In addition, state law restricts the charitable contribution deduction to 5 percent of unrelated business taxable income, rather than 10 percent.

California has not conformed to the following changes made by the Revenue Reconciliation Act of 1993 relating to real estate investments by pension funds:

- Repeal of special treatment of publicly traded partnerships (Act Sec. 13145
- Title-holding companies permitted to receive small amounts of unrelated business taxable income (Act Sec. 13147)
- Exclusion from UBIT of gains from certain property (Act Sec. 13148)
- Treatment of pension fund investments in real estate investment trusts (Act Sec. 13149)

Effective Date

The federal provision applies retroactively to taxable years beginning after December 31, 1986. The Act also provides transitional relief to agricultural or horticultural organizations that had a reasonable basis for not treating membership dues received prior to January 1, 1987, as unrelated business income. In such cases, no portion of such dues will be treated as derived from an unrelated trade or business.

Impact on California Revenue

The revenue loss of this proposal is negligible.

This analysis does not consider the possible changes in employment,

personal income, or gross state product that could result from this measure.

Revenue Discussion:

This proposal would depend upon the amount of membership dues currently subject to UBIT, which would no longer be subject to UBIT.

This revenue estimate was based on federal projections for this provision in HR 3448 of 1996. According to the federal projections, this provision would have a negligible revenue loss.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1116(a)

Section Title: CLARIFICATION OF EMPLOYMENT TAX STATUS OF CERTAIN FISHERMEN

New Federal Law (Sec. 3121)

Service as a crew member on a fishing vessel is generally excluded from the definition of employment for purposes of income tax withholding on wages and for purposes of the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA) taxes if the operating crew of the boat normally consists of fewer than 10 individuals, the individual receives a share of the catch based on the total catch, and the individual does not receive cash remuneration other than proceeds from the sale of the individual's share of the catch. If a crew member receives any other cash, e.g., payment for services as an engineer, the exemption from FICA and FUTA taxes does not apply. Crew members to which the exemption applies are subject to self-employment taxes. Special reporting requirements apply to the operators of boats on which exempt crew members serve.

Under the Act, the operating crew of a boat is treated as normally made up of fewer than 10 individuals if the average size of the operating crew on trips made during the preceding 4 calendar quarters consisted of fewer than 10 individuals. In addition, the exemption applies if the crew member receives certain cash payments. The cash payments cannot exceed $100 per trip, is contingent on a minimum catch, and is paid solely for additional duties (e.g., as mate, engineer, or cook) for which additional cash remuneration is customary.

Current California Law

The Employment Development Department (EDD) is responsible for making determinations of whether a person is an employee or independent contractor for employment tax purposes. Defer to EDD.

Effective Date

The federal provision applies to remuneration paid after December 31, 1994. In addition, the federal provision applies to remuneration paid after December 31, 1984, and before January 1, 1995, unless the payer treated that remuneration when paid as subject to FICA taxes.

Impact on California Revenue

Defer to EDD.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1116(b)

Section Title: REPORTING REQUIREMENTS FOR PURCHASERS OF FISH

Background

A person engaged in a trade or business who makes payments during the calendar year of $600 or more to a person for "rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, or other income" must file an information return with the Internal Revenue Service reporting the amount of those payments, as well as the name, address, and taxpayer identification number of the person to whom such payments were made. A similar statement must also be furnished to the person to whom the payments were made. Treasury regulations provide that payments for "merchandise" are not required to be reported under this provision (Treas. reg. sec. 1.6041-3(d)). Consequently, information reporting is generally not required with respect to purchases of fish or other forms of aquatic life. Information reporting is required by a person engaged in a trade or business who, in the course of that trade or business, receives more than $10,000 in cash in one transaction (or several related transactions) (Sec. 6050I)

New Federal Law (Sec. 6050R)

The Act requires persons engaged in the trade or business of purchasing fish for resale who pay more than $600 in cash in a calendar year for fish or other forms of aquatic life from any seller engaged in the trade or business of catching fish to file information reports with the Secretary regarding those purchases. A copy of the report must be provided to the seller.

Current California Law (R&T Sec. 18644 & 18645)

California generally conforms to other information return requirements in federal law by requiring the filing of a copy of the federal information return with the Franchise Tax Board, upon request.

Effective Date

The federal provision is effective for purchases made after December 31, 1997.

Impact on California Revenue

Revenue gains from this provision are considered to be a base-line issue and will largely occur automatically at the state level due to improved voluntary compliance as a result of the federal requirement.

Base-line revenue gains are estimated as follows:

Estimated Revenue Impact Beginning January 1, 1998 Enactment After June 30, 1997 (In Millions)			
Fiscal Years			
1997-8	1998-9	1999-0	2000-01
* Minor	* Minor	* Minor	* Minor

* Revenue Gains Less than $100 Thousand

Revenue Discussion:

Revenue gains from this proposal would depend on the amount of additional revenue reported from voluntary compliance as a result of the federal requirement.

Base-line revenue estimates were based on federal projections for this provision in H.R. 3448. A proration factor of 1% was used based on state-to-nation comparisons of domestic fisheries by selected ports and value of catches (3%) and average marginal tax rates (32.1%).

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

ct Section: 1117

Section Title: MODIFICATIONS OF TAX-EXEMPT BOND RULES FOR FIRST-TIME FARMERS

New Federal Law (Sec. 147)

Interest on bonds issued by State and local governments to provide financing to private persons is taxable unless an exception is provided in the Internal Revenue Code. One such exception allows State and local governments to issue bonds to finance loans to first-time farmers for the acquisition of land (and limited amounts of related depreciable farm property) if the purchasers will be the principal user of the property and will materially participate in the farming operation in which the property is to be used.

A first-time farmer is defined as an individual who has at no time owned farm land in excess of 15 percent of the median size of the farm in the county in which such land is located, and the fair market value of the land has not at any time when held by the individual exceeded $125,000.

Under general rules governing issuance of tax-exempt bonds, working capital financing (including purchases from related parties) is precluded.

The Act makes two modifications to the rules governing issuance of tax-exempt bonds for first-time farmers. First, the definition of first-time farmer is broadened to include an individual who has at no time owned farm land in excess of 30 percent of the median size farm in the county. Second, these bonds may be used to finance purchases between related parties provided that: (1) the price paid reflects the fair market value of the property and, (2) the seller has no financial interest in the farming operation conducted on the land after the bond-financed sale occurs. A related seller is treated as having a continuing financial interest in bond-financed farmland. In general, the committee report indicates that the conferees intend that such a seller will not be treated as having a financial interest if the seller:

(a) has no more than a ten-percent interest in the capital or profits in a partnership comprising the farm;

(b) has no more than a ten-percent stock interest in a corporation comprising the farm;

(c) has no more than ten-percent of the beneficial interest in a trust comprising the farm;

(d) is not a principal user of the farm; or

(e) has no other direct or indirect ownership or use of the farm which has as a principal purposes, the avoidance of this provision.

In addition, the committee reports indicate that the conferees further intend that issuers making loans to finance related party sales provide appropriate notice to borrowers of these restrictions and of the fact that bond-proceeds may not be re-transferred from sellers to purchasers as part of efforts (e.g., step-transactions) to transfer both property financed with the bond proceeds and the bond proceeds received by the seller.

Current California Law (R&T Sec. 17143 & 24272)

California specifically does not conform to any of the provisions of federal law which exempt from gross income interest earned on bonds issued by State and local governments. Instead the California Constitution provides that interest income from bonds issued by the State of California or its political subdivisions is exempt from income tax. In addition, federal law precludes States from imposing an income tax on federal bonds.

Effective Date

The federal provision applies to bonds issued after August 20, 1996.

Impact on California Revenue

Not applicable.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1118

Section Title: NEWSPAPER DISTRIBUTORS TREATED AS DIRECT SELLERS

New Federal Law (Sec. 3508)

For federal tax purposes, there are two classifications of workers: a worker is either an employee of the service recipient or an independent contractor.

Significant tax consequences result from the classification of a worker as an employee or independent contractor. These differences relate to withholding and employment tax requirements, as well as the ability to exclude certain types of compensation from income or take tax deductions for certain expenses.

Some of these consequences favor employee status, while others favor independent contractor status. For example, an employee may exclude from gross income employer-provided benefits such as pension, health, and group-term life insurance benefits. On the other hand, an independent contractor can establish his or her own pension plan and deduct contributions to the plan. An independent contractor also has greater ability to deduct work-related expenses.

Under present law, the determination of whether a worker is an employee or an independent contractor is generally made under a common-law facts and circumstances test that seeks to determine whether the service provider is subject to the control of the service recipient, not only as to the nature of the work performed, but the circumstances under which it is performed. Under a special safe harbor rule (sec. 530 of the Revenue Act of 1978), a service recipient may treat a worker as an independent contractor for employment tax purposes even though the worker is an employee under the common-law test if the service recipient has a reasonable basis for treating the worker as an independent contractor and certain other requirements are met.

In addition to the common-law test, under federal law there are also some persons who are treated by statute as either employees or independent contractors. For example, "direct sellers" are deemed to be independent contractors.

A direct seller is a person engaged in the trade or business of selling consumer products in the home or otherwise than in a permanent retail establishment, if substantially all the remuneration for the performance of the services is directly related to sales or other output rather than to the number of hours worked, and the services performed by the person are performed pursuant to a written contract between such person and the service recipient and such contract provides that the person will not be treated as an employee for Federal tax purposes.

The newspaper industry has generally taken the position that newspaper distributors and carriers should be treated as direct sellers for income and employment tax purposes. The Internal Revenue Service has generally taken the position that the direct seller rules do not apply to newspaper distributors and carriers operating under an agency distribution system (i.e., where the publisher retains title to the newspapers).

The Act clarifies the treatment of qualifying newspaper distributors and carriers as direct sellers. A person engaged in the trade or business of the delivery or distribution of newspapers or shopping news (including any services that are directly related to such trade or business such as solicitation of customers or collection of receipts) qualifies as a direct seller, provided substantially all the remuneration for the performance of the services is directly related to sales or other output rather than to the number of hours worked, and the services performed by the person are performed pursuant to a written contract between such person and the service recipient and such contract provides that the person will not be treated as an employee for Federal tax purposes. This provision is intended to apply to newspaper distributors and carriers whether or not they hire others to assist in the delivery of newspapers.

The provision also applies to newspaper distributors and carriers operating under either a buy-sell distribution system (i.e., where the newspaper distributors or carriers purchase the newspapers from the publisher) or an agency distribution system. For example, newspaper distributors and carriers operating under an agency distribution system who are paid based on the number of papers delivered and have an appropriate written agreement qualify as direct sellers. The status of newspaper distributors and carriers who do not qualify as direct sellers under the provision continue to be determined under present-law rules.

The Committee report indicates that no inference is intended with respect to the employment status of newspaper distributors and carriers prior to the effective date of the provision.

Further, the Committee report indicates that the provision is intended to clarify the worker classification issue for income and employment taxes only. The provision is not intended to have any impact whatsoever on the interpretation or applicability of Federal, State, or local labor laws.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

.rrent California Law

The Employment Development Department (EDD) is responsible for making determinations of whether a person is an employee or independent contractor for employment tax purposes. Defer to EDD.

Effective Date

The federal provision is effective with respect to services performed after December 31, 1995.

Impact on California Revenue

Defer to EDD.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1119

Section Title: APPLICATION OF INVOLUNTARY CONVERSION RULES TO PRESIDENTIALLY DECLARED DISASTERS

New Federal Law (Sec. 1033)

Any tangible property acquired and held for productive use in a business is treated as similar or related in service or use to property that (1) was held for investment or for productive use in a business and (2) was involuntarily converted as a result of a Presidentially declared disaster. Thus, the involuntary conversion rules are expanded to include replacement property that previously would not have qualified as similar or related in service or use to the converted property.

In addition, the Act provides that the boundaries of the enterprise community for Oklahoma City designated by the Secretary of Housing and Urban Development on December 21, 1994, may be extended with respect to the census tracts located in the area damaged by the bombing of the Alfred P. Murrah Federal Building in Oklahoma City on April 19, 1995.

Current California Law (R&T Sec. 18037 & 24944-24949.3)

California Personal Income Tax Law is conformed by reference to federal law as it read January 1, 1994, which provides that a taxpayer may elect not to recognize gain with respect to property that is involuntarily converted if the taxpayer acquires within an applicable period property similar or related in service or use. If the taxpayer does not replace the converted property with property similar or related in service or use, then gain generally is recognized. Special rules are provided for Presidentially declared disaster areas with respect to the damage or destruction of a principal residence.

California Bank and Corporation Tax Law is substantially the same as the Personal Income Tax Law provision but does not contain any special rules for Presidentially declared disaster areas with respect to the damage or destruction of a principal residence.

Effective Date

The federal involuntary conversion expansion is effective for disasters for which a Presidential declaration is made after December 31, 1994, in taxable years ending after that date.

The Oklahoma City modification is effective on August 20, 1996.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Impact on California Revenue

Revenue losses from this provision are estimated as follows:

Estimated Revenue Impact Post 1994 Enactment After June 30, 1997 (In Millions)		
Fiscal Years		
1997/8	1998/9	1999/00
($2)	($1)	($1)

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion:

Revenue losses from this proposal would depend on the additional amount of gains not recognized for business or investment property that is compulsorily or involuntarily converted to any tangible property of a type held for productive use in a trade or business as a result of a post-1994 Presidentially-declared disaster.

Developing estimates of this sort is very speculative due to inherent uncertainties, e.g. predicting future disasters, the type and magnitude, the extent of insurance/assistance protection, the income characteristics of victims, etc. In order to provide the basis for this estimate we looked back over the past several years at California disasters. Using historic data regarding insurance claims, revenue estimates above were based on federal projections for this provision in HR 3448. A proration factor of 6% was used based on historic averages for state-to-nation insurance claims for disasters (18.8%) and average marginal tax rates (32.1%).

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1120

Section Title: CLASS LIFE FOR GAS STATION CONVENIENCE STORES AND SIMILAR STRUCTURES

New Federal Law (Sec. 168)

The Act provides that for purposes of the Modified Accelerated Depreciation System (MACRS), 15-year property includes generally, any depreciable real property that is a retail motor fuels outlet (whether or not food or other convenience items are sold at the outlet). A retail motor fuels outlet does not include any facility related to petroleum or natural gas pipelines or to any depreciable real property used only to an insubstantial extent in the retail marketing of petroleum or petroleum products.

Current California Law (R&T Sec. 17250, 24349-24355)

Under the Personal Income Tax Law (PITL) California conforms to the federal Modified Accelerated Depreciation System (MACRS) which provides that depreciation for property used in the retail gasoline trade is calculated under Section 168 of the Internal Revenue Code using a 15-year recovery period and the 150-percent declining balance method.

Starting in 1997, AB 38 provides that nonresidential real property is depreciated using a 39-year recovery period and the straight-line method.

It is understood that taxpayers generally have taken the position that convenience stores and other buildings installed at retail motor fuels outlets have a 15-year recovery period. The IRS, in a position described in a recent Coordinated Issues Paper, generally limits the application of the 15-year recovery period to instances where the structure: (1) is 1,400 square feet or less or (2) meets a 50-percent test. The 50-percent test is met if: (1) 50 percent or more of the gross revenues that are generated from the building are derived from petroleum sales and (2) 50 percent or more of the floor space in the building is devoted to petroleum marketing sales.

The Bank and Corporation Tax Law (BCTL) does not conform to federal MACRS lives but instead uses the mid-range of the Class Life Asset Depreciation Range (CLADR) system to determine the economic useful life of depreciable assets.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Effective Date

The federal provision is effective prospectively for property placed in service on or after August 20, 1996 and to which the amendments made by section 201 of the Tax Reform Act of 1986 apply (i.e., property subject to the modified Accelerated Cost Recovery System of sec. 168). The taxpayer may also retroactively elect the application of the federal provision for property placed in service prior to August 20, 1996. The Committee report states that the conferees clarify that if a taxpayer has already treated qualified property that was placed in service before the date of enactment as 15-year property, the taxpayer will be deemed to have made the election with respect to that property.

Impact on California Revenue

State revenue losses for this provision under the PITL will result from federal law changes. These baseline losses are projected at $200,000 annually. Any additional effects from a matching state law change would be negligible.

Revenue losses are considered to be baseline losses since taxpayers under the PITL will assume continued state conformity in this area of the tax law and report the same deduction amount for both federal and state purposes. California has not conformed to MACRS depreciation under the BCTL.

Tax Revenue Discussion:

The revenue impact of this provision will be determined by the amount of accelerated depreciation deductions reported by retail motor fuel outlet stores that meet the 50/50 test and fall under section 1250 property, and the marginal tax rates of affected taxpayers.

Revenue estimates were based on federal projections for this provision in HR 3448. A proration factor of 3.3% was used based on state-to-nation comparisons of income (11.7%) and average marginal tax rates (28.6%). It is assumed that virtually all of this impact will occur automatically at the state level and represent baseline revenue losses under the PIT Law. The incremental revenue loss due to actual conformity would be negligible.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1121

Section Title: TREATMENT OF ABANDONMENT OF LESSOR IMPROVEMENTS AT TERMINATION OF LEASE

New Federal Law (Sec. 168 & 280B)

A lessor of leased property that disposes of a leasehold improvement which was made by the lessor for the lessee of the property may take the adjusted basis of the improvement into account for purposes of determining gain or loss, if the improvement is irrevocably disposed of or abandoned by the lessee at the termination of the lease.

The Committee report states that the conferees wish to clarify that the provision does not apply to the extent that a deduction is denied upon the demolition of a structure, a portion of which may include leasehold improvements.

Current California Law (R&T Sec. 17250, 24349-24355)

Under the Personal Income Tax Law (PITL) California conforms to the federal Modified Accelerated Depreciation System (MACRS).

Starting in 1997, AB 38 conforms to the federal treatment of nonresidential real property which provides that it is to be depreciated using a 39-year recovery period and the straight-line method.

A taxpayer generally recovers the adjusted basis of property for purposes of determining gain or loss upon the disposition of the property. Upon the termination of a lease, the adjusted basis of leasehold improvements that were made, but are not retained, by a <u>lessee</u> are taken into account to compute gain or loss by the lessee.

The proper treatment of the adjusted basis of improvements made by a <u>lessor</u> upon termination of a lease is less clear. It appears that it is the position of the Internal Revenue Service that leasehold improvements made by a lessor that constitute structural components of a building must be continued to be depreciated in the same manner as the underlying real property, even if such improvements are retired at the end of the lease term.

It is understood that some lessors, on the other hand, may be taking the position that a leasehold improvement is a property separate and distinct from the underlying building and that an abandonment loss is allowable at the end of the lease term for the adjusted basis of the property.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Effective Date

The federal provision is effective for leasehold improvements disposed of after June 12, 1996. The Committee report states that no inference is intended as to the proper treatment of such dispositions before June 13, 1996.

Impact on California Revenue

The revenue impact of this provision will be determined by the value of leasehold improvements made by lessors for certain lessees and the marginal tax rates of affected lessors.

This provision is a clarification of how taxpayers are generally reporting their gain or loss on leasehold improvements in cases of abandonment by lessees for both federal and state tax purposes. The state revenue implications, therefore, represent a baseline issue and no significant additional effects will occur as a result of clarifying state legislation.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1122

Section Title: SPECIAL RULES RELATING TO DETERMINATION WHETHER INDIVIDUALS ARE EMPLOYEES FOR PURPOSES OF EMPLOYMENT TAXES

New Federal Law (Sec. 530 of the Revenue Act of 1978)

With increased enforcement of the employment tax laws beginning in the late 1960s, controversies developed between the IRS and taxpayers as to whether businesses had correctly classified certain workers as self employed rather than as employees. In response to this problem, the Congress enacted Section 530 of the Revenue Act of 1978. That provision generally allows a taxpayer to treat a worker as not being an employee for employment tax purposes (but not income tax purposes), regardless of the individual's actual status under the common-law test, unless the taxpayer has no reasonable basis for such treatment.

It is the position of the IRS, based on legislative history, that Section 530 can only apply after a determination has been made that a worker is an employee under the common-law test.

Under Section 530, reliance on judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the taxpayer is deemed a reasonable basis for treating a worker as an independent contractor. If a taxpayer relies on this safe harbor, the IRS will look to see whether the facts of the judicial precedent or published ruling are sufficiently similar to the taxpayer's facts.

The Act makes several clarifications of and modifications to Section 530.

First, a worker does not have to otherwise be an employee of the taxpayer in order for Section 530 to apply. The provision is intended to reverse the IRS position, as stated in the IRS Training Guide, that there first must be a determination that the worker is an employee under the common law standards before application of Section 530.

The Act modifies the prior audit safe harbor so that taxpayers may not rely on an audit commencing after December 31, 1996, unless that audit included an examination for employment tax purposes of whether the worker involved (or any worker holding a position substantially similar to the position held by the worker involved) should be treated as an employee of the taxpayer. The provision does not affect the ability of taxpayers to rely on prior audits that commenced before January 1, 1997, even though the audit was not related to employment tax matters.

Also, the Act provides that an officer or employee of the IRS must, at (or before) the commencement of an audit involving worker classification issues, provide the taxpayer with written notice of the provisions of Section 530. The Committee report states that the conferees wish to clarify the notice that the IRS must provide to taxpayers at (or before) the commencement of an audit inquiry involving worker classification issues. The conferees recognize that, in many cases, the portion of an audit involving worker classification issues will not arise until after the examination of the taxpayer begins. In that case, the notice need only be given at the time the worker classification issue is first raised with the taxpayer.

The Act makes a number of changes to the industry practice safe harbor. First, it provides that a significant segment of the taxpayer's industry under the industry practice safe harbor does not require a reasonable showing of the practice of more than 25 percent of an industry (determined without taking into account the taxpayer). The provision is intended to be a safe harbor; a lower percentage may constitute a significant segment of the taxpayer's industry based on the particular facts and circumstances.

The Act also provides that an industry practice need not have continued for more than 10 years in order for the industry practice to be considered long standing. As with the significant segment safe harbor, this provision is intended to be a safe harbor; an industry practice in existence for a shorter period of time may be considered long standing based on the particular facts and circumstances. In addition, the Senate amendment clarifies that an industry practice will not fail to be treated as long standing merely because such practice began after 1978. Consequently, the provision clarifies that new industries can take advantage of Section 530.

The Act modifies the burden of proof in Section 530 cases by providing that if a taxpayer establishes a prima facie case that it was reasonable not to treat a worker as an employee for purposes of Section 530, the burden of proof shifts to the IRS with respect to such treatment. The Committee report states that with respect to the burden of proof in Section 530 cases, the conferees intend that a request for information by the IRS will not be treated as reasonable if (1) it does not relate to the particular basis on which the taxpayer relied for establishing its reasonable basis, or (2) complying with the request would be impracticable given the particular circumstances and the relative costs involved.

The Act also provides that if a taxpayer prospectively changes its treatment of workers from independent contractors to employees for employment tax purposes, such a change will not affect the applicability of Section 530 with respect to such workers for prior periods.

Finally, the Act provides that, in determining whether a worker holds a substantially similar position to another worker, the relationship of the parties must be one of the factors taken into account. The Committee report states that with respect to the substantially similar position provision, the conferees clarify that consideration of the relationship between a taxpayer and a worker includes consideration of the degree of supervision and control of the worker by the taxpayer.

Current California Law

The Employment Development Department (EDD) is responsible for making determinations of whether a person is an employee or independent contractor for employment tax purposes. Defer to EDD.

Effective Date

The provisions generally apply to periods after December 31, 1996. The provision regarding the burden of proof applies to disputes with respect to periods after December 31, 1996. The provision requiring the IRS to notify taxpayers of the provisions of Section 530 applies to audits commencing after December 31, 1996.

Impact on California Revenue

Defer to EDD.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1123

Section Title: TREATMENT OF HOUSING PROVIDED TO EMPLOYEES BY ACADEMIC HEALTH CENTERS

New Federal Law (Sec. 119)

The Act expands the definition of an 'educational institutions' by treating certain medical research institutions ('academic health centers') that engage in basic and clinical research, have a regular faculty and teach a curriculum in basic and clinical research to students in attendance at the institution, as an 'educational institution.' In addition, an entity organized under state law and composed of public educational institutions ('university systems') will qualify as an 'educational institution.'

Current California Law (R&T Sec. 17131)

California is conformed to federal law as it read January 1, 1993, which provides that employees of an 'educational institution,' as defined, do not have to include in income the fair market value of campus housing as long as the rent is at least five percent of the appraised value of the housing.

Effective Date

The federal provision is effective for taxable years beginning after December 31, 1995.

Impact on California Revenue

Revenue losses from this provision are estimated as follows:

Estimated Revenue Impact Beginning January 1, 1997 Enactment After June 30, 1997 (In Millions)		
Fiscal Years		
1997-8	1998-9	1999-0
* Minor	* Minor	* Minor

* Losses Less than $50 thousand

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Revenue Discussion:

Revenue losses from this proposal would depend on the additional amount of income excluded for the fair market value of campus housing as a result of modifications to the definition of "educational institutions" for the purpose of Code section 119(d) of the federal code.

Revenue estimates above were based on federal projections for this provision in HR 3448. A proration factor of 3.3% was used based on state-to-nation comparisons of resident college enrollment, average educational attainment for doctors, and active non-federal physicians (13%) and average marginal tax rates (25.5%).

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1201

Section Title: WORK OPPORTUNITY TAX CREDIT

New Federal Law (Sec. 51)

The Act replaces the targeted jobs tax credit with the 'work opportunity tax credit.' The new credit is available on an elective basis for employers hiring individuals from one or more of the following targeted groups (certification is required):

(a) a qualified IV-A recipient;
(b) a qualified veteran;
(c) a qualified ex-felon;
(d) a high-risk youth;
(e) a vocational rehabilitation referral,
(f) a qualified summer youth employee; and
(g) a qualified food stamp recipient.

The credit generally is equal to 35 percent of qualified first-year wages. No credit is allowed for wages paid unless the eligible individual is employed by the employer for at least 180 days (20 in the case of a qualified summer youth employee) or 400 hours (120 hours in the case of a qualified summer youth employee).

Current California Law (R&T Sec. 17053.7 & 23621)

California does not conform to this federal credit. Instead, with respect to targeted employees hired before 1994, an employer was allowed the California Targeted Jobs Credit which provided a credit equal to 10% of wages paid by an employer to each employee certified as eligible by the Employment Development Department. The credit was limited to $3,000 in wages by employer per year for the first 24 months but maximum credit was $600 for each qualified employee.

Effective Date

The federal provision applies to wages paid or incurred to a qualified individual who begins work for an employer after September 30, 1996, and before October 1, 1997.

Impact on California Revenue

Not applicable.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1202

Section Title: EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE PROGRAMS

New Federal Law (Sec. 127)

Former federal law provided an exclusion from gross income of an employee for amounts paid or incurred by an employer for educational assistance of the employee. The former federal law permitted an exclusion for undergraduate and graduate educational assistance. By its terms, the federal exclusion was not applicable after December 31, 1994.

The Act retroactively extended the exclusion from gross income, not to exceed $5,250 per year, for the amount paid or incurred by an employer for educational assistance (including tuition, fees, books, supplies, equipment and other similar expenses) to an employee, for undergraduate courses taken before July 1, 1997, and for both undergraduate and graduate courses taken before July 1, 1996.

Current California Law (R&T Sec. 17151)

State law conformed to the federal provision, as it read January 1, 1993, except that the termination date did not apply. However, the state provision does not apply to any taxable year that the federal exclusion is not applicable. The recent extension of the federal provision resulted in the extension of the state exclusion for both graduate and undergraduate courses.

In 1996, SB 38 restructured California law based on provisions of the new federal law and excludes from the gross income of an employee any amounts, not exceeding $5,250 per calendar year, paid or incurred by the employer for educational assistance to the employee, other than those employees enrolled in any course or education at the graduate level beginning after June 30, 1996. However, while the new California provision is similar to the new federal law, the state exclusion from gross income is permanent and is not conditioned on the existence of a federal exclusion from gross income.

Effective Date

The California changes apply to taxable or income years beginning on or after January 1, 1996.

Impact on California Revenue

For purposes of SB 38, enacted in 1996, the revenue impacts from this provision were estimated to be a revenue increase of $7 million and $3 million for fiscal years 1996-97 and 1997-98 respectively, and a revenue loss of $7 million for fiscal year 1998-99. Current state law represents the baseline against which changes in law are measured: Revenue gains for fiscal years 1996-97 and 1997-98 result from the removal from current state law of the exclusion for graduate level courses while revenue losses in the later years result from the permanent extension of the provision excluding undergraduate level courses.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1203

Section Title: FUTA EXEMPTION FOR ALIEN AGRICULTURAL WORKERS

New Federal Law (Sec. 3306)

Generally, the Federal unemployment tax (FUTA) is imposed on farm operators who (1) employ 10 or more agricultural workers for some portion of 20 different days, each beginning in a different calendar week or (2) have a quarterly payroll for agricultural services of at least $20,000. An exclusion from FUTA was provided, however, for labor performed by an alien admitted to the United States to perform agricultural labor under section 214(c) and 101(a)(15)(H) of the Immigration and Nationality Act. This exclusion was effective for labor performed before January 1, 1995.

The Act permanently extends the FUTA exemption for alien agricultural workers.

Current California Law

The Employment Development Department (EDD) administers employment taxes. Defer to EDD.

Effective Date

The federal extension is retroactive and applies to services performed after December 31,1994.

Impact on California Revenue

Defer to EDD.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1204

Section Title: RESEARCH CREDIT

New Federal Law (Sec. 41)

Prior to July 1, 1995, federal law provided for a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenditures for a taxable year exceeded its base amount for that year. The research tax credit expired and does not apply to amounts paid or incurred after June 30, 1995.

The Act extends the research tax credit for 11 months--i.e., for the period July 1, 1996, through May 31, 1997 (with a special rule for taxpayers who elect the alternative incremental research credit regime).

The Act also expands the definition of 'start-up firms' to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983. In applying the start-up firm rules, the test is whether a taxpayer, in fact, both incurred research expenses (which under the present-law rules would be qualified research expenses) and had gross receipts in a particular year.

The Act allows taxpayers to elect an alternative incremental research credit regime. If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced. Under the alternative credit regime, a credit rate of 1.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1 percent (i.e., the base amount equals 1 percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 2.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fix-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of 2 percent. A credit rate of 2.75 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 2 percent. An election to be subject to this alternative incremental credit regime may be made only for a taxpayer's first taxable year beginning after June 30, 1996, and such an election applies to that taxable year and all subsequent years unless revoked with the consent of the Secretary of the Treasury. Under the Act, if a taxpayer elects the alternative incremental credit regime for its first taxable year beginning after June 30, 1996, and before July 1, 1997, then all qualified research expenses paid or incurred during such taxable year and the first eleven months of the following taxable year are treated as qualified research expenses for purposes of computing the taxpayer's credit under the alternative incremental credit regime.

The Act also provides a special rule for payments made to certain nonprofit research consortia. Under this special rule, 75 percent of amounts paid to a research consortium for qualified research is treated as qualified research expenses eligible for the research credit (rather than 65 percent under the present-law rule governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer.

In addition, the Act provides that research credit amounts earned under the changes made by the Act may not be taken into account in computing estimated tax payments required to be paid for taxable years beginning in 1997.

<u>Current California Law (R&T Sec. 17052.12 & 23609)</u>

California conforms with specific modifications to the federal research credit as it read January 1, 1994, namely:

- the state credit is not combined with other business credits;
- research must be conducted in California to qualify for the California credit;
- the credit percentage is reduced to 8% for qualified research and 12% for basic research;
- the definition of "gross receipts" differs;
- research which has a specific commercial objective may qualify as basic research; and
- amounts paid or incurred after June 30, 1995, can qualify for the credit.

In order to duplicate federal law which allows the credit for basic research payments only to corporate taxpayers, the Bank and Corporation Tax Law (B&CTL) allows the credit based on qualified research expenses and basic research payments, while non-corporate taxpayers are allowed the credit only for qualified research expenses.

SMALL BUSINESS JOB PROTECTION ACT OF 1996 (PL 104-188)

The California research credit is allowed indefinitely for taxable and income years beginning on or after January 1, 1987.

In 1996, SB 38 amended the existing California research credit to increase the allowable credit percentage from 8% to 11% for qualified research expenses. Thus, the qualified research expenses portion of the credit is calculated as 11% of the difference between the taxpayer's qualified research expenses for the taxable or income year and the base amount (as defined in federal law).

SB 38 also increased the credit percentage for basic research payments from 12% to 24% for corporate taxpayers. The basic research portion of the credit is calculated as 24% of the difference between the taxpayer's basic research payments and the base period amount (as defined in federal law).

Also, for corporate taxpayers engaged in specified biopharmaceutical research and biotech research and development, SB 38 includes hospitals run by public universities and certain cancer centers in the definition of "qualified organization" for purposes of the basic research credit.

SB 38 defines a qualified cancer center as one which is both tax-exempt under federal law and owned by a tax-exempt organization, has been designated a "specialized laboratory cancer center," and has received Clinical Cancer Research Center status from the National Cancer Institute.

SB 38 allows corporate taxpayers involved in the designated biopharmaceutical and biotechnology research and development activities who make payments to the specified university hospitals and cancer centers to claim the basic research credit on these payments. SB 38 also made minor technical changes to the research credit.

California did not enact the alternative incremental credit regime or the rule that treats 75 percent of qualified research consortium payments as qualified research expenses that were contained in the Small Business Job Protection Act of 1996.

Effective Date

1. Under the federal Act, extension of the research tax credit is effective for expenditures paid or incurred during the period July 1, 1996, through May 31, 1997 (with a special rule for taxpayers who elect the alternative incremental research credit regime). The modification to the definition of 'start-up firms' is effective for taxable years ending after June 30, 1996. Taxpayers may elect the alternative research credit

regime (with lower fixed-base percentages and lower credit rates) for the first taxable year beginning after June 30, 1996, and before July 1, 1997, and the credit is available with respect to all qualified research expenses incurred during the first 11 months of such taxable year. The rule that treats 75 percent of qualified research consortium payments as qualified research expenses is effective for taxable years beginning after June 30, 1996.

2. The California changes increasing the research credit rates apply to taxable or income years beginning on or after January 1, 1997. The California changes modifying qualified research for certain biopharmaceutical and biotechnology activities apply to income years beginning on or after January 1, 1996.

Impact on California Revenue

The revenue loss from the changes in SB 38 were estimated for that bill to be $6 million for fiscal year 1996-97, $22 million for fiscal year 1997-98 and $27 million for fiscal year 1998-99.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1205

Section Title: ORPHAN DRUG CREDIT

New Federal Law (Sec. 28)

Prior to January 1, 1995, a 50-percent nonrefundable tax credit was allowed for qualified clinical testing expenses incurred in testing of certain drugs for rare diseases or conditions, generally referred to as 'orphan drugs.' Qualified testing expenses are costs incurred to test an orphan drug after the drug has been approved for human testing by the Food and Drug Administration (FDA) but before the drug has been approved for sale by the FDA. A rare disease or condition is defined as one that (1) affects less than 200,000 persons in the United States, or (2) affects more than 200,000 persons, but for which there is no reasonable expectation that businesses could recoup the costs of developing a drug for such disease or condition from U.S. sales of the drug. These rare diseases and conditions include Huntington's disease, myoclonus, ALS (Lou Gehrig's disease), Tourette's syndrome, and Duchenne's dystrophy (a form of muscular dystrophy).

The Act extends the orphan drug tax credit for 11 months (for the period July 1, 1996, through May 31, 1997).

In addition, the Act allows taxpayers to carry back unused credits to three years preceding the year the credit is earned and to carry forward unused credits to 15 years following the year the credit is earned.

Current California Law

California has no comparable credit.

Effective Date

The Act applies to qualified clinical testing expenses paid or incurred during the period July 1, 1996, through May 31, 1997. The provision allowing for the carry back and carry forward of unused credits is effective for taxable years ending after June 30, 1996. No portion of the unused business credit that is attributable to the orphan drug credit can be carried back to a taxable year ending before July 1, 1996.

Impact on California Revenue

Not Applicable.

Act Section: 1206

Section Title: CONTRIBUTIONS OF STOCK TO PRIVATE FOUNDATIONS

New Federal Law (Sec. 170)

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the fair market value of property contributed to a charitable organization.

As part of the Omnibus Budget Reconciliation Act of 1993, Congress eliminated the treatment of contributions of appreciated property (real, personal, and intangible) as a tax preference for alternative minimum tax (AMT) purposes. Thus, if a taxpayer makes a gift to charity of property (other than short-term gain, inventory, or other ordinary income property, or gifts to private foundations) that is real property, intangible property, or tangible personal property the use of which is related to the donee's tax-exempt purpose, the taxpayer is allowed to claim the same fair-market-value deduction for both regular tax and AMT purposes (subject to present-law percentage limitations).

In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property. However, under a special rule, taxpayers were allowed a deduction equal to the fair market value of `qualified appreciated stock' contributed to a private foundation prior to January 1, 1995.

Qualified appreciated stock was defined as publicly traded stock which is capital gain property.

The fair-market-value deduction for qualified appreciated stock donations applied only to the extent that total donations made by the donor to private foundations of stock in a particular corporation did not exceed 10 percent of the outstanding stock of that corporation. For this purpose, an individual was treated as making all contributions that were made by any member of the individual's family. This special rule expired after December 31, 1994.

The Act extends the special rule for 11 months--i.e., for contributions of qualified appreciated stock made to private foundations during the period July 1, 1996, through May 31, 1997.

Current California Law (R&T Sec. 17201)

California is fully conformed to the federal "itemized deduction" charitable contribution deduction as it read January 1, 1993, including the special rule for contribution of qualified appreciated stock made to private foundations and the expiration of that special rule on December 31, 1994.

California has not conformed to the Omnibus Budget Reconciliation Act of 1993, repeal of the treatment of contributions of appreciated property (real, personal, and intangible) as a tax preference for alternative minimum tax (AMT) purposes. Thus, for California purposes, the difference between the adjusted basis of the contributed appreciated property and its fair market value is a tax preference item.

Effective Date

The federal provision is effective for contributions of qualified appreciated stock to private foundations made during the period July 1, 1996, through May 31, 1997.

Impact on California Revenue

The revenue loss of this proposal is as follows:

Estimated Revenue Impact of C96-12 Contributions Made July 1, 1996-May 31, 1997 Enactment After June 30 1997 ($in millions)		
1997-8	1998-9	1999-0
(-$3.5)	*	*

* Insignificant Losses

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion:

Revenue losses from this proposal will depend on the amount of deductions for contributions that have been made during the period July 1, 1996 through May 31, 1997 and the average marginal tax rates of contributors.

Based on a proration of federal estimates conforming to this provision would produce a revenue loss of $3.5 million for the 1997-8 fiscal year and insignificant losses thereafter due to carryovers.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

ct Section: 1207

Section Title: EXTENSION OF BINDING CONTRACT DATE FOR BIOMASS AND COAL FACILITIES

New Federal Law (Sec. 29)

Certain fuels produced from 'nonconventional sources' and sold to unrelated parties are eligible for an income tax credit equal to $3 (generally adjusted for inflation) per barrel or BTU oil barrel equivalent (sec. 29). Qualified fuels must be produced within the United States.

Qualified fuels include: (1) oil produced from shale and tar sands; (2) gas produced from geopressured brine, Devonian shale, coal seams, tight formations ('tight sands'), or biomass; and (3) liquid, gaseous, or solid synthetic fuels produced from coal (including lignite).

In general, the credit is available only with respect to fuels produced from wells drilled or facilities placed in service after December 31, 1979, and before January 1, 1993. An exception extends the January 1, 1993 expiration date for facilities producing gas from biomass and synthetic fuel from coal if the facility producing the fuel is placed in service before January 1, 1997, pursuant to a binding contract entered into before January 1, 1996.

The credit may be claimed for qualified fuels produced and sold before January 1, 2003 (in the case of nonconventional sources subject to the January 1, 1993 expiration date) or January 1, 2008 (in the case of biomass gas and synthetic fuel facilities eligible for the extension period).

The Act extends the binding contract date for facilities producing synthetic fuels from coal and gas from biomass through December 31, and then placed in service date for eighteen months. The present sunset on producing qualifying for the credit is not changed. Therefore, under the Act, synthetic fuels from coal and gas from biomass produced from a facility placed in service before July 1, 1998, pursuant to a binding contract entered into before January 1, 1997, will be eligible for the tax credit if produced before January 1, 2008.

Current California Law

California has no equivalent credit.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Effective Date

The federal provision is effective on August 20, 1996.

Impact on California Revenue

Not Applicable.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1208

Section Title: MORATORIUM FOR EXCISE TAX ON DIESEL FUEL SOLD FOR USE OR USED IN DIESEL-POWERED MOTORBOATS

New Federal Law (Sec. 4041)

Diesel fuel used in recreational motorboats is subject to a 24.4 cents-per-gallon excise tax through December 31, 1999. This tax was enacted by the Omnibus Budget Reconciliation Act of 1993 as a revenue offset for repeal of the excise tax on certain luxury boats. Revenues from this tax are retained in the General Fund.

The diesel fuel tax is imposed on removal of the fuel from a registered terminal facility (i.e., at the 'terminal rack'). Federal law provides that tax is imposed on all diesel fuel removed from terminal facilities unless the fuel is destined for a nontaxable use and is indelibly dyed pursuant to Treasury Department regulations. If fuel on which tax is paid at the terminal rack (i.e., undyed diesel fuel) ultimately is used in a nontaxable use, a refund is allowed.

Dyed diesel fuel (fuel on which no tax is paid) may not be used in a taxable use. A penalty equal to the greater of $10 per gallon or $1,000 is imposed on persons found to be violating this prohibition.

The Act provides that no tax will be imposed on diesel fuel used in recreational motorboats during the period beginning on August 27, 1996 through December 31, 1997, and requests that the Treasury Department study possible alternatives to the current collection regime for motorboat diesel fuel that will provide comparable compliance with the law, and report to the House Committee on Ways and Means and the Senate Committee on Finance no later than April 1, 1997.

Current California Law

The State Board of Equalization (SBE) is responsible for administering fuel taxes in California. Defer to SBE.

Effective Date

The federal provision is effective August 20, 1996.

Impact on California Revenue

Defer to SBE.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1301 - 1317

Section Title: PROVISIONS RELATING TO S CORPORATIONS

New Federal Law (Sec. 404, 512, 641, 1042, 1237, 1361, 1362, 1366, 1367, 1375, 1377, & 1504)

The taxable income or loss of an S corporation is taken into account by the corporation's shareholders, rather than by the entity, whether or not such income is distributed. A small business corporation may elect to be treated as an S corporation.

The Act makes the following major changes to the S corporation rules to increase the number of corporations eligible to make an S election.

1. Increases maximum number of eligible shareholders from 35 to 75.

2. Allows stock in an S corporation to be held by certain trusts ('electing small business trusts'). In order to qualify for this treatment, all beneficiaries of the trust must be individuals or estates eligible to be S corporation shareholders, except that charitable organizations may hold contingent remainder interests. No interest in the trust may be acquired by purchase. For this purpose, 'purchase' means any acquisition of property with a cost basis. Thus, interests in the trust must be acquired by reason of gift, bequest, etc. A trust must elect to be treated as an electing small business trust.

Each potential current beneficiary of the trust is counted as a shareholder for purposes of the proposed 75 shareholder limitation (or if there were no potential current beneficiaries, the trust would be treated as the shareholder). A potential current income beneficiary means any person, with respect to the applicable period, who is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust.

Treatment of items relating to S corporation stock

The portion of the trust which consists of stock in one or more S corporations is treated as a separate trust for purposes of computing the income tax attributable to the S corporation stock held by the trust. The trust is taxed at the highest individual rate (currently, 39.6 percent on ordinary income and 28 percent on net capital gain) on this portion of the trust's income. The taxable income attributable to this portion includes (1) the items of income, loss, or deduction allocated to it as an S corporation shareholder under the rules of subchapter S, (2) gain or loss from the sale of the S corporation stock, and (3) to the extent provided in regulations, any state or local income taxes and administrative expenses of the trust properly allocable to the S corporation stock. Otherwise allowable capital losses are allowed only to the extent of capital gains.

In computing the trust's income tax on this portion of the trust, no deduction is allowed for amounts distributed to beneficiaries, and no deduction or credit is allowed for any item other than the items described above. This income is not included in the distributable net income of the trust, and thus is not included in the beneficiaries' income. No item relating to the S corporation stock can be apportioned to any beneficiary.

On the termination of all or any portion of an electing small business trust the loss carryovers or excess deductions is taken into account by the entire trust, subject to the usual rules on termination of the entire trust.

<u>Treatment of remainder of items held by trust</u>

In determining the tax liability with regard to the remaining portion of the trust, the items taken into account by the subchapter S portion of the trust are disregarded. Although distributions from the trust are deductible in computing the taxable income on this portion of the trust, under the usual rules of subchapter J, the trust's distributable net income does not include any income attributable to the S corporation stock.

<u>Termination of trust and conforming amendment applicable to all trusts</u>

Where the trust terminates before the end of the S corporation's taxable year, the trust takes into account its pro rata share of S corporation items for its final year. The Act makes a conforming amendment applicable to all trusts and estates clarifying that this is the present-law treatment of trusts and estates that terminate before the end of the S corporation's taxable year.

3. Expands the post-death holding period to two years for all testamentary trusts. Thus, a trust may be an S corporation shareholder for two years after the transfer of S corporation stock pursuant to a will.

4. The definition of 'straight debt' is expanded to include debt held by creditors, other than individuals, that are actively and regularly engaged in the business of lending money.

A small business corporation eligible to be an S corporation may not have more than one class of stock. In the past, in order to qualify as 'straight debt' and not be treated as a second class of stock, the creditor had to be an individual (other than a nonresident alien), an estate, or a qualified trust.

5. The authority of the IRS to waive the effect of an inadvertent termination is extended to allow the Service to waive the effect of an invalid election caused by an inadvertent failure to qualify as a small business corporation or to obtain the required shareholder consents (including elections regarding qualified Subchapter S trusts), or both. The Act also allows the IRS to treat a late Subchapter S election as timely where the Service determines that there was reasonable cause for the failure to make the election timely.

6. The Act provides that the election to close the books of the S corporation upon the termination of a shareholder's interest is made by all 'affected shareholders' <u>and the corporation</u>, rather than by all shareholders. Under federal law prior to the change, if any shareholder terminates his or her interest in an S corporation during a taxable year, the S corporation, with the consent of all its shareholders, may elect to allocate S corporation items by closing its books as of the date of such termination rather than apply the normal per-share, per-day rule. If no election is made, each item of S corporation income, deduction and loss is allocated to shareholders on a per-share, per-day basis.

Under the Act the closing of the books applies only to the 'affected shareholders'. For this purpose, 'affected shareholders' means any shareholder whose interest is terminated and all shareholders to whom such shareholder has transferred shares during the year. If a shareholder transferred shares to the corporation, 'affected shareholders' includes all persons who were shareholders during the year.

7. The Act expands the definition of post-termination period to include the 120-day period beginning on the date of any determination pursuant to an audit of the taxpayer that follows the termination of the S corporation's election and that adjusts a subchapter S item of income, loss or deduction of the S corporation during the S period. In addition, the definition of 'determination' is expanded to include a final disposition by the Secretary of the Treasury of a claim for refund and, under regulations, certain agreements between the Secretary and any person, relating to the tax liability of the person.

In addition, the Act repeals the TEFRA audit provisions applicable to S corporations and provides other rules to require consistency between the returns of the S corporation and its shareholders.

Under the Act distributions made by a former S corporation during its post-termination period are treated in the same manner as if the distributions were made by an S corporation (e.g., treated by shareholders as nontaxable distributions to the extent of the accumulated adjustment account). Distributions made after the post-termination period are generally treated as made by a C corporation (i.e., treated by shareholders as taxable dividends to the extent of earnings and profits).

Prior to the Act changes, the 'post-termination period' was the period beginning on the day after the last day of the last taxable year of the S corporation and ending on the later of: (1) a date that is one year later, or (2) the due date for filing the return for the last taxable year and the 120-day period beginning on the date of a determination that the corporation's S corporation election had terminated for a previous taxable year.

8. An S corporation is allowed to own 80 percent or more of the stock of a C corporation. The C corporation subsidiary can elect to join in the filing of a consolidated return with its affiliated C corporations. However, the S corporation is not allowed to join in such election. Dividends received by an S corporation from a C corporation in which the S corporation has an 80 percent or greater ownership stake is not treated as passive investment income to the extent the dividends are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business.

In addition, an S corporation is allowed to own a qualified Subchapter S subsidiary. The term 'qualified Subchapter S subsidiary' means a domestic corporation that is not an ineligible corporation (i.e., a corporation that would be eligible to be an S corporation if the stock of the corporation were held directly by the shareholders of its parent S corporation) if (1) 100 percent of the stock of the subsidiary were held by its S corporation parent and (2) for which the parent elects to treat as a qualified subchapter S subsidiary. Under the election, the qualified Subchapter S subsidiary is not treated as a separate corporation and all the assets, liabilities, and items of income, deduction, and credit of the subsidiary are treated as the assets, liabilities, and items of income, deduction, and credit of the parent S corporation.

Under federal law before this change, a small business corporation could not be a member of an affiliated group of corporations (other than by reason of ownership in certain inactive corporations). Thus, an S corporation could not own 80 percent or more of the stock of another corporation (whether an S corporation or a C corporation). Also, a small business corporation could not have as a shareholder another corporation (whether an S corporation or a C corporation).

9. The Act provides that the adjustments for distributions made by an S corporation during a taxable year are taken into account before applying the loss limitation for the year. Thus, distributions during a year reduce the adjusted basis for purposes of determining the allowable loss for the year, but the loss for a year does not reduce the adjusted basis for purposes of determining the tax status of the distributions made during that year.

The Act also provides that in determining the amount in the accumulated adjustment account for purposes of determining the tax treatment of distributions made during a taxable year by an S corporation having accumulated earnings and profits, net negative adjustments (i.e., the excess of losses and deductions over income) for that taxable year are disregarded.

Under federal law before this change, the amount of loss an S corporation shareholder could take into account for a taxable year could not exceed the sum of the shareholder's adjusted basis in his or her stock of the corporation and the adjusted basis in any indebtedness of the corporation to the shareholder. Any excess loss is carried forward. Any distribution to a shareholder by an S corporation generally is tax-free to the shareholder to the extent of the shareholder's adjusted basis of his or her stock. The shareholder's adjusted basis is reduced by the tax-free amount of the distribution. Any distribution in excess of the shareholder's adjusted basis is treated as gain from the sale or exchange of property. Income (whether or not taxable) and expenses (whether or not deductible) served, respectively, to increase and decrease an S corporation shareholder's basis in the stock of the corporation. These rules required that the adjustments to basis for items of both income and loss for any taxable year apply before the adjustment for distributions applies.

10. The Act repeals the rule that treats an S corporation in its capacity as a shareholder of another corporation as an individual. Thus, the provision clarifies that the liquidation of a C corporation into an S corporation will be governed by the generally applicable subchapter C rules, including the provisions allowing the tax-free liquidation of a corporation into its parent corporation. Following a tax-free

liquidation, the built-in gains of the liquidating corporation may later be subject to tax upon a subsequent disposition. An S corporation also will be eligible to make a Section 338 election (assuming all the requirements are otherwise met), resulting in immediate recognition of all the acquired C corporation's gains and losses (and the resulting imposition of a tax).

The repeal of this rule does not change the general rule governing the computation of income of an S corporation. For example, it does not allow an S corporation, or its shareholders, to claim a dividends received deduction with respect to dividends received by the S corporation, or to treat any item of income or deduction in a manner inconsistent with the treatment accorded to individual taxpayers.

11. The Act provides that if a corporation is an S corporation for its first taxable year beginning after December 31, 1995, the accumulated earnings and profits of the corporation as of the beginning of that year is reduced by the accumulated earnings and profits (if any) accumulated in any taxable year beginning before January 1, 1983, for which the corporation was an electing small business corporation under Subchapter S. Thus, such a corporation's accumulated earnings and profits are solely attributable to taxable years for which an S election was not in effect. This rule is generally consistent with the change adopted in 1982 limiting the S shareholder's taxable income attributable to S corporation earnings to his or her share of the taxable income of the S corporation.

12. Losses of an S corporation that are suspended under the at-risk rules of section 465 are carried forward to the S corporation's post-termination period.

13. The Act provides that a person acquiring stock in an S corporation from a decedent would treat as income in respect to a decedent (IRD) his or her pro rata share of any item of income of the corporation that would have been IRD if that item had been acquired directly from the decedent. Where an item is treated as IRD, a deduction for the estate tax attributable to the item generally will be allowed. The stepped-up basis in the stock in an S corporation acquired from a decedent is reduced by the extent to which the value of the stock is attributable to items consisting of IRD. This basis rule is comparable to the present-law partnership rule.

14. The Act allows the present-law capital gains presumption to apply in the case of land held by an S corporation. That is, a lot or parcel of land held by a taxpayer other than a corporation generally is not treated as ordinary income property solely by reason of the land being

subdivided if: (1) such parcel had not previously been held as ordinary income property and if in the year of sale, the taxpayer did not hold other real property; (2) no substantial improvement has been made on the land by the taxpayer, a related party, a lessee, or a government; and (3) the land has been held by the taxpayer for five years. The Committee report states that it is expected that rules similar to the attribution rules for partnerships will apply to S corporation.

15. A bank (as defined in Sec. 581) is allowed to be an eligible small business corporation unless such institution uses a reserve method of accounting for bad debts and will no longer be treated as an 'ineligible corporation.'

16. Under the Act, for the first time, tax-exempt organizations described in Sections 401(a) and 501(c)(3) (`qualified tax-exempt shareholders') are allowed to be shareholders in S corporations. For purposes of determining the number of shareholders of an S corporation, a qualified tax-exempt shareholder will count as one shareholder.

Items of income or loss of an S corporation will flow-through to qualified tax-exempt shareholders as unrelated business taxable income (UBTI), regardless of the source or nature of such income (e.g., passive income of an S corporation will flow through to the qualified tax-exempt shareholders as UBTI.) In addition, gain or loss on the sale or other disposition of stock of an S corporation by a qualified tax-exempt shareholder will be treated as UBTI.

In addition, certain special tax rules relating to employee stock ownership plans ('ESOPs') will not apply with respect to S corporation stock held by the ESOP.

Also, if a qualified tax-exempt shareholder acquired, by purchase, stock in an S corporation (whether such stock was acquired when the corporation was a C or an S corporation) and receives a dividend distribution with respect to such S corporation stock (i.e., a distribution of subchapter C earnings and profits), except as provided in regulations the shareholder must reduce its basis in the stock by the amount of the dividend.

17. The Act provides that for purposes of the five-year rule, relating to the waiting period required before re-electing Subchapter S status, any termination of Subchapter S status in effect immediately before August 20, 1996, is not to be taken into account. Thus, any small business corporation that had terminated its S corporation election within the five-year period before August 20, 1996, may re-elect Subchapter S status.

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Current California Law (R&T Sec. 23800)

California conforms to the federal rules relating to S corporations and its shareholders as those rules read on January 1, 1993, with specific exceptions. Thus, under California law, a 'small business corporation' is defined as a domestic corporation which has elected federal S status and which does not have (1) more than 35 shareholders, (2) as a shareholder, a person (other than certain trusts or estates) who is not an individual, and (3) more than one class of stock. For purposes of the 35-shareholder limitation, a husband and wife are treated as one shareholder.

Under California law, in addition to the pass-through of the S corporation's income and deductions to its shareholders, an S corporation continues to be subject to the franchise tax, in an amount equal to the greater of the minimum tax or 1.5% of the net income for the income year. Unlike other corporations, however, in computing its net income, it is allowed to compute depreciation under the modified cost recovery system (MACRS) and is subject to the same at-risk and passive activity loss rules as an individual. An S corporation is not subject to the alternative minimum tax. Credits are allowed against this corporate level tax in an amount equal to one-third of the amount otherwise allowable.

A timely election to be treated as a C corporation for California purposes will be treated as a revocation and the corporation must wait 5 years before a new S election can be made.

Each nonresident shareholder or nonresident fiduciary of an S corporation must file with the S corporation return a statement of consent by that shareholder or fiduciary to be subject to the jurisdiction of California to tax that shareholder's or fiduciary's pro rata share of income attributable to California sources. The S corporation must include in its return for each income year a list of the shareholders. Failure to meet these requirements provides grounds for retroactive revocation of the California S corporation election.

A corporation that makes a valid election to be treated as an S corporation for California purposes is not allowed to be included in a combined report of a unitary group.

Effective Date

In general, the federal changes apply to taxable years beginning after December 31, 1996.

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Impact on California Revenue

The estimated revenue losses from this bill are shown in the following table:

Fiscal Year Cash Flow Impact Effective 1/1/97 $ Millions		
1997-8	*1998-9*	*1999-0*
$(23)	$(27)	$(29)

This estimate does not account for changes in employment, personal income, or gross state product that might result from this bill.

Discussion

The revenue impact of this proposal will be determined by (1) the number of entities that become or remain S corporations in lieu of alternative organizational structures, (2) the number of corporations that would not be subject to the minimum tax due to acquisition by an S corporation, (3) the net change in taxable personal income (reduced corporate dividends and the pass through of losses and income) and the marginal tax rate of PIT filers who report the gains and losses, (4) increased usage of credits that will result from the pass through of credits that would otherwise be limited to the liability of the entity, (5) the amount of NOL's that would have been applied against corporate income but which, after the switch to S status are passed through to the shareholders, (6) the gains from corporate acquisitions that will not be subject to California taxation due to IRS Section 338 elections that would source the otherwise taxable gain out of California, (7) increased depreciation deductions that result from expanded use of MACRS, (8) a number of miscellaneous provisions that are discussed in more detail below, and (9) the loss of baseline revenue that would have otherwise been gained due to the loss of S status of existing S corporations that avail themselves of changes in federal law which would disqualify them for California S status.

The number and characteristics of S corporations that would evolve as a result of this proposal were estimated from federal data presented in "S Corporation Returns, 1993," Gill and Wittman, Internal Revenue Service, Statistics of Income Bulletin, Spring 1996, Washington, D.C. 1996, pp. 27-63. The SOI data shows S corporations nationwide by number of shareholders, income, losses, and assets for 1993. It was assumed that the distribution of California S corporations would not be materially different from the nation as a whole. The national data shows a distribution of S corporations with the tail cut off at 35 shareholders. We imputed how the shape of the distribution would have evolved if the tail were extended to 75 shareholders. Generally this analysis concludes that there would be a relatively small number of additional S corporations, but those corporations would tend to report significantly greater income (and losses) that the average S corporation reports under current law. The newly estimated net income reported by S corporations was disaggregated into totals for corporations with positive income and those with zero income or losses assuming these corporations would exhibit profit and loss results similar to historical profit and losses. These figures were grown to the year 2000 to provide a proxy for new S corporation income and losses that would be reported assuming the estimated equilibrium would be reached by that year. Data for the intervening years was developed assuming the new equilibrium would be reached incrementally over the period 1997-2000. The data developed in the preceding steps provided the basis for the first four itemized revenue impacts noted in the table above.

Increased credit pass-throughs were estimated from the manufacturers' equipment credit amount that would be fully applied by S corporation shareholders on their PIT returns and thus not limited by the entity level tax.

The impact of Section 338 elections was estimated by factoring the losses under current law due to Section 338 elections by the ratio of assets held in S corporations as a percent of assets held by C corporations. Assets reported by S corporations account for about 4.3% of the assets held by C corporations. It is estimated that Section 338 elections result in annual losses of $20 million. Applying 4.3% to the $20 million yields $860 thousand, which was rounded to $1 million for this analysis.

Depreciation would increase as C corporations switch to S corporation status and would thus qualify for the more liberal MACRS depreciation allowances. The revenue impact of this provision was estimated based on the ratio of positive SNI reported by the newly formed S corporations to total SNI reported by positive income C corporations. This ratio was then multiplied by the estimated revenue loss of allowing all corporations to use MACRS.

The revenue impacts of the miscellaneous provisions for which there are insufficient state data for analysis, were calculated from the U.S. Treasury analysis of HR 3408 adjusted for California's share of the national totals.

The baseline revenue loss reflects the revenue that would have been realized from those corporations that would avail themselves of the federal changes and lose their California S status as a result. Without conformity, that revenue would be a current law revenue gain. By conforming, that revenue would be lost.

Act Section: 1401

Section Title: REPEAL OF 5-YEAR INCOME AVERAGING FOR LUMP-SUM DISTRIBUTIONS

New Federal Law (Sec. 402)

The Act repeals 5-year averaging for lump-sum distributions from qualified plans. Thus, the Act repeals the separate tax paid on a lump-sum distribution and also repeals the deduction from gross income for taxpayers who elect to pay the separate tax on a lump-sum distribution.

Current California Law (R&T Sec. 17501 & 17504)

California is conformed to federal law as it read January 1, 1993, which provides in general that a distribution of benefits from a tax-favored retirement arrangement (i.e., a qualified plan, a qualified annuity plan, and a tax-sheltered annuity contract) generally is includable in gross income in the year it is paid or distributed under the rules relating to the taxation of annuities. However, the state substitutes California rates and brackets in lieu of federal rates and brackets and provides a deduction from the amount taxable under federal law for the pre-1987 "California basis" (if any) in the qualified plan. "California basis" is the difference between the amount deductible on the federal and state tax returns for years prior to 1987.

Lump-sum distributions from qualified plans and qualified annuity plans are eligible for special 5-year forward averaging. In general, a lump-sum distribution is a distribution within one taxable year of the balance to the credit of an employee that becomes payable to the recipient first, on account of the death of the employee, second, after the employee attains age 59 1/2 , third, on account of the employee's separation from service, or fourth, in the case of self-employed individuals, on account of disability. Lump-sum treatment is not available for distributions from a tax-sheltered annuity.

A taxpayer is permitted to make an election with respect to a lump-sum distribution received on or after the employee attains age 59 1/2 to use 5-year forward income averaging under the tax rates in effect for the taxable year in which the distribution is made. In general, this election allows the taxpayer to pay a separate tax on the lump-sum distribution that approximates the tax that would be due if the lump-sum distribution were received in 5 equal installments. If the election is made, the taxpayer is entitled to deduct the amount of the lump-sum distribution from gross income. Only one such election on or after 59 1/2 may be made with respect to any employee.

Individuals who attained age 50 by January 1, 1986, can elect to use 10-year averaging in lieu of 5-year averaging. In addition, such individuals may elect to retain capital gains treatment with respect to the pre-1974 portion of a lump sum distribution.

Effective Date

The federal provision is effective for taxable years beginning after December 31, 1998. The House bill preserves the ability of certain individuals to elect 10-year averaging and capital gains treatment as provided under the Tax Reform Act of 1986.

Impact on California Revenue

Conforming to this federal provision would result in revenue gains under the PITL estimated to be as shown in the table below:

Fiscal Year Estimate Effective 1/1/2000 [$ In Millions]		
1999-00	2000-01	2001-02
$2	$5	$3

It is assumed the provision would be effective for taxable years beginning after December 31, 1999.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion:

The federal act suspends the 15% excise tax on excess distributions (i.e., those distributions exceeding $150,000 per year or lump-sums exceeding $750,000) received during 1997, 1998, and 1999. The suspension of this tax for a limited period, coming just before the tax favorable five-year averaging is repealed, will encourage many individuals to re-examine their plans for retirement. In the years before repeal, baseline revenue gains occur. The gains are largely due to additional taxes on lump-sum distributions accelerated by taxpayers reaping the financial advantage of the tax-favorable five-year averaging and escaping the federal excise tax during the suspension window.

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Act Section: 1402

Section Title: REPEAL OF $5,000 EXCLUSION OF EMPLOYEES' DEATH BENEFITS

New Federal Law (Sec. 101)

The Act repeals the $5,000 exclusion for employer-provided death benefits.

Current California Law (R&T Sec. 17131)

California is conformed to federal law as it read January 1, 1993, which provides in general that a distribution of benefits from a tax-favored retirement arrangement (i.e., a qualified plan, a qualified annuity plan, and a tax-sheltered annuity contract) generally is includable in gross income in the year it is paid or distributed under the rules relating to the taxation of annuities. However, the state substitutes California rates and brackets in lieu of federal rates and brackets and provides a deduction from the amount taxable under federal law for the pre-1987 "California basis" (if any) in the qualified plan. "California basis" is the difference between the amount deductible on the federal and state tax returns for years prior to 1987.

In addition, the beneficiary or estate of a deceased employee generally can exclude up to $5,000 in benefits paid by or on behalf of an employer by reason of the employee's death

Effective Date

The federal repeal applies with respect to decedents dying after August 20, 1996.

Impact on California Revenue

Assuming state law would apply to deaths occurring after December 31, 1996 with enactment after June 30, 1997, the tax revenue impact of this provision is estimated to be as follows:

Estimated Revenue Impact
Repeal of Exclusion of Employer Provided Death Benefits
(In $Millions)

Fiscal Years	1997-8	1998-9	1999-2000
Revenue Impact	$2	$2	$2

Note that any possible changes in employment, personal income, or gross state product that might result from this proposal are not taken into account.

Revenue Discussion:

Revenue gains will depend on the amount of death benefits received annually by beneficiaries or estates of deceased employees and the tax brackets of the recipients.

Revenue estimates above were based on federal projections for this provision in HR 3448 adjusted to reflect an effective date of 1/1/97. A proration factor of 3.1% was developed based on state-to-nation comparisons of civilian employed labor force 1992 (11%) and average marginal tax rates (28%).

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(PL 104-188)

Act Section: 1403

Section Title: SIMPLIFIED METHOD FOR TAXING ANNUITY DISTRIBUTIONS UNDER CERTAIN EMPLOYER PLANS

New Federal Law (Sec. 72)

The Act provides that basis recovery on payments from qualified plans generally is determined under a method similar to the present-law simplified alternative method provided by the IRS. The portion of each annuity payment that represents a return of basis equal to the employee's total basis as of the annuity starting date, divided by the number of anticipated payments under the following table:

Age	Number of payments:
Not more than 55	360
56-60	310
61-65	260
66-70	210
More than 70	160

Current California Law (R&T Sec. 17081, 17085-17085.5 & 24272.2)

California is conformed to federal law as it read January 1, 1993, which provides in general that a distribution of benefits from a tax-favored retirement arrangement (i.e., a qualified plan, a qualified annuity plan, and a tax-sheltered annuity contract) generally is includable in gross income in the year it is paid or distributed under the rules relating to the taxation of annuities.

Thus, amounts received as an annuity under a qualified plan generally are includable in income in the year received, except to the extent they represent the return of the recipient's investment in the contract (i.e., basis). First, a pro-rata basis recovery rule generally applies, so that the portion of any annuity payment that represents nontaxable return of basis acquired after 1986 is determined by applying an exclusion ratio equal to the employee's total investment in the contract divided by the total expected payments over the term of the annuity. A simplified alternative method provided by the IRS may be utilized where the taxable portion of qualifying annuity payments is determined under a simplified exclusion ratio method. In no event can the total amount excluded from income as nontaxable return of post-1986 basis be greater than the recipient's total investment in the contract.

Second, the state provides a deduction from the amount taxable under step one for the pre-1987 "California basis" (if any) in the qualified plan. "California basis" is the difference between the amount deductible on the federal and state tax returns for years prior to 1987. This "California basis" deduction is not taken on a pro-rata basis, but instead is absorbed before any amount determined in step one is taxed by California.

Effective Date

The federal provision is effective with respect to annuity starting dates beginning 90 days after August 20, 1996.

Impact on California Revenue

Assuming state law would be enacted after June 30, 1997, the tax revenue impact of this provision is estimated to be as follows:

Estimated Revenue Impact Simplified Method for Taxing Annuity Distributions (In $Millions)			
Fiscal Years	1997-98	1998-99	1999-2000
Revenue Impact	$2	$1	$1

Note that any possible changes in employment, personal income, or gross state product that might result from this proposal are not taken into account.

Revenue Discussion:

Revenue gains will depend on the amount of annuities distributed from certain specified employer retirement plans, the larger taxable portion thereof, and the tax brackets of the recipients.

Revenue estimates above were based on federal projections for this provision in HR 3448. A proration factor of 3.7% was used based on state-to-nation comparisons of adjusted gross income (11.7%) and average marginal tax rates (32.1%).

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Act Section: 1404

Section Title: REQUIRED DISTRIBUTIONS

New Federal Law (Sec. 401)

The Act modifies the rule that requires all participants in qualified plans to commence distributions by age 70 1/2 without regard to whether the participant is still employed by the employer and generally replaces it with the rule in effect prior to the Tax Reform Act of 1986.

Under the Act, distributions generally are required to begin by April 1 of the calendar year following the later of first, the calendar year in which the employee attains age 70 1/2 or second, the calendar year in which the employee retires. However, in the case of a 5-percent owner of the employer, distributions are required to begin no later than the April 1 of the calendar year following the year in which the 5-percent owner attains age 70 1/2 .

In addition, in the case of an employee (other than a 5-percent owner) who retires in a calendar year after attaining age 70 1/2 , the Act generally requires the employee's accrued benefit to be actuarially increased to take into account the period after age 70 1/2 in which the employee was not receiving benefits under the plan. Thus, under the Act, the employee's accrued benefit is required to reflect the value of benefits that the employee would have received if the employee had retired at age 70 1/2 and had begun receiving benefits at that time.

The actuarial adjustment rule and the rule requiring 5-percent owners to begin distributions after attainment of age 70 1/2 does not apply, under the Act, in the case of a governmental plan or church plan.

Current California Law (R&T Sec. 17501)

California is conformed to federal law as it read January 1, 1993, which provides in general that a distribution of benefits from a tax-favored retirement arrangement (i.e., a qualified plan, a qualified annuity plan, and a tax-sheltered annuity contract) generally is includable in gross income in the year it is paid or distributed under the rules relating to the taxation of annuities. However, the state substitutes California rates and brackets in lieu of federal rates and brackets and provides a deduction from the amount taxable under federal law for the pre-1987 "California basis" (if any) in the qualified plan. "California basis" is the difference between the amount deductible on the federal and state tax returns for years prior to 1987.

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Present law provides uniform minimum distribution rules generally applicable to all types of tax-favored retirement vehicles, including qualified plans and annuities, IRAs, and tax-sheltered annuities. A qualified plan is required to provide that the entire interest of each participant will be distributed beginning no later than the participant's required beginning date. The required beginning date is generally April 1 of the calendar year following the calendar year in which the plan participant or IRA owner attains age 70 1/2 . In the case of a governmental plan or a church plan, the required beginning date is the later of first, such April 1, or second, the April 1 of the year following the year in which the participant retires.

Effective Date

The federal provision is effective for years beginning after December 31, 1996. The Committee report states that if a participant is currently receiving distributions, but does not have to under the provision, it is intended that a plan (or annuity contract) could (but would not be required to) permit the participant, with his or her consent, to stop receiving distributions until such distributions are required under the provision and that the conferees intend that the actuarial adjustment rule does not apply in the case of a defined contribution plan.

Impact on California Revenue

The revenue impact of this provision will be determined by the number of taxpayers who delay minimum distributions until the calendar year in which the taxpayer retires rather than an earlier year in which the employee attains age 70½.

Based on the low level of federal estimates for this provision in H.R. 3448, conforming to the provision would result in minor revenue losses under the PITL of less than $500,000 annually beginning in 1997-98.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

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(PL 104-188)

Act Section: 1421-1422

Section Title: ESTABLISHMENT OF SAVINGS INCENTIVE MATCH PLANS FOR EMPLOYEES OF SMALL EMPLOYERS

New Federal Law (Sec. 408)

The Act creates a simplified retirement plan for small business called the savings incentive match plan for employees (SIMPLE) retirement plan. SIMPLE plans can be adopted by employers who employed 100 employees or less with at least $5,000 in compensation for the preceding and who do not maintain another employer-sponsored retirement plan. Employers who no longer qualify are given a 2-year grace period to continue to maintain the plan. A SIMPLE plan can be either an IRA for each employee or part of a qualified cash or deferred arrangement ('401(k) plan'). Eligible employees are given 60 days before the beginning of any year (or the 60-day period before first becoming eligible to participate in the plan) to elect to participate in the SIMPLE plan.

If established in IRA form, a SIMPLE plan is not subject to the nondiscrimination rules generally applicable to qualified plans (including the top-heavy rules) and simplified reporting requirements apply. Within limits, contributions to a SIMPLE plan are not taxable until withdrawn.

A SIMPLE plan can also be adopted as part of a 401(k) plan. In that case, the plan does not have to satisfy the special nondiscrimination tests applicable to 401(k) plans and is not subject to the top-heavy rules. The other qualified plan rules continue to apply.

SIMPLE retirement plans in IRA form.

In general- A SIMPLE retirement plan allows employees to make elective contributions to an IRA. Employee contributions have to be expressed as a percentage of the employee's compensation, and cannot exceed $6,000 per year. The $6,000 dollar limit is indexed for inflation in $500 increments.

Under the Act, the employer is required to satisfy one of two contribution formulas. Under the matching contribution formula, the employer generally is required to match employee elective contributions on a dollar-for-dollar basis up to 3 percent of the employee's compensation. Under a special rule, the employer can elect a lower percentage matching contribution for all employees (but not less than 1 percent of each employee's compensation). A lower percentage cannot be elected for more than 2 out of any 5 years.

Alternatively, for any year, in lieu of making matching contributions, an employer may elect to make a 2 percent of compensation nonelective contribution on behalf of each eligible employee with at least $5,000 in compensation for such year. For purposes of the 2 percent of compensation nonelective contribution formula, no more than $150,000 of compensation can be taken into account in any year with respect to any eligible employee. No contributions other than employee elective contributions and required employer matching contributions (or, alternatively, required employer nonelective contributions) can be made to a SIMPLE account.

Each employee of the employer who received at least $5,000 in compensation from the employer during any 2 prior years and who is reasonably expected to receive at least $5,000 in compensation during the year generally must be eligible to participate in the SIMPLE plan. Self-employed individuals can participate in a SIMPLE plan.

All contributions to an employee's SIMPLE account have to be fully vested.

<u>Tax treatment of SIMPLE accounts, contributions, and distributions-</u> Contributions to a SIMPLE account generally are deductible by the employer. In the case of matching contributions, the employer is allowed a deduction for a year only if the contributions are made by the due date (including extensions) for the employer's tax return. Contributions to a SIMPLE account are excludable from the employee's income. SIMPLE accounts, like IRAs, are not subject to tax. Distributions from a SIMPLE retirement account generally are taxed under the rules applicable to IRAs. Thus, they are includable in income when withdrawn. Tax-free rollovers can be made from one SIMPLE account to another. A SIMPLE account can be rolled over to an IRA on a tax-free basis after a two-year period has expired since the individual first participated in the SIMPLE plan. To the extent an employee is no longer participating in a SIMPLE plan (e.g., the employee has terminated employment) and 2 years have expired since the employee first participated in the SIMPLE plan, the employee's SIMPLE account is treated as an IRA.

Early withdrawals from a SIMPLE account generally are subject to the 10-percent early withdrawal tax applicable to IRAs. However, withdrawals of contributions during the 2-year period beginning on the date the employee first participated in the SIMPLE plan are subject to a 25-percent early withdrawal tax (rather than 10 percent).

Employer matching or nonelective contributions to a SIMPLE account are not treated as wages for employment tax purposes.

Administrative requirements - Each eligible employee can elect, with the 60-day period before the beginning of any year (or the 60-day period before first becoming eligible to participate), to participate in the SIMPLE plan (i.e., to make elective deferrals), and to modify any previous elections regarding the amount of contributions. An employer is required to contribute employees' elective deferrals to the employee's SIMPLE account within 30 days after the end of the month to which the contributions relate. Employees must be allowed to terminate participation in the SIMPLE plan at any time during the year (i.e., to stop making contributions). The plan can provide that an employee who terminates participation cannot resume participation until the following year. A plan can permit (but is not required to permit) an individual to make other changes to his or her salary reduction contribution election during the year (e.g., reduce contributions). An employer is permitted to designate a SIMPLE account trustee to which contributions on behalf of eligible employees are made.

Definitions - For purposes of the rules relating to SIMPLE plans, compensation means compensation required to be reported by the employer on Form W-2, plus any elective deferrals of the employee. In the case of a self-employed individual, compensation means net earnings from self-employment. The term employer includes the employer and related employers. Related employers include trades or businesses under common control (whether incorporated or not), controlled groups of corporations, and affiliated service groups. In addition, the leased employee rules apply.

SIMPLE 401(k) plans

In general, under the Act, a cash or deferred arrangement (i.e., 401(k) plan), is deemed to satisfy the special nondiscrimination tests applicable to employee elective deferrals and employer matching contributions if the plan satisfies the contribution requirements applicable to SIMPLE plans. In addition, the plan is not subject to the top-heavy rules for any year for which this safe harbor is satisfied. The plan is subject to the other qualified plan rules.

The safe harbor is satisfied if, for the year, the employer does not maintain another qualified plan and (1) employees' elective deferrals are limited to no more than $6,000, (2) the employer matches employees' elective deferrals up to 3 percent of compensation (or, alternatively, makes a 2 percent of compensation nonelective contribution on behalf of all eligible employees with at least $5,000 in compensation), and (3) no other contributions are made to the arrangement. Contributions under the safe harbor have to be 100 percent vested. The employer cannot reduce the matching percentage below 3 percent of compensation.

Repeal of Salary Reduction Simplified Employee Pensions (SARSEPs)

Under the Act, SARSEPs are repealed.

Current California Law (R&T Sec. 17507)

California law does not contain rules relating to SIMPLE retirement plans. However, state law does provide a number of ways in which individuals can save for retirement on a tax-favored basis. These include employer-sponsored retirement plans that meet the requirements of the Internal Revenue Code (a 'qualified plan') and individual retirement arrangements (IRAs). Employees can earn significant retirement benefits under employer-sponsored retirement plans. However, in order to receive tax-favored treatment, such plans must comply with a variety of rules, including complex nondiscrimination and administrative rules (including top-heavy rules). Early withdrawals from an IRA generally are subject to a 2-percent early withdrawal tax instead of the 10-percent federal early withdrawal tax.

Contributions to an IRA can also be made by an employer at the election of an employee under a SARSEP. Under SARSEPs, which are not qualified plans, employees can elect to have contributions made to the SARSEP or to receive the contributions in cash. The amount the employee elects to have contributed to the SARSEP is not currently includable in income.

Effective Date

The federal provision relating to SIMPLE plans are effective for years beginning after December 31, 1996. The repeal of SARSEPs applies to years beginning after December 31, 1996, unless the SARSEP was established before January 1, 1997. Consequently, an employer is not permitted to establish a SARSEP after December 31, 1996. SARSEPs established before January 1, 1997, can continue to receive contributions under present-law rules, and new employees of the employer hired after December 31, 1996, can participate in the SARSEP in accordance with such rules.

Impact on California Revenue

Conforming to this federal provision would result in revenue losses estimated to be as shown in the table below:

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Fiscal Year Estimate Effective 1/1/97 [$ In Millions]		
1997-98	1998-99	1999-00
($4)	($3)	($3)

It is assumed the provision would be effective with years beginning after December 31, 1996, with enactment after June 30, 1997. The impact would be under the PITL and the B&CTL.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion:

The revenue impact of this provision will be determined by (1) the amount of employee elective contributions or deferrals that are excludable from the employee's income, (2) the amount of employer matching or nonelective contributions that are deductible from income, and (3) the applicable tax rates.

Revenue estimates above were based on federal projections for this provision in H.R. 3448. A proration factor of 3.7% was used based on state-to-nation comparisons of income and average tax rates.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1426

Section Title: TAX-EXEMPT ORGANIZATIONS ELIGIBLE UNDER SECTION 401(k)

New Federal Law (Sec. 401)

The Act allows tax-exempt organizations (including, for this purpose, Indian tribal governments, a subdivision of an Indian tribal government, an agency or instrumentality of an Indian tribal government or subdivision thereof, or a corporation chartered under Federal, State, or tribal law which is owned in whole or in part by any of such entities) to maintain qualified cash or deferred arrangements ('401 (k) plans'). The Act retains the present-law prohibition against the maintenance of 401(k) plans by State and local governments except to the extent it may apply to Indian tribal governments. The Committee report states that no inference is intended with respect to whether Indian tribal governments are permitted to maintain qualified cash or deferred arrangements under present law.

Current California Law (R&T Sec. 17501)

California conforms to federal law as it read January 1, 1993, which provides that tax-exempt and State and local government organizations are generally prohibited from establishing 401(k) plans. The 401(k) plans (1) of rural cooperatives, (2) adopted by State and local governments before May 6, 1986, or (3) adopted by tax-exempt organizations before July 2, 1986, are not subject to this prohibition.

Effective Date

The federal provision is effective for plan years beginning after December 31, 1996.

Impact on California Revenue

The revenue impact of this provision will be determined by (1) the number of tax-exempt organizations that establish section 401(k) plans for their employees, (2) the amount of elective deferrals by the employees, and (3) the marginal tax rates of employees.

Based on the low level of federal estimates for this provision in H.R. 3448, conforming to this provision would result in revenue losses under the PITL as shown in the table below:

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Fiscal Year Estimate Effective 1/1/97 [$ In Millions]		
1997-98	1998-99	1999-00
($1)	($1)	($1)

It is assumed this provision applies to plan years beginning after December 31, 1996, with enactment after June 30, 1997.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1427

Section Title: SPOUSAL IRA DEDUCTION

New Federal Law (Sec. 219)

The Act permits deductible IRA contributions of up to $2,000 to be made for each spouse (including, for example, a homemaker who does not work outside the home) if the combined compensation of both spouses is at least equal to the contributed amount.

Current California Law (R&T Sec. 17210 & 17507)

SB 38 conformed California law to the changes made to federal law by this provision so that the state deduction for IRA contributions remains the same as the federal deduction.

Effective Date

The changes made to both federal and California law are effective for taxable years beginning on or after January 1, 1997.

Impact on California Revenue

This provision of SB 38 was estimated to result in revenue losses of $3 million for fiscal year 1996-97, $8 million for fiscal year 1997-98 and $9 million for fiscal year 1998-99.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1431-1465

Section Title: NONDISCRIMINATION AND MISCELLANEOUS PENSION PROVISIONS

New Federal Law (Sec. 401, 403, 414, 415, 417, 457, 1402, 4795, 6724)

The following federal rules for pension plan administration are simplified by the Act.

1. Definition of highly compensated employee - Under the Act, an employee is treated as highly compensated if the employee (1) was a 5-percent owner of the employer at any time during the year or the preceding year or (2) had compensation for the preceding year in excess of $80,000 (indexed for inflation) and (at the election of the taxpayer) the employee was in the top 20 percent employees by compensation for such year. The Act also repeals the rule requiring the highest paid officer to be treated as a highly compensated employee.

2. Family aggregation rules - The Act repeals the family aggregation rules.

3. Modification of additional participation requirements - The Act provides that the minimum participation rule applies only to defined benefit pension plans. In addition, the Act provides that a defined benefit pension plan does not satisfy the rule unless it benefits no fewer than the lesser of (1) 50 employees or (2) the greater of (a) 40 percent of all employees of the employer or (b) 2 employees (1 employee if there is only 1 employee).

The Act provides that the requirement that a line of business has at least 50 employees does not apply in determining whether a plan satisfies the minimum participation rule on a separate line of business basis.

4. Nondiscrimination rules for qualified cash or deferred arrangements (401(k) plans) and matching contributions - The Act modifies the special nondiscrimination tests applicable to elective deferrals and employer matching and after-tax employee contributions to provide that the maximum permitted actual deferral percentage (and actual contribution percentage) for highly compensated employees for the year is determined by reference to the actual deferral percentage (and actual contribution percentage) for nonhighly compensated employees for the preceding, rather than the current, year. A special rule applies for the first plan year.

Alternatively, under the Act, an employer is allowed to elect to use the current year actual deferral percentage (and actual contribution percentage). Such an election can be revoked only as provided by the Secretary.

Safe harbor for cash or deferred arrangements

The Act provides that a cash or deferred arrangement, for years beginning after December 31, 1998, satisfies the special nondiscrimination tests if the plan satisfies one of two contribution requirements and satisfies a notice requirement.

A plan satisfies the contribution requirements under the safe harbor rule for qualified cash or deferred arrangements if the plan either first, satisfies a matching contribution requirement or second, the employer makes a nonelective contribution to a defined contribution plan of at least 3 percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement without regard to whether the employee makes elective contributions under the arrangement.

A plan satisfies the matching contribution requirement if, under the arrangement: first, the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to (a) 100 percent of the employee's elective contributions up to 3 percent of compensation and (b) 50 percent of the employee's elective contributions from 3 to 5 percent of compensation; and second, the rate of match with respect to any elective contribution for highly compensated employees is not greater than the rate of match for nonhighly compensated employees.

Alternatively, if the rate of matching contribution with respect to any rate of elective contribution requirement is not equal to the percentages described in the preceding paragraph, the matching contribution requirement will be deemed to be satisfied if first, the rate of an employer's matching contribution does not increase as an employer's rate of elective contribution increases and second, the aggregate amount of matching contributions at such rate of elective contribution at least equals the aggregate amount of matching contributions that would be made if matching contributions satisfied the above percentage requirements.

Employer matching and nonelective contributions used to satisfy the contribution requirements of the safe harbor rules are required to be nonforfeitable and are subject to the restrictions on withdrawals that apply to an employee's elective deferrals under a qualified cash or deferred arrangement. It is intended that employer matching and nonelective contributions used to satisfy the contribution requirements of the safe harbor rules can be used to satisfy other qualified retirement plan nondiscrimination rules (except the special nondiscrimination test applicable to employer matching contributions (the ACP test)). So, for example, a cross-tested defined contribution plan that includes a qualified cash or deferred arrangement can consider such employer matching and nonelective contributions in testing.

The notice requirement is satisfied if each employee eligible to participate in the arrangement is given written notice, within a reasonable period before any year, of the employee's rights and obligations under the arrangement.

Alternative method of satisfying special nondiscrimination test for matching contributions

The Act provides a safe harbor method of satisfying the special nondiscrimination test applicable to employer matching contributions (the ACP test). Under this safe harbor, a plan is treated as meeting the special nondiscrimination test if first, the plan meets the contribution and notice requirements applicable under the safe harbor method of satisfying the special nondiscrimination requirement for qualified cash or deferred arrangements, and second, the plan satisfies a special limitation on matching contributions.

The limitation on matching contributions is satisfied if: first, the employer matching contributions on behalf of any employee may not be made with respect to employee contributions or elective deferrals in excess of 6 percent of compensation; second, the rate of an employer's matching contribution does not increase as the rate of an employee's contributions or elective deferrals increases; and third, the matching contribution with respect to any highly compensated employee at any rate of employee contribution or elective deferral is not greater than that with respect to an employee who is not highly compensated.

Any after-tax employee contributions made under the qualified cash or deferred arrangement will continue to be tested under the ACP test. Employer matching and nonelective contributions used to satisfy the safe harbor rules for qualified cash or deferred arrangements cannot be considered in calculating such test. However, employer matching and nonelective contributions in excess of the amount required to satisfy the safe harbor rules for qualified cash or deferred arrangements can be taken into account in calculating such test.

Distribution of excess contributions and excess aggressive contributions

The Act provides that the total amount of excess contributions (and excess aggregate contributions) is determined as under present law, but the distribution of excess contributions (and excess aggregate contributions) are required to be made on the basis of the amount of contribution by, or on behalf of, each highly compensated employee. Thus, excess contributions (and excess aggregate contributions) are deemed attributable first to those highly compensated employees who have the greatest dollar amount of elective deferrals.

5. Definition of compensation for purposes of the limits on contributions and benefits - The Act provides that, for years beginning after December 31, 1997, elective deferrals to 401(k) plans and similar arrangements, elective contributions to nonqualified deferred compensation plans of tax-exempt employers and State and local governments (457 plans), and salary reduction contributions to a cafeteria plan are considered compensation for purposes of the limits on contributions and benefits.

6. Plans covering self-employed individuals - The Act eliminates the special aggregation rules that apply to plans maintained by self-employed individuals that do not apply to other qualified plans.

7. Elimination of special vesting rule for multiemployer plans - The Act conforms the vesting rules for multiemployer plans to the rules applicable to other qualified plans, for plan years beginning on or after the earlier of (1) the later of January 1, 1997, or the date on which the last of the collective bargaining agreements pursuant to which the plan is maintained terminates, or (2) January 1, 1999.

8. Distributions under rural cooperative plans - The Act provides that a rural cooperative plan that includes a cash or deferred arrangement may permit distributions to plan participants after the attainment of age 59 1/2 or on account of hardship. In addition, the definition of a rural cooperative is expanded to include certain public utility districts.

9. Treatment of governmental plans under Section 415 - The Act makes the following modifications to the limits on contributions and benefits as applied to governmental plans, for years beginning after December 31, 1994: (1) the 100 percent of compensation limitation on defined benefit pension plan benefits do not apply; and (2) the early retirement reduction and the 10-year phase-in of the defined benefit pension plan dollar limit do not apply to certain disability and survivor benefits.

The Act also permits State and local government employers to maintain excess benefit plans without regard to the limits on unfunded deferred compensation arrangements of State and local government employers.

10. Uniform retirement age - The Act provides that for purposes of the general nondiscrimination rules the Social Security retirement age is a uniform retirement age and that subsidized early retirement benefits and joint and survivor annuities are not treated as not being available to employees on the same terms merely because they are based on an employee's Social Security retirement age.

11. Contributions on behalf of disabled employees - The Act provides that the special rule for contributions on behalf of disabled employees is applicable without an employer election and to highly compensated employees if the defined contribution plan provides for the continuation of contributions on behalf of all participants who are permanently and totally disabled.

12. Treatment of deferred compensation plans of state and local governments and tax-exempt organizations (457 plans) - The Act changes the rules for 457 plans to: (1) permits in-service distributions of accounts that do not exceed $3,500 under certain circumstances; (2) increase the number of elections that can be made with respect to when distributions must begin under the plan; and (3) provide for indexing (in $500 increments) of the dollar limit on deferrals.

13. Trust requirement for 457 plans - All amounts deferred under a 457 plan maintained by a state and local governmental employer have to be held in trust (or custodial account or annuity contract) for the exclusive benefit of employees. The trust (or custodial account or annuity contract) is provided tax-exempt status. Amounts are not considered made available merely because they are held in a trust, custodial account, or annuity contract. Amounts held in a trust, custodial account, or annuity contract may be loaned to plan participants (or beneficiaries) pursuant to rules applicable to loans from qualified plans. A 457 plan is not required to permit loans. This provision is effective with respect to amounts held on or after August 20, 1996. In the case of amounts deferred before August 20, 1996, (and the earnings thereon) do not have to be held in trust (or custodial account or annuity contract) until January 1, 1999.

14. Correction of GATT interest and mortality rate provisions in the Retirement Protection Act - The Act conforms the effective date of the new interest rate and mortality assumptions that must be used to calculate the limits on benefits and contributions to the effective date of the provision relating to the calculation of lump-sum distributions. This rule applies only in the case of plans that were adopted and in

effect before December 8, 1994. To the extent plans have already been amended to reflect the new assumptions, plan sponsors are permitted within 1 year of August 20, 1996, to amend the plan to reverse retroactively such amendment. The Act also repeals the GATT interest provision relating to a reduced benefit payable before age 62 as a lump sum. Thus, regardless of the form of benefit, the interest rate to be used cannot be less than the greater of 5 percent or the rate specified in the plan. This provision is effective as if included in GATT.

15. Multiple salary reduction agreements permitted under Sec. 403(b) - Under the Act, for taxable years beginning after December 31, 1995, for participants in a tax-sheltered annuity plan, the frequency that a salary reduction agreement may be entered into, the compensation to which such agreement applies, and the ability to revoke such agreement shall be determined under the rules applicable to qualified cash or deferred arrangements.

16. Treatment of Indian tribal governments under Sec. 403(b) - The Act provides that any 403(b) annuity contract purchased in a plan year beginning before January 1, 1995, by an Indian tribal government will be treated as purchased by an entity permitted to maintain a tax-sheltered annuity plan. The Act also provides that such contracts may be rolled over into a 401(k) plan maintained by the Indian tribal government.

17. Application of elective deferral limit to Sec. 403(b) contracts - Under the Act, for years beginning after December 31, 1995, each tax-sheltered annuity contract, not the tax-sheltered annuity plan, must provide that elective deferrals made under the contract may not exceed the annual limit on elective deferrals. The Committee report states that it is intended that the contract terms be given effect in order for this requirement to be satisfied. An annuity contract is not required to meet any change in any requirement before the 90th day after August 20, 1996.

18. Waiver of minimum waiting period for qualified plan distributions - The Act provides that a plan may permit a participant to elect (with any applicable spousal consent) a distribution with an annuity starting date before 30 days have elapsed since the explanation of the form of benefit was provided, as long as the distribution commences more than seven days after the explanation was provided. The Act also provides that a plan is permitted to provide the explanation after the annuity starting date if the distribution commences at least 30 days after such explanation was provided, subject to the same waiver of the 30-day minimum waiting period. The Committee report states that this is intended to allow retroactive payments of benefits which are attributable to the period before the explanation was provided.

19. Repeal of combined plan limit - The Act repeals the combined plan limit (i.e. an overall limit on contributions and benefits when an individual is a participant in both a defined benefit and a defined contribution plan) with respect to limitation years beginning after December 31, 1999, and suspends the excise tax on excess distributions with respect to distributions received in 1997, 1998, and 1999.

20. Tax on prohibited transactions - The Act increases the initial-level prohibited transaction tax from 5 percent to 10 percent for prohibited transactions occurring after August 20, 1996.

21. Treatment of leased employees - Under the Act, whether an individual (a leased employee) who performs services for another (the service recipient - leasing organization) is required to be treated as the service recipient's employee for various employee benefit provisions is to be based on whether the individual has performed services for the service recipient on a substantially full-time basis for a year, and the individual's services are performed under primary direction or control by the service recipient.

22. Uniform penalty provisions to apply to certain pension reporting requirements - The Act incorporates into the general penalty structure the penalties for failure to provide information reports relating to pension payments to the IRS and to recipients.

23. Retirement benefits of ministers not subject to tax on net earnings from self-employment - The Act provides that retirement benefits received from a church plan after a minister retires, and the rental value or allowance of a parsonage (including utilities) furnished to a minister after retirement, are not subject to self-employment taxes. The provision is effective for years beginning before, on, or after December 31, 1994.

24. Treasury to provide model forms for spousal consent and qualified domestic relations orders (QDROs) - The Act requires the Secretary to develop simple language which can be understood by the average person to be included with the currently required spousal consent form and QDRO, no later than January 1, 1997.

25. Treatment of length of service awards for certain volunteers under Sec. 457 - Under the Act, the requirements of Sec. 457 do not apply to any plan paying solely length of service awards to bona fide volunteers (or their beneficiaries) on account of fire fighting and prevention, emergency medical, and ambulance services performed by such volunteers. In addition, any amounts exempt from the requirements of Sec. 457 under the Act are not considered wages for FICA purposes.

26. Alternative nondiscrimination rules for certain plans that provide for early participation - Under the Act, for plan years beginning after December 31, 1998, for purposes of the actual deferral percentage (ADP) test, a 401(k) plan may elect to disregard employees (other than highly compensated employees) eligible to participate before they have completed 1 year of service and reached age 21, provided the plan separately satisfies the minimum coverage rules taking into account only those employees who have not completed 1 year of service or are under age 21. Instead of applying two separate ADP tests, such a plan could apply a single ADP test that compares the ADP for all highly compensated employees who are eligible to make elective contributions with the ADP for those non-highly compensated employees who are eligible to make elective contributions and who have completed 1 year of service and reached age 21.

27. Clarification of application of ERISA to insurance company general accounts - The Act requires the Secretary of Labor to issue proposed regulations by June 30, 1997, providing guidance for the purpose of determining, in cases where an insurer issues 1 or more policies (supported by the assets of the insurer's general account) to or for the benefit of an employee benefit plan, which assets of the insurer (other than plan assets held in its separate account) constitute plan assets for purposes of the fiduciary rules of ERISA and the prohibited transaction provisions of the Internal Revenue Code.

28. Church plan simplification - The Act allows self-employed ministers to participate in a church plan. For purposes of the definition of a church plan, a self-employed minister is treated as his or her own employer and as if the employer were a tax-exempt organization. The earned income of the self-employed minister is treated as his or her compensation. Self-employed ministers are able to deduct their contribution. In addition, ministers employed by an organization other than a church are treated as if employed by a church. Thus, such ministers can also participate in a church plan.

The Act provides that if a minister is employed by an employer that is not eligible to maintain a church plan, the minister is not taken into account by that employer in applying nondiscrimination rules. Also, the act permits retirement income accounts to be established for self-employed ministers.

The Act provides that church plans subject to the pre-ERISA nondiscrimination rules are to apply the same definition of highly compensated employee as other pension plans, rather than the pre-ERISA rule.

The Act permits the Secretary of the Treasury to develop safe harbor rules for church plans under the applicable coverage and nondiscrimination rules.

The Act provides that, in the case of foreign missionaries, amounts contributed to a plan by the employer are investment in the contract even though the amounts, if paid directly to the employee would have been excludable under Sec. 911.

29. Waiver of excise tax on failure to pay liquidity shortfall - The Act gives the Secretary authority to waive all or part of the excise tax imposed for a failure to make a liquidity shortfall payment (enacted as part of GATT) if the plan sponsor establishes to the satisfaction of the Secretary that the liquidity shortfall was due to reasonable cause and not willful neglect and reasonable steps have been taken to remedy such shortfall. The provision is effective as if included in GATT.

Current California Law (R&T Sec. 17501, 17551, 17547 & 19183)

California has conformed to the federal rules for pension plan administration as those rules read on January 1, 1993. However, the state does not conform to the imposition of the federal excise tax on prohibited transactions or the federal tax on net earnings from self-employment. In addition, California has yet to conform to changes made to federal pension provisions in 1994 by the Uruguay Round Agreements Act (GATT).

Effective Date

In general, the federal provisions are effective for years beginning after December 31, 1996 except as noted in the discussion of the provision.

Under the Act, any amendments to a plan or annuity contract required by the pension simplification amendments are not required to be made before the first plan year beginning on or after January 1, 1998. The date for amendments is extended to the first plan year beginning on or after January 1, 2000, in the case of a governmental plan.

Impact on California Revenue

1. Definition of highly compensated employee

Assuming state law would be enacted after June 30, 1997, the tax revenue impact of this provision is estimated to be as follows:

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Estimated Revenue Impact Simplified Definition of Highly Compensated Employees Effective Date 1/1/97 (In $Millions)			
Fiscal Years	1997-98	1998-99	1999-2000
Revenue Impact (Rounded)	($1)	($0.5)	($0.5)

Any possible changes in employment, personal income, or gross state product that might result from this provision are not taken into account.

Revenue Discussion:

Revenue losses would depend on the amounts contributed by employers to additional pension plans passing the nondiscrimination test under the new rules, and the tax rates of affected employers for deduction purposes.

Revenue estimates stated above were based on federal projections for this provision in HR 3448. A proration factor of 3.9% was used based on state-to-nation comparisons of adjusted gross income of $75,000 and over (13.8%) and average corporate tax rates (28.5%).

2. Repeal of Family Aggregation Rules

Federal estimates for this provision are insignificant. State impacts under conformity would be negligible revenue losses.

Any possible changes in employment, personal income, or gross state product that might result from this provision are not taken into account.

3. Modification of Additional Participation Requirements

The revenue impact of this provision will be determined by (1) the number of additional employees that will be covered under defined benefit pension plans, (2) the level of deductible contributions made to the plans, and (3) the applicable tax rates.

Based on the low level of federal estimates for this provision in H.R. 3448, conforming to the provision would result in minor revenue losses under primarily the B&CTL of less than $500,000 annually beginning in 1997-98. It is assumed this provision is effective for years beginning after December 31, 1996, with enactment after June 30, 1997.

This analysis does not consider the possible changes in employment,

personal income, or gross state product that could result from this measure.

4. Nondiscrimination Rules for Qualified Cash or Deferred Arrangements and Matching Contributions

Assuming enactment after June 30, 1997, the tax revenue impact of these provisions is estimated to be as follows:

Estimated Revenue Impact Nondiscrimination Rules for Qualified Pension Plans (In $Millions)				
Fiscal Years	1997-8	1998-9	1999-0	2000-1
New Safe Harbors	-	(1.5)	(7)	(7)
Excess Contributions, etc.	minor	minor	minor	minor

(Minor is less than $500,000)

Note that any possible changes in employment, personal income, or gross state product that might result from this proposal are not taken into account.

Revenue Discussion:

Estimated state revenue losses were based on federal projections in HR 3448. A proration factor of 4.1% was used based on state-to-nation comparisons of adjusted gross incomes of $50,000 and over (12.8%) and average marginal tax rates (32.1%).

5. Definition of Compensation for Section 415 Purposes

The revenue impact of this provision will be determined by the (a) increased amounts that may be contributed to a defined contribution plan on behalf of nonhighly compensated employees and (2) applicable tax rates.

Based on the low level of federal estimates for this provision in H.R. 3448, conforming to the provision would result in minor revenue losses of less than $500,000 annually beginning in 1997-98. It is assumed the provision would be effective for years beginning after December 31, 1997.

[1] This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

6. Plans Covering Self-Employed Individuals

The revenue impact of this provision will be determined by (1) additional participation in qualified plans by or on behalf of self-employed individuals, (2) less participation by employees in qualified plans to which self-employed individuals contribute, and (3) the affected taxpayers' marginal tax rates.

Based on the very low level of federal estimates for this provision in H.R. 3448, conforming to the provision would result in, on balance, minor revenue losses of less than $500,000 annually beginning in 1997-98. It is assumed the provision would apply to years after December 31, 1996, with enactment after June 30, 1997.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

7. Distributions Under Rural Cooperative Plans

The revenue impact of this provision will be determined by (1) the amount of distributions to plan participants under the expanded circumstances and (2) the employees' marginal tax rates.

Based on the very low level of federal estimates for this provision in H.R. 3448, conforming to the provision would result in minor revenue gains of less than $500,000 annually beginning in 1997-98. It is assumed the provision would apply to distributions after December 31, 1996, with enactment after June 30, 1997.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

8. Treatment of Governmental Plans Under Section 415

The revenue impact of this provision will be determined by (1) the amount of annual distributions from defined benefit plans exceeding an employee's average compensation for the highest paid three years, and (2) the employee's marginal tax rate.

Based on the very low level of federal estimates for this provision in H.R. 3448, conforming to the provision would result in minor revenue gains of less than $500,000 annually beginning in 1997-98. It is assumed the provision would apply to years after December 31, 1996, with enactment after June 30, 1997.

This analysis does not consider the possible changes in employment,

personal income, or gross state product that could result from this measure.

9. Contributions on Behalf of Disabled Employees

The revenue impact of this provision will be determined by (1) the amount of contributions made on behalf of any additional employees who are permanently and totally disabled (including highly compensated employees) and (2) the applicable tax rates of the contributing employers.

Based on the very low level of federal estimates for this provision in H.R. 3448, conforming to the provision would result in minor revenue losses under the PITL of less than $500,000 annually beginning in 1997-98.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

10. Treatment of Deferred Compensation Plans of State and Local Government and Tax-Exempt Organizations

The revenue impact of this provision will be determined by (1) the amount of additional in-service distributions of accounts under $3,500, (2) any additional elections to defer the commencement of distributions, (3) the amount of additional annual contributions due to the maximum deferral amount indexed for inflation, and (4) the participants' marginal tax rates.

Based on the low level of federal estimates for this provision in H.R. 3448, conforming to the provision would result in minor revenue losses of less than $500,000 annually beginning in 1997-98. It is assumed the provision would apply to years after December 31, 1996, with enactment after June 30, 1997.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

11. Required Sec. 457 Assets to be Held in Trusts; Transition Rules for Existing Plans

This provision is a federal law mandate and would represent a state base-line impact which, based on the low federal projections, will result in the following revenue losses:

Estimated Base-line Revenue Impact Sect.457 Assets Must be Held in Trusts (In $Millions)			
Fiscal Years	1996-97	1997-98	1998-99
Revenue Impact (Rounded)	(minor)	($1)	($1)

(Minor is less than $500,000)

Any possible changes in employment, personal income, or gross state product that might result from this provision are not taken into account.

Revenue Discussion:

This proposal would provide additional security to pension funds for employees and may result in greater employee participation in these plans. Revenue losses would depend on additional amounts contributed by participants to qualified pension plans and average marginal tax rates.

Base-line revenue estimates above were derived from federal projections in HR 3448. A proration factor of 3.9% was used based on state-to-nation comparisons of adjusted gross income of $75,000 and over (13.8%) and average tax rates (28.5%).

12. Multiple Salary Reduction Agreements Permitted Under Sect.403(b)

The revenue impact will depend on the number and amount of secondary salary reduction plans entered into by 403(b) employees and their average marginal tax rates.

Based on very low federal projections, conformity would result in minor state revenue losses, less than $500,000 annually.

13. Treatment of Indian Tribal Government Under Sect.403(b)

The revenue impact will depend on additional contributions to tax-sheltered annuity plans associated with Indian tribal governments that would not have otherwise occurred due to confusion in prior federal law.

Based on very low federal projections in HR 3448, conformity would result in negligible revenue losses.

14. Application of Elective Deferral Limit to Sect.403(b) Contracts

The revenue impact will depend on those tax-sheltered annuity plans that are not disqualified due to excessive 403(b) deferrals by certain employees and the tax rates of affected participants.

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Based on very low federal projections in HR 3448, conformity would result in negligible revenue losses.

15. Allow Waiver of 30-day Waiting Period for Qualified Plan Distributions

The revenue impact will depend on the additional amount of distributions reported in any given tax year and the marginal tax rates of affected annuitants.

Based on very low federal projections in HR 3448, conformity would result in negligible revenue gains.

16. Repeal of Combined Plan Limit

The revenue impact from repealing combined plan limits is estimated to be as follows:

Estimated Revenue Impact Enactment After June 30, 1997 (In $Millions)			
Fiscal Years	1999-0	2000-1	2001-2
Revenue Impact (Rounded)	($2)	($7)	($7)

The Act will also suspend the 15% excise tax on excess distributions (over $150,000 per year or lump-sums exceeding $750,000) made during the period of 1997-99. This tax waiver will produce additional pension plan distributions resulting in baseline revenue gains for California on the order of $2 million per year. Taxpayers will report the same taxable distributions for state tax purposes as for federal.

Any possible changes in employment, personal income, or gross state product that might result from this proposal are not taken into account.

Revenue Discussion:

Revenue losses for the repeal of the combined plan limit will depend on additional contributions on behalf of employees participating in both pension plans stated above (subject to meeting nondiscrimination rules, etc.) and average marginal tax rates.

State estimates were based on federal projections for HR 3448. A proration factor of 3.6% was used based on state-to-nation comparisons of adjusted gross incomes (13.8%) and average marginal tax rates (25.8%).

17. Permit Volunteer Firefighters to Make Deferrals Under Sec.457 (Limited to $3,000 per year)

Revenue losses would depend on additional tax deferrals for length of service awards received through 457 plans of certain volunteers and their average marginal tax rates.

State revenue losses would be minor, not exceeding $500,000 annually, based on very low federal projections for HR 3448.

18. Alternative Nondiscrimination Rules for 401(k) Plans

The revenue impact from this provision is estimated to be as follows:

Estimated Revenue Impact Alternative Nondiscrimination Rules for 401(k) Plans (In $Millions)				
Fiscal Years	1998-9	1999-0	2000-1	2001-2
Revenue Impact (Rounded)	(Minor)	($1)	($1)	($1)

(Minor is less than $500,000)

Any possible changes in employment, personal income, or gross state product that might result from this proposal are not taken into account.

Revenue Discussion:

Revenue losses will depend on additional deferrals by employees and increased employer contributions to plans and applicable marginal tax rates.

Estimated state revenue losses were based on very low federal projections for HR 3448. A proration factor of 3.6% was used based on state-to-nation comparisons of adjusted gross incomes (13.8%) and average tax rates (25.8%).

19. Allow Pension Plan Coverage for Self-Employed Clergy

The revenue impact will depend on the additional amount of contributions to retirement income accounts in any given tax year and the marginal tax rates of affected participants.

Based on very low federal projections in HR 3448, conformity would result in negligible revenue losses annually.

20. Allow Church Pension Plan to Use New Definition of Highly Compensated Employee

The revenue impact will depend on the additional amount of contributions to church pension plans in any given tax year and the marginal tax rates of affected taxpayers.

Based on very low federal projections in HR 3448, conformity would result in negligible annual revenue losses.

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Act Section: 1501

Section Title: REPEAL OF INCLUSION OF CERTAIN EARNINGS INVESTED IN EXCESS PASSIVE ASSETS

New Federal Law (Sec. 951 - 964)

Under the rules of subpart F (secs. 951-964), certain 10-percent U.S. shareholders of a controlled foreign corporation (CFC) are required to include in income currently for U.S. tax purposes certain earnings of the CFC, whether or not such earnings are actually distributed currently to the shareholders. The 10-percent U.S. shareholders of a CFC are subject to current U.S. tax on their shares of certain income earned by the CFC (referred to as 'subpart F income'). The 10-percent U.S. shareholders are also subject to current U.S. tax on their shares of the CFC's earnings to the extent such earnings are invested by the CFC in certain U.S. property.

In addition to these current inclusion rules, the Omnibus Budget Reconciliation Act of 1993 enacted section 956A, which applies another current inclusion rule to U.S. shareholders of a CFC. Section 956A requires the 10-percent U.S. shareholder of a CFC to include in income currently their shares of the CFC's earnings to the extent such earnings are invested by the CFC in excess passive assets. A CFC generally is created as having excess passive assets if the average of the amounts of its passive assets exceeds 25 percent of the average of the amounts of its total assets; this calculation requires a quarterly determination of the CFC's passive assets and total assets.

The Act repeals section 956A.

Current California Law (R&T Sec. 25110)

California has not conformed to the Omnibus Budget Reconciliation Act of 1993 provision which enacted Sec. 956A.

Effective Date

The federal provision applies to taxable years of foreign corporations beginning after December 31, 1996, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

Impact on California Revenue

Not Applicable.

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Act Section: 1601

Section Title: MODIFICATIONS OF PUERTO RICO AND POSSESSION TAX CREDIT

New Federal Law (Sec. 936)

Certain domestic corporations with business operations in the U.S. possessions (including, for this purpose, Puerto Rico and the U.S. Virgin Islands) may elect the Puerto Rico and possession tax credit which generally eliminates the U.S. tax on certain income related to their operations in the possessions. In contrast to the foreign tax credit, the Puerto Rico and possession tax credit is a 'tax sparing' credit. That is, the credit is granted whether or not the electing corporation pays income tax to the possession.

The Act generally repeals the Puerto Rico and possession tax credit for taxable years beginning after December 31, 1995. However, the House bill provides grandfather rules under which a corporation that is an existing credit claimant would be eligible to claim credits for a transition period. A special transition rule applies to the credit attributable to operations in Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands.

Current California Law

California has no comparable credit.

Effective Date

The Act is effective for taxable years beginning after December 31, 1995.

Impact on California Revenue

Not applicable.

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Act Section: 1602

Section Title: REPEAL OF EXCLUSION FOR INTEREST ON LOANS USED TO ACQUIRE EMPLOYER SECURITIES

New Federal Law (Sec. 133, 291, 812, 4978-4978B & 6047)

The Act repeals a provision, relating to employee stock ownership plans (ESOP), under prior law which allowed a bank, insurance company, regulated investment company, or a corporation actively engaged in the business of lending money to exclude from gross income 50 percent of interest received on an ESOP loan.

Current California Law

California conformity to the 50 percent interest exclusion rule expired at the end of 1994. Thus, under current state law, no interest exclusion is allowed with respect to interest received on an ESOP loan.

Effective Date

The federal provision is effective with respect to loans made after August 20, 1996, other than loans made pursuant to a written binding contract in effect before June 10, 1996, and at all times thereafter before such loan is made. The repeal of the 50-percent interest exclusion does not apply to the refinancing of an ESOP loan originally made on or before the date of enactment or pursuant to a binding contract in effect before June 10, 1996, provided: (1) such refinancing loan otherwise meets the requirements of section 133 in effect on the day before the date of enactment; (2) the outstanding principal amount of the loan is not increased; and (3) the term of the refinancing loan does not extend beyond the term of the original ESOP loan.

Impact on California Revenue

Not applicable.

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Act Section: 1603

Section Title: CERTAIN AMOUNTS DERIVED FROM FOREIGN CORPORATIONS TREATED AS UNRELATED BUSINESS TAXABLE INCOME (UBI)

New Federal Law (Sec. 512)

The Act make certain Subpart F "insurance income" received by an exempt organization from foreign corporations taxable as UBI to the extent that the amount is attributable to "insurance income" which, if derived directly by the organization would be treated as gross income from an unrelated trade or business.

Current California Law (R&T Sec. 13201-13222)

Corporations which have made a water's-edge election for state purposes and which receive income from a controlled foreign corporation (CFC) are required to include a portion of the Subpart F income of the CFC in the water's-edge apportionable income.

Effective Date

This federal provision applies to amounts included in gross income in any taxable year beginning after December 31, 1995.

Impact on California Revenue

The revenue impact of this provision will be determined by (1) the amount of insurance income earned by CFCs that will be treated as income from an unrelated trade or business to the extent that it would be characterized that way if a tax-exempt organization had received the income directly and (2) the applicable tax rates.

Based on the low level of federal estimates for this provision in H.R. 3448, conforming to the provision would result in minor revenue gains of less than $500,000 annually beginning in 1997-98. It is assumed the provision would be effective with years after December 31, 1996, with enactment after June 30, 1997.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

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Act Section: 1604

Section Title: DEPRECIATION UNDER INCOME FORECAST METHOD

Background

In general, a taxpayer generally must capitalize the cost of property used in a trade or business and is allowed to recover such cost over time through allowances for depreciation or amortization.

The 'income forecast' method is an allowable method for calculating depreciation for certain property. Under the income forecast method, the depreciation deduction for a taxable year for a property is determined by multiplying the cost of the property (less estimated salvage value) by a fraction, the numerator of which is the income generated by the property during the year and the denominator of which is the total forecasted or estimated income to be derived from the property during its useful life. The income forecast method has been held to be applicable for computing depreciation deductions for motion picture films, television films and taped shows, books, patents, master sound recordings and video games. The total forecasted or estimated income to be derived from a property is to be based on the conditions known to exist at the end of the period for which depreciation is claimed.

New Federal Law (Sec. 167)

The Act provides the following modifications to the income forecast method.

Determination of estimated income

First, the agreement provides that income to be taken into account under the income forecast method includes all estimated income generated by the property.

In applying this rule, a taxpayer generally need not take into account income expected to be generated after the close of the tenth taxable year after the year the property was placed in service. In the case of a film, television show, or similar property, such income includes, but is not necessarily limited to, income from foreign and domestic theatrical, television, and other releases and syndications; and video tape releases, sales, rentals, and syndications.

Pursuant to a special rule, in the case of television and motion picture films, the income from the property shall include income from the financial exploitation of characters, designs, scripts, scores, and other incidental income associated with such films, but only to the extent the income is earned in connection with the ultimate use of such items by, or the ultimate sale of merchandise to, persons who are not related to the taxpayer.

As an example of this special rule, assume a taxpayer produces a motion picture the subject of which is the adventures of a newly-created fictional character. If the taxpayer produces dolls or T-shirts using the character's image, income from the sales of these products by the taxpayer to consumers would be taken into account in determining depreciation for the motion picture under the income forecast method.

Similarly, if the taxpayer enters into any licensing or similar agreement with an unrelated party with respect to the use of the image, such licensing income would be taken into account in determining depreciation for the motion picture. However, if the taxpayer uses the character's image to promote a ride at an amusement park that is wholly-owned by the taxpayer, no portion of the admission fees for the amusement park are to be taken into account under the income forecast method with respect to the motion picture.

In addition, pursuant to another special rule, if a taxpayer produces a television series and initially does not anticipate syndicating the episodes from the series, the forecasted income for the episodes of the first three years of the series need not take into account any future syndication fees (unless the taxpayer enters into an arrangement to syndicate such episodes during such period).

The 10th-taxable-year rule, the financial exploitation rule, and the syndication rule apply for purposes of the look-back method described below.

<u>Determination and treatment of costs of property</u>

The adjusted basis of property that may be taken into account under the income forecast method only will include amounts that satisfy the economic performance. For this purpose, if the taxpayer incurs a noncontingent liability to acquire property subject to the income forecast method from another person, economic performance will be deemed to occur with respect to such noncontingent liability when the property is provided to the taxpayer. In addition, the recurring item exception of section 461(h)(3) will apply in a manner similar to the way such exception applies under present law. Thus, expenditures that relate to an item of property that are incurred in the taxable year following the taxable year in which the property is placed in service may be taken into account in the year the property is placed in service to the extent uch expenditures meet the recurring item exception for such year.

Any costs that are taken into account after the property is placed in service are treated as a separate piece of property to the extent (1) such amounts are significant and are expected to give rise to a significant increase in the income from the property that was not included in the estimated income from the property, or (2) such costs are incurred more than 10 years after the property was placed in service. To the extent costs are incurred more than 10 years after the property was placed in service and give rise to a separate piece of property for which no income is generated, such costs may be written off and deducted as they are incurred. For example, assume a taxpayer places property subject to the income forecast method in service during a taxable year and all income from the property is generated in the following four-year period. If the taxpayer incurs additional costs with respect to that property more than 10 years later (e.g., a payment pursuant to a deferred contingent compensation arrangement to a person that produced the property), such costs may be deducted in the year incurred provided no more income is generated with respect to such costs or the original property.

Any costs that are not recovered by the end of the tenth taxable year after the property was placed in service may be taken into account as depreciation in such year.

Look-back method

Finally, taxpayers that claim depreciation deductions under the income forecast method are required to pay (or would receive) interest based on the recalculation of depreciation under a 'look-back' method. The 'look-back' method is applied in any 'recomputation year' by (1) comparing depreciation deductions that had been claimed in prior periods of depreciation deductions that would have been claimed had the taxpayer used actual, rather than estimated, total income from the property; (2) determining the hypothetical overpayment or underpayment of tax based on this recalculated depreciation; and (3) applying the overpayment rate of Sec. 6621 of the Code.

Except as provided in Treasury regulations, a 'recomputation year' is the third and tenth taxable year after the taxable year the property was placed in service, unless the actual income from the property for each taxable year ending with or before the close of such years was within 10 percent of the estimated income from the property for such years. The Secretary of the Treasury has the authority to allow a taxpayer to delay the initial application of the look-back method where the taxpayer may be expected to have significant income from the property after the third taxable year after the taxable year the property was placed in service (e.g., the Treasury Secretary may exercise such authority where the depreciable life of the property is expected to be longer than three years).

In applying the look-back method, any cost that is taken into account after the property was placed in service may be taken into account by discounting (using the Federal mid-term rate determined under sec. 1274(d) as of the time the costs were taken into account) such cost to its value as of the date the property was placed in service.

Property that had an unadjusted basis of $100,000 or less is not subject to the look-back method. For this purpose, 'unadjusted basis' means the total capitalized cost of a property as of the close of a recomputation year.

The Act provides a simplified look-back method for pass-through entities.

Current California Law (R&T Sec. 17201, 24349-24355 & 24368.1)

California conforms to federal law rules relating to the "income forecast" method of depreciation for both corporate and non-corporate taxpayers as those rules read prior to this federal change.

Effective Date

The provision is effective for property placed in service after September 13, 1995, unless produced or acquired pursuant to a binding written contract in effect on such date and all times thereafter.

For this purpose, the binding contract exception may apply to a written contract in effect on the relevant dates if that contract binds a taxpayer to produce, license or deliver property that will be used by the other party to the contract once the property is produced.

The provision may apply to property placed in service in taxable years that ended before the date of enactment of this Act (August 20, 1996).

The Act waives additions to tax imposed for any underpayments of tax or estimated tax for any taxable year ending before August 20, 1996, to the extent the underpayment was created or increased by the changes made to the income forecast method of depreciation by the provision. The application of the provision (including the look-back method) is not waived for any taxable year that ends after August 20, 1996.

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Impact on California Revenue

Conforming to this federal provision would result in revenue gains estimated to be as shown in the table below:

Fiscal Year Estimate Effective 1/1/97 [$ In Millions]		
1997-98	1998-99	1999-00
$3	$1	$1

It is assumed the provision would be effective for property placed in service after December 31, 1996, with enactment after June 30, 1997.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion:

The revenue impact of this provision will be determined by (1) the cost of certain property not being recovered as rapidly in the initial years of the property's depreciable life as in the past because of the expanded types of income that must be treated as estimated income from the property (the denominator of the income forecast method ratio); (2) the adjusted basis of the property for determining depreciation only includes amounts that satisfy the economic performance standard; (3) a limitation on the final year's depreciation deduction; and (2) applicable tax rates.

Revenue estimates above were based on federal projections for this provision in H.R. 3448. A proration factor of 3.7% was used based on state-to-nation comparisons of income and average marginal tax rates.

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Act Section: 1605

Section Title: REPEAL OF EXCLUSION FOR PUNITIVE DAMAGES AND FOR DAMAGES NOT ATTRIBUTABLE TO PHYSICAL INJURIES OR SICKNESS

Background

Gross income does not include any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injury or sickness.

The exclusion from gross income of damages received on account of personal injury or sickness specifically does not apply to punitive damages received in connection with a case not involving physical injury or sickness. Courts presently differ as to whether the exclusion applies to punitive damages received in connection with a case involving a physical injury or physical sickness. Certain States provide that, in the case of claims under a wrongful death statute, only punitive damages may be awarded.

The Supreme Court recently agreed to decide whether punitive damages awarded in a physical injury lawsuit are excludable from gross income. *O'Gilvie v. U.S.,* 66 F.3d 1550 (10th Cir. 1995), cert. granted, 64 U.S.L.W. 3639 (U.S. March 25, 1996) (No. 95-966).

Also, the Tax Court recently held that if punitive damages are not of a compensatory nature, they are not excludable from income, regardless of whether the underlying claim involved a physical injury or physical sickness. *Bagley v. Commissioner,* 105 T.C. No. 27 (1995).

Courts have interpreted the exclusion from gross income of damages received on account of personal injury or sickness broadly in some cases to cover awards for personal injury that do not relate to a physical injury or sickness. For example, some courts have held that the exclusion applies to damages in cases involving certain forms of employment discrimination and injury to reputation where there is no physical injury or sickness. The damages received in these cases generally consist of back pay and other awards intended to compensate the claimant for lost wages or lost profits.

The Supreme Court recently held that damages received based on a claim under the Age Discrimination in Employment Act could not be excluded from income. In light of the Supreme Court decision, the Internal Revenue Service has suspended existing guidance on the tax treatment of damages received on account of other forms of employment discrimination.

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New Federal Law (Sec. 104)

Include in income all punitive damages

The Act provides that the exclusion from gross income does not apply to any punitive damages received on account of personal injury or sickness whether or not related to a physical injury or physical sickness. Under the Act, present law continues to apply to punitive damages received in a wrongful death action if the applicable State law (as in effect on September 13, 1995 without regard to subsequent modification) provides, or has been construed to provide by a court decision issued on or before such date, that only punitive damages may be awarded in a wrongful death action. The Committee report states that no inference is intended as to the application of the exclusion to punitive damages prior to the effective date of the Act in connection with a case involving a physical injury or physical sickness.

Include in income damage recoveries for nonphysical injuries

The Act provides that the exclusion from gross income only applies to damages received on account of a personal physical injury or physical sickness. If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party. For example, damages (other than punitive damages) received by an individual on account of a claim for loss of consortium due to the physical injury or physical sickness of such individual's spouse are excludable from gross income. In addition, damages (other than punitive damages) received on account of a claim of wrongful death continue to be excludable from taxable income as under present law.

The Act also specifically provides that emotional distress is not considered a physical injury or physical sickness. The Committee report states that no inference is intended as to the application of the exclusion to damages prior to the effective date of the Act in connection with a case not involving a physical injury or physical sickness. Thus, the exclusion from gross income does not apply to any damages received (other than for medical expenses as discussed below) based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress. Because all damages received on account of physical injury or physical sickness are excludable from gross income, the exclusion from gross income applies to any damages received based on a claim of emotional distress that is attributable to a physical injury or physical sickness. In addition, the exclusion from gross income specifically applies to the amount of damages received that is not in excess of the amount paid for medical care attributable to emotional distress.

Current California Law (R&T Sec. 17131)

California conforms to federal law as it read January 1, 1993, which provides that gross income does not include any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injury or sickness.

Effective Date

The federal provisions generally are effective with respect to amounts received after August 20, 1996. The provisions do not apply to amounts received under a written binding agreement, court decree, or mediation award in effect on (or issued on or before) September 13, 1995.

Impact on California Revenue

State revenue gains for this provision will result from federal law changes and any additional effects from a matching state law change would be negligible.

These gains are considered to be base-line revenues since taxpayers will assume continued state conformity in this area of the tax law and report the same income for both federal and state purposes for punitive damages received.

Revenue Discussion:

Revenue gains for this proposal would depend on the additional income reported as a result of modifications for the exclusion of damage awards received on account of personal injury or sickness.

A "base-line revenue gain in the $2 to $3 million range would occur regardless of conformity in that many taxpayers would assume continued state conformity in this area of the tax law and report income in the same manner for state purposes. Any additional revenue by conforming would be negligible.

Base-line estimates were based on federal projections for this provision in HR 3448. A proration factor of 4.7% was used based on state-to-nation comparisons of average insurance expense and AGI (14.7 %) and average marginal tax rates (32.1%).

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Act Section: 1606

Section Title: REPEAL OF DIESEL FUEL TAX REBATE TO PURCHASERS OF DIESEL-POWERED AUTOMOBILES AND LIGHT TRUCKS

Background

In 1984, the diesel excise tax rate was increased above the gasoline tax as the revenue offset for a reduction in the annual heavy truck use tax. Because automobiles, vans, and light trucks did not benefit from the use tax reductions, a provision was enacted allowing first purchasers of model year 1979 and later diesel-powered automobiles and light trucks a tax credit to offset this increased diesel fuel tax. The credit is $102 for automobiles and $198 for vans and light trucks.

New Federal Law (Sec. 6427)

The Act repeals the tax credit for purchasers of diesel-powered automobiles, vans and light trucks.

Current California Law

Fuel taxes are administered by the State Board of Equalization (SBE). Defer to SBE.

Effective Date

The repeal of the federal credit is effective for vehicles purchased after August 20, 1996.

Impact on California Revenue

Defer to SBE.

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Act Section: 1607

Section Title: EXTENSION AND PHASEDOWN OF LUXURY PASSENGER AUTOMOBILE TAX

Background

An excise tax is imposed on the sale of an automobile, before January 1, 2000, whose price exceeds a designated threshold, currently $34,000. The excise tax is imposed at a rate of 10-percent on the excess of the sales price above the designated threshold. The $34,000 threshold is indexed for inflation.

New Federal Law (Sec. 4001)

The Act extends and phases out the luxury tax on automobiles. The tax rate is reduced by one percentage point per year beginning in 1996. The tax rate for sales (on or after August 27) in 1996 is 9%; 1997 - 8%; 1998 - 7%; 1999 - 6%; 2000 - 5%; 2001 - 4%; and 2002 - 3%. The tax will expire after December 31, 2002.

Current California Law

California has no comparable excise tax.

Effective Date

The provision is effective for sales on or after August 27, 1996.

Impact on California Revenue

Not applicable.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
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. t Section: 1608

Section Title: TERMINATION OF FUTURE TAX-EXEMPT BOND FINANCING FOR LOCAL FURNISHERS OF ELECTRICITY AND GAS

Background

Interest on State and local government bonds generally is excluded from federal income except where the bonds are issued to provide financing for private parties.

However, there are several exceptions that allow tax-exempt bonds to be used to provide financing for certain specifically identified private parties.

One such exception allows tax-exempt bonds to be issued to finance facilities for the furnishing of electricity or gas by private parties if the area served by the facilities does not exceed (1) two contiguous counties or (2) a city and a contiguous county (commonly referred to as the 'local furnishing' of electricity or gas).

For federal purposes, most private activity tax-exempt bonds are subject to general State private activity bond volume limits of $50 per resident of the State ($150 million, if greater) per year. Tax-exempt bonds for facilities used in the local furnishing of electricity or gas are subject to this limit.

Like most other private beneficiaries of tax-exempt bonds, borrowers using tax-exempt bonds to finance these facilities are denied interest deductions on the debt underlying the bonds if the facilities cease to be used in qualified local furnishing activities.

Additionally, as with all tax-exempt bonds, if the use of facilities financed with the bonds changes to a use not qualified for tax-exempt financing after the debt is incurred, interest on the bonds becomes taxable unless certain safe harbor standards are satisfied.

New Federal Law (Sec. 142)

In general, the Act allows persons that have received tax-exempt financing of facilities that currently qualify as used in the local furnishing of electricity or gas to elect to terminate their qualification for this tax-exempt financing and to expand their service areas without incurring the present-law loss of interest deductions and loss of tax-exemption penalties under specified conditions.

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Current California Law (R&T Sec. 17133, 17143, 24272 23701d)

California Personal Income Tax Law specifically does not conform to federal tax-exempt bond interest rules. Instead, the state Constitution provides that interest on bonds issued by California or of a local jurisdiction within the state are exempt from income tax. In addition, federal law precludes the states imposing an income tax on the interest earned from federal bonds.

With regard to the franchise tax, the Bank and Corporation Tax Law specifically includes all interest (including interest from California state and local bonds as well as federal bonds) to be included for purposes of the measured tax.

Effective Date

These federal provisions are effective on August 20, 1996.

Impact on California Revenue

Not applicable.

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Act Section: 1609

Section Title: EXTENSION OF AIRPORT AND AIRWAY TRUST FUND EXCISE TAXES

Background

Before January 1, 1996, the following excise taxes were imposed to fund the Airport and Airway Trust Fund: (1) a 10-percent tax on domestic air passenger tickets; (2) a 6.25-percent tax on domestic air freight waybills; (3) a $6-per-person tax on international air departures; (4) a 17.5 cents-per-gallon tax on jet fuel used in noncommercial aviation; and (5) a 15-cents-per-gallon tax on gasoline used in noncommercial aviation (14 cents per gallon of this tax continues, with the revenues being deposited in the Highway Trust Fund). In addition, jet fuel and gasoline used in noncommercial aviation are subject to a tax of 4.3 cents per gallon, the revenues of which are deposited in the General Fund of the Treasury. Prior to January 1, 1996, of the total tax of 19.3 cents per gallon imposed on gasoline used in noncommercial aviation, 18.3 cents per gallon was collected when the gasoline was removed from a pipeline or barge terminal. The remaining 1 cent per gallon was imposed at the retail level.

New Federal Law (Sec. 4091)

The Act reinstates the five Airport and Airway Trust Fund excise taxes at the pre-1996 rates for the period beginning seven calendar days after the date of enactment and through December 1, 1996, with specific new rules.

Current California Law

California fuel taxes are administered by the State Board of Equalization (SBE). Defer to SBE.

Effective Date

The Act applies to transportation or fuel sold beginning on August 27, 1996. The air passenger and air freight taxes do not apply to any amount paid before that date, even if for transportation occurring during the reinstatement period.

Impact on California Revenue

Defer to SBE.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1610

Section Title: BASIS ADJUSTMENT TO PROPERTY HELD BY A CORPORATION WHERE STOCK IN THE CORPORATION IS REPLACEMENT PROPERTY UNDER INVOLUNTARY CONVERSION RULES

New Federal Law (Sec. 1033)

The Act provides that where the taxpayer satisfies the replacement property requirement by acquiring stock in a corporation, the corporation generally will reduce its adjusted bases in its assets by the amount by which the taxpayer reduces its basis in the stock.

The corporation's adjusted bases in its assets will not be reduced, in the aggregate, below the taxpayer's basis is its stock (determined after the appropriate basis adjustment for the stock). In addition, the basis of any individual asset will not be reduced below zero.

The basis reduction first is applied to: (1) property that is similar or related in service or use to the converted property, then (2) to other depreciable property, then (3) to other property.

Current California Law (R&T Sec. 18031 & 24943-24949.3)

California conforms to federal rules for involuntary conversions as they read on January 1, 1993, and thus, gain realized by a taxpayer from certain involuntary conversions of property is deferred to the extent the taxpayer purchases property similar or related in service of use to the converted property within a specified replacement period of time.

The replacement property may be acquired directly or by acquiring control of a corporation (generally, 80 percent of the stock of the corporation) that owns replacement property.

The taxpayer's basis in the replacement property generally is the same as the taxpayer's basis in the converted property, decreased by the amount of any money or loss recognized on the conversion, and increased by the amount of any gain recognized on the conversion. In cases in which a taxpayer purchases stock as replacement property, the taxpayer generally reduces the basis of the stock, but does not reduce the basis of the underlying assets. Thus, the reduction in the basis of the stock generally does not result in reduced depreciation deductions where the corporation holds depreciable property, and may result in the taxpayer having more aggregate depreciable basis after the acquisition of replacement property than before the involuntary conversion.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

ffective Date

The federal provision applies to involuntary conversions occurring after August 20, 1996.

Impact on California Revenue

The revenue gain of this proposal is as follows:

Estimated Revenue Impact Applies to conversions occurring after August 20, 1996 Enactment After June 30 1997 ($in millions)		
1997-8	1998-9	1999-0
Less than $500,000	Less than $500,000	Less than $500,000

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion:

.evenue gains from this proposal will result from smaller depreciation deductions and/or larger reported gains on the eventual sale of business property.

Based on the minor impact projected for the federal law change, conforming to this modification of basis rules would produce insignificant revenue gains at the State level, less than $500,000 annually.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1611

Section Title: TREATMENT OF CERTAIN INSURANCE CONTRACTS ON RETIRED LIVES

Background

Life insurance companies are allowed a deduction for any net increase in reserves and are required to include in income any net decrease in reserves. The reserve of a life insurance company for any contract is the greater of the net surrender value of the contract or the reserve determined under federally prescribed rules. In no event, however, may the amount of the reserve for tax purposes for any contract at any time exceed the amount of the reserve for annual statement purposes.

Special rules are provided in the case of a variable contract. Under these rules, the reserve for a variable contract is adjusted by (1) subtracting any amount that has been added to the reserve by reason of appreciation in the value of assets underlying such contract, and (2) adding any amount that has been subtracted from the reserve by reason of depreciation in the value of assets underlying such contract. In addition, the basis of each asset underlying a variable contract is adjusted for appreciation or depreciation to the extent the reserve is adjusted.

A variable contract generally is defined as any annuity or life insurance contract (1) that provides for the allocation of all or part of the amounts received under the contract to an account that is segregated from the general asset accounts of the company, and (2) under which, in the case of an annuity contract, the amounts paid in, or the amounts paid out, reflect the investment return and the market value of the segregated asset account, or, in the case of a life insurance contract, the amount of the death benefit (or the period of coverage) is adjusted on the basis of the investment return and the market value of the segregated asset account. A pension plan contract that is not a life, accident, or health, property, casualty, or liability insurance contract is treated as an annuity contract for purposes of this definition.

New Federal Law (Sec. 817)

The Act provides that a variable contract is to include a contract that provides for the funding of group term life or group accident and health insurance on retired lives if: (1) the contract provides for the allocation of all or part of the amounts received under the contract to an account that is segregated from the general asset account of the company; and (2) the amounts paid in, or the amounts paid out, under the contract reflect the investment return and the market value of the segregated asset account underlying the contract.

Thus, the reserve for such a contract is to be adjusted by (1) subtracting any amount that has been added to the reserve by reason of appreciation in the value of assets underlying such contract, and (2) adding any amount that has been subtracted from the reserve by reason of depreciation in the value of assets underlying such contract. In addition, the basis of each asset underlying the contract is to be adjusted for appreciation or depreciation to the extent that the reserve is adjusted.

Current California Law (R&T Sec. 13201-13222)

California does not impose a franchise or income tax on "insurance income" but instead the state Constitution imposes a "gross premiums tax" on insurance companies. With respect to insurers admitted to issue insurance in this state, the "gross premiums tax" is the liability of the insurer and is administered by the State Board of Equalization. With respect to non-admitted insurers, the "gross premiums tax" is the liability of the insured and is administered by the Franchise Tax Board.

Effective Date

The federal provision applies to taxable years beginning after December 31, 1995.

Impact on California Revenue

Not applicable.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1612

Section Title: TREATMENT OF MODIFIED GUARANTEED CONTRACTS

Background

Life insurance companies are allowed a deduction for any net increase in reserves and are required to include in income any net decrease in reserves. The reserve of a life insurance company for any contract is the greater of the net surrender value of the contract or the reserve determined under Federally prescribed rules. The net surrender value of a contract is the cash surrender value reduced by any surrender penalty, except that any market value adjustment required on surrender is not taken into account. In no event, however, may the amount of the reserve for tax purposes for any contract at any time exceed the amount of the reserve for annual statement purposes.

In general, assets held for investment are treated as capital assets. Any gain or loss from the sale or exchange of a capital asset is treated as a capital gain or loss and is taken into account for the taxable year in which the asset is sold or exchanged.

New Federal Law (Sec. 817A)

The Act generally applies a mark-to-market regime to assets held as part of a segregated account under a modified guaranteed contract issued by a life insurance company. Gain or loss with respect to such assets held as of the close of any taxable year are taken into account for that year (even though the assets have not been sold or exchanged), and are treated as ordinary. If gain or loss is taken into account by reason of the mark-to-market requirement, then the amount of gain or loss subsequently realized as a result of sale, exchange, or other disposition of the asset, or as a result of the application of the mark-to-market requirement is appropriately adjusted to reflect such gain or loss. In addition, the reserve for a modified guaranteed contract is determined by taking into account the market value adjustment required on surrender of the contract.

A modified guaranteed contract is defined as any life insurance contract, annuity contract or pension plan contract that is not a variable contract, and that satisfies the following requirements. All or part of the amounts received under the contract must be allocated to an account which, pursuant to State law or regulation, is segregated from the general asset accounts of the company and is valued from time to time by reference to market values.

The reserves for the contract must be valued at market for annual statement purposes and the federally prescribed reserve for the contract must be valued at market. Further, a modified guaranteed contract includes only a contract that provides either for a net surrender value or for a policyholder's fund. If only a portion of the contract is not described in Sec. 817, that portion is treated as a separate contract for purposes of the provision.

Current California Law (R&T Sec. 13201-13222)

California does not impose a franchise or income tax on "insurance income" but instead the state Constitution imposes a "gross premiums tax" on insurance companies. With respect to insurers admitted to issue insurance in this state, the "gross premiums tax" is the liability of the insurer and is administered by the State Board of Equalization. With respect to non-admitted insurers, the "gross premiums tax" is the liability of the insured and is administered by the Franchise Tax Board.

Effective Date

The federal provision applies to taxable years beginning after December 31, 1995. A taxpayer that is required to (1) change its calculation of reserves to take into account market value adjustments and (2) mark to market its segregated assets in order to comply with the requirements of the provision is treated as having initiated changes in methods of accounting and as having received the consent of the Treasury Department to make such changes.

Except as otherwise provided in special rules, the adjustments required by reason of the changes in method of accounting are to be taken into account as ordinary income for the taxpayer's first taxable year beginning after December 31, 1995.

Impact on California Revenue

Not applicable.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1613

Section Title: TREATMENT OF CONTRIBUTIONS IN AID OF CONSTRUCTION

New Federal Law (Sec. 118)

1. The Act restores the contributions in aid of construction provisions that were repealed by the 1986 Act for regulated public utilities that provide water or sewerage disposal services.

2. The Act provides that water utility property will be depreciated using a 25-year recovery period and the straight-line method for regular tax purposes. For this purpose, 'water utility property' means (1) property that is an integral part of the gathering, treatment, or commercial distribution of water, and that, without regard to the proposal, would have had a recovery period of 20 years and (2) any municipal sewer. Such property generally is described in Asset Classes 49.3 and 51 of Revenue Procedure 87-56, 1987-2 C.B. 674. The Act does not change the class lives of water utility property for purposes of the alternative depreciation system of Sec. 168(g).

Current California Law (R&T Sec. 17250, 24324, 24325 & 24349-24355)

1. California is conformed to federal law as it read January 1, 1993, thus, the gross income of a corporation does not include contributions to its capital. A contribution to the capital of a corporation does not include any contribution in aid of construction or any other contribution as a customer or potential customer. Therefore, the receipt by a utility of a contribution in aid of construction is includable in the gross income of the utility, and the basis of property received or constructed pursuant to the contribution is not reduced.

From January 1, 1977, through December 31, 1991, California conformed to the prior federal exclusion from gross income for a regulated public utility that provided electric energy, gas water, or sewage disposal services for any amount of money or property received from any person as a contribution to its capital so long as such amount: (1) was a contribution in aid of construction; and (2) was not included in the taxpayer's rate base for rate-making purposes.

2. Under the Personal Income Tax Law (PITL) California conforms to the federal Modified Accelerated Depreciation System (MACRS).

Starting in 1997, nonresidential real property is depreciated using a 39-year recovery period and the straight-line method in conformity with federal law.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

The Bank and Corporation Tax Law (BCTL) does not conform to federal MACRS lives but instead uses the mid-range of the Class Life Asset Depreciation Range (CLADR) system to determine the economic useful life of depreciable assets.

Effective Date

1. The federal provision is effective for amounts received after June 12, 1996.

2. The federal provision is effective for property placed in service after June 12, 1996, other than property placed in service pursuant to a binding contract in effect before June 10, 1996, and at all times thereafter before the property is placed in service.

Impact on California Revenue

Revenue losses from this proposal are as follows:

Estimated Revenue Impact Applies to Amounts Received After June 12, 1996 Enactment After June 30 1997 ($in millions)		
1997-8	1998-9	1999-0
($3.5)	($2.5)	($2.5)

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion:

Revenue losses from this proposal will result depending on the amount of qualifying contributions to public utilities and the marginal tax rates of such utilities.

Based on a proration of federal estimates conforming to this provision would produce revenue losses as shown above.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1614

Section Title: ELECTION TO CEASE STATUS AS QUALIFIED SCHOLORSHIP FUNDING CORPORATION

New Federal Law (Sec. 150)

The Act provides that a nonprofit student loan funding corporation may elect to cease its status as a qualified scholarship funding corporation. If the corporation meets the requirements outlined below, such an election would not cause any bond outstanding as of the date of the issuer's election and any bond issued to refund such a bond to fail to be a qualified student loan bond. Once made, an election could be revoked only with the consent of the Secretary of the Treasury. After making the election, the issuer would not be authorized to issue any new bonds.

Requirements- First, upon making the election, the issuer is required to transfer all of the student loan notes to another, taxable, corporation in exchange for senior stock of such corporation within a reasonable period of time after the election is made. Immediately after the transfer, the issuer, and any other issuer who made the election, is required to hold all of the senior stock of the corporation. Senior stock is stock whose rights to dividends, liquidation or redemption rights are not inferior to those of any other class of stock and that (1) participates pro rata and fully in the equity value of any other common stock of the corporation, (2) has the right to payments receivable in liquidation prior to any other stock in the corporation, (3) upon liquidation or redemption, has a fixed right to receive the greater of (a) the fair market value of the stock at the date of liquidation or redemption or (b) the net fair market value of all assets transferred to the corporation by the issuer, and (4) has a right to require its redemption by a date which is not later than 10 years after the date that the election is made.

Second, the transferee corporation is required to assume or otherwise provide for the payment of all the qualified scholarship funding bond indebtedness of the issuer within a reasonable period after the election.

Third, immediately after the transfer, the issuer (i.e., the nonprofit student loan funding corporation) is required to become a charitable organization that is exempt from tax, at least 80 percent of the members of its board of directors must be independent members, and it must hold all of the senior stock of the corporation.

_ ..ess business holdings_- For purposes of the excess business holding restrictions imposed on a private foundation, the charity is not required to divest its ownership in a corporation most of whose assets are student loan notes incurred under the Higher Education Act of 1965.

Current California Law (R&T Sec. 17133, 17143, 24272 & 23701d)

California Personal Income Tax Law specifically does not conform to federal tax-exempt bond interest rules. Instead, the state Constitution provides that interest on bonds issued by California or of a local jurisdiction within the state are exempt from income tax. In addition, federal law precludes the states imposing an income tax on the interest earned from federal bonds.

With regard to the franchise tax, the Bank and Corporation Tax Law specifically includes all interest (including interest from California state and local bonds as well as federal bonds) to be included for purposes of the measured tax.

California rules for tax-exempt charitable organizations parallel the federal rules for charitable tax-exempt status.

Effective Date

..e federal changes is effective August 20, 1996.

Impact on California Revenue

Not applicable.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1615

Section Title: CERTAIN TAX BENEFITS DENIED TO INDIVIDUALS FAILING TO PROVIDE TAXPAYER IDENTIFICATION NUMBERS

Background

Under federal law, individuals who claim personal exemptions for dependents must include on their tax return the name and taxpayer identification number (TIN) of each dependent. The penalty for failure to provide a correct TIN for a dependent is $50.

New Federal Law (Sec. 6109)

If an individual fails to provide a correct TIN for a dependent, the IRS is authorized to deny the dependency exemption. Such a change also has indirect consequences for other tax benefits currently conditioned on being able to claim a dependency exemption (e.g., head of household filing status and the dependent care credit). In addition, the failure to provide a correct TIN for a dependent will be treated as a mathematical or clerical error and thus any notification that the taxpayer owes additional tax because of that failure will not be treated as a notice of deficiency.

Current California Law (R&T Sec. 18624)

Although California generally conforms to the federal rules requiring identification numbers on state tax returns, statements or other documents, the state specifically does not require the TIN of each dependent to be shown on the tax return.

Effective Date

The federal provision is effective for tax returns for which the due date (without regard to extensions) is 30 days or more after August 20, 1996. For taxable years beginning in 1995, no requirement to obtain a TIN applies in the case of dependents born after October 31, 1995. For taxable years beginning in 1996, no requirement to obtain a TIN applies in the case of dependents born after November 30, 1996.

Impact on California Revenue

This has not been a conformity issue previously. California does not require identification numbers for dependents on the return. Enforcement of proper dependency reporting is seen as an outcome of federal requirements which apply.

SMALL BUSINESS JOB PROTECTION ACT OF 1996 (PL 104-188)

ct Section: 1616

Section Title: REPEAL OF BAD DEBT RESERVE METHOD FOR THRIFT SAVINGS ASSOCIATIONS

Background

Generally, a taxpayer engaged in a trade or business may deduct the amount of any debt that becomes wholly or partially worthless during the year (the 'specific charge-off' method).

Under federal law, certain thrift institutions (building and loan associations, mutual savings banks, or cooperative banks) are allowed deductions for bad debts under rules more favorable than those granted to other taxpayers (and more favorable than the rules applicable to other financial institutions). Qualified thrift institutions may compute deductions for bad debts using either the specific charge-off method or the reserve method. Large banks (assets exceeding $500 million) are not permitted to use the reserve method for deduction of bad debts. Large banks are required to use the specific charge-off method. Smaller banks (assets under $500 million) are permitted to make additions to a reserve for bad debts based upon their own loss experience, using a six-year moving average.

ew Federal Law (Sec. 50, 593 repealed, 595 repealed, 596 repealed, 860E)

The Act repeals the reserve method of accounting for bad debts by thrift institutions, effective for taxable years beginning after 1995. Thrift institutions that would be treated as small banks are allowed to utilize the experience method applicable to such institutions, while thrift institutions that are treated as large banks are required to use only the specific charge-off method. Special rules are provided for the recapture of the existing reserve for bad debts.

The Act also repeals the following present-law provisions that only apply to thrift institutions to which section 593 applies: (1) the denial of a portion of certain tax credits to a thrift institution; (2) the special rules with respect to the foreclosure of property securing loans of a thrift institution; (3) the reduction in the dividends received reduction of a thrift institution; and (4) the ability of a thrift institution to use a net operating loss to offset its income from a residual interest in REMIC.

Current California Law (R&T Sec. 24348)

California does not conform to federal law. Instead, all banks are treated in a similar manner, since California has not conformed to the federal rules for large banks. Also, savings and loan associations are generally treated in the same manner as banks.

Under California law, all banks are permitted to make additions to a reserve for bad debts based upon their own loss experience, using a moving average of either three or six years.

California also allows the "out clause" or "facts and circumstances" method, if the taxpayer is able to establish that its reserve is understated.

The "out clause" or the "facts and circumstances" method, under California regulations, is also available if the taxpayer is able to establish that the addition to the reserve under other methods is not sufficient to absorb anticipated losses. The taxpayer may then claim an additional amount necessary to absorb such losses, provided that the amount of the reserve does not exceed the lower of:

a. The amount of the reserve required by or reported to bank or savings and loan association regulatory agencies and reflected in the taxpayer's published financial statements, or

b. One percent of the amount of loans outstanding at the close of the income year.

In order to come under the provisions of the "out clause" or the "facts and circumstances" method, the burden of proof lies exclusively with the taxpayer. The mere adoption of a book reserve amount is not sufficient to justify the allowance of the book reserve amount for tax purposes without specific documentation that the book reserve amount is necessary to absorb anticipated losses. The dollar amount of the book reserve is not important. Of great importance in meeting their burden of proof are the facts used to determine the reserve.

Effective Date

The repeal of Sec. 593 is effective for taxable years beginning after December 31, 1995. The repeal of Sec. 595 is effective for property acquired in taxable years beginning after December 31, 1995. The amendment to section 860E does not apply to any residual interest in a REMIC held by the taxpayer on October 31, 1995, and at all times thereafter. Special rules are provided for any distributions with espect to preferred stock (including redemptions of such stock)

Impact on California Revenue

Not applicable.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1617

Section Title: EXCLUSION FOR ENERGY CONSERVATION SUBSIDIES LIMITED TO SUBSIDIES WITH RESPECT TO DWELLING UNITS

Background

Federal law provides an exclusion from the gross income of a customer of a public utility for the value of any subsidy provided by the utility for the purchase or installation of an energy conservation measure with respect to a dwelling unit.

In addition, for subsidies received after 1994, federal law provides a partial exclusion from gross income for the value of any subsidy provided by a utility for the purchase or installation of an energy conservation measure with respect to property that is not a dwelling unit. The amount of the exclusion is 40 percent of the value for subsidies received in 1995, 50 percent of the value for subsidies received in 1996, and 65 percent of the value for subsidies received after 1996.

New Federal Law (Sec. 136)

The Act repeals the partial exclusion for any subsidy provided by a utility for the purchase or installation of an energy conservation measure with respect to property that is not a dwelling unit.

Current California Law (R&T Sec. 17139 & 24326)

For amounts received before January 1, 1995, California partially conformed to this federal provision by allowing the exclusion for energy conservation subsidies on only residential rental property. For amounts received on or after January 1 1995, no exclusion is allowed.

Effective Date

The federal provision is effective for subsidies received after December 31, 1996, unless received pursuant to a binding written contract in effect on September 13, 1995, and all times thereafter.

Impact on California Revenue

Not applicable.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1621

Section Title: FINANCIAL ASSET SECURITIZATION INVESTMENT TRUSTS

Background

An individual can own income-producing assets directly, or indirectly through an entity (i.e., a corporation, partnership, or trust). Where an individual owns assets through an entity (e.g., a corporation), the nature of the interest in the entity (e.g., stock of a corporation) is different than the nature of the assets held by the entity (e.g., assets of the corporation).

Securitization is the process of converting one type of asset into another and generally involves the use of an entity separate from the underlying assets. In the case of securitization of debt instruments, the instruments created in the securitization typically have different maturities and characteristics than the debt instruments that are securitized.

Entities used in securitization include entities that are subject to tax (e.g., a corporation), conduit entities that generally are not subject to tax (e.g., a partnership, grantor trust, or real estate mortgage investment conduit ('REMIC')), or partial-conduit entities that generally are subject to tax only to the extent income is not distributed to owners (e.g., a trust, real estate investment trust ('REIT'), or regulated investment company ('RIC')).

New Federal Law (Sec. 860H-L)

The Act creates a new type of statutory entity called a 'financial asset securitization investment trust' ('FASIT') that facilitates the securitization of debt obligations such as credit card receivables, home equity loans, and auto loans. A FASIT generally will not be taxable; the FASIT's taxable income or net loss will flow through to the owner of the FASIT. Detailed rules are provided regarding: (1) qualification; (2) permitted assets; (3) transfers of interests; (4) taxation of the assets, liabilities, income, gain, deduction or loss of a FASIT; (5) taxation of interests in the FASIT; (6) transfers to FASITs; (7) definitions of related person; and (8) modifying the wash sale rule to account for the creation of FASITs.

Current California Law

Under California law there is no statutory entity that facilitates the securitization of revolving, non-mortgage debt obligations.

Effective Date

This provision takes effect September 1, 1997. A special transition rule applies to entities (e.g., a trust whose interests are taxed like a partnership) that were in existence on August 31, 1997, that subsequently elect to be a FASIT (called a 'pre-effective date FASIT'). Under the special transitional rule, gain is not recognized on property contributed, or deemed contributed, to the FASIT to the extent that any such property is allocable to interests issued by a 'pre-effective date FASIT' (called a 'pre-FASIT interest'). The portion of such property that is allocable to pre-FASIT interests is to be determined by the Treasury Secretary, except that the property of the entity allocable to 'pre-FASIT interests' shall not be less than 107 percent of the aggregate principal amounts of outstanding 'pre-FASIT interests.'

Impact on California Revenue

Conforming to this federal provision would result in net revenue impacts estimated to be as shown in the table below:

Fiscal Year Estimate Effective 1/1/97 [$ In Millions]		
1997-98	1998-99	1999-00
$3	$2	minor loss

It is assumed the provision would be effective on September 1, 1997, (with enactment after June 30, 1997) and would extend a special transitional rule to any entity created before that date. Estimates above reflect the net impact for the year from both revenue gain and loss effects. Earlier year net gains are largely due to the taxable transfer of assets to FASITs.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion:

The revenue impact of this provision will be determined by (1) amounts of recognized net gains or losses (upon transfer of assets to or disposition by FASITs) and residual income passed-through to owners; (2) the treatment of FASIT-issued securities as debt rather than equity-owned interests; (3) amounts of FASIT income from foreclosure property;

(4) amounts of interest income to "holders" of a "regular" (including a "high-yield") interest in a FASIT; (5) amounts of interest income to "dealers" holding a high-yield interest (if securities held for investment or change in dealer status); and (6) applicable tax rates.

Revenue estimates above were based on federal projections for this provision in H.F. 3448. Federal estimates are not particularly significant due to the netting of both revenue gain and loss issues. A proration factor of 3.5% was used based on state-to-nation comparisons of income and average marginal tax rates.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1701-1703

Section Title: TECHNICAL CORRECTIONS

New Federal Law

The Act contains technical, clerical, and conforming amendments to the Revenue Reconciliation Act of 1990, the Revenue Reconciliation Act of 1993, and other recently enacted tax legislation.

Current California Law (R&T Sec. 17024.5 & 23051.5)

In general, when California conforms to federal law provisions by incorporating them into state law by reference, it does so as of a "specified date." Currently, the "specified date" is the Internal Revenue Code as it read January 1, 1993, prior to the passage of the Revenue Reconciliation Act of 1993. Several provisions of the Revenue Reconciliation Act of 1993, however, have been selectively adopted (either fully or partially) and made applicable to California.

Effective Date

In general, the federal technical, clerical, and conforming amendments apply as if included in the Acts being amended.

Impact on California Revenue

No identifiable revenue impact.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1801

Section Title: EXEMPTION FROM DIESEL FUEL DYEING REQUIREMENTS WITH RESPECT TO CERTAIN STATES

New Federal Law (Sec. 4082)

The Act provides that diesel fuel sold in the State of Alaska will be exempt from the diesel dyeing requirement during the period when that State is exempt from the Clean Air Act dyeing requirements. Thus, subject to a certification procedure to be developed by the Treasury Department, undyed diesel fuel which is destined for a nontaxable use may be removed from terminals without payment of tax through September 30, 1996 (urban areas, unless extended by the Environmental Protection Agency) or permanently (remote areas).

Current California Law

Not applicable to California.

Effective Date

The federal provision is effective beginning with the first calendar quarter after August 2, 1996.

Impact on California Revenue

Not applicable.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1802

Section Title: TREATMENT OF CERTAIN UNIVERSITY ACCOUNTS

New Federal Law (Sec. 3121)

In general, the OASDI portion of FICA taxes are payable with respect to employee remuneration not in excess of a contribution base. If an employee works for more than one employer during a year, these taxes are payable for each employer up to the contribution base. Under the common paymaster rule if an individual works for two or more related corporations, the remuneration may be treated as being from one employer and therefore taxable for one contribution base. The Social Security Amendments of 1983 provided a common paymaster rule for certain State universities that employ health care professionals as faculty members at a medical school and at a tax-exempt faculty practice plan. This rule does not explicitly apply to situations where compensation is made through a university agency account and not directly by a medical school faculty practice plan.

The Act establishes a common paymaster rule in cases where: (1) a State or State university provides remuneration pursuant to a single contract of employment to certain health care professionals as members of its medical school faculty; and (2) as agency account at such institution also provides remuneration to such health care professionals. The agency account must receive funds for the remuneration from a faculty practice plan described in Sec. 501(c)(3) of the Code. The payments may only be distributed by the agency account to faculty members who render patient care at the medical school. The faculty members receiving payments must comprise at least 30 percent of the membership of the faculty practice plan.

Current California Law

In California, employment taxes are administered by the Employment Development Department (EDD). Defer to EDD.

Effective Date

This federal provision applies to remuneration paid after December 31, 1996.

Impact on California Revenue

Defer to EDD.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1803

Section Title: MODIFICATIONS TO EXCISE TAX ON OZONE-DEPLETING CHEMICALS

New Federal Law (Sec. 4682)

An excise tax is imposed on the sale or use by the manufacturer or importer of certain ozone-depleting chemicals. A reduced rate of tax of $1.67 per pound applies to chemicals used as propellants in metered-dose inhalers. Taxable chemicals that are recovered and recycled within the United States are exempt from tax.

1. The Act extends the exemption from tax for domestically recovered and recycled ozone-depleting chemicals to imported recycled halons. The exemption for imported recycled halons applies only to such chemicals imported from countries that are signatories to the Montreal Protocol on Substances that Deplete the Ozone Layer.

2. The Act exempts chemicals used as propellants in metered-dose inhalers from the excise tax on ozone-depleting chemicals.

Current California Law

California has no comparable tax.

Effective Date

1. The provision is effective for halon-1301 and halon-2402 imported after December 31, 1996, and for halon-1211 imported after December 31, 1997.

2. The provision is effective for chemicals sold or used seven days after August 20, 1997.

Impact on California Revenue

Not applicable.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1804

Section Title: TAX-EXEMPT BONDS FOR SALE OF ALASKA POWER ADMINISTRATION FACILITY

New Federal Law (Sec. 142)

Interest on State and local government bonds to provide financing to private parties (private activity bonds) is taxable unless an exception is provided in the Internal Revenue Code. One such exception relates to the financing of facilities for the furnishing of electricity and gas. Most private activity bonds are subject to annual State volume limits of the greater of $50 per resident of the State or $150 million. Additionally, persons acquiring existing property financed with most private activity bonds must satisfy a rehabilitation requirement as a condition of the financing.

The Act provides an exception from the general rehabilitation requirement for private activity bonds used to acquire existing property for certain bonds to finance the acquisition of the Snettisham hydroelectric project for the Alaska Power Administration pursuant to legislation that has been enacted authorizing that transaction. These bonds are subject to the State of Alaska's private activity bond volume limit.

Current California Law (R&T Sec. 17133, 17143, 24272 23701d)

California Personal Income Tax Law specifically does not conform to federal tax-exempt bond interest rules. Instead, the state Constitution provides that interest on bonds issued by California or of a local jurisdiction within the state are exempt from income tax. In addition, federal law precludes the states imposing an income tax on the interest earned from federal bonds.

With regard to the franchise tax, the Bank and Corporation Tax Law specifically includes all interest (including interest from California state and local bonds as well as federal bonds) to be included for purposes of the measured tax.

Effective Date

The federal provision applies to bonds issued after August 20, 1996.

Impact on California Revenue

Not applicable.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1805

Section Title: NONRECOGNITION TREATMENT FOR CERTAIN TRANSFERS BY COMMON TRUST FUNDS TO REGULATED INVESTMENT COMPANIES

Background

Common trust funds

A common trust fund is a fund maintained by a bank exclusively for the collective investment and reinvestment of monies contributed by the bank in its capacity as a trustee, executor, administrator, guardian, or custodian of certain accounts and in conformity with rules and regulations of the Board of Governors of the Federal Reserve System or the Comptroller of the Currency pertaining to the collective investment of trust funds by national banks (sec. 584(a)).

The common trust fund is not subject to tax and is not treated as a corporation. Each participant in a common trust fund includes his proportional share of common trust fund income, whether or not the income is distributed or distributable.

No gain or loss is realized by the fund upon admission or withdrawal of a participant. Participants generally treat their admission to the fund as the purchase of an interest. Withdrawals from the fund generally are treated as the sale of an interest by the participant.

Regulated investment companies ('RICs')

A RIC also is treated as a conduit for federal income tax purposes. Conduit treatment is accorded by allowing the RIC a deduction for dividend distributions to its shareholders. Present law is unclear as to the tax consequences when a common trust fund transfers its assets to one or more RICs.

New Federal Law (Sec. 584)

In general, the Act permits a common trust fund to transfer substantially all of its assets to one or more RICs without gain or loss being recognized by the fund or its participants. The fund must transfer its assets to the RICs solely in exchange for shares of the RICs, and the fund must then distribute the RIC shares to the fund's participants in exchange for the participants' interests in the fund.

The basis of any asset received by a RIC will be the basis of the asset in the hands of the fund prior to transfer (increased by the amount of gain recognized by reason of the rule regarding the assumption of liabilities). In addition, the basis of any RIC shares that are received by a fund participant will be an allocable portion of the participant's basis in the interests exchanged. If stock in more than one RIC is received in exchange for assets of a common trust fund, the basis of the shares in each RIC shall be determined by allocating the basis of common fund assets used in the exchange among the shares of each RIC received in the exchange on the basis of the respective fair market values of the RICs.

The tax-free transfer is not available to a common trust fund with assets that are not diversified, except that the diversification test is modified so that Government securities are not to be included as securities of an issuer and are to be included in determining total assets for purposes of the 25- and 50-percent tests.

In order to qualify for the provision, the transfer by the common trust fund to the RIC must occur after December 31, 1995. The Committee report states that the conferees intend that there is no requirement for qualification that the transfer of assets by the common trust fund to one or more RICs and the distribution of RIC shares to participants in the common trust fund be made contemporaneously or pursuant to a single plan.

Current California Law (R&T Sec. 17671 & 17677)

California fully conforms to the federal rules for common trust funds as they read on January 1, 1993. In addition, California requires an annual return by every trust company operating a common trust fund. That annual return is required to state specifically the items of gross income and deductions and include information sufficient to identify the trusts and estates entitled to share in the taxable income of the common trust fund and the amount of the proportionate share of each participant.

Effective Date

The federal provision is effective for transfers after December 31, 1995.

Impact on California Revenue

The revenue impact of this provision will be determined by (1) the gain or loss on assets transferred to one or more regulated investment companies, (2) and the marginal tax rate of each participant in the common trust fund.

SMALL BUSINESS JOB PROTECTION ACT OF 1996 (PL 104-188)

Based on the low level of federal estimates for this provision in H.R. 3448, conforming to the provision would result in minor revenue losses of less than $500,000 annually beginning in 1997-98. It is assumed the provision would be effective with transfers after December 31, 1996, with enactment after June 30, 1997.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1806

Section Title: QUALIFIED STATE TUITION PROGRAMS

Background

In Michigan v. United States, 40 F.3d 817 (6th Cir. 1994), the Sixth Circuit held that the Michigan Education Trust, an entity created by the State of Michigan to operate a prepaid tuition payment program, is an integral part of the State, and, thus, the investment income realized by the Trust is not currently subject to Federal income tax. The Trust was established to receive advance payments of college tuition, invest the money, and ultimately make disbursements under a program that allows beneficiaries to attend any of the State's public colleges or universities without further tuition costs for a year or more (depending on the terms of the contract).

New Federal Law (Sec. 529)

The Act provides tax-exempt status to 'qualified State tuition programs,' meaning programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the sole purpose of meeting qualified higher education expenses of the designated beneficiary of the account. 'Qualified higher education expenses' are defined as tuition, fees, books, and equipment required for enrollment or attendance at a college or university (or certain vocational schools). The Senate amendment specifically provides that, although a qualified State tuition program generally is exempt from Federal income tax, such a program is subject to the unrelated business income tax (UBIT). Detailed qualification rules are provided.

In addition, the Act provides that no amount shall be included in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary (e.g., when the beneficiary attends college) will be included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amount or the value of the educational benefits exceeds contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent or other relative receives a refund) will be included in the contributor's gross income to the extent such amounts exceed contributions made by that person. Contributions made by an individual to a qualified State tuition program are treated as a qualified transfer and, thus, not subject to federal gift tax.

Current California Law (R&T Sec. 17133, 17143, 24272 23701d)

California Personal Income Tax Law does not have any specific rules relating to state tuition plans, however, the state does not conform to federal tax-exempt bond interest rules. Instead, the state Constitution provides that interest on bonds issued by California or of a local jurisdiction within the state are exempt from income tax.

Effective Date

The federal provision is effective for taxable years ending after August 20, 1996. The Act also includes a transition rule providing that if (1) a State maintains (on the date of enactment) a program under which persons may purchase tuition credits on behalf of, or make contributions for educational expenses of, a designated beneficiary, and (2) such program meets the requirements of a qualified State tuition program before the later of (a) one year after August 20, 1996, or (b) the first day of the first calendar quarter after the close of the first regular session of the State legislature that begins after August 20, 1996, then the provisions of the Act will apply to contributions (and earnings allocable thereto) made before the date the program meets the requirements of a qualified State tuition program, without regard to whether the requirements of a qualified State tuition program are satisfied with respect to such contributions and earnings (e.g., even if the interest in the tuition or educational savings program covers not only qualified higher education expenses but also room and board expenses).

Impact on California Revenue

Pending.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1807

Section Title: ADOPTION ASSISTANCE

New Federal Law (Sec. 23 & 137)

Adoption Tax Credit

The Act provides taxpayers with a maximum nonrefundable credit against income tax liability of $5,000 ($6,000 for certain special needs adoptions) per child for qualified adoption expenses paid or incurred by the taxpayer. Any unused adoption credit may be carried forward by the taxpayer for up to five years.

Qualified adoption expenses are reasonable and necessary adoption fees, court costs, attorneys' fees and other expenses that are directly related to the legal adoption of an eligible child. In the case of an international adoption, the credit is not available unless the adoption is finalized.

An eligible child is an individual (1) who has not attained age 18 as of the time of the adoption, or (2) who is physically or mentally incapable of caring for himself or herself. No credit is allowed for expenses incurred (1) in violation of State or Federal law, (2) in carrying out any surrogate parenting arrangement, or (3) in connection with the adoption of a child of the taxpayer's spouse.

The credit is phased out ratably for taxpayers with modified adjusted gross income (AGI) above $75,000, and is fully phased out at $115,000 of modified AGI. The credit is not allowed for any expenses for which a grant is received under any Federal, State, or local program.

Otherwise, qualified adoption expenses paid in one taxable year are not taken into account for purposes of the credit until the next taxable year unless the expenses are incurred in the year the adoption becomes final.

Exclusion from income

The Act provides a maximum $5,000 ($6,000 for certain special needs adoptions) exclusion from the gross income of an employee for specified certain adoption expenses paid by the employer. The limit is a per child limit, not an annual limitation. The exclusion is phased out ratably for taxpayers with modified AGI above $75,000 and is fully phased out at $115,000 of modified AGI.

No credit is allowed for adoption expenses paid or reimbursed under an adoption assistance program.

Current California Law (R&T Sec. 17052.25)

Since 1994, California allows a credit equal to 50% of the cost of adopting a minor child who is an American citizen and is in the custody of a California public agency or a political subdivision of California. The credit is to be claimed in the taxable year in which the decree or order of adoption is entered although qualifying costs paid or incurred in prior years can qualify for the credit. Costs eligible for the credit include:

- o fees for required services of either the Department of Social Services or a licensed adoption agency;
- o travel and related expenses for the adoptive family that are directly related to the adoption process; and
- o medical fees and expenses that are not reimbursed by insurance and are directly related to the adoption process.

The maximum allowable credit can not exceed $2,500 per minor child; however, credit amounts exceeding the net tax may be carried over to succeeding taxable years until exhausted. Otherwise deductible medical expenses relating to child adoption costs are reduced by the amount of the credit.

Effective Date

The federal provision is effective for taxable years beginning after December 31, 1996.

Impact on California Revenue

This proposal is estimated to impact PIT revenue as shown in the following table.

Fiscal Year Cash Flow Impact Effective 1/1/97 Assumed Enactment After 6/30/97 $ Millions				
	1997-8	1998-9	1999-00	2000-01
Tax Credit	(7)	(20)	(35)	(40)
Exclusion	(minor*)	(minor*)	(minor*)	(minor*)

* Loss less than $500,000

Some credits in any given period would be limited due to TMT interaction, but probably not significant. Additionally, this analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion:

The revenue impact in conforming to the federal credit in lieu of the existing state credit will be determined by the amount of qualified adoption expenses incurred during any given taxable year and the amount of additional credits applied against tax liabilities. The exclusion portion of this proposal would be insignificant.

Revenue estimates above were based on federal projections for this provision in H.R. 3448. A proration factor of 3.5% was used based on state to nation comparisons of adjusted gross income (11.7%) and average marginal tax rates (30.0%). The above estimate reflects the additional revenue losses due to federal conformity. It is assumed that 30% of the credit claimed on CA returns would be applied in the first year and unapplied carryover credits would be exhausted over a two year period. The significant increase in revenue losses after the initial year reflects the build-up of large carryover credits since, for this analysis, the state would be adopting the same credit amount as under federal law.

The state currently has a law allowing a child adoption credit, currently generating revenue losses of approximately $500,000 annually and is not limited to AGI categories, but is only for agency adoptions made in California. The federal law allows a credit for all adoptions and limits the credit based on AGI.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1808

Section Title: REMOVAL OF BARRIERS TO INTERETHNIC ADOPTION

New Federal Law (Sec. 471 of the Social Security Act)

Federal law is amended to prohibit a state or other entity that receives federal assistance from denying to any person the opportunity to become an adoptive or a foster parent on the basis of the race, color, or national origin of the person or of the child involved. Similarly, no state or other entity receiving federal funds can delay or deny the placement, on the basis of the race, color, or national origin of the adoptive or foster parent or the child involved. Noncompliance constitutes a violation of Title VI of the Civil Rights Act of 1964. The Indian Child Welfare Act of 1978 is not affected by these changes. In addition, monetary penalties are provided.

Current California Law

The California program is administered by the Department of Social Services (DSS). Defer to DSS.

Effective Date

The federal provisions related to civil rights enforcement are effective August 20, 1996. The provisions related to state plan requirements are effective on January 1, 1997.

Impact on California Revenue

Defer to DSS.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1809

Section Title: 6-MONTH DELAY OF ELECTRONIC FUND TRANSFER REQUIREMENT

Background

Employers are required to withhold income taxes and FICA taxes from wages paid to their employees. Employers also are liable for their portion of FICA taxes, excise taxes, and estimated payments of their corporate income tax liability.

The Code requires the development and implementation of an electronic fund transfer system to remit these taxes and convey deposit information directly to the Treasury. The Electronic Federal Tax Payment System ('EFTPS') was developed by Treasury in response to this requirement. Employers must enroll with one of two private contractors hired by the Treasury. After enrollment, employers generally initiate deposits either by telephone or by computer.

The new system is phased in over a period of years by increasing each year the percentage of total taxes subject to the new EFTPS system. For fiscal year 1994, 3 percent of the total taxes are required to be made by electronic fund transfer. These percentages increased gradually for fiscal years 1995 and 1996. For fiscal year 1996, the percentage was 20.1 percent (30 percent for excise taxes and corporate estimated tax payments). For fiscal year 1997, these percentages increased significantly, to 58.3 percent (60 percent for excise taxes and corporate estimated tax payments). The specific implementation method required to achieve the target percentages is set forth in Treasury regulations. Implementation began with the largest depositors. Treasury has implemented the 1997 percentages by requiring that all employers who deposit more than $50,000 in 1995 must begin using EFTPS by January 1, 1997.

New Federal Law (Sec. 6302)

The Committee report states that the conferees are concerned that the initial mailing by IRS to employers that informed them of the 1997 requirements confused many of these employers. The conferees believe that it is necessary to provide additional time prior to implementation of the 1997 requirements so that employers may be better informed about their responsibilities. Accordingly, the Act provides that the increase in the required percentages for fiscal year 1997 (which, pursuant to Treasury regulations, was to take effect on January 1, 1997) shall not take effect until July 1, 1997.

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0Current California Law (R&T Sec. 19011)

The Franchise Tax Board administers an ongoing Electronic Funds Transfer Program with respect to corporate franchise and income tax. The Employment Development Department (EDD) administers employer withholding of wages and employment taxes. Defer to EDD with respect to those taxes.

Effective Date

The provision is effective on August 20, 1996.

Impact on California Revenue

Defer to EDD regarding wage and employment taxes.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1901-1907

Section Title: FOREIGN TRUST COMPLIANCE

Background

1.Inbound grantor trusts with foreign grantors

Under the grantor trust rules (secs. 671-679), a grantor that retains certain rights or powers generally is treated as the owner of the trust's assets without regard to whether the grantor is a domestic or foreign person. Under these rules, U.S. trust beneficiaries are not subject to U.S. tax on distributions from a trust where a foreign grantor is treated as owner of the trust, even though no tax may be imposed on the trust income by any jurisdiction. In addition, a special rule provides that if a U.S. beneficiary of an inbound grantor trust transfers property to the foreign grantor by gift, that U.S. beneficiary is treated as the grantor of the trust to the extent of the transfer.

2. Foreign trusts that are not grantor trusts

Under the accumulation distribution rules (which generally apply to distributions from a trust in excess of the trust's distributable net income for the taxable year), a distribution by a foreign nongrantor trust of previously accumulated income generally is taxed at the U.S. beneficiary's average marginal rate for the prior 5 years, plus interest (secs. 666 and 667). Interest is computed at a fixed annual rate of 6 percent, with no compounding. If adequate records of the trust are not available to determine the proper application of the rules relating to accumulation distributions to any distribution from a trust, the distribution is treated as an accumulation distribution out of income earned during the first year of the trust.

If a foreign nongrantor trust makes a loan to one of its beneficiaries, the principal of such a loan generally is not taxable as income to the beneficiary.

3. Outbound foreign grantor trusts with U.S. grantors

Under the grantor trust rules, a U.S. person that transfers property to a foreign trust generally is treated as the owner of the portion of the trust comprising that property for any taxable year in which there is a U.S. beneficiary of any portion of the trust. This treatment generally does not apply, however, to transfers by reason of death, to transfers made before the transferor became a U.S. person, or to transfers that represent sales or exchanges of property at fair market value where gain is recognized to the transferor.

4. Residence of trusts

A trust is treated as foreign if it is not subject to U.S. income taxation on its income that is neither derived from U.S. sources nor effectively connected with the conduct of a U.S. trade or business. Thus, if a trust is taxed in a manner similar to a nonresident alien individual, it is considered to be a foreign trust. Any other trust is treated as domestic.

Section 1491 generally imposes a 35-percent excise tax on a U.S. person that transfers appreciated property to certain foreign entities, including a foreign trust. In the case of a domestic trust that changes its situs and becomes a foreign trust, it is unclear whether property has been transferred from a U.S. person to a foreign entity and, thus, whether the transfer is subject to the excise tax.

5. Information reporting and penalties related to foreign trusts

Any U.S. person that creates a foreign trust or transfers money or property to a foreign trust is required to report that event to the Treasury Department without regard to whether the trust is a grantor or a nongrantor trust. Similarly, any U.S. person that transfers property to a foreign trust that has one or more U.S. beneficiaries is required to report annually to the Treasury Department. In addition, any U.S. person that makes a transfer described in section 1491 is required to report the transfer to the Treasury Department.

Any person that fails to file a required report with respect to the creation of, or a transfer to, a foreign trust may be subject to a penalty of 5 percent of the amount transferred to the foreign trust. Similarly, any person that fails to file a required annual report with respect to a foreign trust with U.S. beneficiaries may be subject to a penalty of 5 percent of the value of the corpus of the trust at the close of the taxable year. The maximum amount of the penalty imposed under either case may not exceed $1,000. A reasonable cause exception is available.

6. Reporting of foreign gifts

There was no requirement to report gifts or bequests from foreign sources prior to the Act.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

New Federal Law (Sec. 643, 665, 668, 672, 679, 1494, 603F, 6048, 6677 & 7701)

1. Inbound grantor trusts with foreign grantors

The Act generally applies only to the extent it results, directly or indirectly, in income or other amounts (if any) being currently taken into account in computing the income of a U.S. citizen or resident or a domestic corporation. Certain exceptions apply to this rule. Under one exception, the grantor trust rules continue to apply to the portion of a trust where that portion of the trust is revocable by the grantor either without approval of another person or with the consent of a related or subordinate party who is subservient to the grantor. Under another exception, the grantor trust rules continue to apply to the portion of a trust where the only amounts distributable from that portion during the lifetime of the grantor are to the grantor or the grantor's spouse. The general rule denying grantor trust status does not apply to trusts established to pay compensation, and certain trusts in existence as of September 19, 1995 provided that such trust is treated as owned by the grantor. In addition, the grantor trust rules generally apply where the grantor is a controlled foreign corporation. Finally, the grantor trust rules continue to apply in determining whether a foreign corporation is characterized as a passive foreign investment company ('PFIC'). Thus, a foreign corporation cannot avoid PFIC status by transferring its assets to a grantor trust.

The Act provides a special rule that allows the Secretary of the Treasury to recharacterize a transfer, directly or indirectly, from a partnership or foreign corporation which the transferee treats as a gift or bequest.

The Act provides a transition rule for any domestic trust that has a foreign grantor that is treated as the owner of the trust under present law, but becomes a non-grantor trust under the bill. If such a trust becomes a foreign trust before January 1, 1997, or if the assets of such a trust are transferred to a foreign trust before that date, such trust is exempt from the excise tax on transfers to a foreign trust otherwise imposed. However, the Act's new reporting requirements and penalties are applicable to such a trust and its beneficiaries. In addition, the assets of such a trust will be treated as if they were recontributed to a non-grantor trust by the foreign grantor, with no recognition of gain or loss, on the date the trust ceases to be treated as a grantor trust. The non-grantor trust will have the same basis in such assets as did the grantor on the date the trust ceases to be treated as a grantor trust.

2. Foreign trusts that are not grantor trusts

The Act changes the interest rate applicable to accumulation distributions from foreign trusts from simple interest at a fixed rate of 6 percent to compound interest determined in the same manner as interest imposed on underpayments of tax. Simple interest is accrued at the rate of 6 percent through 1995. Beginning on January 1, 1996, however, compound interest based on the underpayment rate is imposed not only on tax amounts determined under the accumulation distribution rules but also on the total simple interest for pre-1996 periods, if any. For purposes of computing the interest charge, the accumulation distribution is allocated proportionately to prior trust years in which the trust has undistributed net income (and the beneficiary receiving the distribution was a U.S. citizen or resident), rather than to the earliest of such years. An accumulation distribution is treated as reducing proportionately the undistributed net income from prior years.

In the case of a loan of cash or marketable securities by the foreign trust to a U.S. grantor or a U.S. beneficiary (or a U.S. person related to such grantor or beneficiary), except, to the extent provided by Treasury regulations, the Act treats the full amount of the loan as distributed to the grantor or beneficiary. In addition, any subsequent transaction between the trust and the original borrower regarding the principal of the loan (e.g., repayment) is disregarded for all purposes of the Code. This provision does not apply to loans made to persons that are exempt from U.S. income tax.

Effective Date

The provision to modify the interest charge on accumulation distributions applies to distributions after the date of enactment. The provision with respect to loans to U.S. grantors, U.S. beneficiaries or a related U.S. person related to such a grantor or beneficiary applies to loans made after September 19, 1995.

3. Outbound foreign grantor trusts with U.S. grantors

The Act makes several modifications to the general rules under which a U.S. person who transfers property to a foreign trust generally is treated as the owner of the portion of the trust comprising that property for any taxable year in which there is a U.S. beneficiary of the trust. The Act also contains an amendment to conform the definition of certain foreign corporations the income of which is deemed to be accumulated for the benefit of a U.S. beneficiary to the definition controlled foreign corporations.

Sale or exchange at market value.--Present law contains several exceptions to grantor trust treatment described above. Under one of the exceptions, grantor trust treatment does not result from a transfer of property by a U.S. person to a foreign trust in the form of a sale or exchange at fair market value where gain is recognized to the transferor. In determining whether the trust paid fair markets value to the transferor, the Act provides that obligations issued (or, to the extent provided by regulations, guaranteed) by the trust, by any grantor or beneficiary of the trust, or by any person related to any grantor or beneficiary (referred to as 'trust obligations') generally are not taken into account except as provided in Treasury regulations. Principal payments by the trust on any such trust obligations generally will reduce the portion of the trust attributable to the property transferred (i.e., the portion of which the transferor is treated as the grantor).

Other transfers.--The Act adds new exception to the general rule described above. Under the Act, a transfer of property to certain charitable trusts is exempt from the application of the rules treating foreign trusts with U.S. grantors and U.S. beneficiaries as grantor trusts.

Transferors or beneficiaries who become U.S. persons.--The Act applies the grantor trust rule to certain foreign persons who transfer property to a foreign trust and subsequently become U.S. persons. A nonresident alien individual who transfers property, directly or indirectly, to a foreign trust and then becomes a resident of the United States within 5 years after the transfer generally is treated as making a transfer to the foreign trust on the individual's U.S. residency starting date. The amount of the deemed transfer is the portion of the trust (including undistributed earnings) attributable to the property previously transferred. Consequently, the individual generally is treated as the owner of that portion of the trust in any taxable year in which the trust has U.S. beneficiaries.

Outbound trust migrations.--The Act applies the grantor trust rules to a U.S. person who transferred property to a domestic trust if the trust subsequently becomes a foreign trust while the transferor is still alive. Such a person is deemed to make a transfer to the foreign trust on the date of the migration. The amount of the deemed transfer is the portion of the trust (including undistributed earnings) attributable to the property previously transferred. Consequently, the individual generally is treated as the owner of that portion of the trust in any taxable year in which the trust has U.S. beneficiaries.

Effective Date

These provisions apply to transfers of property after February 6, 1995.

4. Anti-abuse regulatory authority

The Act includes an anti-abuse rule which authorizes the Secretary of the Treasury to issue regulations, on or after the date of enactment, that may be necessary or appropriate to carry out the purposes of the rules applicable to estates, trusts and beneficiaries, including regulations to prevent the avoidance of those purposes.

5. Residence of trusts

The Act establishes a two-part objective test for determining for tax purposes whether a trust is foreign or domestic. If both parts of the test are satisfied, the trust is treated as domestic. Under the first part of the proposed test, if a U.S. court (i.e., Federal, State, or local) exercises primary supervision over the administration of the trust, the trust is treated as domestic. Under the second part of the test, in order for a trust to be treated as domestic, one or more U.S. fiduciaries must have the authority to control all substantial decisions of the trust.

Under the Act, if a domestic trust changes its situs and becomes a foreign trust, the trust is treated as having made a transfer of its assets to a foreign trust and is subject to the 35-percent excise tax imposed by present-law unless one of the exceptions to this excise tax is applicable.

Effective Date

The provision to modify the treatment of a trust as a U.S. person applies to taxable years beginning after December 31, 1996. In addition, if the trustee of a trust so elects, the provision applies to taxable years ending after the date of enactment. The amendment to Sec. 1491 is effective on the date of enactment.

6. Information reporting and penalties relating to foreign trusts

The Act generally requires the grantor, transferor or executor (i.e., the 'responsible party') to file information returns with the Treasury Department upon the occurrence of certain events. The term 'reportable event' generally means the creation of any foreign trust by a U.S. person, the direct and indirect transfer of any money or property to a foreign trust, including a transfer by reason of death, and the death of a U.S. citizen or resident if any portion of a foreign trust was included in the gross estate of the decedent. In addition, a U.S. owner of any portion of a foreign trust generally is required to ensure that the trust files an annual return to provide full accounting of all the trust activities for the taxable year. Finally, any U.S. person that receives (directly or indirectly) any distribution from a foreign trust generally is required to file a return to report the name of the trust, the aggregate amount of the distributions received, and other information that the Secretary of the Treasury may prescribe.

Under the Act, a person that fails to provide the required notice or return in cases involving the transfer of property to a new or existing foreign trust, or a distribution by a foreign trust to a U.S. person, is subject to an initial penalty equal to 35 percent of the gross reportable amount. A failure to provide an annual reporting of trust activities will result in an initial penalty equal to 5 percent of the gross reportable amount.

The Act provides that if a U.S. owner of any portion of a foreign trust fails to appoint a limited U.S. agent to accept service of process with respect to any requests and summons by the Secretary of the Treasury in connection with the tax treatment of any items related to the trust, the Secretary may determine the tax consequences of amounts to be taken into account under the grantor trust rules. In cases where adequate records are not provided to the Secretary to determine the proper treatment of any distributions from a foreign trust, the distribution is includable in the gross income of the U.S. distributee and is treated as an accumulation distribution from the middle year of a foreign trust (i.e., computed by taking the number of years that the trust has been in existence divided by 2) for purposes of computing the interest charge applicable to such distribution, unless the foreign trust elects to have a U.S. agent for the limited purpose of accepting service of process (as described above).

Under the Act, a person that fails to provide the required notice or return in cases involving the transfer of property to a new or existing foreign trust, or a distribution by a foreign trust to a U.S. person, is subject to an initial penalty equal to 35 percent of the gross reportable amount (generally the value of the property involved in the transaction). A failure to provide an annual reporting of trust activities will result in an initial penalty equal to 5 percent of the gross reportable amount. An additional $10,000 penalty is imposed for continued failure for each 30-day period (or fraction thereof) beginning 90 days after the Treasury Department notifies the responsible party of such failure. Such penalties are subject to a reasonable cause exception. In no event will the total amount of penalties exceed the gross reportable amount.

Effective Date

The reporting requirements and applicable penalties generally apply to reportable events occurring or distributions received after the date of enactment. The annual reporting requirement and penalties applicable to U.S. grantors apply to taxable years of such persons beginning after December 31, 1995.

7. Reporting of foreign gifts

The Act generally requires any U.S. person (other than certain tax-exempt organizations) that receives purported gifts or bequests from foreign sources total more than $10,000 during the taxable year to report them to the Treasury Department. The threshold for this reporting requirement is indexed for inflation. The definition of a gift to a U.S. person for this purpose excludes amounts that are qualified tuition or medical payments made on behalf of the U.S. person, as defined for gift tax purposes, and amounts that are distributions to a U.S. beneficiary of a foreign trust if such amounts are properly disclosed under the reporting requirements of the House bill. If the U.S. person fails, without reasonable cause, to report foreign gifts as required, the Secretary of the Treasury is authorized to determine the tax treatment of the unreported gifts. In addition, the U.S. person is subject to a penalty equal to 5 percent of the amount of the gift for each month that the failure continues, with the total penalty not to exceed 25 percent of such amount.

Current California Law (R&T Sec. 17024.5(b)(6) & 17731)

In general, California conforms to the federal rules relating to the taxation of the income of estates and trusts as well as the beneficiaries of those estates and trusts.

However, the state specifically does not conform to any of the federal foreign trust rules. Instead California taxes non-grantor trusts having both resident and nonresident fiduciaries based on the ratio of resident fiduciaries to nonresident fiduciaries. Also, California taxes non-grantor trusts having both resident and nonresident beneficiaries based on the ratio of resident beneficiaries to nonresident beneficiaries. In addition, for those trusts having some fiduciaries and beneficiaries who are residents and some who are nonresidents, California will combine the two previous ratios.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Special rules are provided for the taxation of non-grantor trust income, for trusts having beneficiaries whose interest in the trust is contingent during the years trust income is accumulated, to that beneficiary when the accumulated income is distributed.

California does not impose an excise tax on a trust fiduciary or beneficiary which changes from resident to nonresident.

Effective Date

In general, the federal provisions apply to amounts received after August 20, 1996, except as stated in the individual item.

Impact on California Revenue

Not applicable.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 1951 - 1954

Section Title: GENERALIZED SYSTEM OF PREFERENCES

New Federal Law (Title V of the Trade Act of 1974)

Reinstates several trade provisions.

Current California Law

California has no comparable provisions.

Impact on California Revenue

Not applicable.

SMALL BUSINESS JOB PROTECTION ACT OF 1996
(PL 104-188)

Act Section: 2101 - 2105

Section Title: PAYMENT OF WAGES

New Federal Law

Beginning October 1, 1996, the minimum wage increases from $4.25 to $4.75, and beginning September 1, 1997, the minimum wage increases from $4.75 to $5.15.

Current California Law

The Employment Development Department (EDD) administers the state minimum wage. Defer to EDD.

Impact on California Revenue

Defer to EDD.

HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT OF 1996
(PL 104-191)

Act Section: 301

Section Title: MEDICAL SAVINGS ACCOUNTS

New Federal Law (Sec. 62, 106, 125, 220 new, 848, 3231, 3306, 3401, 4980E new, 4973, 4975 & 6693)

Under the Act, beginning on January 1, 1997, within limits, contributions to a medical savings account (MSA) are deductible as an adjustment to gross income if made by an eligible individual or excludable from gross income if made by the employer of an eligible individual. Earnings on amounts in an MSA are not taxable prior to distribution, and distributions from an MSA for medical expenses are not taxable.

MSAs are available to individuals covered under an employer-sponsored high deductible plan of a small employer and self-employed individuals covered under a high deductible plan.

In general, the MSA deduction/exclusions are limited to a maximum of 750,000 taxpayers. Previously uninsured individuals are not taken into consideration in determining whether the cap is reached. After December 31, 2000, generally, no new contributions may be made to MSAs except for those who were participating in the pilot program.

California Law (R&T Sec. 17138.5, 17141.5, 17150, 17201.5, 17267 & 24343.3)

California conformed in SB 38 to the federal MSA provisions. The California law applies only to those individuals in the federal MSA pilot program and filing California returns.

Effective Date

These provisions in federal and California law apply to taxable years beginning on or after January 1, 1997.

Impact on California Revenue

In SB 38 the revenue loss from this provision is estimated to be $4 million for fiscal year 1996-97, $8 million for fiscal year 1997-98 and $10 million for fiscal year 1998-99.

HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT OF 1996 (PL 104-191)

Act Section: 311

Section Title: INCREASE IN DEDUCTION FOR HEALTH INSURANCE COSTS OF SELF-EMPLOYED INDIVIDUALS

Background

The Revenue Reconciliation Act of 1993 increased the deduction for health insurance of self-employed individuals from 25 percent to 30 percent starting in 1994.

New Federal Law (Sec. 104 & 162)

The Act increases the deduction for health insurance of self-employed individuals as follows: the deduction would be 40 percent in 1997; 45 percent in 1998 through 2002; 50 percent in 2003; 60 percent in 2004; 70 percent in 2005; and 80 percent in 2006 and thereafter.

The Act also provides that payments for personal injury or sickness through an arrangements having the effect of accident or health insurance (and that are not merely reimbursement arrangements) are excludable from income. In order for the exclusion to apply, the arrangement must be insurance (e.g., there must be adequate risk shifting). The Committee report states that this provision equalizes the treatment of payments under commercial insurance and arrangements other than commercial insurance that have the effect of insurance. Under this provision, a self-employed individual who receives payments from such an arrangement could exclude the payments from income.

California Law (R&T Sec. 17273)

California is conformed to federal law as it read on January 1, 1993, prior to the passage of the Revenue Reconciliation Act of 1993, and allows a deduction for 25 percent of the cost of health insurance of self-employed individuals.

Effective Date

The federal provision is effective for taxable years beginning after December 31, 1996.

Impact on California Revenue

The revenue losses from this provision are estimated to be as shown in the following table.

HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT OF 1996
(PL 104-191)

Fiscal Year Cash Flow Impact Effective 1/1/97 Enacted after 6/30/97 $ Millions									
1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
$(14)	$(14)	$(16)	$(18)	$(21)	$(27)	$(42)	$(65)	$(94)	$(120)

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion:

The revenue impact of this provision will be determined by the number of self-employed individuals who claim additional insurance deductions, and the average marginal tax rate applicable to the deduction amounts.

This estimate was developed in the following steps. First, the number of California resident taxpayers who currently claim the self-employed insurance deduction was calculated from returns filed for 1994 (256 thousand). Secondly, the current deduction amount of 25% was calculated to be $793 for returns filed in 1994, making the average annual health insurance premium $3,172 ($793 x 4). Third, the estimated number of qualified taxpayers for 1994 was grown at 5% per year to yield 296 thousand qualified taxpayers for 1997. Fourth, the insurance premium was grown at 10% per year to yield an average $4,222 insurance premium for 1997. Fifth, the total amount of deduction at 25% was calculated to be $313 million for 1997 at a average marginal tax rate of 4.5% (computed by the PIT microsimulation model for self-employed individuals), generating a $14 million tax loss for 1997. Sixth, the total amount of deduction was calculated at 40% at a 4.5% marginal tax rate for 1997, generating a $23 million tax loss. These steps resulted in a 1997 estimate of an additional $9 million tax loss. Seventh, the total amount of deduction was then calculated at various percentages from 40% phasing up to 80% by the year 2006, as stated above. This loss was grown to reflect a combined annual growth of 5% (qualified taxpayers) and 10% (premiums).

HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT OF 1996 (PL 104-191)

Act Section: 321-327

Section Title: TREATMENT OF LONG-TERM CARE INSURANCE AND LONG-TERM CARE SERVICES

Background

Under both federal and California law, prior to the Health Insurance Portability and Accountability Act of 1996 and California's enactment of SB 38, no explicit rules were provided for the tax treatment of premiums paid for long-term care insurance contracts or the expenses of long-term care services. Those long-term care expenses qualifying as medical expenses could be deducted under that provision. The medical expense deduction, however, is limited to expenses paid for the diagnosis, cure, mitigation, treatment, or prevention of disease (including prescription medicines or drugs and insulin). Costs of transportation primarily for, and essential to medical care, as well as medical care insurance premiums, are deductible as medical expenses. These medical expenses are deductible as an itemized deduction to the extent that they exceed a floor of 7.5% of adjusted gross income.

New Federal Law (Sec. 106, 125, 213, 7702B)

The Act specifically allows a deduction for medical expenses for the unreimbursed expenses for qualified long-term care services provided to the taxpayer, the taxpayer's spouse or the taxpayer's dependents (subject to the present-law floor of 7.5% of adjusted gross income). Amounts received under a long-term care insurance contract (regardless of whether the contract reimburses expenses or pays benefits on a per diem or other periodic basis) are treated as reimbursement for expenses actually incurred for medical care.

Long-term care insurance premiums, like medical care insurance premiums, are explicitly treated as medical expenses and are deductible on a graduated scale based on the individual's age before the close of the taxable year. This scale ranges from $200 of premium being treated as medical expenses at age 40 to a maximum of $2,500 of premium being treated as medical expenses when the individual's age is more than 70.

As medical expenses, the Act also excludes from gross income of the employee employer contributions to accident and health plans, except for contributions to cafeteria plans or "flexible spending arrangements," as defined. In addition, the Act excludes from gross income the receipt of benefits from long-term care insurance.

In addition, the Act imposes an information reporting requirement on persons paying long-term care benefits as well as requirements on the type of policy which may be issued and penalty excise taxes on issuers of long-term care insurance which fails to satisfy those requirements.

California Law (R&T Sec. 17213)

Starting in 1997, SB 38 conformed California law to the new federal provisions which allow a deduction for medical expenses for the unreimbursed expenses of qualified long-term care services provided to the taxpayer, the taxpayer's spouse or the taxpayer's dependents (subject to the present-law floor of 7.5% of adjusted gross income) and provides that long-term care insurance premiums are explicitly treated as medical expenses and the same portion is deductible for state purposes as allowed under federal law.

California, however, has not conformed to: (a) the exclusion from income for certain employer contributions to an employee benefit plan; (b) the exclusion from income for benefits received under long-term care insurance; (d) the requirements on insurance companies issuing long-term care insurance; and (e) the reporting requirement contained in the federal Act.

Effective Date

In general, the federal and state provisions apply to taxable years beginning on or after January 1, 1997.

Impact on California Revenue

1. The provisions to which California conformed in SB 38 are estimated to result in revenue losses of $2 million in fiscal year 1996-97, $9 million in fiscal year 1997-98 and $10 million in fiscal year 1998-99.

2. Exclusion From Income

(a) The revenue losses from the provision to exclude employer paid long-term care premiums from gross income of the employee, unless provided through a cafeteria or other flexible plan, under conformity are estimated as shown in the following table.

Fiscal Year Cash Flow Impact Effective 1/1/97 Enacted after 6/30/97		
1997-8	1998-9	1999-00
minor *	minor *	minor *

* Loss less than $500,000

(b) Revenue losses from the provision to exclude amounts received under long-term care insurance policies under conformity are estimated as shown in the following table.

Fiscal Year Cash Flow Impact Effective 1/1/97 Enacted after 6/30/97		
1997-8	1998-9	1999-00
minor *	minor *	minor *

* Loss less than $1 million

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion:

The revenue impact of this provision will be determined by the amount of payments received from long-term care policies.

Revenue estimates above were based on federal projections for this provision in H.R. 3103. A proportion factor of 3.3% was used based on state-to-nation comparisons of adjusted gross income (11.7%) and average marginal tax rates (28.6%). It is assumed that most of this impact (perhaps 90%) will occur automatically at the state level and represent baseline revenue losses. This assumption is based on the realization that the majority of taxpayers would not voluntarily report qualified payments at the federal level as non-qualified, taxable benefits to California. Estimates above, therefore, reflect 10 percent as a result of conformity legislation.

HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT OF 1996 (PL 104-191)

Act Section: 331-332

Section Title: TREATMENT OF ACCELERATED DEATH BENEFITS

New Federal Law (Sec. 101)

The Act provides an exclusion from gross income as an amount paid by reason of the death of an insured for (1) amounts received under a life insurance contract and (2) amount received for the sale or assignment of a life insurance contract to a qualified viatical settlement provider, provided that the insured under the life insurance contract is either terminally ill or chronically ill. Extensive rules relating to taxation of insurance companies issuing the policies, insurance policy qualifications and definitions are provided as well.

California Law (R&T Sec. 17131.5)

Since 1991, California law excludes from gross income certain advance payments received in exchange for a reduction of death benefits by a person having a terminal illness under a "living benefits" life insurance policy.

Insurance companies are not subject to the income or franchise tax on the income derived by that company. The California Constitution imposes a "gross premiums tax" on insurance companies.

Effective Date

The federal provision applies to amounts received after December 31, 1996.

Impact on California Revenue

None.

HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT OF 1996 (PL 104-191)

Act Section: 341-342

Section Title: EXEMPTION FROM INCOME TAX FOR STATE-SPONSORED ORGANIZATIONS PROVIDING HEALTH COVERAGE FOR HIGH-RISK INDIVIDUALS; EXEMPTION FROM TAX FOR STATE-SPONSORED WORKERS' COMPENSATION REINSURANCE ORGANIZATIONS

New Federal Law (Sec. 501)

The Act provides tax-exempt status to any membership organization that is established by a State exclusively to provide coverage for medical care on a nonprofit basis to certain high-risk individuals, provided certain criteria are satisfied. The organization may provide coverage for medical care either by issuing insurance itself or by entering into an arrangement with a health maintenance organization ("HMO").

High-risk individuals eligible to receive medical care coverage from the organization must be residents of the State who, due to a pre-existing medical condition, are unable to obtain health coverage for such condition through insurance or an HMO, or are able to acquire such coverage only at a rate that is substantially higher than the rate charged for such coverage by the organization. The State must determine the composition of membership in the organization. For example, a State could mandate that all organizations that are subject to insurance regulation by the State must be members of the organization.

The Act further requires the State or members of the organization to fund the liabilities of the organization to the extent that premiums charged to eligible individuals are insufficient to cover such liabilities. Finally, no part of the net earnings of the organization can inure to the benefit of any private shareholder or individual.

In addition, the Act provides tax-exempt status to any membership organization that is established before June 1, 1996, exclusively to reimburse its members for workers' compensation insurance losses, and that satisfy certain other conditions.

California Law

Under California law, insurance companies are generally not subject to the income or franchise tax. Instead, insurers pay a tax based generally on premiums received the year on business done in California. The gross premiums tax rate is set each year by the State Board of Equalization (SBE). Since 1990, the tax rate has been set at 2.35%. Defer to SBE

HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT OF 1996 (PL 104-191)

Effective Date

The federal provision applies to taxable years ending after August 21, 1996.

Impact on California Revenue

Defer to SBE.

HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT OF 1996
(PL 104-191)

Act Section: 351

Section Title: ORGANIZATIONS SUBJECT TO SECTION 833

New Federal Law (Sec. 833)

The Act broadens the organizations eligible qualify for tax-exempt status by applying the rules in present law relating to certain Blue Cross and Blue Shield organizations to those organizations as well.

California Law

Under California law, insurance companies are generally not subject to the income or franchise tax. Instead, insurers pay a tax based generally on premiums received the year on business done in California. The gross premiums tax rate is set each year by the State Board of Equalization (SBE). Since 1990, the tax rate has been set at 2.35%. Defer to SBE

Effective Date

The provision is effective for taxable years ending after December 31, 1996.

Impact on California Revenue

Defer to SBE.

Act Section: 361

Section Title: DISTRIBUTIONS FROM CERTAIN PLANS MAY BE USED WITHOUT ADDITIONAL TAX TO PAY FINANCIALLY DEVASTATING MEDICAL EXPENSES

New Federal Law (Sec. 72)

The Act extends the exception to the 10-percent tax on the premature distribution from qualified employer-sponsored pension plans for medical expenses in excess of 7.5 percent of AGI to withdrawals from IRAs. In addition, the Act provides that the 10-percent additional tax does not apply to withdrawals for medical insurance (without regard to the 7.5 percent of AGI floor) if the individual (including a self-employed individual) has received unemployment compensation under Federal or State law for at least 12 weeks, and the withdrawal is made in the year such unemployment compensation is received or the following year. If a self-employed individual is not eligible for unemployment compensation under applicable law, then, to the extent provided in regulations, a self-employed individual is treated as having received unemployment compensation for at least 12 weeks if the individual would have received unemployment compensation but for the fact that the individual was self-employed. The exception ceases to apply if the individual has been reemployed for at least 60 days.

California Law (R&T Sec. 17085)

California conforms to federal law as it read on January 1, 1993, except that the penalty rate is 2.5% rather than the 10% federal rate, which provides an exception to the penalty on the premature distribution from qualified employer-sponsored pension plans for medical expenses in excess of 7.5 percent of AGI.

Effective Date

The federal provision is effective for taxable years beginning after December 31, 1996.

Impact on California Revenue

The revenue impact of this provision will be determined by (1)amounts withdrawn from individual retirement arrangements for (a) medical expenses in excess of 7.5% of adjusted gross income and (b) health insurance premiums without regard to the 7.5% floor, and (2) the applicable penalty tax rate of 2.5%.

Based on the low level of federal estimates for this provision in H.R.

3103 of 1996, conforming to the provision would result in minor reductions in penalty collections under the PITL of less than $500,000 annually beginning in 1997-98. It is assumed the provision would apply to withdrawals after December 31, 1996, with enactment after June 30, 1997.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT OF 1996 (PL 104-191)

Act Section: 371

Section Title: ORGAN AND TISSUE DONATION INFORMATION INCLUDED WITH INCOME TAX REFUND PAYMENTS

New Federal Law

The Act requires Treasury to include, to the extent practicable, organ and tissue donation with the mailing of any payment of a refund of individual income taxes.

California Law

California has no comparable provision.

Effective Date

The provision is effective for refunds made on or after February 1, 1997, through June 30, 1997.

Impact on California Revenue

Not applicable.

HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT OF 1996
(PL 104-191)

Act Section: 401-421

Section Title: APPLICATION AND ENFORCEMENT OF GROUP HEALTH PLAN REQUIREMENTS

New Federal Law (New Sec. 4980C, New Subtitle K & Public Health Service Act Sec. 2202)

The Act provides new rules to increase group health plan portability, access and renewability along with an excise penalty tax on failure to meet certain group health plan requirements. The Act also clarifies COBRA continuation coverage requirements.

California Law

No comparable provisions are contained in the provisions of the Revenue and Taxation Code administered by the FTB.

Effective Date

In general, the federal provisions apply to plan years beginning after June 30, 1997.

Impact on California Revenue

Not applicable.

HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT OF 1996 (PL 104-191)

Act Section: 501

Section Title: DENIAL OF DEDUCTION FOR INTEREST ON LOANS WITH RESPECT TO COMPANY-OWNED LIFE INSURANCE

Background

Under both federal and California law, no tax generally is imposed on a policyholder for the earnings under a life insurance contract, commonly called "inside buildup." Further, an exclusion from income is provided for amounts received under a life insurance contract paid on the death of the insured. The policyholder may borrow against the life insurance contract without affecting these exclusions, subject to certain limitations.

These limitations contained in both federal and California law, prior to the enactment of the Health Insurance Portability and Accountability Act of 1996, on August 21, 1996, provided that no deduction was allowed for any interest paid or accrued on indebtedness for one or more company-owned life insurance policies covering the life of any individual who is an officer or employee of, or financially interested in, any trade or business carried on by the taxpayer to the extent that the aggregate amount of that debt with respect to policies covering the individual exceeded $50,000.

New Federal Law (Sec. 264)

Under the Act, federal law denies a deduction for interest paid or accrued on any indebtedness for one or more life insurance policies or annuity or endowment contracts owned by the taxpayer covering any individual who is an officer or employee of, or financially interested in, any trade or business carried on by the taxpayer. An exception retains the prior law deduction for up to 20 key persons. Interest paid or accrued after October 13, 1995, on debt with respect to a life insurance contract covering a key person is capped by reference to Moody's Corporate Bond Yield Average-Monthly Average Corporates for each month interest is paid or accrued. A phase-in of this Moody's rate is provided.

California Law (R&T Sec. 17279.5 & 24424)

In 1996, California conformed to this federal change in SB 38, except that it applies to interest paid or accrued after December 31, 1995.

HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT OF 1996 (PL 104-191)

Effective Date

The federal provision applies to interest paid or accrued after October 13, 1995. Extensive transition rules are provided.

The state provision applies to interest paid or accrued after December 31, 1996. Extensive transition rules are provided.

Impact on California Revenue

This provision of SB 38 was estimated to result in revenue gains of $10 million for fiscal year 1996-97, $15 million for fiscal year 1997-98 and $20 million for fiscal year 1998-99.

HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT OF 1996 (PL 104-191)

Act Section: 511

Section Title: TREATMENT OF INDIVIDUALS WHO LOSE UNITED STATES CITIZENSHIP

New Federal Law (Sec. 877 & 6039F new)

The Act expands and substantially strengthens in several ways the present-law provisions that subject U.S. citizens who lose their citizenship for tax avoidance purposes to special tax rules for 10 years after such loss of citizenship. Extensive rules, information reporting requirements and a tax compliance study are provided.

California Law

California has no comparable provisions. The state does not use citizenship as basis of its income tax, but instead uses residency. Only the income of an individual who is not a resident of California, whether or not a U.S. citizen, which has a source in this state is taxable by California. A resident of California, whether or not a U.S. citizen, is taxable on all income without regard to its source.

Effective Date

In general, the federal provisions apply to individuals losing U.S. citizenship on or after February 6, 1995.

Impact on California Revenue

Not applicable.

HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT OF 1996 (PL 104-191)

Act Section: 521

Section Title: REPEAL OF FINANCIAL INSTITUTION TRANSITION RULE TO INTEREST ALLOCATION RULES

Background

For foreign tax credit purposes, taxpayers generally are required to allocate and apportion interest expense between U.S. and foreign source income based on the proportion of the taxpayer's total assets in each location. Such allocation and apportionment is required to be made for affiliated groups as a whole rather than on a subsidiary-by-subsidiary basis. However, certain types of financial institutions that are members of an affiliated group are treated as members of a separate affiliated group for purposes of allocating and apportioning their interest expense. The Tax Reform Act of 1986 includes a targeted rule which treats a certain corporation as a financial institution for this purpose.

New Federal Law (Sec. 27 & 901-908)

The Act repeals the targeted rule of the Tax Reform Act of 1986 effective on the date of enactment. Under the Act, a taxpayer will perform two computations with respect to its taxable year that includes the enactment date. Under the first computation, the taxpayer's pre-effective date interest expense is allocated and apportioned taking into account the targeted rule, and under the second computation, the taxpayer's post-effective date interest expense is allocated and apportioned without regard to the targeted rule. The Committee report states that these computations will not require a closing of a taxpayer's books and records and it is intended that an administratively simple approach be used in applying this rule.

California Law

California has no credit comparable to the federal foreign tax credit.

Effective Date

In general, the repeal applies to taxable years beginning after December 31, 1995, subject to a transition rule.

Impact on California Revenue

Not applicable.

Act Section: 910

Section Title: MODIFICATION OF ADJUSTED GROSS INCOME DEFINITION FOR EARNED INCOME CREDIT

New Federal Law (Sec. 32)

The Act modifies the definition of AGI used for phasing out the earned income credit by disregarding certain losses.

California Law

California does not have a credit comparable to the federal earned income credit.

Effective Date

The federal change applies to taxable years beginning after December 31, 1995. For certain individuals who have in effect an earned income eligibility certificate for the individuals' taxable year beginning in 1996, the provision applies to taxable years beginning after December 31, 1996.

Impact on California Revenue

Not Applicable.

EXHIBIT A

EXPIRING TAX PROVISIONS

California Sunset *	Calif. Section	Federal Sunset*	Federal Section	Description and Comments
12/31/96	17053.5	N/A	N/A	Credit: Renters (no credit for 1996 but credit resumes in 1997 without any limitation based upon AGI)
12/31/96	19136	Permanent	6654	Estimated Tax Penalty: Limitation on use of preceding year's tax safe harbor
1/01/97[1]	18706	N/A	N/A	Voluntary Contribution: California Election Campaign Fund
1/01/97[1]	18715	N/A	N/A	Voluntary Contribution: Children's Trust Fund for the Prevention of Child Abuse
1/01/97[1]	18734	N/A	N/A	Voluntary Contribution: Veterans' Memorial Account
1/01/97[1]	18745	N/A	N/A	Voluntary Contribution: Rare and Endangered Species Preservation Program
12/31/97	17052.15 23612.6	N/A	N/A	Credit: Sales and Use taxes paid in the LA Revitalization Zone
12/31/97	17052.17 23617	N/A	N/A	Credit: Employer constructed child care facilities
12/31/97	17052.18 23617.5	N/A	N/A	Credit: Employer paid child care program
12/31/97	17053.10 17053.17 23623.5 23625	N/A	N/A	Credit: Hiring in the LA Revitalization Zone
12/31/97	17233 24385	N/A	N/A	Deduction: Interest earned on loans made to businesses in the LA Revitalization Zone
12/31/97	17266 24356.4	N/A	N/A	Deduction: Expensing of business property in the LA Revitalization Zone
12/31/97	17276.2 24416.2	N/A	N/A	Deduction: Net operating losses in the LA Revitalization Zone
1/01/98[2]	18796	N/A	N/A	Voluntary Contribution: California Breast Cancer Research Fund
12/31/98	18152.5	Permanent	1202	Exclusion: Capital Gain on Sale of Small Business Stock

EXHIBIT A

EXPIRING TAX PROVISIONS

California Sunset *	Calif. Section	Federal Sunset*	Federal Section	Description and Comments
12/31/98	19283	N/A	N/A	Collection of Amounts Due a Court
1/01/99[3]	18785	N/A	N/A	Voluntary Contribution: D.A.R.E. California (Drug Abuse Resistance Education) Fund
1/01/99[3]	18804	N/A	N/A	Voluntary Contribution: California Firefighters' Memorial Fund
1/01/99[3]	18816	N/A	N/A	Voluntary Contribution: California Public School Library Protection Fund
1/01/99	19290.1	N/A	N/A	Collections for the Department of Industrial Relations
12/31/99	17053.66 23666	N/A	N/A	Credit: Restoration of Habitat for Salmon and Steelhead Trout
12/31/99	17091 24272.3	Permanent	865	Sourcing Rules: Unprocessed timber
12/31/99	25135	N/A	N/A	Apportionment Formula: Sales of Unprocessed Timber
1/01/00[4]	18844	N/A	N/A	Voluntary Contribution: California Military Museum Fund
1/01/00[4]	18724	N/A	N/A	Voluntary Contribution: California Fund for Senior Citizens
1/01/00[4]	18766	N/A	N/A	Voluntary Contribution: Alzheimer's Disease and Related Disorders Fund
1/01/01[5]	18824	N/A	N/A	Voluntary Contribution: Mexican American Veterans' Memorial Account
12/31/02	17276.2 24416.2	N/A	N/A	Deduction: Net operating losses in the Local Agency Military Base Recovery Area

* In general, this is the last taxable year to which the provision applies. Fiscal years beginning within this taxable year are, in general, also covered by the provision. In some cases, the expiration applies to transactions occurring after this date.

[1] The last return upon which this voluntary contribution will appear is the 1996 return.

[2] The last return upon which this voluntary contribution will appear is the 1997 return.

EXHIBIT A

EXPIRING TAX PROVISIONS

California Sunset *	Calif. Section	Federal Sunset*	Federal Section	Description and Comments

[3] The last return upon which this voluntary contribution will appear is the 1998 return.

[4] The last return upon which this voluntary contribution will appear is the 1999 return.

[5] The actual date this provision expires is unknown at this time. The law provides that this voluntary contribution appear on the tax return upon completion of construction Veterans' Memorial and continue to be on the tax return for five (5) taxable years.