SUMMARY OF
FEDERAL INCOME TAX CHANGES
1997

Prepared by the Staff of the

FRANCHISE TAX BOARD

State of California

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This report is submitted in fulfillment of the requirement in

Revenue and Taxation Code Section 19522.

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SUMMARY OF FEDERAL INCOME TAX CHANGES - 1997
Prepared by the Staff of the
FRANCHISE TAX BOARD
State of California

Executive Summary

During 1997, the Internal Revenue Code was changed by:

PUBLIC LAW	TITLE
105-2	AIRPORT AND AIRWAY TRUST FUND EXTENSION ACT OF 1997
105-33	REVENUE PROVISIONS OF THE BALANCED BUDGET ACT OF 1997
105-34	TAXPAYER RELIEF ACT OF 1997
105-35	TAXPAYER BROWSING PROTECTION ACT
105-130	HIGHWAY TRUST FUND EXTENSION

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 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 California law.

AIRPORT AND AIRWAY TRUST FUND EXTENSION ACT OF 1997 (P.L. 105-2)

Background

Tax Rates.

Excise taxes are imposed on commercial air passenger and freight transportation and on fuels used in general aviation (i.e., transportation on noncommercial aircraft which is not for hire) to fund the Airport and Airway Trust Fund (Airport Trust Fund). These taxes generally had expired after December 31, 1996.

The Airport Trust Fund excise taxes which had expired included three taxes on commercial air transportation:

(1) A 10% excise tax on domestic air passenger transportation;

(2) A $6 per person international air passenger departure tax; and

(3) A 6.25-percent domestic air freight excise tax.

Noncommercial aviation (e.g., corporate aircraft) was subject to Airport Trust Fund excise taxes on the fuels it used rather than the commercial aviation passenger ticket and freight excise taxes. The Airport Trust Fund rates for these excise taxes were 17.5 cents per gallon for jet fuel and 15 cents per gallon for aviation gasoline.

Collection and Deposit of Tax.

The air passenger ticket and freight excise taxes are collected from passengers and freight shippers by the commercial air carriers. The air carriers then remit the funds to the Treasury Department; however, the air carriers are not required to remit moneys immediately. Excise tax returns are filed quarterly (similar to annual income tax returns) with taxes being deposited on a semi-monthly basis (similar to estimated income taxes). For air transportation sold during a semi-monthly period, air carriers may elect to treat the taxes as collected on the last day of the first week of the second following semi-monthly period. Air carriers generally make this election because it allows them to delay remitting tax beyond the date when remittance otherwise would be required. Under these “deemed collected” rules, for example, the taxes on air transportation sold between October 1 and October 15 are treated as collected by the air carriers on or before November 7. These amounts generally must be deposited with the Treasury by November 10. Thus, on average, revenues from commercial air passenger transportation generally are not received by the Federal Government until approximately one month after the air carrier actually sells the transportation.

Like income tax withholding and estimated tax payments, the excise taxes contain payment safe harbors for avoiding underpayment penalties. In general, Treasury Department regulations provide that commercial air carriers are not subject to underpayment penalties if their semi-monthly deposits of passenger

ticket and freight waybill taxes for a quarter are at least equal to the amount of taxes they were required to remit during the second preceding calendar quarter (the “look back” rules). For example, air carriers generally would not be subject to underpayment penalties if their semi-monthly deposits for the fourth quarter (October 1 through December 31) equaled at least the amount they were required to remit during the second quarter (April 1 through June 30) of the same year.

In a general information letter to the Air Transport Association of America, dated August 30, 1996, the Internal Revenue Service advised the air carriers that, notwithstanding that no excise taxes were required to be remitted during a look-back quarter, applicable Treasury Department regulations in 1997 permitted the air carriers to continue to avail themselves of the safe harbor and avoid remitting taxes collected from consumers during September, October, and November of 1996 until the air carriers filed their quarterly excise tax returns for that period on February 28, 1997. (Similarly, the air carriers were expected to retain most taxes collected from consumers during December 1996 until their excise tax returns for the first quarter of 1997 were due on May 31, 1997.)

Trust Fund Deposits

The Airport Trust Fund received gross receipts attributable to the excise taxes described above. The Internal Revenue Code provided that taxes received by the Treasury Department through the end of the period when the taxes were last imposed (i.e., through December 31, 1996 at the time of the legislation) were deposited in the Airport Trust Fund. Thus, under prior law, taxes received after December 31, 1996, were not transferred to the Airport Trust Fund.

New Federal Law

Reinstate Air Transportation Excise Taxes.

The Act reinstated the air transportation excise taxes that expired after December 31, 1996, during the period beginning seven days after the date of enactment and ending after September 30, 1997.

Transfer Revenues to the Airport Trust Fund.

The Act authorized the Treasury Department to transfer to the Airport Trust Fund receipts attributable to excise taxes described above that were imposed on commercial and general aviation. This permitted transfer of receipts attributable to taxes imposed both during the period August 27, 1996, through December 31, 1996, and during the period beginning seven days after the date of enactment.

AIRPORT AND AIRWAY TRUST FUND EXTENSION ACT OF 1997 (P.L. 105-2)

Modify Treasury Department Excise Tax Deposit Regulations.

To prevent a delay in depositing tax similar to that which occurred with respect to the fourth quarter of 1996, the provisions of Treasury Department regulations providing an exception to penalties for underpayment of estimated excise taxes based on a look-back period were made inapplicable when tax was not imposed throughout the look-back period. In such a case, taxpayers could continue to use an alternative safe harbor that provides that no underpayment penalty is imposed as long as the taxpayer has paid at least 95% of the current quarter's liability.

Current California Law

The Franchise Tax Board does not administer any excise taxes. When applicable, the State Board of Equalization (SBE) administers excise taxes.

Effective Date

The provisions reinstating the commercial air transportation excise taxes were effective for (1) transportation beginning during the period beginning seven days after the date of enactment (March 7, 1997) and ending after September 30, 1997, and (2) amounts paid during such period for transportation occurring after September 30, 1997. Refunds would have been provided for any taxes paid on air passenger and air freight transportation purchased before October 1, 1997, for transportation that occurs at a time when the taxes are not in effect. (This refund provision was rendered moot by provisions of the Taxpayer Relief Act of 1997 (see sec. 1031) that extended the Airport Trust Fund excise taxes, as modified in that Act, for 10 years, through September 30, 2007.)

The provisions reinstating the general aviation gasoline excise tax were effective for gasoline removed during the period beginning seven days after the date of enactment (March 7, 1997) and ending after September 30, 1997. The provision reinstating the general aviation jet fuel excise tax was effective for fuels sold by producers during the same period. Floor stocks taxes were imposed on these fuels held beyond the removal or producer level on the date which is seven days after the date of enactment (March 7, 1997).

The provisions relating to transfer of receipts to the Airport Trust Fund and the modification of the Treasury Department's excise tax deposit regulations were effective on the date of enactment (February 28, 1997).

Impact on California Revenue

Defer to SBE.

BALANCED BUDGET ACT OF 1997
(P.L. 105-33)

Act Section	Section Title
4006	Taxation of Medicare+Choice Medical Savings Accounts

Background

Under present and prior law, the value of Medicare coverage and benefits is not includible in gross income.

Individuals who itemize deductions may deduct amounts paid during the taxable year (if not reimbursed by insurance or otherwise) for medical expenses of the taxpayer and the taxpayer's spouse and dependents (including expenses for insurance providing medical care) to the extent that the total of such expenses exceeds 7.5% of the taxpayer's adjusted gross income (AGI).

Within limits, contributions to a medical savings account (MSA) are deductible in determining AGI if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. The number of MSAs which can be established is subject to a cap. Under prior law, individuals covered under Medicare were not eligible to have an MSA.

Earnings on amounts in an MSA are not currently includible in income. Distributions from an MSA for medical expenses of the MSA account holder and his or her spouse or dependents are not includible in income. For this purpose, medical expenses are defined as under the itemized deduction for medical expenses, except that medical expenses do not include any insurance premiums other than premiums for long-term care insurance, continuation coverage (so-called “COBRA coverage”), or premiums for coverage while an individual is receiving unemployment compensation. Distributions not used for medical expenses are subject to an additional 15% tax unless the distribution is made after age 65, death, or disability.

Under prior law, there were no tax provisions for Medicare+Choice medical savings accounts (Medicare+Choice MSAs).

New Federal Law (Sec. 138)

In General.

Under the Act, individuals who are eligible for Medicare are permitted to choose either the traditional Medicare program or a Medicare+Choice MSA plan. As under prior law, individuals who are eligible for Medicare are not eligible for an MSA that is not a Medicare+Choice MSA. To the extent an individual chooses such a plan, the Secretary of Health and Human Services makes a specified contribution directly into a Medicare+Choice MSA designated by such individual. Only contributions by the Secretary of Health and Human Services can be made to a Medicare+Choice MSA and such contributions are not included in the taxable income of the Medicare+Choice MSA holder. Income earned on amounts held in a Medicare+Choice MSA are not currently includible in taxable income.

Withdrawals from a Medicare+Choice MSA are excludable from taxable income if used for the qualified medical expenses of the Medicare+Choice MSA holder. Medical expenses of the account holder's spouse or dependents are not treated as qualified medical expenses. Withdrawals from a Medicare+Choice MSA that are not used for the qualified medical expenses of the account holder are includible in income and may be subject to an additional tax (described below).

Definition of Medicare+Choice MSAs.

In general, a Medicare+Choice MSA is an MSA that is designated as Medicare+Choice MSA and to which the only contributions that can be made are those by the Secretary of Health and Human Services. Medicare+Choice MSAs are not taken into account for purposes of the cap on non-Medicare+Choice MSAs, nor are they subject to that cap. Thus, a Medicare+Choice MSA is a tax-exempt trust (or a custodial account) created exclusively for the purpose of paying the qualified medical expenses of the account holder that meets requirements similar to those applicable to IRAs. For example, no Medicare+Choice MSA assets could be invested in life insurance contracts, Medicare+Choice MSA assets cannot be commingled with other property except in a common trust fund or common investment fund, and an account holder's interest in a Medicare+Choice MSA is nonforfeitable. In addition, if an account holder engages in a prohibited transaction with respect to a Medicare+Choice MSA or pledges assets in a Medicare+Choice MSA, rules similar to those for IRAs apply, and any amounts treated as distributed to the account holder under such rules are treated as not used for qualified medical expenses. The trustee of a Medicare+Choice MSA can be a bank, insurance company, or other person that demonstrates to the satisfaction of the Secretary of the Treasury that the manner in which such person will administer the trust will be consistent with applicable requirements.

A Medicare+Choice MSA trustee is required to make such reports as may be required by the Secretary of the Treasury. A $50 penalty is imposed for each failure to file without reasonable cause.

Taxation of Distributions from a Medicare+Choice MSA.

Distributions from a Medicare+Choice MSA that are used to pay the qualified medical expenses of the account holder are excludable from taxable income regardless of whether the account holder is enrolled in the Medicare+Choice MSA plan at the time of the distribution. Under the provision, medical expenses of the account holder's spouse or dependents are not treated as qualified medical expenses. Qualified medical expenses are defined as under the rules relating to the itemized deduction for medical expenses. However, for this purpose, qualified medical expenses do not include any insurance premiums other than premiums for long-term care insurance, continuation insurance (so-called “COBRA coverage”), or premium for coverage while an individual is receiving unemployment compensation. Distributions from a Medicare+Choice MSA that are excludable from gross income under the provision cannot be taken into account for purposes of the itemized deduction for medical expenses.

Distributions for purposes other than qualified medical expenses are includible in taxable income. An additional tax of 50% applies to the extent the total distributions for purposes other than qualified medical expenses in a taxable year exceed the amount by which the value of the Medicare+Choice MSA as of December 31, of the preceding year exceeds 60% of the deductible of the plan under which the individual is covered on January 1 of the current year. The additional tax does not apply to distributions on account of the disability or death of the account holder.

Following is an example of how the amount available to be withdrawn from a Medicare+Choice MSA without penalty is calculated. The numbers are provided for illustrative purposes only.

	Year 1	Year 2	Year 3	Year 4
1. Deductible.....	$3,000	$3,000	$3,000	$3,000
2. 60% of deductible.....	1,800	1,800	1,800	1,800
3. Contributions.....	1,300	1,300	1,300	1,300
4. Earnings.....	130	200	300	400
5. Total withdrawals.....	600	500	600	600
6. Closing balance (Dec. 31 of current year).....	830	1,830	2,830	3,930
7. Amount available for nonmedical withdrawal without penalty (6. from prior year—2., or 0 if less than 0)..	0	0	30	1,030

Direct trustee-to-trustee transfers can be made from one Medicare+Choice MSA to another Medicare+Choice MSA without income inclusion.

The provision includes a correction mechanism so that if contributions for a year are erroneously made by the Secretary of Health and Human Services, such erroneous contributions can be returned to the Secretary of Health and Human Services (along with any attributable earnings) from the Medicare+Choice MSA without tax consequence to the account holder.

Treatment of Medicare+Choice MSA at Death.

Upon the death of the account holder, if the beneficiary of the Medicare+Choice MSA is the account holder's surviving spouse, the surviving spouse may continue the Medicare+Choice MSA, but no new contributions can be made. Distributions from the Medicare+Choice MSA are subject to the rules applicable to MSAs that are not Medicare+Choice MSAs. Thus, earnings on the account balance are not currently includible in income. Distributions from the account for the qualified medical expenses of the spouse or the spouse's dependents (or subsequent spouse) are not includible in income. Distributions not for such medical expenses are includible in income, and subject to a 15% excise tax unless the distribution is made after the surviving spouse attains age 65, dies, or becomes disabled.

If the beneficiary of a Medicare+Choice MSA is not the account holder's spouse, the Medicare+Choice MSA is no longer treated as a Medicare+Choice MSA and the value of the Medicare+Choice MSA on the account holder's date of death is included in the taxable income of the beneficiary for the taxable year in which the death occurred (under the rules applicable to MSAs generally). If the account holder fails to name a beneficiary, the value of the Medicare+Choice MSA on the account holder's date of death is to be included in the taxable income of the account holder's final income tax return (under the rules applicable to MSAs generally).

In all cases, the value of the Medicare+Choice MSA is included in the account holder's gross estate for estate tax purposes.

Current California Law (R&T Sec. 17267)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to “medical savings account. California’s Medi-Cal program supplements the federal Medicare program and is administered by the Department of Health Services.

Effective Date

The provision is effective with respect to taxable years beginning after December 31, 1998.

Impact on California Revenue

Conformity to federal law as it relates to “medical savings account” would result in negligible revenue effects. This estimate is based on the negligible impact projected for the federal law change.

BALANCED BUDGET ACT OF 1997
(P.L. 105-33)

Act Section	Section Title
4041	Hospitals Participating in Provider-Sponsored Organizations

Background

To qualify as a charitable tax-exempt organization described in section 501(c)(3), an organization must be organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster international sports competition, or for the prevention of cruelty to children or animals. Although section 501(c)(3) does not specifically mention furnishing medical care and operating a nonprofit hospital, such activities have long been considered to further charitable purposes, provided that the organization benefits the community as a whole.

No part of the net earnings of a 501(c)(3) organization may inure to the benefit of any private shareholder or individual. No substantial part of the activities of a 501(c)(3) organization may consist of carrying on propaganda, or otherwise attempting to influence legislation, and such organization may not participate in, or intervene in, any political campaign on behalf of (or in opposition to) any candidate for public office. In addition, under section 501(m), an organization described in section 501(c)(3) or 501(c)(4) is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance.

A tax-exempt organization may, subject to certain limitations, enter into a joint venture or partnership with a for-profit organization without affecting its tax-exempt status. Under current ruling practice, the IRS examines the facts and circumstances of each arrangement to determine (1) whether the venture itself and the participation of the tax-exempt organization therein furthers a charitable purpose, and (2) whether the sharing of profits and losses or other aspects of the arrangement entail improper private inurement or more than incidental private benefit. See IRS General Counsel Memorandum 39862; Announcement 92-83, 1992-22 I.R.B. 59 (IRS Audit Guidelines for Hospitals). Even where no prohibited private inurement exists, however, more than incidental private benefit conferred on individuals may result in the organization not being operated “exclusively” for an exempt purpose. See, e.g., American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989).

New Federal Law (Sec. 501(o))

The provision provides that an organization does not fail to be treated as organized and operated exclusively for a charitable purpose for purposes of Internal Revenue Code section 501(c)(3) solely because a hospital which is owned and operated by such organization participates in a provider-sponsored organization (PSO) (as defined in section 1845(a)(1) of the Social Security Act), regardless of whether such PSO is exempt from tax. Thus, participation by a hospital in a PSO (whether taxable or tax-exempt) is deemed to satisfy the

first part of the inquiry under current IRS ruling practice. The qualification of a hospital as a tax-exempt charitable organization under section 501(c)(3) is determined as under present law.

The provision does not change present-law restrictions on private inurement and private benefit. However, the provision provides that any person with a material financial interest in such a PSO shall be treated as a private shareholder or individual with respect to the hospital for purposes of applying the private inurement prohibition in Code section 501(c)(3). Accordingly, the facts and circumstances of each PSO arrangement are evaluated to determine whether the arrangement entails impermissible private inurement or more than incidental private benefit (e.g., where there is a disproportionate allocation of profits and losses to the non-exempt partners, the tax-exempt partner makes loans to the joint venture that are commercially unreasonable, the tax-exempt partner provides property or services to the joint venture at less than fair market value, or a non-exempt partner receives more than reasonable compensation for the sale of property or services to the joint venture).

The provision does not change present-law restrictions on lobbying and political activities. In addition, the restrictions of Code section 501(m) on the provision of commercial-type insurance continue to apply.

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

California law contains stand alone language that mirrors IRC section 501(c)(3) as it read on January 1, 1997. In addition, California law requires that the assets used by the organization be dedicated to purposes listed in R&T section 23701(d) (IRC section 501(c)(3)). California law also contains “inurement” rules similar to the federal rules.

Effective Date

The provision was effective on August 5, 1997.

Impact on California Revenue

Based on the negligible impact projected for the federal law, the state revenue loss would be negligible (less than $250,000) annually.

BALANCED BUDGET ACT OF 1997
(P.L. 105-33)

Act Section	Section Title
4313	Provision of Employer Identification Numbers by Medicare Providers Taxation of Medicare+Choice Medical Savings Accounts

Background

Entities participating in Medicare, Medicaid and the Maternal and Child Health Block Grant programs are required to provide certain information regarding the identity of each person with an ownership or control interest in the entity or in any subcontractor in which the entity has a direct or indirect 5% or more ownership interest. Providers under part B of Medicare also are required to provide information regarding persons with an ownership or control interest in a provider or any subcontractor in which the provider has a direct or indirect 5% or more ownership interest.

New Federal Law

The Act requires that all Medicare providers supply the Secretary of HHS with the federal employer identification number (FEIN) of each disclosing entity, each person with an ownership or control interest, and any subcontractor in which the entity has a direct or indirect 5% or more ownership interest. The Secretary of HHS is required to transmit to the Secretary of the Treasury the FEIN's received, and the Secretary of the Treasury is directed to verify or correct the FEINs. The Secretary of HHS is to reimburse the Secretary of the Treasury for the costs incurred in performing the verification and correction.

Current California Law

California does not have a Medicare or a Maternal and Child Health Block Grant program. California’s Medi-Cal program which supplements the federal Medicare program, is administered by the Department of Health Services.

Effective Date

The provision is effective 90 days after the Secretary of HHS submits to the Congress a report on the steps taken to ensure the confidentiality of social security account numbers required to be provided to the Secretary of HHS.

Impact on California Revenue

Not applicable.

BALANCED BUDGET ACT OF 1997
(P.L. 105-33)

Act Section	Section Title
4631	Disclosure of Tax Return Information

Background

The Internal Revenue Code prohibits disclosure of tax returns and return information, except to the extent specifically authorized. Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both. An action for civil damages also may be brought for unauthorized disclosure. No tax information may be furnished by the IRS to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives.

Among the disclosures permitted under the Internal Revenue Code is disclosure of taxpayer filing status and identity information for the purpose of verifying the employment status of Medicare beneficiaries and the spouse of a Medicare beneficiary.

The Medicare disclosure provision was generally scheduled to expire after September 30, 1998.

New Federal Law (Sec. 6103(l)(12))

The Act permanently extends the Medicare disclosure provision.

Current California Law (R&T Sec. 19542)

California does not have a Medicare program. California does have a Medi-Cal program that supplements the federal Medicare program. Medi-Cal is administered by the Department of Health Services. Upon request from the DSS, the Franchise Tax Board is required to disclose unearned income information to the DSS for applicants for recipients of public social services programs under Division 9 of the Welfare and Institutions Code. This requirement is permanent.

Effective Date

The provision is effective on August 5, 1997.

Impact on California Revenue

Not applicable.

BALANCED BUDGET ACT OF 1997
(P.L. 105-33)

Act Section	Section Title
5405-07	Unemployment Tax Provisions

New Federal Law

Act Section 5405 (Code sec. 3309(b)) Exemption from Service Performed by Election Workers from the Federal Unemployment Tax

The Federal Unemployment Tax Act (FUTA) generally requires states to cover under their unemployment compensation laws service performed in the employ of a states or local government. Only certain enumerated exceptions are allowed.

The Act exempts from FUTA service performed as an election official or election worker. This exemption applies only if the annual wages received by the individual for such service are less than $1,000. These persons are also ineligible to claim unemployment benefits with respect to such wages. The provision was effective with respect to services performed after August 5, 1997.

Act Section 5406 (Code sec. 3306) Treatment of Certain Services Performed by Inmates.

FUTA imposes a 6.2% gross tax rate on the first $7,000 of wages paid annually by covered employers to each employee. Generally, wages are defined to include all remuneration for employment unless specifically exempted. Under prior law, there was no exemption for wages paid to persons committed to penal institutions who earn wages through private-sector jobs.

The Act exempts wages paid to persons committed to penal institutions from the definition of wages for FUTA tax purposes. These persons are also ineligible to claim unemployment benefits with respect to such wages. The provision was effective with respect to services performed after January 1, 1994.

Act Section 5407 (Code sec. 3309(b)) Exemption of Service Performed for an Elementary or Secondary School Operated Primarily for Religious Purposes from the Federal Unemployment Tax.

FUTA requires states to cover under their unemployment compensation laws certain nonprofit organizations designated under FUTA that are not subject to the FUTA tax. These nonprofit organizations generally must elect whether to pay states unemployment taxes or reimburse the states unemployment insurance agency for the benefits provided to its former employees. However, FUTA exempts from coverage under states unemployment compensation laws services performed in the employ of: (1) a church or convention or association of churches, or (2) an organization which is operated primarily for religious purposes and which is operated, supervised, controlled, or principally supported by a church or convention or association of churches. Under prior law, services provided by individuals who are in the employ of entities with a religious orientation which are not affiliated with a particular church, or

convention or association of churches, were not exempt from states unemployment compensation laws.

The Act exempts from FUTA requirements of coverage under state unemployment compensation laws service performed in an elementary or secondary school which is operated primarily for religious purposes. This exemption is available to such schools even though they are not operated, supervised, controlled, or principally supported by a church or convention or association of churches. Persons performing such service are also ineligible to claim unemployment benefits with respect to such wages. The provision was effective with respect to service performed after August 5, 1997.

Current California Law

The Franchise Tax Board does not administer employment taxes. These taxes are administered by Employment Development Department (EDD).

Impact on California Revenue

Defer to EDD.

BALANCED BUDGET ACT OF 1997
(P.L. 105-33)

Act Section	Section Title
5702	Authorization of Appropriations for Enforcement Initiatives Related to the Earned Income Credit

Background

Certain eligible low-income workers are entitled to claim a refundable earned income credit on their income tax return. A refundable credit is a credit that not only reduces an individual's tax liability but allows refunds to the individual in excess of income tax liability. The amount of the credit an eligible individual may claim depends upon whether the individual has one, more than one, or no qualifying children, and is determined by multiplying the credit rate by the individual's earned income up to an earned income amount. The maximum amount of the credit is the product of the credit rate and the earned income amount. The credit is reduced by the amount of the alternative minimum tax (AMT) the taxpayer owes for the year. The credit is phased out above certain income levels.

The Taxpayer Relief Act of 1997 modified the Internal Revenue Code to include several earned income credit compliance initiatives. Prior to fiscal year 1998, however, there was no explicit authorization of appropriations for the enforcement of the earned income credit.

New Federal Law

The Act authorizes appropriation to the Secretary of the Treasury for improved enforcement of the earned income credit, the following amounts: $138 million in FY 1998, $143 million in FY 1999, $144 million in FY 2000, $145 million in FY 2001, and $146 million in FY 2002.

Current California Law

California has no comparable credit.

Effective Date

The provision was effective on August 5, 1997.

Impact on California Revenue

Not applicable.

BALANCED BUDGET ACT OF 1997
(P.L. 105-33)

Act Section	Section Title
9302	Increase in Excise Tax on Tobacco Products

Background

The following is a listing of the federal excise tax rates imposed on tobacco products under present law (through December 31, 1999):

Article	Tax rate	
Cigars:		
Small cigars.	$1.125	per thousand.
Large cigars	12.75%	of manufacturer's price, up to $30 per thousand.
Cigarettes:		
Small cigarettes	$12.00	per thousand (24 cents per pack of 20 cigarettes).
Large cigarettes	$25.20	per thousand.
Cigarette papers	$0.0075	per 50 papers.
Cigarette tubes	$0.15	per 50 tubes.
Chewing tobacco	$0.12	per pound.
Snuff.	$0.36	per pound.
Pipe tobacco	$0.675	per pound.

New Federal Law (TRA of 1997 Act Sec. 1604(f)(3), IRC Sec. 5701)

In General.

The Act increases the current excise tax rates on all tobacco products, including cigarettes, cigars, chewing tobacco, snuff, and pipe tobacco, effective in two stages: January 1, 2000 and January 1, 2002. Excise tax is also imposed on “roll-your-own” tobacco, beginning in 2000. Floor stocks taxes are imposed on tobacco products at the time of the rate increases (including tobacco products in foreign trade zones). The Act also includes expanded compliance measures designed to prevent diversion of non-tax-paid tobacco products nominally destined for export to use within the United States.

Specific Tax Rate Increases.

The following table shows the specific tobacco excise tax rates under the Act in effect for the period, January 1, 2000-December 31, 2001:

Article	January 1, 2000-December 31, 2001 Tax rate
Cigars:	
Small cigars.	$1.594 per thousand.
Large cigars	18.063% of manufacturer's price, up to $42.50 per thousand.
Cigarettes:	
Small cigarettes	$17.00 per thousand (34 cents per pack of 20 cigarettes).
Large cigarettes	$37.50 per thousand.
Cigarette papers	$0.0106 per 50 papers.
Cigarette tubes	$0.0213 per 50 tubes.
Chewing tobacco	$0.17 per pound.
Snuff.	$0.51 per pound.
Pipe tobacco	$0.9567 per pound.
Roll-your-own	$0.9567 per pound.

The following table shows the specific tobacco excise tax rates in effect for 2002 and thereafter:

Article	2002 and Thereafter Tax rate
Cigars:	
Small cigars.	$1.828 per thousand.
Large cigars	20.719% of manufacturer's price, up to $48.75 per thousand.
Cigarettes:	
Small cigarettes	$19.50 per thousand (39 cents per pack of 20 cigarettes).
Large cigarettes	$40.95 per thousand.
Cigarette papers	$0.0122 per 50 papers.
Cigarette tubes	$0.0244 per 50 tubes.
Chewing tobacco	$0.19 per pound.
Snuff.	$0.585 per pound.
Pipe tobacco	$1.0969 per pound.
Roll-your-own	$1.0969 per pound.

Coordination with Tobacco Industry Settlement Agreement.

Section 1604(f)(3) of the Taxpayer Relief Act of 1997 provided that the increase in tobacco excise taxes collected as a result of the above increases are to be "credited against the total payments made by parties pursuant to federal legislation implementing the tobacco industry settlement agreement of June 20, 1997." This provision was repealed under section 519 of the Fiscal Year 1998 Appropriations for Labor, Health and Human Resources (H.R. 2264) as passed by the Congress and signed by the President

Current California Law

The Franchise Tax Board does not administer excise taxes. Excise taxes are generally administered by the State Board of Equalization (SBE).

Effective Date

The provision generally is effective on January 1, 2000.

Impact on California Revenue

Defer to the SBE.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
101	Child Tax Credit

New Federal Law (Sec. 24)

Beginning for tax years 1998, federal law provides for a nonrefundable tax credit for each qualifying child under the age of 17. The credit is $400 for taxable year 1998, and $500 for 1999 taxable years and thereafter. A qualifying child is defined as an individual for whom the taxpayer can claim a dependency exemption and who is a son or daughter of the taxpayer (or descendent of either), a stepson or stepdaughter of the taxpayer or an eligible foster child of the taxpayer. For taxpayers with modified adjusted gross income(AGI) in excess of certain thresholds, the sum of the otherwise allowable child credit and the otherwise allowable dependent care credit is phased out. The phase-out rate is $50 for each $1,000 of modified AGI (or fraction thereof) in excess of the threshold. For married taxpayers filing joint returns, the threshold is $110,000. For taxpayers filing single or head of household returns, the threshold is $75,000. For married taxpayers filing separate returns, the threshold is $55,000. These thresholds are not indexed for inflation.

In general, in the case of a taxpayer with qualifying children, the amount of the child credit equals $500 ($400 for 1998) times the number of qualifying children. In the case of a taxpayer with one or two qualifying children, a portion of the child credit may be treated as a refundable supplemental child credit amount. This amount equals the excess of (1) $500 times the number of qualifying children up to the excess of the taxpayer's income tax liability (net of applicable credits other than the earned income credit) over the taxpayer's tentative minimum tax liability (determined without regard to the alternative minimum foreign tax credit) over (2) the sum of the taxpayer's regular income tax liability (net of applicable credits other than the earned income credit) and the employee share of FICA reduced by any earned income credit amount. In no case will the total amount of the allowable child credit exceed the amount that would result from its calculation as a nonrefundable personal credit. In the case of a taxpayer with three or more qualifying children, the maximum amount of the child credit for each taxable year cannot exceed the greater of: (1) the excess of the taxpayer's regular tax liability (net of applicable credits other than the earned income credit) over the taxpayer's tentative minimum tax liability (determined without regard to the alternative minimum foreign tax credit), or (2) an amount equal to the excess of the sum of the taxpayer's regular income tax liability (net of applicable credits other than the earned income credit) and the employee share of FICA reduced by the earned income credit. To the extent that the amount determined under (1) is greater than the amount determined under (2), the difference is treated as a supplemental child credit amount. The conferees anticipate that the Secretary of the Treasury will determine whether a simplified method of calculating the child credit, consistent with the formula described above, can be achieved.

In the case of a taxpayer with three or more qualifying children, if the amount of the allowable child credit as computed under the computation described immediately above exceeds the taxpayer's regular tax liability before the computation, then the excess is a refundable tax credit.

In addition to the child tax child, federal law allows a standard deduction of $2,650 (for 1997) for each qualifying dependent. The standard deduction is phased-out for taxpayers with (AGI) exceeding certain limits.

Current California Law (R&T Sec. 17054)

California does not have a credit based solely on a dependent child under the age of 17. California does provide a non-refundable exemption credit for qualifying dependents. SB 1233 (Stat. 1997, Ch. 612) increased the dependent exemption credit from $68 to $120 for 1998 and to $222 in 1999. The $222 will be adjusted for inflation beginning in year 2000. California has conformed to the definition of dependent under the Internal Service Code (IRC). Exemption credits also have a phase-out provision if AGI is over certain limits. For 1997, the phase-out thresholds start at $144,152 for single taxpayers, $228,305 for married taxpayers filing joint and $171,228 for head of household filers. For single taxpayers the credit is reduced by $6 for each $2,500 by which the taxpayer’s AGI exceeds the threshold amount. For married taxpayers filing joint the credit is phased-out by $12 for each $2,500 the taxpayer’s AGI exceeds the threshold amount. Additionally, exemption credits cannot reduce regular tax below tentative minimum tax.

Effective Date

The child tax credit is effective for taxable years beginning after December 31, 1997.

Impact on California Revenue

California addressed this issue in SB 1233 (Stat. 1997, Ch. 612).

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
201	HOPE Credit & Lifetime Learning Credit

New Federal Law (Sec. 25)

Individual taxpayers are allowed to claim a non-refundable HOPE credit or lifetime learning credit against federal income taxes. The HOPE credit rate is 100% on the first $1,000 of qualified tuition and fees, and 50% on the next $1,000 of qualified tuition and fees per student. The lifetime learning credit is 20% of the first $5,000 (increased to $10,000 in 2003) of qualified tuition and fees per taxpayer. Both the HOPE and the lifetime learning credit are available only for tuition and fees required for the enrollment or attendance of an eligible student at an eligible institution, and are not available for expenses incurred to purchase books nor for room and board. For a taxable year, a taxpayer must elect with respect to an eligible student either the HOPE credit, the lifetime learning credit, or the exclusion from gross income for certain distributions from an education IRA.

HOPE Credit.

The HOPE credit is for tuition and fees paid for the first two years of the student's post-secondary education in a degree or certificate program. The qualified tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent. The HOPE credit is available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education. Beginning in 2001, the maximum credit amount of $1,500 will be indexed for inflation, rounded down to the closest multiple of $50.

The HOPE credit may not be claimed against a taxpayer's alternative minimum tax (AMT) liability. The HOPE credit amount that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $40,000 and $50,000 ($80,000 and $100,000 for joint returns). Modified AGI includes amounts otherwise excluded with respect to income earned abroad (or income from Puerto Rico or U.S. possessions). The income phase-out ranges will be indexed for inflation occurring after the year 2000, rounded down to the closest multiple of $5,000. The first taxable year for which the inflation adjustment could be made to increase the income phase-out ranges will be 2002. The HOPE credit is available in the taxable year the expenses are paid, subject to the requirement that the education commence or continue during that year or during the first three months of the next year. Qualified tuition expenses paid with the proceeds of a loan generally are eligible for the HOPE credit (rather than repayment of the loan itself).

The Treasury Department is granted authority to issue regulations providing that the HOPE credit will be recaptured in cases where the student or taxpayer receives a refund of tuition and related expenses with respect to which a credit was claimed in a prior year.

A taxpayer may claim the HOPE credit with respect to an eligible student who is not the taxpayer or the taxpayer's spouse (e.g., in cases where the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent by the parent or other taxpayer, the eligible student is not entitled to claim a HOPE credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of the provision.

For each taxable year, a taxpayer may elect with respect to an eligible student either the HOPE credit or the deduction for qualified higher education expenses. Thus, for example, if a parent claims a child as a dependent for a taxable year, then all qualified tuition expenses paid by both the parent and child are deemed paid by the parent, and the parent may claim the HOPE credit (assuming that the AGI phaseout does not apply) on the parent's return.
Qualified Tuition & Fees.

The HOPE credit is available for “qualified tuition and related expenses,” meaning tuition and fees required for the enrollment or attendance of an eligible student at an eligible educational institution. The credit is not available for expenses incurred to purchase books. Charges and fees associated with meals, lodging, student activities, athletics, insurance, transportation, and similar personal, living or family expenses are also not included. The expenses of education involving sports, games, or hobbies are not qualified tuition and related expenses unless this education is part of the student's degree program. Qualified tuition and fees generally include only out-of-pocket expenses. Qualified tuition and fees do not include expenses covered by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and fees are reduced by any scholarship or fellowship grants excludable from gross income under present-law and any other tax-free educational benefits received by the student during the taxable year. No reduction of qualified tuition and fees is required for a gift, bequest, devise, or inheritance. A HOPE credit is not allowed with respect to any education expense for which a deduction is claimed as a business expense or any other section of the IRC.

Coordination with U.S. Savings Bonds.

In addition, the TRA of 1997 amended exclusion from income of interest earned from federal savings bonds if used for higher education to provide that the amount of qualified higher education expenses taken into account for that purpose is reduced by the amount of the expenses taken into account in determining the HOPE credit or lifetime learning credit claimed by any taxpayer with respect to the student for the taxable year.

Eligible Student

An eligible student for purposes of the HOPE credit is an individual who is

enrolled in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible educational institution. The student must pursue a course of study, for at least one academic period which begins during the taxable year, and must carry at least one-half the normal full-time work load for the course of study the student is pursuing. In addition, an eligible student may not have been convicted of a federal or state felony consisting of the possession or distribution of a controlled substance.

Eligible Educational Institutions.

Eligible educational institutions are defined by reference to section 481 of the Higher Education Act of 1965. Such institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible educational institutions. The institution must be eligible to participate in Department of Education student aid programs.

Regulations.

The Secretary of the Treasury (in consultation with the Secretary of Education) is granted authority to issue regulations to implement the provision. The Secretary of the Treasury will have authority to issue regulations providing appropriate rules for recordkeeping and information reporting. These regulations may address the information reports that eligible educational institutions will be required to file to assist students and the IRS in calculating the amount of the HOPE credit potentially available.

Lifetime Learning Credit.

Taxpayers are also allowed to claim a nonrefundable lifetime learning credit against federal income taxes equal to 20% of qualified tuition and fees incurred during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or any dependents. For expenses paid after June 30, 1998, and prior to January 1, 2003, up to $5,000 of qualified tuition and fees per taxpayer return will be eligible for the 20% lifetime learning credit (i.e., the maximum credit per taxpayer return will be $1,000). For expenses paid after December 31, 2002, up to $10,000 of qualified tuition and fees per taxpayer return will be eligible for the 20% lifetime learning credit (i.e., the maximum credit per taxpayer return will be $2,000). In contrast to the HOPE credit, a taxpayer may claim the lifetime learning credit for an unlimited number of taxable years. Also in contrast to the HOPE credit, the maximum amount of the lifetime learning credit that may be claimed on a taxpayer's return will not vary based on the number of students in the taxpayer's family. The lifetime learning credit is phased out ratably over the same phaseout range that applies for purposes of the HOPE credit--i.e., taxpayers with modified AGI between $40,000 and $50,000 ($80,000 and $100,000 for joint returns). The income phase-out ranges will be indexed for inflation occurring after the year 2000, rounded

down to the closest multiple of $1,000. The first taxable year for which the inflation adjustment could be made to increase the income phase-out ranges will be 2002.

The lifetime learning credit is available in the taxable year the expenses are paid, subject to the requirement that the education commence or continue during that year or during the first three months of the next year. Qualified tuition and fees paid with the proceeds of a loan generally are eligible for the lifetime learning credit (rather than repayment of the loan itself).

Dependent Students.

As with the HOPE credit, a taxpayer may claim the lifetime learning credit with respect to a student who is not the taxpayer or the taxpayer's spouse (e.g., in cases where the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent by the parent or other taxpayer, the student is not entitled to claim the lifetime learning credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of the provision.

Election of Lifetime Learning Credit.

A taxpayer may claim the lifetime learning credit for a taxable year with respect to one or more students, even though the taxpayer also claims a HOPE credit (or claims an exclusion from gross income for certain distributions from qualified state tuition programs or education IRAs) for that same taxable year with respect to other students. If, for a taxable year, a taxpayer claims a HOPE credit with respect to a student (or claims an exclusion for certain distributions from an education IRA with respect to a student), then the lifetime learning credit will not be available with respect to that same student for that year (although the lifetime learning credit may be available with respect to that same student for other taxable years).

Qualified Tuition and Fees.

The lifetime learning credit is available for qualified tuition and fees, meaning tuition and fees required for the enrollment or attendance of the eligible student at an eligible institution. Charges and fees associated with meals, lodging, student activities, athletics, insurance, transportation, and similar personal, living or family expenses are not included. The 20% credit is not available for expenses incurred to purchase books. The expenses of education involving sports, games, or hobbies are not qualified tuition expenses unless this education is part of the student's degree program. In contrast to the HOPE credit, qualified tuition and fees for purposes of the lifetime learning credit include tuition and fees incurred with respect to undergraduate or graduate-level (and professional degree) courses.

In addition to allowing a credit for the tuition and fees of a student who attends classes on at least a half-time basis as part of a degree or certificate program, the lifetime learning credit also is available with respect to any course of instruction at an eligible educational institution (whether enrolled in by the student on a full-time, half-time, or less than half-time basis) to acquire or improve job skills of the student. The HOPE credit is available only with respect to the first two years of a student's undergraduate education. Qualified tuition and fees are defined in the same manner as under the HOPE credit provisions.

Eligible Educational Institutions.

Eligible educational institutions are (as with the HOPE credit) defined by reference to section 481 of the Higher Education Act of 1965. Such institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, graduate-level or professional degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible educational institutions. The institution must be eligible to participate in Department of Education student aid programs.

Regulations.

The Secretary of the Treasury (in consultation with the Secretary of Education) is granted authority to issue regulations to implement the provision. The Secretary of the Treasury will have authority to issue regulations providing appropriate rules for recordkeeping and information reporting. These regulations may address the information reports that eligible educational institutions will be required to file to assist students and the IRS in calculating the amount of the lifetime learning credit potentially available.

Neither the HOPE or lifetime learning credit are not available to married taxpayers filing separate returns. Married taxpayers must file joint tax returns to qualify for the credits.

Current California Law

California has no comparable credit.

Effective Date

The HOPE credit applies to qualified educational expenses incurred after January 1, 1998. The lifetime learning credit applies to qualified educational expenses incurred after June 30, 1998.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
202	Deduction for Student Loan Interest

Background

The Tax Reform Act of 1986 repealed the deduction for personal interest. Student loan interest generally is treated as personal interest and thus is not allowable as an itemized deduction from income. Taxpayers generally may not deduct education and training expenses. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment (Treas. Reg. sec. 1.162-5). Education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses relate to the employee's current job and only to the extent that the expenses, along with other miscellaneous deductions, exceed 2% of the taxpayer's adjusted gross income (AGI).

New Federal Law (Sec. 62 & 221)

Under the TRA, certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, up to a maximum deduction of $2,500 for the 2001 taxable year. The maximum deduction is phased in over four years, with a $1,000 maximum deduction in 1998, $1,500 in 1999, $2,000 in 2000, and $2,500 in 2001. The maximum deduction amount is not indexed for inflation. In addition, the deduction is phased out ratably for individual taxpayers with modified AGI of $40,000-$55,000 ($60,000-$75,000 for joint returns).

The phase-out income ranges will be indexed for inflation occurring after the year 2002, rounded down to the closest multiple of $5,000. Thus, the first taxable year for which the inflation adjustment could be made will be 2003. For purposes of the deduction, modified AGI includes amounts otherwise excluded with respect to income earned abroad (or income from Puerto Rico or U.S. possessions), and is calculated after application of section 86 (income inclusion of certain Social Security benefits), section 219 (deductible IRA contributions), section 469 (limitation on passive activity losses and credits), and amounts excludable from gross income under section 137, (qualified adoption expenses). For purposes of sections 86, 135, 219, 469, and 137 adjusted gross income is determined without regard to the deduction for student loan interest.

Any person in a trade or business or any governmental agency that receives $600 or more in qualified education loan interest from an individual during a calendar year must provide an information report on such interest to the IRS and to the payor.

The deduction is allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. Months during which the qualified education loan is in deferral or forbearance do not count against the 60-month period. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year. A qualified education loan generally is defined as any indebtedness incurred to pay for the qualified higher education expenses of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending (1) post-secondary educational institutions and certain vocational schools defined by reference to section 481 of the Higher Education Act of 1965, or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.

Qualified higher education expenses are defined as the student's cost of attendance as defined in section 472 of the Higher Education Act of 1965 (generally, tuition, fees, room and board, and related expenses), reduced by (1) any amount excluded from gross income under section 135, (2) any amount distributed from an education IRA and excluded from gross income, and (3) the amount of any scholarship or fellowship grants excludable from gross income under present-section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance that is excludable from the employee's gross income under section 127. It is expected that the Secretary of Treasury will issue regulations setting forth reporting procedures to facilitate the administration of this provision. Specifically, such regulations should require lenders separately to report to borrowers the amount of interest that constitutes deductible student loan interest (i.e., interest on a qualified education loan during the first 60 months in which interest payments are required). In this regard, the regulations should include a method for borrower certification to a lender that the loan proceeds are being used to pay for qualified higher education expenses. Such expenses must be paid or incurred within a reasonable period before or after the indebtedness is incurred, and must be attributable to a period when the student is at least a half-time student.

Current California Law (R&T Sec. 17201)

California law generally is in conformity with the IRC as it read on January 1, 1997, as it relates to educational incentives, which did not specially allow a deduction for student loan interest.

Effective Date

The provision is effective for interest payments due and paid after December 31, 1997, on any qualified education loan.

Impact on California Revenue

Fiscal Year Cash Flow Interest Payments Due After 1997 $ Millions			
1997-8	1998-9	1999-0	2000-01
(minor*)	($14)	($15)	($16)

* Loss less than $500,000

The revenue impact for this provision would depend on the amount of qualified interest payments in any given year and the average marginal tax rate applicable to the deduction amounts.

These estimates were derived from information from the California Aid Commission Office on students loans. The vast majority of taxpayers would be former students (rather than parents) with modest incomes. It was projected that of the approximately 1,000,000 students in repayment status, half (500,000) would claim the interest deduction for tax year 1998. Many would not be eligible due to the interest period limitation, AGI tests, home equity financing of loans for which interest is currently deductible, and defaults on loans. It was assumed that the average annual interest payment would be $600 (one-half of an average annual payment of $1,200). If a marginal tax rate of 4.5% is applied to these deductions, the impact would be around $14 million.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
203	Penalty-Free Withdrawal from IRAs for Higher Education Expenses

Background

Prior to the Act, federal law provided that amounts held in an individual retirement arrangement (IRA) are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Amounts withdrawn prior to attainment of age 59½ are subject to an additional 10% early withdrawal tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, is used to pay medical expenses in excess of 7.5% of AGI, or is used to purchase health insurance of an unemployed individual.

New Federal Law (Sec. 72)

The Act provides that the 10% early withdrawal tax additionally does not apply to distributions from IRAs if the taxpayer uses the amounts to pay qualified higher education expenses (including those related to graduate level courses) of the taxpayer, the taxpayer's spouse, or any child or grandchild of the individual, or the individual's spouse. The penalty-free withdrawal is available for “qualified higher education expenses,” meaning tuition, fees, books, supplies, equipment required for enrollment or attendance, and room and board at a post-secondary educational institution (defined by reference to sec 481 of the Higher Education Act of 1965). Qualified higher education expenses are reduced by any amount excludable from gross income under section 135 relating to the redemption of a qualified U.S. savings bond and certain scholarships and veterans benefits.

Current California Law (R&T Sec. 17085, 17085.5, 17085.8)

California has conformed to this provision in SB 1233 with the same effective dates.

Effective Date

The provision is effective for withdrawals from IRAs made after December 31, 1997, which respect to expenses paid after such date for education furnished in academic periods beginning after such date.

Impact on California Revenue

These changes were adopted in SB 1233 (Stat. 1997, Ch. 612).

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
211	Modifications of Qualified State Tuition Programs.

Background

IRC section 529 (enacted as part of the Small Business Job Protection Act of 1996) provides tax-exempt status to “qualified state tuition programs,” meaning certain 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 of payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account. “Qualified higher education expenses” are defined as tuition, fees, books, supplies, and equipment required for the enrollment or attendance at a college or university (or certain vocational schools). Prior to the Act, qualified higher education expenses did not include room and board expenses. IRC section 529 also 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 IRC section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent receives a refund) will be included in the contributor's gross income to the extent such amounts exceed contributions made by that person. Specifically, section 529(c)(3)(A) provides that any distribution under a qualified state tuition program shall be includible in the gross income of the distributee in the same manner as provided under present-IRC section 72 to the extent not excluded from gross income under any other provision of the IRC.

New Federal Law (Secs. 135(c), 529, 6693)

The Act made the following modifications to IRC section 529, which governs the tax treatment of qualified state tuition programs.

- Room and board expenses --The Act expands the definition of “qualified higher education expenses” under section 529(e)(3) to include room and board expenses (meaning the minimum room and board allowance applicable to the student as determined by the institution in calculating costs of attendance for federal financial aid programs under section 472 of the Higher Education Act of 1965) for any period during which the student is at least a half-time student.

- Eligible educational institution --The Act expands the definition of “eligible educational institution” for purposes of section 529 by defining

the term by reference to section 481 of the Higher Education Act of 1965. Such institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, a graduate-level or professional degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible institutions. The institution must be eligible to participate in Department of Education student aid programs.

- Member of family --The Act expands the definition of the term “member of the family” for purposes of allowing tax-free transfers or rollovers of credits or account balances in qualified state tuition programs (and redesignations of named beneficiaries) so that the term means persons described in paragraphs (1) through (8) of section 152(a)--e.g., sons, daughters, brothers, sisters, nephews and nieces, certain in-laws, etc., and any spouse of such persons. The Act also provides a special rule that, in the case of any contract issued prior to August 20, 1996 (i.e., the date of enactment of section 529), section 529(c)(3)(C) will be applied without regard to the requirement that a distribution be transferred to a member of the family or the requirement that a change in beneficiaries may be made only to a member of the family.

- Prohibition against investment direction-- The Act clarifies the present-law rule contained in section 529(b)(5) that qualified state tuition programs may not allow contributors or designated beneficiaries to direct the investment of contributions to the program (or earnings thereon) by specifically providing that contributors and beneficiaries may not “directly or indirectly” direct the investment of contributions to the program (or earnings thereon).

- Interaction with HOPE credit and lifetime learning credit-- Under the Act (as under present law), no amount will be includible in the gross income of a contributor to, or beneficiary of, a qualified state tuition program with respect to any contribution to or earnings on such a program until a distribution is made from the program, at which time the earnings portion of the distribution (whether made in cash or in-kind) will be includible in the gross income of the distributee. However, to the extent that a distribution from a qualified state tuition program is used to pay for qualified tuition and fees, the distributee (or another taxpayer claiming the distributee as a dependent) will be able to claim the HOPE credit or lifetime learning credit provided for by the Act with respect to such tuition and fees (assuming that the other requirements for claiming the HOPE credit or lifetime learning credit are satisfied and the modified AGI phaseout for those credits does not apply).

In cases where in-kind benefits are provided to a beneficiary under a qualified state prepaid tuition program, section 529(c)(3)(B) provides that the provision of such benefits is treated as a distribution to the beneficiary. Thus, to the extent such in-kind benefits, if paid for by the beneficiary, would constitute

payment of qualified tuition and fees for purposes of the HOPE credit or lifetime learning credit, the beneficiary (or another taxpayer claiming the beneficiary as a dependent) may be able to claim the HOPE credit or lifetime learning credit with respect to payments that are deemed to be made by the beneficiary with respect to the in-kind benefit.

- For federal estate and gift tax purposes, any contribution to a qualified tuition program or education IRA will be treated as a completed gift of a present interest from the contributor to the beneficiary at the time of the contribution. Thus contributions made to a qualified tuition program and/or education investment account will be eligible for the present-law gift tax exclusion provided by section 2503(b) and also will be excludable for purposes of the generation-skipping transfer tax (provided that the contribution, when combined with any other contributions made by the donor to that same beneficiary, does not exceed the annual gift-tax exclusion limit of $10,000 in the case of an individual or $20,000 in the case of a married couple that splits their gifts). Contributions to a qualified tuition program (either a state-sponsored program or one maintained by a private education institution) or to an education IRA will not, however, be eligible for the educational expense exclusion provided by section 2503(e). In no event will a distribution from a qualified tuition program or education investment account be treated as a taxable gift.

  A special rule is provided in the case of contributions that exceed the annual gift tax exclusion limit ($10,000 for individuals). For such contributions, the contributor may elect to have the contribution treated as if made ratably over a five-year period. For example, a $30,000 contribution to a qualified state tuition program would be treated as five annual contributions of $6,000, and the donor could therefore make up to $4,000 in other transfers to the beneficiary each year without payment of gift tax. Under this rule, a donor may contribute up to $50,000 every five years ($100,000 in the case of a married couple) with no gift tax consequences, assuming no other gifts are made from the donor to the beneficiary in the five-year period. A gift tax return must be filed with respect to any contribution in excess of the annual gift-tax exclusion limit, and the election for five-year averaging must be made on the contributor's gift tax return.

  If a donor making an over-$10,000 contribution dies during the five-year averaging period, the portion of the contribution that has not been allocated to the years prior to death is includible in the donor's estate. For example, if a donor makes a $40,000 contribution, elects to treat the transfer as being made over a five-year period, and dies the following year, $8,000 would be allocated to the year of contribution, another $8,000 would be allocated to the year of death, and the remaining $24,000 would be includible in the estate.

  If a beneficiary's interest is rolled over to another beneficiary, there are no transfer tax consequences if the two beneficiaries are in the same generation. If a beneficiary's interest is rolled over to a beneficiary in a

lower generation (e.g., parent to child or uncle to niece), the five-year averaging rule described above may be applied to exempt up to $50,000 of the transfer from gift tax.

The federal estate and gift tax treatment of educational accounts has no effect on the actual rights and obligations of the parties pursuant to the terms of the contracts under state law.

Transfers or rollovers of credits or account balances from an account benefiting one beneficiary to an account benefiting another beneficiary (or a change in the designated beneficiary) will not be treated as a taxable gift to the extent that the new beneficiary is: (1) a member of the family of the old beneficiary, and (2) assigned to the same generation as the old beneficiary (within the meaning of section 2651). In all other cases, a transfer from one beneficiary to another beneficiary (or a change in the designated beneficiary) will be treated as a taxable gift from the old beneficiary to the new beneficiary to the extent it exceeds the $10,000 present-law gift tax exclusion. Thus, a transfer of an account from a brother to his sister will not be treated as a taxable gift, whereas a transfer from a father to his son will be treated as a taxable gift (to the extent it exceeds the $10,000 present-law gift tax exclusion).

For estate tax purposes, the value of any interest in a qualified tuition program or education investment account will be includible in the estate of the designated beneficiary. In no event will such interests be includible in the estate of the contributor.

Current California Law (R&T Secs. 17140, 24306, 24328, and 23735)

AB 530 (Stat. 1997, Ch. 851), under the Education Code, created the Golden State Scholarshare Trust, effective for taxable years beginning on or after January 1, 1998. (The Golden State Scholarshare was designed to meet the requirements of section 529 as a state-sponsored qualified tuition program.) The Revenue and Taxation Code was modified to make the Scholarshare trust tax exempt and earnings on the deposits to the trust non-taxable to the participant or beneficiary until the earnings are distributed. AB 530 states under uncodified law, that it is the intent of the Legislature that the Golden State Scholarshare program be maintained as a qualified state tuition program as provided in IRC Section 529. Further, AB 530 is to be applied in a manner consistent with IRC Section 529 and any ambiguities shall be resolved consistent with IRC Section 529.

Effective Date

The modifications to IRC section 529 generally are effective after December 31, 1997. The expansion of the term “qualified higher education expenses” to cover

certain room and board expenses is effective as if included in the Small Business Job Protection Act of 1996 (enacted on August 20, 1996). The gift tax provisions are effective for contributions (or transfers) made after the date of enactment (August 5, 1997), and the estate tax provisions are effective for decedents dying after June 8, 1997.

Impact on California Revenue

These changes were adopted in AB 530 (Stat. 1997, Ch. 851).

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
213	Establish Education Individual Retirement Accounts

New Federal Law (Sec. 530)

The Act created another type of IRA called an Education IRA. Taxpayers with modified AGI below $150,000 ($95,000 for single taxpayers) may contribute up to $500 per year per beneficiary to an Education IRA. Like Roth IRAs, contributions to an Education IRA are not deductible. Earnings on contributions can be distributed to beneficiaries tax free provided the earnings distributed are used to pay for "qualified higher education expenses." The exclusion from the beneficiary's gross income is not available in any year that a Hope credit or lifetime learning credit is claimed.

The $500 maximum amount a taxpayer can contribute to an Education IRA is phased-out for married taxpayers with modified AGI between $150,000 and 160,000, and $95,000 and $110,000 for single taxpayers. Modified AGI is the taxpayer's AGI for the year increased by gross income excluded under the federal foreign earned income or other nondomestic earned income exclusion. After applying the phase-out limitations, the computed allowable contribution is less than $200 but more than zero, a $200 contribution is allowed. Like other IRAs, a 6% penalty applies to excess contributions. The limitation applies to each beneficiary (multiple Education IRAs cannot exceed $500 per beneficiary).

Qualified higher education expenses include tuition, books, supplies and equipment required for enrollment or attendance of the designated beneficiary at an eligible educational institution. Qualified higher education expenses also include, with certain limitations, room and board. An eligible educational institution is generally an accredited, postsecondary educational institution that is eligible to participate in the Department of Education student aid program.

An Education IRA is a tax-exempt trust and must be designated as such at the time it created. The trust instrument must provide that:

- no contribution will be accepted by the Education IRA after the beneficiary attains age 18.
- except in the case of rollover contributions, annual contributions to the Education IRA may not exceed $500.
- all contributions must be made in cash.
- the trustee must be either a bank or other person that demonstrates an ability to properly administer the trust.
- no portion of the trust's assets will be invested in life insurance contracts.
- the assets of the trust will not be commingled with other property, except in a common trust or investment fund.

- upon the death of the beneficiary, any trust balance will be distributed to the beneficiary's estate within 30 days.

Any amount in an Education IRA may be rolled over into another Education IRA with the same beneficiary or for the benefit of a member of the original beneficiary's family. This provision allows any residual assets in an Education IRA, after the beneficiary finishes his or her education, to be transferred to another family member. A family member is defined to include ancestors, lineal descendants of the taxpayer and the lineal descendants of the taxpayer's ancestors (e.g., uncles, aunts, nieces and nephews).

The Act requires the trustee of the Education IRA to file information reports with the Secretary of the Treasury and the beneficiary. Federal law also provides for a penalty for failure to file such reports.

Under the federal conference report, Congress indicated its intent that any balance remaining in an Education IRA at the time the beneficiary becomes 30 years old must be distributed, and the earnings portion of the distribution will be includible in gross income and subject to the 10% early withdrawal tax because the distribution was not used for education purposes. However, the law as enacted did not contain this provision.

Current California Law (R&T Secs. 19184 and 23712)

Effective for taxable years beginning on or after January 1, 1998, SB 1233 (Stat. 1997, Ch. 612) provides for education IRAs. California law follows federal law with one exception. Under California law, education IRAs are required to distribute all of the IRA's assets to the beneficiary within 30 days of the date the beneficiary becomes 30 years of age.

Effective Date

For federal purposes, the provisions governing education IRAs apply to tax years beginning after December 31, 1997.

Impact on California Revenue

These changes were adopted in SB 1233 (Stat. 1997, Ch. 612).

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
221	Extension of Exclusion for Employer-Provided Educational Assistance.

Background

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

The exclusion does not apply to graduate-level courses beginning after June 30, 1996. The exclusion would have expired with respect to all other courses of instruction beginning after June 30, 1997. In the absence of the exclusion, educational assistance is excludable from income only if it is related to the employee's current job.

New Federal Law (Sec. 127(d))

The exclusion for employer-provided educational assistance is extended with respect to courses beginning before June 1, 2000. The exclusion does not apply with respect to graduate-level courses.

Current California Law (R&T Sec. 17151)

California law conforms to federal law in respect to education assistance plans. However, California’s exclusion of up to $5,250 a year for education assistance is permanent.

Effective Date

This provision for federal purposes is effective for tax years beginning after December 31, 1996.

Impact on California Revenue

Not applicable. California’s exclusion is permanent.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
222	Repeal of Limitation on Certain Qualified 501(c)(3) Bonds.

Background

Interest on state and local government bonds generally is excluded from income if the bonds are issued to finance activities carried out and paid for with revenues of these governments. Interest on bonds issued by these governments to finance activities of other persons, e.g., private activity bonds, is taxable unless a specific exception is included in the IRC. One such exception is for private activity bonds issued to finance activities of private, charitable organizations described in section 501(c)(3) ("section 501(c)(3) organizations") when the activities do not constitute an unrelated trade or business.

Present law treats IRC section 501(c)(3) organizations as private persons; thus, bonds for their use may only be issued as private activity "qualified 501(1)(c)(3) bonds," subject to the restrictions of section 145. The most significant of these restrictions limits the amount of outstanding bonds from which a section 501(c)(3) organization may benefit to $150 million. In applying this $150 million limit, all section 501(c)(3) organizations under common management or control are treated as a single organization. The limit does not apply to bonds for hospital facilities, defined to include only acute care, primarily inpatient, organizations.

New Federal Law (Sec. 145(b))

The Act repeals the $150 million limit for bonds issued after August 5, 1997, to finance capital expenditures incurred after August 5, 1997. Because this provision of the Act applies only to bonds issued with respect to capital expenditures incurred after August 5, 1997, the $150 million limit will continue to govern issuance of other non-hospital qualified 501(c)(3) bonds (e.g., refunding bonds or new-money bonds for capital expenditures incurred before the date of enactment). Thus, bond issuers will continue to need Treasury Department guidance on the application of this limit in the future and expect that the Treasury will continue to provide interpretative rules on this limit.

Current California Law (R&T Sec. 17133 and 24272)

The Personal Income Tax Law specifically does not conform to federal law regarding private activity bonds. The California Constitution provides an exemption from income taxation for all interest from bonds issued by this state or a local government of this state. Federal law, other than the IRC, prohibits state taxation of interest on federal bonds, if the interest on state obligations is exempt from tax. Taxpayers subject to the corporate franchise

tax must report as income all interest received. Interest received from federal obligations and California obligations or its political subdivision generally is excluded from income subject to the corporation and personal income tax.

Effective date

The provision is effective for bonds issued after August 5, 1997, to finance capital expenditures incurred after such date.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
223	Expansion of Arbitrage Rebate Exception for Certain Bonds.

Background

Generally, all arbitrage profits earned on bonds unrelated to the purpose of the borrowing ("nonpurpose investments"), when such earnings are permitted, must be rebated to the Federal Government. An exception is provided for bonds issued by governmental units having general taxing powers if the governmental unit (and all subordinate units) issues $5 million or less of governmental bonds during the calendar year ("the small-issuer exception"). This exception does not apply to private activity bonds.

New Federal Law (Sec. 148(f))

The Act provides that up to $5 million of bonds used to finance public school capital expenditures incurred after December 31, 1997, are excluded from application of the present-law $5 million limit. Thus, small issuers will continue to benefit from the small issue exception from arbitrage rebate if they issue no more than $10 million in governmental bonds per calendar year and no more than $5 million of the bonds is used to finance expenditures other than for public school capital expenditures.

Current California Law (R&T Sec. 17133 and 24272)

The Personal Income Tax Law specifically does not conform to federal law regarding treatment of arbitrage profit from issuance of exempt bonds. The California Constitution provides an exemption from income taxation for all interest from bonds issued by this state or a local government of this state. Federal law, other than the IRC, prohibits state taxation of interest on federal bonds, if the interest on state obligations is exempt from tax. Taxpayers subject to the corporate franchise tax must report as income all interest received. Interest received from federal obligations and California obligations or its political subdivision generally is excluded from income subject to the corporation and personal income tax.

Effective Date

The provision is effective for bonds issued after December 31, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
224	Enhanced Deduction for Corporate Contributions of Computer Technology and Equipment

Background

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. However, in the case of a charitable contribution of inventory or other ordinary-income property, short-term capital gain property, or certain gifts to private foundations, the amount of the deduction is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, a taxpayer's deduction is limited to the adjusted basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer. Corporations are entitled to claim a deduction for charitable contributions, generally limited to 10% of their taxable income (computed without regard to the contributions) for the taxable year.

Special rules in the IRC provide augmented deductions for certain corporate contributions of inventory property for the care of the ill, the needy, or infants, and certain corporate contributions of scientific equipment constructed by the taxpayer, provided the original use of such donated equipment is by the donee for research or research training in the United States in physical or biological sciences. Under these special rules, the amount of the augmented deduction available to a corporation making a qualified contribution is equal to its basis in the donated property plus one-half of the amount of ordinary income that would have been realized if the property had been sold. However, the augmented deduction cannot exceed twice the basis of the donated property. S corporations are not eligible donors for purposes of these special rules. Eligible donees are limited to post-secondary educational institutions, scientific research organizations, and certain other organizations that support scientific research.

New Federal Law (Sec. 170(e))

The Act expands the list of qualified contributions that qualify for the augmented deduction. Under the Act, qualified contributions mean gifts of computer technology and equipment (i.e., computer software, computer or peripheral equipment, and fiber optic cable related to computer use) to be used within the United States for educational purposes in any of grades K through 12.

Eligible donees are: (1) any educational organization that normally maintains a regular faculty and curriculum and has a regularly enrolled body of pupils in attendance at the place where its educational activities are regularly carried on; and (2) charitable or educational entities that are organized primarily for purposes of supporting elementary and secondary education. A private foundation also is an eligible donee, provided that, within 30 days after receipt of the contribution, the private foundation contributes the property to an eligible donee described above.

Qualified contributions are limited to gifts made no later than two years after the date the taxpayer acquired or substantially completed the construction of the donated property. In addition, the Act clarifies that the original use of the donated property must commence with the donor or the donee. Accordingly, qualified contributions generally are limited to property that is no more than two years old. Such donated property could be computer technology or equipment that is inventory or depreciable trade or business property in the hands of the donor. The Act permits payment by the donee organization of shipping, transfer, and installation costs. The special treatment applies only to donations made by C corporations. S corporations, personal holding companies, and service organizations are not eligible donors.

In the case of contributions made through private foundations, the Act permits the payment by the private foundation of shipping, transfer, and installation costs.

Current California Law (R&T Sec. 24357.8)

Charitable contributions can be deducted by corporations up to 10% of its modified net income (computed without regard to contribution, built –in gains and organizational expenses deductions). California law limits the charitable contribution of property to the corporation’s basis in the property. Prior California law did allow an augmented deduction for contribution of “qualified research property,” similar to the federal augmented contribution of scientific property. To qualify for the California augmented contribution, the deduction had to be made between July 1, 1983, and December 31, 1993.

Effective Date

The provision is effective for contributions made in taxable years beginning after December 31, 1997 and before January 1, 2001.

Impact on California Revenue

Not applicable. California law does not conform to the federal augmented deduction for certain charitable donations.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
225	Treatment of Cancellation of Certain Student Loans.

Background

In the case of an individual, gross income subject to federal income tax does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers.

Student loans eligible for this special rule must be made to an individual to assist the individual in attending an educational institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education activities are regularly carried on. Loan proceeds may be used not only for tuition and required fees, but also to cover room and board expenses. In addition, the loan must be made by (1) the United States (or an instrumentality or agency thereof), (2) a state (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a state, county, or municipal hospital and whose employees have been deemed to be public employees under state law, or (4) an educational organization that originally received the funds from which the loan was made from the United States, a state, or a tax-exempt public benefit corporation. Thus, loans made with private, nongovernmental funds are not qualifying student loans for purposes of the exclusion.

New Federal Law (Sec. 108(f))

The Act expands the exclusion so that an individual's gross income does not include forgiveness of loans made by tax-exempt charitable organizations (e.g., educational organizations or private foundations) if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance outstanding student loans and the student is not employed by the lender organization. As under present law, the exclusion applies only if the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers. In addition, in the case of loans made by tax-exempt charitable organizations, the student's work must fulfill a public service requirement. The student must work in an occupation or area with unmet needs and such work must be performed for or under the direction of a tax-exempt charitable organization or a governmental entity.

Current California Law (R&T Sec. 17144)

California conformed to the federal law as it read on January 1, 1997, prior to the TRA of 1997 change as it relates to the cancellation of student loan income. In addition, AB 364 (Stat. 1997, Ch. 228) provides that any loan made pursuant to the Forgivable Loan Program of the California State University

would be a “student loan” for purposes of the exclusion from gross income of income resulting from discharges of student loan indebtedness. .

Effective Date

The provision applies to discharges of indebtedness occurring after August 5, 1997.

Impact on California Revenue

The revenue impact of conforming to this provision would be determined by the amount of specified student loans that would be discharged and the marginal tax rates of those whose loans were discharged.

Based on the very low level of federal estimates for this provision in H.R. 2014, 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 discharges of indebtedness after the date of federal enactment.

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

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
226	Tax Credit for Holders of Qualified Zone Academy Bonds.

New Federal Law (Sec. 1397E)

Generally, interest on bonds issued for general governmental purposes, including public schools, is exempt from federal income tax. Under the Act, certain financial institutions (i.e., banks, insurance companies, and corporations actively engaged in the business of lending money) that hold "qualified zone academy bonds" are entitled to a nonrefundable tax credit in an amount equal to a credit rate (set by the Treasury Department) multiplied by the face amount of the bond. The credit rate applies to all such bonds purchased in each month. A taxpayer holding a qualified zone academy bond is entitled to a credit for each year the taxpayer holds the bond. The credit is includible in gross income, but may be claimed against regular income tax and AMT liability.

The Treasury Department will set the credit rate each month so that such bonds can be issued without discount and without any interest cost to the issuer. The maximum term of the bond issued in a given month also is determined by the Treasury Department so that the present value of the obligation to repay the bond is 50% of the face value of the bond. Such present value will be determined using as a discount rate the average annual interest rate of tax-exempt obligations with a term of 10 years or more issued during the month.

"Qualified zone academy bonds" are defined as any bond issued by a state or local government, provided that (1) 95% of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a "qualified zone academy" and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10% of the bond proceeds.

A school is a "qualified zone academy" if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in an empowerment zone or enterprise community (including empowerment zones designated or authorized to be designated under the conference agreement), or (b) it is reasonably expected that at least 35% of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

A total of $400 million of “qualified zone academy bonds” may be issued in each of 1998 and 1999. The $800 million aggregate bond cap will be allocated to the States according to their respective populations of individuals below the poverty line. A state may carry over any unused allocation into subsequent years. Each state, in turn, will allocate the credit to qualified zone academies within such state.

Current California Law

California has no comparable credit.

Effective Date

The provision is effective for bonds issued after December 31, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
301	Increase IRA Phase-Out Range & Modify Active Participant Rule.

New Federal Law (Sec. 219)

The Act increased the federal "AGI threshold levels" for phasing out the $2,000 IRA deduction for active participants in an pension plan and changed the definition of active participation in an employer-sponsored retirement plan. Beginning in 1998, the phase-out limits are increased as follows:

For married taxpayers filing joint	Phase-Out Begins At	Phase-Out Ends At
1998	$50,000	$ 60,000
1999	$51,000	$ 61,000
2000	$52,000	$ 62,000
2001	$53,000	$ 63,000
2002	$54,000	$ 64,000
2003	$60,000	$ 70,000
2004	$65,000	$ 75,000
2005	$70,000	$ 80,000
2006	$75,000	$ 85,000
2007 and thereafter	$80,000	$100,000
For single taxpayers		
1998	$30,000	$40,000
1999	$31,000	$41,000
2000	$32,000	$42,000
2001	$33,000	$43,000
2002	$34,000	$44,000
2003	$40,000	$50,000
2004	$45,000	$55,000
2005 and thereafter	$50,000	$60,000

No deduction is allowed for married taxpayers filing a separate return if the individual is an active participant in an employer-sponsored retirement plan.

Additionally, under the Act an individual will not be considered an active participant in an employer-sponsored retirement plan merely because the individual's spouse is an active participant for any part of the tax year. This change allows most homemakers the full $2,000 IRA deduction regardless of whether their spouse is an active participant in an employer-sponsored retirement plan. A special phase-out limit applies to individuals who are not active participants but whose spouses are active participants. The maximum deductible IRA contribution for an individual who is not an active participant, but whose spouse is, phases out at AGI between $150,000 and $160,000.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Current California Law (R&T Sec.17201)

California has conformed to this provision in SB 1233 with the same effective dates.

Effective Date

This provision is effective for tax years beginning after December 31, 1997.

Impact on California Revenue

These changes were adopted in SB 1233 (Stat. 1997, Ch. 612).

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
302	Tax-Free Nondeductible IRAs

New Federal Law (Sec. 408)

Beginning in 1998, the Act provides for a new type of IRA, called a Roth IRA. A Roth IRA differs from other IRAs in that the tax advantages are "backloaded." Contributions to a Roth IRA are not tax deductible. Instead, the IRA earnings (e.g., interest and dividends) are distributed tax free (provided that certain requirements are met). To be treated as a Roth IRA, the account must be designated as such when it is established. The contribution limit of $2,000 per year is coordinated with other IRAs (all IRA contributions in any one year cannot exceed $2,000 in the aggregate). A 6% penalty applies to any contribution in excess of $2,000. Unlike other IRAs, an individual may make contributions to a Roth IRA beyond the individual's age of 70½.

Roth IRAs also are subject to AGI limitations. The maximum amount allowed for a Roth IRA contribution is phased out for single taxpayers with AGI between $95,000 and $110,000 and for married taxpayers filing joint with AGI between $150,000 and $160,000. If after applying the phase-out limitations, the computed allowable contribution is less than $200 but more than zero, a $200 contribution is allowed.

Distributions from a Roth IRA are not included in gross income and are not subject to the 10% early withdrawal tax if certain requirements are met. The individual must have held the Roth IRA for a five-year period beginning with the first year in which a contribution was made to the Roth IRA and ending with the end of the fifth year after the contribution. In addition, one of the four following requirements also must be met:

- made on or after the date the individual has obtains age 59½.
- made to a beneficiary (or the individual's estate) on or after the individual death.
- attributable to the individual being disabled.
- a distribution for "qualified first-time home buyer expenses."

Additionally, holders of a Roth IRA do not need to start receiving distributions by the age of 70½, as do holders of other types of IRAs.

If a non-qualified distribution is made from a Roth IRA, the distribution is first treated as made from contributions that were not deductible. No portion of a nonqualified distribution is treated as attributable to earnings, or is includible in gross income, until the total of all distributions exceeds the amount of total contributions that were not deductible.

The Act also permits the "rollover" of a non-Roth IRA into a Roth IRA if the taxpayer's AGI for the year does not exceed $100,000 (computed without regard

to the rollover distribution) and the taxpayer is not married filing separate. The $2,000 annual contribution limit does not apply to rollovers. The rollover of an ordinary IRA into a Roth IRA requires the taxpayer to report the ordinary IRA distribution in gross income. However, if the ordinary IRA is contributed to the new Roth IRA within 60 days of the distribution, the 10% early withdrawal tax will not apply. If an ordinary IRA is rolled into a Roth IRA before January 1, 1999, the amount that is includible in gross income may be included ratably over a four-year period. Federal law permits a rollover into or between Roth IRAs more than one time a year.

Current California Law (R&T Sec. 17507.6)

SB 1233 (Stat. 1997, Ch. 612) conformed California law to federal law as it relates to Roth IRAs with one exception. A technical error was made in the federal Act that could encourage immediate distributions from a Roth IRA of rollover amounts. SB 1233 corrected that drafting error by requiring a regular IRA rollover to be held in a Roth IRA for five years to avoid a premature withdrawal penalty and to use the ratable income inclusion rules.

Effective Date

This provision is effective for years beginning after December 1, 1997.

Impact on California Revenue

These changes were adopted in SB 1233 (Stat. 1997, Ch. 612).

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
303	Modifications to Early Withdrawal Penalty for First-Time Home Buyers

New Federal Law (Sec. 72)

The Act provides that the 10% tax on early withdrawals from an IRA does not apply to distributions from an IRA if the taxpayer uses the funds to pay for "first-time home buyer expenses."

First-time home buyer withdrawals must be used to buy, build, or rebuild a home within 120 days of distribution. A "first home" is the principal residence of the taxpayer, child, grandchild, or ancestor of the taxpayer. Acquisition costs include any usual or reasonable settlement, financing, or other closing cost. A first-time home buyer is an individual (and spouse, if married) who must not have had an ownership interest in a principal residence during the two-year period ending on the date the new home is purchased. The maximum amount of IRA distribution a taxpayer may receive in a lifetime and use for first-time home buyer expenses is $10,000.

Current California Law (R&T Sec. 17085.8)

SB 1233 (Stat. 1997, Ch. 612) conformed California law to federal law as it relates to IRA distributions used for the purchase of a new home by a first-time homebuyer.

Effective Date

This provision is effective for years beginning after December 1, 1997.

Impact on California Revenue

These changes were adopted in SB 1233 (Stat. 1997, Ch. 612).

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
304	IRA Investments in Coins and Bullion.

New Federal Law (Sec. 408)

The Act allows IRA assets to be invested in certain platinum coins and in any gold, silver, platinum, or palladium bullion of a fineness equal to or exceeding the minimum fineness required for metals which may be delivered in satisfaction of a regulated futures contract subject to regulation by the Commodity Futures Trading Commission. This provision does not apply unless the bullion is in the physical possession of the IRA trustee.

Current California Law (R&T Sec. 17507.4)

SB 1233 (Stat. 1997, Ch. 612) conformed California law to federal law as it relates to IRA investments in coins and bullion.

Effective Date

This provision is effective for years beginning after December 1, 1997.

Impact on California Revenue

These changes were adopted in SB 1233 (Stat. 1997, Ch. 612).

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
311	Maximum Rate of Tax on Net Capital Gain of Individuals.

Background

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of capital assets, the net capital gain is taxed at the same rate as ordinary income, except that individuals are subject to a maximum marginal rate of 28% of the net capital gain. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, or (5) certain U.S. publications. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances that would have been available under the straight-line method of depreciation.

New Federal Law (Sec. 1(h) & 55(b))

Under the Act, the maximum rate of tax on the net capital gain of an individual is reduced from 28% to 20%. In addition, any net capital gain which otherwise would be taxed at a 15% rate is taxed at a rate of 10%. These rates apply for purposes of both the regular tax and the alternative minimum tax.

The tax on the net capital gain attributable to any long-term capital gain from the sale or exchange of collectibles will remain at a maximum rate of 28%; any long-term capital gain from the sale or exchange depreciable real estate, to the extent the gain would have been treated as ordinary income if the property, had been tangible personal property will be taxed at a maximum rate of 25%.

In addition, for taxable years beginning after December 31, 2000, the maximum capital gains rates for assets which are held more than five years, are 8% and 18% (rather than 10% and 20%). The 18% rate only applies to assets the holding period for which begins after December 31, 2000. A taxpayer holding a capital asset or asset used in the taxpayer's trade or business on January 1, 2001, may elect to treat the asset as having been sold on such date for an amount equal to its fair market value, and as having been reacquired for an amount equal to such value. If the election is made, any gain is recognized (and any loss

disallowed)at that time. The conference agreement allows the Treasury Department to issue regulations coordinating the capital gain provisions with other rules involving the treatment of sales and exchanges by pass-thru entities and of interests therein.

Under the Act, the lower capital gains rates do not apply to the sale or exchange of assets held for 18 months or less, effective for amounts properly taken into account after July 28, 1997. The 28% maximum rate will continue to apply to the sale or exchange of capital assets held more than one year but not more than 18 months.

Current California Law (R&T Sec. 17041)

Under California law, the tax rates on ordinary income and net capital gains are the same. California generally conforms to federal law on the definition of a capital asset and how gain or loss is calculated.

Effective Date

The provision generally applies to sales and exchanges (and installment payments received) after May 6, 1997.

Impact on California Revenue

The revenue loss from this provision is estimated as follows:

Estimated Revenue Impact Effective after January 1, 1998 Assumed Enactment After June 20, 1998 (in millions)			
	1998-9	1999-0	2000-1
Direct Revenue Impact	($1,414)	($1,131)	($1,131)
Behavioral Impact	$95	$110	$98
Total	($1,319)	($1,021)	($1,033)

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

The above estimates were based on the department’s personal income tax model. The tax rate for California that was used is 4.7 percent (one-half of the current 9.3% rate). This rate is analogous to the federal treatment of capital gains, which set the maximum tax rate on capital gains at 20 percent. That rate is roughly one-half of the maximum federal regular tax rate of 39.6 percent. Based on the federal provision an asset qualifies for long term if it is held for 18 months or more. We have assumed that the rate of 4.7 percent would apply to the AMT as well as the regular tax.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
312	Exclusion of Gain on the Sale of a Principal Residence

Prior Law

Under prior state and federal law, no gain was recognized on the sale of a principal residence if a new residence at least equal in cost to the sales price of the old residence was purchased and used by the taxpayer as his or her principal residence within a specified period of time. This replacement period generally began two years before and ended two years after the sale date of the old residence. The basis of the replacement residence is reduced by the amount of any gain not recognized on the sale of the old residence by reason of this gain rollover rule. Additionally, an individual, on a one-time basis, could exclude from gross income up to $125,000 of gain from the sale or exchange of a principal residence if the taxpayer (1) had attained age 55 before the sale and (2) had owned the property and used it as a principal residence for three or more of the five years preceding the sale.

California law provided that if a taxpayer was a member of the Peace Corps, time served in the Corps, up to 18 months, could be counted toward the three years the taxpayer is required to reside in the residence to qualify for the "once in a lifetime $125,000 exclusion." In addition, brokers considered real estate reporting persons (i.e., escrow companies, lenders, brokers, etc.) were required to report to the Internal Revenue Service the amount of gross proceeds and other amounts in transactions involving real estate (including residences). A copy of the federal return is required to be submitted to the Franchise Tax Board.

New Federal Law (Sec. 121, 1034)

Under the Act, a taxpayer generally is able to exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. The exclusion is allowed each time a taxpayer selling a principal residence meets certain eligibility requirements, but generally no more frequently than once every two years (sales occurring before May 7, 1997, are not considered for the two-year rule). Federal law provides that gain would be recognized to the extent of any depreciation allowable with respect to the rental or business use of such principal residence for periods after May 6, 1997. To be eligible for the exclusion, a taxpayer must have owned the residence and occupied it as a principal residence for a period of at least two years during the five years prior to the sale or exchange.

The federal House, Senate, and Conference Committee Reports state a taxpayer who fails to meet these requirements (use for two out of the last five years and no sale within two years of another sale) by reason of a change of place of employment, health, or other unforeseen circumstances is able to exclude the fraction of the $250,000 ($500,000 if married filing a joint return) equal to the portion of the two-year period that these requirements are met. This proration rule also is available for any sale occurring within the two year

period following enactment of this provision. However, the federal law as enacted could be interpreted to limit the exclusion to the fraction of the taxpayer's realized gain on the sale equal to the fraction of two years that the requirements are met. The Joint Committee staff members have indicated they will recommend a technical change to make the statutory language consistent with the unambiguous intent of Congress. The Internal Revenue Service is expected to apply the law as intended from the date of enactment.

In the case of joint filers not sharing a principal residence, an exclusion of $250,000 is available on a qualifying sale of the principal residence of one of the spouses. Similarly, if a single taxpayer who is otherwise eligible for an exclusion marries someone who has used the exclusion within the two years prior to the marriage, the couple would be allowed a maximum exclusion of $250,000. Once both spouses satisfy the eligibility rules and two years have passed since the last exclusion was allowed to either, the taxpayers may exclude $500,000 of gain on their joint return. Federal law also contains special rules regarding: sale of a remainder interest, cooperative housing corporations (e.g., co-ops and condominiums), involuntary conversions, and taxpayers residing in nursing homes.

The Act repealed the once-in-a-lifetime exclusion of $125,000 and the rollover of gain from the sale of a principal residence provisions of the IRC. The Act also modified the reporting requirements of brokers for the sale of the broker's client's principal residences.

Current California Law (R&T Sec. 17152, 18037.6)

California conformed to this Act provision with the same effective dates. SB 5 (Stat. 1997, Ch. 610) conformed to the exclusion for sales or exchanges occurring on or after May 7, 1997, and on or before June 30, 1998. SB 1233 conformed to the exclusion for sales or exchanges occurring on or after July 1, 1998.

Effective Date

This provision is effective for sale or exchanges of a principal residence occurring on or after May 7, 1997.

Impact on California Revenue

These changes were adopted in SB 5 (Stat. 1997, Ch. 610).

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
313	Small Business Stock (Rollover of Gain)

Background

The Revenue Reconciliation Act of 1993 provided individuals a 50% exclusion for the sale of certain small business stock acquired at original issue and held for at least five years. One-half of the excluded gain is a minimum tax preference item. The amount of gain eligible for the 50% exclusion by an individual with respect to any corporation is the greater of (1) 10 times the taxpayer's basis in the stock or (2) $10 million. In order to qualify as a small business, when the stock is issued, the gross assets of the corporation may not exceed $50 million. The corporation also must meet an active trade or business requirement.

New Federal Law (Sec. 1045)

The Act allows an individual to rollover tax-free gain from the sale or exchange of qualified small business stock held more than six months where the taxpayer uses the proceeds to purchase other qualified small business stock within 60 days of the sale. For purposes of the rollover provision, the replacement stock must meet the active business requirement for the six-month period following the purchase. Generally, the holding period of the stock purchased will include the holding period of the stock sold, except for purposes of determining whether the six-month holding period is met.

Current California Law (R&T Sec. 18152.5)

California law conforms to the federal exclusion of 50% of the gain from the sale of small business stock with modifications. In addition to the federal requirements, for California purposes the corporation must be doing business in California throughout the five year period and 80% of its payroll must be attributable to employment located in California.

California has not conformed to the rollover provision.

Effective Date

The provision applies to sales after August 5, 1997.

Impact on California Revenue

Revenue losses from conforming to the roll-over provision are estimated as follows:

Act Section 313 Effective After August 5, 1997 (in millions)		
1998-9	1999-0	2000-1
($2)	($4)	($5)

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

Revenue losses from this proposal depend on the amount of gains from sales of qualified small business stock that is rolled over within 60 days to other small business stock, within the context of current state law requirements.

The above estimates were based on previous estimates for SB 671, (Stats. 1993, Ch. 881) for California’s conformity to the federal small business stock 50% exclusion rules.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
314	Corporate Capital Gains.

Background

Under prior federal law, the net capital gain of a corporation was taxed at the same rates as ordinary income and subject to tax at graduated rates up to 35%. When a corporation has a net capital gain for a particular year, the corporation will pay an alternative tax if such tax is less than the income tax computed under the regular method.

New Federal Law (Sec. 1201(b))

The Act provides that the amount of gain subject to the alternative rate of tax may not exceed the corporation's taxable income. Because the alternative tax does not presently apply, this change has no effect under the rate structure of present law (the highest marginal rate under the ordinary method is presently equal to the highest tax rate under the alternative tax rate).

Current California Law (R&T Sec. 23151)

California law has no comparable provision. California law taxes the net capital gain of a corporation at the ordinary rate (presently 8.84%).

Effective Date

This provision applies to tax years ending after December 31, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
401	Repeal Alternative Minimum Tax for Small Businesses

Background

The corporate alternative minimum tax is imposed at a rate of 20% on alternative minimum taxable income in excess of a phased-out $40,000 exemption amount. Alternative minimum taxable income (AMTI) is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

New Federal Law (Sec. 55(e))

The corporate alternative minimum tax is repealed for small business corporations for taxable years beginning after December 31, 1997. A corporation that had average gross receipts of less than $5 million per year for the three-year period beginning after December 31, 1994, is a small business corporation for any taxable year beginning after December 31, 1997. A corporation that meets the $5 million gross receipts test will continue to be treated as a small business corporation exempt from the alternative minimum tax so long as its average gross receipts over the preceding three period do not exceed $7.5 million. A corporation that fails to meet the $7.5 million gross receipts test will become subject to corporate alternative minimum tax only with respect to preferences and adjustments that relate to transactions and investments entered into after the corporation loses its status as a small business corporation. In addition, the alternative minimum tax credit allowable to a small business corporation is limited to 25% of the amount by which the corporation’s regular tax (reduced by other credits) exceeds $25,000.

Current California Law (R&T Sec. 23400)

California law is conformed to federal law as it relates to corporate alternative minimum tax with modifications. Basically, California assesses an alternative minimum tax at a rate of 6.65% on AMTI in excess of $40,000 (the exemption is gradually phased-out when AMTI reaches $150,000). California law does not contain an exemption from alternative minimum tax for “small corporations.” However, California “S” corporations are exempt from the alternative minimum tax. In addition, California law provides that an individual’s AMTI does not include adjustments or items of tax preference attributable to any “qualified business” of the individual taxpayer. A qualified business is defined as any trade or business in which the individual taxpayer has an ownership interest in and has aggregate gross receipts of less than $1 million from all trade or businesses. In the case of an individual taxpayer owning less than 100% of the trade or business, the individual taxpayer’s proportionate share of the trade or business gross income is counted.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

Impact on California Revenue

Revenue losses from this provision under the Bank & Corporation Tax Law are estimated as follows:

Estimated Revenue Impact Effective After January 1, 1998 Assumed Enactment After June 30, 1998 (in millions)		
1998-9	1999-0	2000-1
($8)	($6)	($6)

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

The revenue effect for this provision would depend on the amount of state net income that would no longer be subject to the AMT.

The impact above was based on state corporate tax data.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
402	Repeal the Depreciation Adjustment for Alternative Minimum Tax

Background

One of the most significant alternative minimum tax adjustments relates to depreciation. In computing AMTI, depreciation on property placed in service after 1986 must be computed by using the class lives prescribed by the alternative depreciation system of section 168(g) and either (1) the straight-line method in the case of property subject to the straight-line method under the regular tax or (2) the 150% declining balance method in the case of other property. For regular tax purposes, depreciation on tangible personal property generally is computed using shorter recovery periods and more accelerated methods than are allowed for alternative minimum tax purposes.

New Federal Law (Sec. 56(a))

For property (including pollution control facilities) placed in service after December 31, 1998, the Act conforms the recovery periods (but not the methods) used for purposes of alternative minimum tax depreciation adjustment to the recovery periods used for purposes of regular tax.

Current California Law (R&T Secs. 17062, 23400, 23456)

For individuals and corporations, California law is conformed to the federal rules prior to the passage of the TRA with respect to the amount allowable in computing alternative minimum taxable income. An adjustment is required to be made for the difference between the amount allowed as depreciation for regular tax and the amount allowed as depreciation for AMT purposes. Although the federal rules apply for determining the amount allowable for AMT purposes, the amount of the actual adjustment may be different, due to differences (past and present) in state and federal rules for computing depreciation for regular tax purposes.

For California and federal law, the AMTI of a corporation is increased by an amount equal to 75% of the amount by which adjusted current earnings (ACE) of the corporation exceed AMTI (as determined before this adjustment). In general, ACE is AMTI with additional adjustments that generally follow the rules presently applicable to corporations in computing their earnings and profits. For purposes of California law and federal law prior to 1994, ACE depreciation is computed using the straight-line method over the class life of the property. Thus, a corporation generally must make two depreciation calculations for purposes of the AMT -- once using the 150% declining balance method over the class life and again using the straight-line method over the class life. Taxpayers may elect to use either method for regular tax purposes. If a taxpayer uses the straight-line method for regular tax purposes, it must

also use the straight-line method for AMT purposes. The ACE depreciation adjustment was eliminated from federal law for property placed in service after December 31, 1993. California has not conformed to the elimination of the ACE depreciation adjustment.

Effective Date

This provision is effective for property placed in service after December 31, 1998.

Impact on California Revenue

Business taxpayers for state purposes are using the federal method for calculating AMT depreciation as the baseline for determining any preference adjustment for the year. Adopting the federal AMT depreciation change would reduce the add-back adjustment for AMT purposes. Estimated revenue losses below are based on federal projections and allow for different state deduction allowances for regular tax purposes for this type of property and available state data.

Estimated Revenue Impact of		
Section 402(a) of HR 2014		
Property Placed In Service After 12/31/98		
Assumed Enactment After June 30, 1998		
1998-9	1999-0	2000-01
($1)	($6)	($9)

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

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
403	Repeal AMT Installment Method Adjustment for Farmers

Background

The installment method allows gain on the sale of property to be recognized as payments are received. Under the regular tax, dealers in personal property are not allowed to defer the recognition of income by use of the installment method on the installment sale of such property. For this purpose, dealer dispositions do not include sales of any property used or produced in the trade or business of farming. For alternative minimum tax purposes, the installment method is not available with respect to the disposition of any property that is the stock in trade of the taxpayer or any other property of a kind which would be properly included in the inventory of the taxpayer if held at year end, or property held by the taxpayer primarily for sale to customers. No explicit exception is provided for installment sales of farm property under the alternative minimum tax.

New Federal Law (Sec. 56(a))

The Act generally provides that for purposes of the alternative minimum tax, farmers may use the installment method of accounting. Therefore, a farmer using the installment method will not have an adjustment for AMT purposes.

Current California Law (R&T Secs. 17062, 23400, 23456)

California law is in conformity with federal law prior to the passage of the TRA. Therefore, California law generally does not allow the installment method for alternative minimum tax purposes.

Effective Date

The provision generally is effective for dispositions in taxable years beginning after December 31, 1987, with a special rule for dispositions occurring in 1987.

Impact on California Revenue

Cash-method farmers may use the installment method of accounting to compute income from the disposition of farm property when computing an AMT liability.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Revenue losses from this provision are estimated to be:

Estimated Revenue Impact Effective After January 1, 1998 (in millions)		
1997-8	1998-9	1999-0
($2)	($2)	($2)

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

The revenue effect for this provision would depend on the amount of preference income associated with installment sales that would no longer be reportable for AMT purposes.

The impact above was based on the federal estimates for this provision discounted to reflect the state’s lower AMT rate and relative AMT preference income.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
501	Increase in Estate and Gift Tax Unified Credit

Background

A federal gift tax is imposed on lifetime transfers by gift and an federal estate tax is imposed on transfers at death. Since 1976, the gift tax and the estate tax have been unified so that a single graduated rate schedule applies to cumulative taxable transfers made by a taxpayer during his or her lifetime and at death. A unified credit of $192,800 is provided against the estate and gift tax, which effectively exempts the first $600,000 in cumulative taxable transfers from tax. For transfers in excess of $600,000, estate and gift tax rates begin at 37% and reach 55% on cumulative taxable transfers over $3 million. In addition, a 5% surtax is imposed upon cumulative taxable transfers between $10 million and $21,040,000, to phase out the benefits of the graduated rates and the unified credit.

New Federal Law (Secs. 2001, 2010, 2032A, 2102, 2503, 2505)

The Act increases the present-law unified credit beginning in 1998, from an effective exemption of $600,000 to an effective exemption of $1 million in 2006. The increase in the effective exemption is phased in according to the following schedule: the effective exemption is $625,000 for decedents dying and gifts made in 1998; $650,000 in 1999; $675,000 in 2000 and 2001; $700,000 in 2002 and 2003; $850,000 in 2004; $950,000 in 2005; and $1 million in 2006 and thereafter. The Act does not index the effective exemption for inflation. Conforming amendments to reflect the increased unified credit were made (1) to the 5% surtax to conform the phase out of the increased unified credit and graduated rates, (2) to the general filing requirements for an estate tax return under section 6018(a), and (3) to the amount of the unified credit allowed under section 2102(c)(3) with respect to nonresident aliens with U.S. situs property who are residents of certain treaty countries.

Current California Law (R&T Sec. None)

California does not impose a gift tax; the California estate tax is a "pick-up" tax, that is, the state tax is equal to the maximum credit for a state death tax on the federal estate tax return for that particular decedent's estate. This "pick-up" tax is administered by the State Controller's Office.

Effective Date

The provision is effective for decedents dying, and gifts made, after December 31, 1997.

Impact on California Revenue

Defer to the State Controller’s Office.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
502	Estate Tax Exclusion for Qualified Family-Owned Businesses

Background

No special estate tax rules apply for qualified family-owned businesses. All taxpayers are allowed a unified credit in computing the taxpayer's estate and gift tax, which effectively exempts a total of $600,000 in cumulative taxable transfers from the estate and gift tax. An executor also may elect, under IRC section 2032A, to value certain qualified real property used in farming or another qualifying closely-held trade or business at its current use value, rather than its highest and best use value (up to a maximum reduction of $750,000). In addition, an executor may elect to pay the federal estate tax attributable to a qualified closely-held business in installments over, at most, a 14-year period. The tax attributable to the first $1 million in value of a closely-held business is eligible for a special 4% interest rate.

New Federal Law (Sec. 2033A)

The Act allows an executor to elect special estate tax treatment for qualified “family-owned business interests” if such interests comprise more than 50% of a decedent's estate and certain other requirements are met. The exclusion for family-owned business interest may be taken only to the extent that the exclusion for family-owned business interests, plus the amount effectively exempted by the unified credit, does not exceed $1.3 million.

Current California Law

California does not impose a gift tax; the California estate tax is a "pick-up" tax, that is, the state tax is equal to the maximum credit for a state death tax on the federal estate tax return for that particular decedent's estate. This "pick-up" tax is administered by the State Controller's Office.

Effective Date

The provision is effective with respect to the estates of decedents dying after December 31, 1997.

Impact on California Revenue

Defer to the State Controller’s Office.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
503	Installment Payments of Estate Tax for Closely Held Businesses

Background

In general, the federal estate tax is due within nine months of a decedent's death. An executor generally may elect to pay the estate tax attributable to an interest in a closely held business in installments over, at most, a 14-year period. If the election is made, the estate may pay only interest for the first four years, followed by up to ten annual installments of principal and interest. Interest generally is imposed at the rate applicable to underpayments of tax (i.e., the federal short-term rate plus three percentage points). However, a special 4% interest rate applies to the amount of deferred estate tax attributable to the first $1 million in value of the closely-held business.

To qualify for the installment payment election, the business must be an active trade or business and the value of the decedent's interest in the closely held business must exceed 35% of the decedent's adjusted gross estate. An interest in a closely held business includes: (1) any interest as a proprietor in a business carried on as a proprietorship; (2) any interest in a partnership carrying on a trade or business if the partnership has 15 or fewer partners, or if at least 20% of the partnership's assets are included in determining the decedent's gross estate; or (3) stock in a corporation if the corporation has 15 or fewer shareholders, or if at least 20% of the value of the voting stock is included in determining the decedent's gross estate.

New Federal Law (Secs. 6601(j), 6166)

The Act reduces the 4% interest rate to 2% and makes the interest paid on estate taxes deferred under IRC section 6166 non-deductible for estate or income tax purposes. The 2% interest rate is imposed on the amount of deferred estate tax attributable to the first $1 millionin taxable value of the closely held business (i.e., the first $1 million in value in excess of the effective exemption provided by the unified credit and any other exclusions). The interest rate imposed on the amount of deferred estate tax attributable to the taxable value of the closely held business in excess of $1 million is reduced to an amount equal to 45% of the rate applicable to underpayments of tax.

Current California Law

California does not impose a gift tax; the California estate tax is a "pick-up" tax, that is, the state tax is equal to the maximum credit for a state death tax on the federal estate tax return for that particular decedent's estate. This "pick-up" tax is administered by the State Controller's Office.

Effective Date

The provision is effective for decedents dying after December 31, 1997. Estates deferring estate tax under current law may make a one-time election to use the lower interest rates and forego the interest deduction for installments due after the date of the election (but such estates do not receive the benefit of the increase in the amount eligible for the 6601(j) interest rate--i.e., only the amount that was previously eligible for the 4% rate would be eligible for the 2% rate).

Impact on California Revenue

Defer to the State Controller’s Office.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
504	Estate Tax Recapture from Cash Leases of Specially-Valued Property

Background

Federal estate tax is imposed on the value of property passing at death. Generally, such property is included in the decedent's estate at its fair market value. Under IRC section 2032A, the executor may elect to value certain “qualified real property” used in farming or an other qualifying trade or business at its current use value rather than its highest and best use. If, after the special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years (15 years for individuals dying before 1982) of the decedent's death, an additional estate tax is imposed in order to “recapture” the benefit of the special-use valuation. Some courts have held that cash rental of specially-valued property after the death of the decedent is not a qualified use under section 2032A because the heirs no longer bear the financial risk of working the property, and, therefore, results in the imposition of the additional estate tax under section 2032A(c). With respect to a decedent's surviving spouse, a special rule provides that the surviving spouse will not be treated as failing to use the property in a qualified use solely because the spouse rents the property to a member of the spouse's family on a net cash basis. Under section 2032A, members of an individual's family include (1) the individual's spouse, (2) the individual's ancestors, (3) lineal descendants of the individual, of the individual's spouse, or of the individual's parents, and (4) the spouses of any such lineal descendants.

New Federal Law (Sec. 2032A)

The Act provides that the cash lease of specially-valued real property by a lineal descendant of the decedent to a member of the lineal descendant's family, who continues to operate the farm or closely held business, does not cause the qualified use of such property to cease for purposes of imposing the additional estate tax under section 2032A(c).

Current California Law

California does not impose a gift tax; the California estate tax is a "pick-up" tax, that is, the state tax is equal to the maximum credit for a state death tax on the federal estate tax return for that particular decedent's estate. This "pick-up" tax is administered by the State Controller's Office.

Effective Date

The provision is effective for cash rentals occurring after December 31, 1976.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
505	Clarify Eligibility for Extension for Payment of Estate Tax

Background

In general, the federal estate tax is due within nine months of a decedent's death. An executor generally may elect to pay the estate tax attributable to an interest in a closely held business in installments over, at most, a 14-year period. If the election is made, the estate may pay only interest for the first four years, followed by up to 10 annual installments of principal and interest. To qualify for the installment payment election, the business must meet certain requirements. If certain events occur during the repayment period (e.g., the closely held business is sold), full payment of all deferred estate taxes is required at that time. Under prior law, there was limited access to judicial review of disputes regarding initial or continuing eligibility for the deferral and installment election. If the Commissioner determines that an estate was not initially eligible for deferral, or has lost its eligibility for such deferral, the estate is required to pay the full amount of estate taxes asserted by the Commissioner as being owed in order to obtain judicial review of the Commissioner's determination.

New Federal Law (Sec. 7479)

The Act authorizes the U.S. Tax Court to provide declaratory judgments regarding initial or continuing eligibility for deferral of estate tax.

Current California Law

California does not impose a gift tax; the California estate tax is a "pick-up" tax, that is, the state tax is equal to the maximum credit for a state death tax on the federal estate tax return for that particular decedent's estate. This "pick-up" tax is administered by the State Controller's Office.

Effective Date

This provision applies to persons dying after August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
506	Gifts May Not Be Revalued for Estate Tax Purposes After Expiration of Statute of Limitations

Background

Generally, any estate or gift tax must be assessed within three years after the filing of the return. No proceeding in a court for the collection of an estate or gift tax can be begun without an assessment within the three-year period. If no return is filed, the tax may be assessed, or a suit commenced to collect the tax without assessment, at any time. If an estate or gift tax return is filed, and the amount of unreported items exceeds 25% of the amount of the reported items, the tax may be assessed or a suit commenced to collect the tax without assessment, within six years after the return was filed.

Commencement of the statute of limitations generally does not require that a particular gift be disclosed. A special rule, however, applies to certain gifts that are valued under the special valuation rules of Chapter 14. The gift tax statute of limitations runs for such a gift only if it is disclosed on a gift tax return in a manner adequate to apprise the Secretary of the Treasury of the nature of the item.

Most courts have permitted the Commissioner to redetermine the value of a gift for which the statute of limitations period for the gift tax has expired in order to determine the appropriate tax rate bracket and unified credit for the estate tax

New Federal Law (Secs. 2001, 6501(c), 7477)

The Act provides that a gift for which the limitations period has passed cannot be revalued for purposes of determining the applicable estate tax bracket and available unified credit.

Current California Law

California does not impose a gift tax; the California estate tax is a "pick-up" tax, that is, the state tax is equal to the maximum credit for a state death tax on the federal estate tax return for that particular decedent's estate. This "pick-up" tax is administered by the State Controller's Office.

Effective Date

The provision generally applies to gifts made after August 5, 1997

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
507	Repeal of Throwback Rules Applicable to Domestic Trusts

Background

A nongrantor trust is treated as a separate taxpayer for federal income tax purposes. Such a trust generally is treated as a conduit with respect to amounts distributed currently and taxed with respect to any income which is accumulated in the trust rather than distributed. The conduit treatment is achieved by allowing the trust a deduction for amounts distributed to beneficiaries during the taxable year to the extent of distributable net income and by including such distributions in the beneficiaries' income.

A separate graduated tax rate structure applies to trusts, which historically has permitted accumulated trust income to be taxed at lower rates than the rates applicable to trust beneficiaries. This benefit often was compounded through the creation of multiple trusts.

The Internal Revenue Code has several rules intended to limit the benefit that would otherwise occur from using the lower rates applicable to one or more trusts. Under the so-called “throwback” rules, the distribution of previously accumulated trust income to a beneficiary will be subject to tax (in addition to any tax paid by the trust on that income) where the beneficiary's average top marginal rate in the previous five years is higher than those of the trust.

Under IRC section 643(f), two or more trusts are treated as one trust if (1) the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose for the existence of the trusts is to avoid federal income tax. For trusts that were irrevocable as of March 1, 1984, IRC section 643(f) applies only to contributions to corpus after that date. Under IRC section 644, if property is sold within two years of its contribution to a trust, the gain that would have been recognized had the contributor sold the property is taxed at the contributor's marginal tax rates. In effect, section 644 treats such gains as if the contributor had realized the gain and then transferred the net after-tax proceeds from the sale to the trust as corpus.

IRC sections 665 through 668 apply different rules to distributions of previously accumulated trust income from a foreign trust than to distributions of such income from domestic trusts. If a foreign trust accumulates income, changes its situs so as to become a domestic trust, and then makes a distribution that is deemed to have been made in a year in which the trust was a foreign trust, the distribution is treated as a distribution from a foreign trust for purposes of the accumulation distribution rules.

New Federal Law (Secs. 644(e), 665)

The Act generally exempts from the throwback rules amounts distributed by a domestic trust after August 5, 1997. The throwback rule continues to apply

with respect to (1) foreign trusts, (2) domestic trusts that were once treated as a foreign trust (except as provided in Treasury regulations), and (3) domestic trusts created before March 1, 1984, that are treated as multiple trusts under section 643(f).

The Act also provides that precontribution gain on property sold by a domestic trust is no longer subject to IRC section 644 (i.e., tax at the contributor's marginal tax rate.)

Current California Law (R&T Secs. 17731, 17745, 17779)

California law is in conformity with federal law as in effect and as it relates to distributions of accumulated trust income prior to August 5, 1997. California has additional rules relating to trusts located outside of the state with resident beneficiaries.

Effective Date

The provision with respect to the throwback rules is effective for distributions made in taxable years beginning after August 5, 1997. The modification to section 644 applies to sales or exchanges after August 5, 1997.

Impact on California Revenue

Based on the very low level of federal estimates, state revenue losses would be minor, less than $500,000 annually.

Revenue losses would depend on the amount of specified distributions and sales made after August 5, 1997, by certain domestic trusts in any given tax year and the lower marginal tax rates of trusts. State estimates are based on federal projections.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
508	Reduction in Estate Tax for Land Subject to Conservation Easement

Background

A deduction is allowed for federal estate and gift tax purposes for a contribution of a qualified real property interest to a charity (or other qualified organization) exclusively for conservation purposes. For this purpose, a qualified real property interest means the entire interest of the transferor in real property (other than certain mineral interests), a remainder interest in real property, or a perpetual restriction on the use of real property. A “conservation purpose” is (1) preservation of land for outdoor recreation by, or the education of, the general public, (2) preservation of natural habitat, (3) preservation of open space for scenic enjoyment of the general public or pursuant to a governmental conservation policy, and (4) preservation of historically important land or certified historic structures. Also, a contribution will be treated as “exclusively for conservation purposes” only if the conservation purpose is protected in perpetuity.

A donor making a qualified conservation contribution generally is not allowed to retain an interest in minerals which may be extracted or removed by any surface mining method. However, deductions for contributions of conservation interests satisfying all of the above requirements will be permitted if two conditions are satisfied. First, the surface and mineral estates in the property with respect to which the contribution is made must have been separated before June 13, 1976 (and remain so separated) and, second, the probability of surface mining on the property with respect to which a contribution is made must be so remote as to be negligible. The same definition of qualified conservation contributions also applies for purposes of determining whether such contributions qualify as charitable deductions for income tax purposes.

New Federal Law (Secs. 170(h), 1014(a), 2031)

The Act allows an executor to elect to exclude from the taxable estate 40% of the value of any land subject to a qualified conservation easement that meets the following requirements: (1) the land is located within 25 miles of a metropolitan area (as defined by the Office of Management and Budget) or a national park or wilderness area, or within 10 miles of an Urban National Forest (as designated by the Forest Service of the U.S. Department of Agriculture); (2) the land has been owned by the decedent or a member of the decedent's family at all times during the three-year period ending on the date of the decedent's death; and (3) a qualified conservation contribution (within the meaning of IRC section 170(h)) of a qualified real property interest (as generally defined in IRC section 170(h)(2)(C)) was granted by the transferor or a member of his or her family. For purposes of the provision, preservation of a historically important land area or a certified historic structure does not qualify as a conservation purpose. To the extent that the value of such land is excluded from the taxable estate, the basis of such land acquired at death

is a carryover basis (i.e., the basis is not stepped-up to its fair market value at death). Debt-financed property is not eligible for the exclusion. The exclusion amount is calculated based on the value of the property after the conservation easement has been placed on the property. The exclusion from estate taxes does not extend to the value of any development rights retained by the decedent or donor, although payment for estate taxes on retained development rights may be deferred for up to two years, or until the disposition of the property, whichever is earlier. For this purpose, retained development rights are any rights retained to use the land for any commercial purpose which is not subordinate to and directly supportive of farming purposes, as defined in IRC section 6420 (e.g., tree farming, ranching, viticulture, and the raising of other agricultural or horticultural commodities). The Act provides that de minimis commercial recreational activity that is consistent with the conservation purpose, such as the granting of hunting and fishing licenses, will not cause the property to fail to qualify under this provision. It is anticipated that the Secretary of the Treasury will provide guidance as to the definition of de minimis activities.

The 40% estate tax exclusion for land subject to a qualified conservation easement (described above) may be taken only to the extent that the total exclusion for qualified conservation easements is limited to $100,000 in 1998, $200,000 in 1999, $300,000 in 2000, $400,000 in 2001, and $500,000 in 2002 and thereafter. The exclusion for land subject to a qualified conservation easement may be taken in addition to the maximum exclusion for qualified family-owned business interests (i.e., there is no coordination between the two provisions). The executor of an estate holding land subject to a qualified conservation easement and/or qualified family-owned business interests is required to designate which of the two benefits is being claimed with respect to each property on which a benefit is claimed. If the value of the conservation easement is less than 30% of (1) the value of the land without the easement, reduced by (2) the value of any retained development rights, then the exclusion percentage is reduced. The reduction in the exclusion percentage is equal to two percentage points for each point that the above ratio falls below 30%.

The granting of a qualified conservation easement is not treated as a disposition triggering the recapture provisions of section 2032A. In addition, the existence of a qualified conservation easement does not prevent such property from subsequently qualifying for special-use valuation treatment under section 2032A.

The Act also allows a charitable deduction (for <u>income</u> tax purposes or estate tax purposes) to taxpayers making a contribution of a permanent conservation easement on property where a mineral interest has been retained and surface mining is possible, but its probability is “so remote as to be negligible.” Present law provides for a charitable deduction in such a case if the mineral interests have been separated from the land prior to June 13, 1976. The provision allows such a charitable deduction to be taken regardless of when the mineral interests had been separated.

In addition, the Act makes technical modifications (a) to provide that the definition of farming for purposes of this provision is the same as the definition set forth in section 2032A(e)(5), and (b) to clarify that a post-mortem conservation easement may be placed on the property, as long as the easement has been made no later than the date of the election. The Act clarifies that debt-financed property is eligible for this provision to the extent of the net equity in the property. For example, if a $1 million property is subject to an outstanding debt balance of $100,000, it is treated in the same manner as a $900,000 property that is not debt-financed.

Current California Law (R&T Secs. 17201, 24357.7)

The California Revenue and Taxation Code does conform to the federal provision allowing a charitable contribution deduction for gifts of qualified conservation contributions.

California does not impose a gift tax; the California estate tax is a "pick-up" tax, that is, the state tax is equal to the maximum credit for a state death tax on the federal estate tax return for that particular decedent's estate. This "pick-up" tax is administered by the State Controller's Office.

Effective Date

The estate tax exclusion applies to decedents dying after December 31, 1997. The rules with respect to the treatment of conservation easements under section 2032A and with respect to retained mineral interests are effective for easements granted after December 31, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
511	Modification of Generation-Skipping Transfer Tax for Transfers to Individuals with Deceased Parents

Background

Under the “predeceased parent exception,” a direct skip transfer to a transferor's grandchild is not subject to the generation-skipping transfer (GST) tax if the child of the transferor who was the grandchild's parent is deceased at the time of the transfer. This “predeceased parent exception” to the GST tax is not applicable to (1) transfers to collateral heirs, e.g., grandnieces or grandnephews, or (2) taxable terminations or taxable distributions.

New Federal Law (Sec. 2651)

The Act extends the predeceased parent exception to transfers to collateral heirs, provided that the decedent has no living lineal descendants at the time of the transfer. For example, the exception would apply to a transfer made by an individual (with no living lineal heirs) to a grandniece where the transferor's nephew or niece who is the parent of the grandniece is deceased at the time of the transfer.

In addition, the Act extends the predeceased parent exception (as modified by the change in the preceding paragraph) to taxable terminations and taxable distributions, provided that the parent of the relevant beneficiary was dead at the earliest time that the transfer (from which the beneficiary's interest in the property was established) was subject to estate or gift tax. For example, where a trust was established to pay an annuity to a charity for a term for years with a remainder interest granted to a grandson, the termination of the term for years would not be a taxable termination subject to the GST tax if the grandson's parent (who is the son or daughter of the transferor) is deceased at the time the trust was created and the transfer creating the trust was subject to estate or gift tax.

Current California Law

California does not impose a gift tax; the California estate tax is a "pick-up" tax, that is, the state tax is equal to the maximum credit for a state death tax on the federal estate tax return for that particular decedent's estate. This "pick-up" tax is administered by the State Controller's Office.

Effective Date

The provision is effective for generation skipping transfers occurring after December 31, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
601	Extension of the Research Tax Credit

Background

Federal law provides for a research tax credit equal to 20% of the amount by which a taxpayer's qualified research expenditures for a taxable year exceeded its base amount for that year. The research credit was scheduled to expire and was not to apply to amounts paid or incurred after May 31, 1997.

A 20% research tax credit also applies to the excess of (1) 100% of corporate cash expenditures (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation is commonly referred to as the “university basic research credit”.

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's “fixed-base percentage” by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its “fixed-base percentage” is the ratio that its total qualified research expenditures for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (so-called “start-up firms”) are assigned a fixed-base percentage of 3%.

The Small Business Job Protection Act of 1996 expanded the definition of “start-up firms” under IRC section 41(c)(3)(B)(I) 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 computing the credit, a taxpayer's base amount may not be less than 50% of its current-year qualified research expenditures. To prevent artificial increases in research expenditures by shifting expenditures among commonly-controlled or otherwise related entities, a special aggregation rule provides that all members of the same controlled group of corporations are treated as a single taxpayer. Special rules apply for computing the credit when a major portion of a business changes hands, under which qualified research expenditures and gross receipts for periods prior to the change of ownership of a trade or business are treated as transferred with the trade or business that gave rise to those expenditures and receipts for purposes of recomputing a taxpayer's fixed-base percentage.

As part of the Small Business Job Protection Act of 1996, taxpayers are allowed 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 allowable) and the credit rate likewise is reduced. Under the alternative credit regime, a credit rate of 1.65% 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% (i.e., the base amount equals 1% 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%. A credit rate of 2.2% applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5% but do not exceed a base amount computed by using a fixed-base percentage of 2%. A credit rate of 2.75% 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%. An election to be subject to this alternative incremental credit regime was to be made only for a taxpayer's first taxable year beginning after June 30, 1996, and before July 1, 1997, and such an election applies to that taxable year and all subsequent years (in the event that the credit subsequently is extended by Congress) unless revoked with the consent of the Secretary of the Treasury.

Qualified research expenditures eligible for the research tax credit consist of: (1) “in-house” expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65% of amounts paid by the taxpayer for qualified research conducted on the taxpayer's behalf (so-called ``contract research expenses'').

Under a special rule enacted as part of the Small Business Job Protection Act of 1996, 75% of amounts paid to a research consortium for qualified research is treated as qualified research expenses eligible for the research credit (rather than 65% under the general 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.

To be eligible for the credit, the research must not only satisfy the requirements of present-law IRC section 174 (described below) but must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and must pertain to functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors. In addition, research does not qualify for the credit if conducted after the beginning of commercial production of the business component, if related to the adaptation of an existing business component to a particular customer's

requirements, if related to the duplication of an existing business component from a physical examination of the component itself or certain other information, or if related to certain efficiency surveys, market research or development, or routine quality control.

Expenditures attributable to research that is conducted outside the United States do not enter into the credit computation. In addition, the credit is not available for research in the social sciences, arts, or humanities, nor is it available for research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

New Federal Law (Sec. 41)

Under the Act, the research tax credit is extended for 13 months-i.e., generally for the period June 1, 1997, through June 30, 1998.

Under the provision, taxpayers are permitted to elect the alternative incremental research credit regime under IRC section 41(c)(4) for any taxable year beginning after June 30, 1996, and such election will apply to that taxable year and all subsequent taxable years unless revoked with the consent of the Secretary of the Treasury.

Current California Law (R&T Secs. 17052.12, 23609)

California conforms with specific modifications to the federal research credit as it read January 1, 1997, 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 changed to 11% for qualified research and 24% for basic research;
- the definition of “gross receipts” differs;
- research which has a specific commercial objective may qualify as basic research;
- amounts paid or incurred after June 30, 1995, can qualify for the credit,
- for taxable and income years beginning on or after January 1, 1998, under the alternative incremental method the three-tiered fixed-base percentage federal amounts (used in 1997 for state also) of 1.65%, 2.2% and 2.75% are reduced to .91%, 1.21% and 1.51%, respectively; and
- California allows taxpayers to make a separate state election for the alternative incremental credit and allows taxpayers to make the election at any one time (as opposed to the federal window period).

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.

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

Also, for corporate taxpayers engaged in specified biopharmaceutical research and biotech research and development, California law includes hospitals operated by public universities and qualified cancer centers in the definition of “qualified organization” for purposes of the basic research credit. A qualified cancer center is defined 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.

AB 1042 (Stat. 1997, Ch. 613) conformed California law to the changes made to federal research credit by the Small Business Job Protection Act of 1996. For 1997 and thereafter, AB 1042 conformed to the federal treatment of consortia and start–up companies. Except for the credit rates, AB 1042 conformed California law to the alternative incremental credit regime. As stated above, the federal three-tiered rate applies to California for 1997. For 1998 and thereafter, California has a reduced three-tiered credit rate.

Effective Date

The provision generally is effective for qualified research expenditures paid or incurred during the period June 1, 1997, through June 30, 1998. A special rule provides that, notwithstanding the general termination date for the research credit of June 30, 1998, if a taxpayer elects to be subject to the alternative incremental research credit regime for its first taxable year beginning after June 30, 1996, and before July 1, 1997, the alternative incremental research credit will be available during the entire 24-month period beginning with the first month of such taxable year--i.e., the equivalent of the 11-month extension provided for by the Small Business Job Protection Act of 1996 plus an additional 13-month extension provided for by the conference agreement. However, to prevent taxpayers from effectively obtaining more than 24 months of research credits from the Small Business Job Protection Act of 1996 and this bill, the 24-month period for taxpayers electing the alternative incremental research credit regime is reduced by the number of months (if any) after June 1996 with respect to which the taxpayer claimed research credit amounts under the regular, 20% research credit rules.

Impact on California Revenue

These changes were adopted in AB 1042.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
602	Contributions Of Stock To Private Foundation

Background

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).

However, in the case of a charitable contribution of short-term gain, inventory or other ordinary income property, the amount of the deduction allowable for a taxable year with respect to a charitable contribution may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.

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 are allowed a deduction equal to the fair market value of “qualified appreciated stock” contributed to a private foundation prior to May 31, 1997 (prior to the passage of this Act). Qualified appreciated stock is defined as publicly traded stock which is capital gain property. The fair-market-value deduction for qualified appreciated stock donations applies only to the extent that total donations made by the donor to private foundations of stock in a particular corporation did not exceed 10% of the outstanding stock of that corporation. For this purpose, an individual is treated as making all contributions that were made by any member of the individual's family.

The special rule regarding the contribution of qualified appreciated stock to certain foundations was originally enacted in 1984, and expired January 1, 1995. The Small Business Job Protection Act of 1996 reinstated the rule for 11 months for contributions of qualified appreciated stock made to private foundations during the period July 1, 1996, through May 31, 1997.

New Federal Law (Sec. 170(e))

The Act extended that the special rule regarding the contributions of qualified appreciated stock to certain foundations is extended for the period June 1, 1997, through June 30, 1998.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Current California Law (R&T Sec. 17201)

California, in general, is conformed to the federal “itemized deduction” charitable contribution deduction. However, the special rule for contributions of qualified appreciated stock made to private foundations expired on December 31, 1994, and California has not conformed to its extension.

In addition, California law did not conform to the repeal of the treatment of contributions of appreciated property (real, personal, and intangible) as a tax preference for 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 provision is effective for contributions of qualified appreciated stock to private foundations made during the period June 1, 1997, through June 30, 1998.

Impact on California Revenue

The revenue loss of this proposal is as follows:

Contributions Made July 1, 1997-May 31, 1998 Enactment After June 30 1998 ($in millions)		
1998-9	1999-0	2000-1
($4)	*	*

* Insignificant Losses

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

Based on a proration of federal estimates conforming to this provision would produce a revenue loss of $4 million for the 1998-9 fiscal year and insignificant losses thereafter due to carryovers.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
603	Work Opportunity Tax Credit

Background

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of seven targeted groups. The credit generally is equal to 35% of qualified wages. Generally, qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer. Generally, no more than $6,000 of wages during the first year of employment is permitted to be taken into account with respect to any individual. Thus, the maximum credit per individual is $2,100. With respect to qualified summer youth employees, the maximum credit is 35% of up to $3,000 of qualified first-year wages, for a maximum credit of $1,050. The deduction for wages is reduced by the amount of the credit. The following target groups are eligible for the credit:

(1) Families receiving AFDC – An eligible recipient is an individual certified by the designated local employment agency as being a member of a family eligible to receive benefits under AFDC or its successor program for a period of at least nine months part of which is during the nine-month period ending on the hiring date. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for the AFDC or its successor program.

(2) Qualified ex-felon - A qualified ex-felon is an individual certified as: (1) having been convicted of a felony under any state or federal law, (2) being a member of a family that had an income during the six months before the earlier of the date of determination or the hiring date which on an annual basis is 70% or less of the Bureau of Labor Statistics lower living standard, and (3) having a hiring date within one year of release from prison or date of conviction.

(3) High-risk youth - A high-risk youth is an individual certified as being at least 18 but not yet 25 on the hiring date and as having a principal place of abode within an empowerment zone or enterprise community (as defined under Subchapter U of the Internal Revenue Code). Qualified wages will not include wages paid or incurred for services performed after the individual moves outside an empowerment zone or enterprise community.

(4) Vocational rehabilitation referral - Vocational rehabilitation referrals are those individuals who have a physical or mental disability that constitutes a substantial handicap to employment and who have been referred to the employer while receiving, or after completing, vocational rehabilitation services under an individualized, written rehabilitation plan under a state plan approved under the Rehabilitation Act of 1973 or under a rehabilitation plan for veterans carried out under Chapter 31 of Title 38, U.S. Code. Certification will be provided by the designated local employment agency upon assurances from

the vocational rehabilitation agency that the employee has met the above conditions.

(5) Qualified summer youth employee - Qualified summer youth employees are individuals: (1) who perform services during any 90-day period between May 1 and September 15, (2) who are certified by the designated local agency as being 16 or 17 years of age on the hiring date, (3) who have not been an employee of that employer before, and (4) who are certified by the designated local agency as having a principal place of abode within an empowerment zone or enterprise community (as defined under Subchapter U of the Internal Revenue Code). As with high-risk youths, no credit is available on wages paid or incurred for service performed after the qualified summer youth moves outside of an empowerment zone or enterprise community. If, after the end of the 90-day period, the employer continues to employ a youth who was certified during the 90-day period as a member of another targeted group, the limit on qualified first-year wages will take into account wages paid to the youth while a qualified summer youth employee.

(6) Qualified veteran - A qualified veteran is a veteran who is a member of a family certified as receiving assistance under: (1) AFDC for a period of at least nine months part of which is during the 12-month period ending on the hiring date, or (2) a food stamp program under the Food Stamp Act of 1977 for a period of at least three months part of which is during the 12-month period ending on the hiring date. For these purposes, members of a family are defined to include only those individuals taken into account for purposes of determining eligibility for: (i) the AFDC or its successor program, and (ii) a food stamp program under the Food Stamp Act of 1977, respectively. Further, a qualified veteran is an individual who has served on active duty (other than for training) in the Armed Forces for more than 180 days or who has been discharged or released from active duty in the Armed Forces for a service-connected disability. However, any individual who has served for a period of more than 90 days during which the individual was on active duty (other than for training) is not an eligible employee if any of this active duty occurred during the 60-day period ending on the date the individual was hired by the employer. This latter rule is intended to prevent employers who hire current members of the armed services (or those departed from service within the last 60 days) from receiving the credit.

(7) Families receiving food stamps - An eligible recipient is an individual aged 18 but not yet 25 certified by a designated local employment agency as being a member of a family receiving assistance under a food stamp program under the Food Stamp Act of 1977 for a period of at least six months ending on the hiring date. In the case of families that cease to be eligible for food stamps under section 6(o) of the Food Stamp Act of 1977, the six-month requirement is replaced with a requirement that the family has been receiving food stamps for at least three of the five months ending on the date of hire. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for a food stamp program under the Food Stamp Act of 1977.

No credit is allowed for wages paid unless the eligible individual is employed by the employer for at least 180 days (20 days in the case of a qualified summer youth employee) or 400 hours (120 hours in the case of a qualified summer youth employee).

The credit was effective for wages paid or incurred to a qualified individual who begins work for an employer after September 30, 1996, and before October 1, 1997 (prior to the passage of this Act).

New Federal Law (Sec. 51)

The Act provides a nine month extension of the work opportunity tax credit (through June 30, 1998).

The Act extends eligibility to members of families receiving AFDC (or it successor program) benefits for any nine months during the eighteen month period ending on the hiring date and adds SSI beneficiaries as a new category of workers for which the credit is available.

Additionally, the Act provides a credit percentage of 25% for employment of less than 400 hours of employment and 40% for employment of 400 or more hours. The minimum employment period is reduced from 400 to 120 hours.

Current California Law (R&T Secs. 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.

Additionally, California has hiring credits available in the various economic development areas of the state (e.g., enterprise zone and targeted tax area).

Effective Date

The credit is generally effective for wages paid to qualified individuals who begin work for an employer after September 30, 1997, and before July 1, 1998.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
604	Orphan Drug Tax Credit

Background

A 50% nonrefundable tax credit is 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 fewer 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). As with other general business credits, taxpayers are allowed to carry back unused credits to three years preceding the year the credit is earned (but not to a taxable year ending before July 1, 1996) and to carry forward unused credits to 15 years following the year the credit is earned. The credit cannot be used to offset a taxpayer's alternative minimum tax liability.

The orphan drug tax credit originally was enacted in 1983 and was extended on several occasions. The credit expired on December 31, 1994, and later was reinstated for the period July 1, 1996, through May 31, 1997.

New Federal Law (Sec. 45C)

The orphan drug tax credit is permanently extended.

Current California Law

California no longer has a comparable credit.

Effective Date

The provision is effective for qualified clinical testing expenses paid or incurred after May 31, 1997.

Impact on California Revenue

Not applicable. California’s credit sunseted on January 1, 1993 with annual impacts on the order of $500,000.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
701	Tax Incentives for Revitalization of the District of Columbia

New Federal Law (Secs. 1400, 1400A, 1400B, 1400C)

The Act provides that certain economically depressed census tracts within the District of Columbia are designated as the "D.C. Enterprise Zone," within which businesses and individual residents are eligible for special tax incentives. The following tax incentives that are available under present law in empowerment zones generally will be available in the D.C. Enterprise Zone: (1) a 20% wage credit for the first $15,000 of wages paid to D.C. residents who work in the D.C. Enterprise Zone; (2) an additional $20,000 of expensing under Code section 179 for qualified zone property; and (3) special tax-exempt financing for certain zone facilities.

In addition, the Act provides two more incentives:

1. A zero-percent capital gains rate for capital gains from the sale of certain qualified D.C Zone assets held for more than five years. For purposes of the zero-percent capital gains rate, the D.C. Enterprise Zone is defined to include all census tracts within the District of Columbia where the poverty rate is not less than 10%.

2. First-time homebuyers of a principal residence in the District ere allowed a tax credit of up to $5,000 of the amount of the purchase price. The credit phases out for individual taxpayers with adjusted gross income between $70,000 and $90,000 ($110,000-$130,000 for joint filers). The Act provides that the credit is available with respect to purchases of existing property as well as new construction, and specifies that a taxpayer's basis in a property is reduced by the amount of any homebuyer tax credit claimed with respect to such property. The credit is available with respect to property purchased after August 4, 1997, and before January 1, 2001.

Current California Law

Existing state law does not conform to the federal economic development area provisions. Instead, California provides for the designation of the following economic development areas: 39 enterprise zones, five local agency military base recovery areas, one targeted tax area, and two manufacturing enhancement areas. California allows the following tax incentives to qualifying businesses operating in economic development areas:

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Types of Incentives	EZ	LAMBRA	TTA	MEA
Sales or Use Tax Credit	X	X	X	
Hiring Credit	X	X	X	X
Construction Hiring Credit				
Employee Wage Credit	X			
Business Expense Deduction	X	X	X	
Net Interest Deduction	X			
Net Operating Loss	X	X	X	

Effective Date

The D.C. Enterprise Zone designation generally will remain in effect for five years for the period from January 1, 1998, through December 31, 2002.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
801	Welfare-To-Work Tax Credit

Background

The work opportunity tax credit is available on an elective basis (see Act Section 603 above) for employers hiring individuals from one or more of seven targeted groups. The credit generally was equal to 35% of qualified wages. Generally, qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer. For purposes of the work opportunity tax credit, the targeted groups for which the credit is available include: (1) families receiving Aid to Families with Dependent Children (AFDC); (2) qualified ex-felons; (3) high-risk youth; (4) vocational rehabilitation referrals; (5) qualified summer youth employees; (6) qualified veterans; and (7) families receiving food stamps. Generally, no more than $6,000 of wages during the first year of employment is permitted to be taken into account with respect to any individual. The deduction for wages is reduced by the amount of the credit.

New Federal Law (Sec. 51A)

The Act provides to employers a tax credit on the first $20,000 of eligible wages paid to qualified long-term family assistance (AFDC or its successor program) recipients during the first two years of employment. The credit is 35% the first $10,000 of eligible wages in the first year of employment and 50% of the first $10,000 of eligible wages in the second year of employment. The maximum credit is $8,500 per qualified employee. Qualified long-term family assistance recipients are: (1) members of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) members of a family that has received family assistance for a total of at least 18 months (whether or not consecutive) after the date of enactment of this credit if they are hired within two years after the date that the 18-month total is reached; and (3) members of a family who are no longer eligible for family assistance because of either federal or state time limits, if they are hired within two years after the federal or state time limits made the family ineligible for family assistance. Eligible wages include cash wages paid to an employee plus amounts paid by the employer for the following: (1) educational assistance excludable under a section 127 program (or that would be excludable but for the expiration of sec. 127); (2) health plan coverage for the employee, but not more than the applicable premium defined under section 4980B(f)(4); and (3) dependent care assistance excludable under section 129.

Current California Law

California has no comparable provision.

Effective Date

The provision is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 1998 and before May 1, 1999.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
901	General Revenue Portion of Highway Motor Fuels Taxes Deposited Into Highway Trust Fund

Background

The Highway Trust Fund receives revenues from taxes on gasoline, special motor fuels (14 cents per gallon) and diesel fuel (20 cents per gallon) used in highway vehicles, through September 30, 1999. These fuels also are subject to an additional, permanent 4.3-cents-per-gallon rate. Revenues from the 4.3-cents-per-gallon rate are retained in the General Fund. Excise taxes imposed on these three motor fuels (gasoline, diesel fuel, and special motor fuels) generally must be paid to the Treasury in semi-monthly deposits, which are credited to tax liability that is reported on quarterly returns. Subject to special rules for deposits attributable to taxes for the period September 16th through 26th, deposits generally must be made 9 days after the end of each semi-monthly period (14 days in the case of gasoline and diesel fuel taxes deposited electronically).

New Federal Law (Sec. 9503)

The Act transfers the 4.3 cents-per-gallon excise tax from motor fuels used in highway transportation is transferred to the Highway Trust Fund from the General Trust Fund beginning October 1, 1997. In apportioning the money, 80% of the Highway Trust Fund allocation goes to the Highway Account, with the remaining 20% going to the Mass Transit Account.

Current California Law

No comparable provisions are contained in the parts of the Revenue and Taxation Code administered by the FTB.

Effective Date

The federal provisions are effective for taxes received after September 30, 1997.

Impact on California Revenue

Defer to the Board of Equalization.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
902	Repeal of Tax on Diesel Fuel Used in Recreational Boats

Background

Before a temporary suspension through December 31, 1997, was enacted in 1996, diesel fuel used in recreational motorboats was subject to the 24.3-cents-per-gallon diesel fuel excise tax. Revenues from this tax were retained in the General Fund.

New Federal Law (Secs. 4041(a), 4083(a), 6421(e)(2))

The Act repeals the 24.3 cents-per-gallon diesel fuel tax imposed on diesel fuel used in recreational motorboats.

Current California Law

No comparable provisions are contained in the parts of the Revenue and Taxation Code administered by the FTB.

Effective Date

The federal repeal provisions are effective for fuel sold on or after January 1, 1998.

Impact on California Revenue

Defer to the Board of Equalization.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
903	Continued Application of Tax on Imported Recycled Halon-1211

Background

An excise tax is imposed on the sale or use by the manufacturer or importer of certain ozone-depleting chemicals. The amount of tax generally is determined by multiplying the base tax amount applicable for the calendar year by an ozone-depleting factor assigned to each taxable chemical. The base tax amount is $6.25 per pound in 1997 and is scheduled to increase by 45 cents per pound per year thereafter. The ozone-depleting factors for taxable halons are 3 for halon-1211, 10 for halon-1301, and 6 for halon-2402. Taxable chemicals that are recovered and recycled within the United States are exempt from tax. In addition, exemption is provided for imported recycled halon-1301 and halon-2402 if such chemicals are imported from countries that are signatories to the Montreal Protocol on Substances that Deplete the Ozone Layer. Prior law further provides that exemption is to be provided for imported recycled halon-1211, for such chemicals imported from countries that are signatories to the Montreal Protocol on Substances that Deplete the Ozone Layer after December 31, 1997.

New Federal Law (Sec. 4682(d)(1))

The Act repeals the prior-law exemption for imported recycled halon-1211.

Current California Law

No comparable provisions are contained in the parts of the Revenue and Taxation Code administered by the FTB.

Effective Date

The federal provisions are effective on August 5, 1997.

Impact on California Revenue

Defer to the Board of Equalization.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
904	Uniform Rate of Tax on Vaccines

Background

A manufacturer's excise tax is imposed on the following vaccines routinely recommended for administration to children: DPT (diphtheria, pertussis, tetanus), $4.56 per dose; DT (diphtheria, tetanus), 6 cents per dose; MMR (measles, mumps, or rubella), $4.44 per dose; and polio, 29 cents per dose. In general, if any vaccine is administered by combining more than one of the listed taxable vaccines, the amount of tax imposed is the sum of the amounts of tax imposed for each taxable vaccine. However, in the case of MMR and its components, any component vaccine of MMR is taxed at the same rate as the MMR-combined vaccine. Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines.

New Federal Law (Secs. 4131(b), 4132(a))

The Act imposes a single tax rate of 75 cents per dose on any listed vaccine component. Vaccines containing more than one component are taxed at a rate of 75 cents multiplied by the number of components. In addition, the Act adds the following three new vaccines to the list of taxable vaccines: HIB (haemophilus influenza type B), Hepatitis B, and any varicella (chicken pox) vaccine.

Current California Law

No comparable provisions are contained in the parts of the Revenue and Taxation Code administered by the FTB.

Effective Date

The new federal tax rates apply to vaccine sales beginning after August 5, 1997.

Impact on California Revenue

Defer to the Board of Equalization.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
905	Operators of Multiple Gasoline Retail Outlets Treated as Wholesale Distributor for Refund Purposes

Background

Federal law taxes gasoline at 18.3 cents per gallon upon removal from a registered pipeline or barge terminal facility. The position holder in the terminal at the time of removal is liable for payment of the tax. Certain uses of gasoline, including use by states and local governments, are exempt from tax. In general, these exemptions are realized by refunds to the exempt users of tax paid by the party that removed the gasoline from a terminal facility. Present law includes an exception to the general rule that refunds are made to consumers in the case of gasoline sold to states and local governments and certain other exempt users. In those cases, wholesale distributors sell the gasoline net of tax previously paid and receive the refunds. The term wholesale distributor includes only persons that sell gasoline to producers, retailers, or to users in bulk quantities. Retailers that are not also wholesale distributors do not qualify, regardless of their size.

New Federal Law (Sec. 6416(a)(4)(B))

The Act expands the definition of wholesale distributor to include certain “chain retailers” - retailers who own and make retail sales from 10 or more retail gasoline outlets. This modification conforms the definition of wholesale distributor to that which existed before 1987 when the point of collection of the gasoline tax was moved from the wholesale distribution level to removal from a terminal facility.

Current California Law

No comparable provisions are contained in the parts of the Revenue and Taxation Code administered by the FTB.

Effective Date

The federal provisions apply to sales made after August 5, 1997.

Impact on California Revenue

Defer to the Board of Equalization.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
906	Exemption of Electric and Other Clean-Fuel Motor Vehicles from Luxury Automobile Classification

Background

Federal law imposes an excise tax on the sale of automobiles whose price exceeds a designated threshold, currently $36,000. The excise tax is imposed at a rate of 8% for 1997 on the excess of the sales price above the designated threshold. The 8% rate declines by 1% point per year until reaching 3% in 2002, with no tax thereafter. The $36,000 threshold is indexed for inflation. The present-law-indexed threshold of $36,000 is the result of adjusting a $30,000 threshold specified in the Code for inflation occurring after 1990. The tax generally applies only to the first retail sale after manufacture, production, or importation of an automobile. It does not apply to subsequent sales of taxable automobiles. A 10% tax is imposed on the separate purchase of parts and accessories for a vehicle within six months of the first retail sale when the sum of the separate purchases of the vehicle, parts, and accessories exceeds the luxury tax threshold.

New Federal Law (Secs. 4001, 4003(a)(1), 4003(a)(2))

The Act modifies the threshold above which the luxury excise tax on automobiles will apply for each of two identified classes of automobiles, both in the case of a purchase of a vehicle and in the case of the separate purchase of a vehicle and parts and accessories therefor. First, for an automobile that is not a clean-burning fuel vehicle to which retrofit parts and components are installed to make the vehicle a clean-burning vehicle, the threshold is $30,000, as adjusted for inflation under present law, plus an amount equal to the increment to the retail value of the automobile attributable to the retrofit parts and components installed. In the case of a passenger vehicle designed to be propelled primarily by electricity and built by an original equipment manufacturer, the threshold applicable for any year is modified to equal 150% of $30,000, with the result increased for inflation occurring after 1990 and rounded to the next lowest multiple of $2,000.

Current California Law

No comparable provisions are contained in the parts of the Revenue and Taxation Code administered by the FTB.

Effective Date

The federal provision is effective for sales and installations occurring after August 5, 1997.

Impact on California Revenue

Defer to the Board of Equalization.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
907	Rate of Tax on Certain Special Fuels Determined on Basis of BTU Equivalence with Gasoline

Background

Special motor fuels are subject to an 18.3-cents-per-gallon excise tax. Special motor fuels include propane, methanol derived from natural gas, liquefied natural gas, and compressed natural gas. Reduced tax rates apply to methanol from natural gas and compressed natural gas.

New Federal Law (Secs. 4041(a)(2), 4041(d)(1), 4041(m)(1)(A))

The Act adjusts the aggregate tax rates imposed on propane, liquefied natural gas, and methanol derived from natural gas to reflect the energy content of these fuels relative to gasoline. The revised tax rates per gallon (through September 30, 1999) are:

Propane 13.6 cents.
Liquefied natural gas 11.9 cents.
Methanol 9.15 cents.

After September 30, 1999, these three fuels will be taxed based on BTU equivalency to gasoline's 4.3-cents-per-gallon rate. No change is made to the current reduced tax rate on compressed natural gas.

Current California Law

No comparable provisions are contained in the parts of the Revenue and Taxation Code administered by the FTB.

Effective Date

The federal revised tax rates apply to fuels sold on or after October 1, 1997.

Impact on California Revenue

Defer to the Board of Equalization.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
908	Modification of Tax Treatment of Hard Cider

Background

Distilled spirits are taxed at a rate of $13.50 per proof gallon; beer is taxed at a rate of $18 per barrel (approximately 58 cents per gallon); and still wines of 14% alcohol or less are taxed at a rate of $1.07 per wine gallon. Higher rates of tax are applied to wines with greater alcohol content and to sparkling wines (champagne). Certain small wineries may claim a credit against the excise tax on wine of 90 cents per wine gallon on the first 100,000 gallons of wine produced annually (i.e., net tax rate of 17 cents per wine gallon). Certain small breweries pay a reduced tax of $7.00 per barrel (approximately 22.6 cents per gallon) on the first 60,000 barrels of beer produced annually. Apple cider containing alcohol (hard cider) is classified and taxed as wine.

New Federal Law (Sec. 5041)

The Act adjusts the tax rate on apple cider having an alcohol content of no more than 7% to 22.6 cents per gallon for those persons who produce more than 100,000 gallons of hard cider during a calendar year. The tax rate applicable to hard cider produced by persons who produce 100,000 gallons or less in a calendar year will remain as under present law, and those persons may continue to claim the 90 cents per wine gallon credit permitted for small wineries. Hard cider production will continue to be counted in determining whether other production of a producer qualifies for the tax credit for small producers. The Act does not change the classification of qualifying hard cider as wine.

Current California Law

No comparable provisions are contained in the parts of the Revenue and Taxation Code administered by the FTB.

Effective Date

The federal provision tax rate change is effective for hard cider removed after September 30, 1997.

Impact on California Revenue

Defer to the Board of Equalization.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
909	Study of Feasibility of Moving Collection Point for Distilled Spirits Excise Tax

Background

Distilled spirits are subject to tax at $13.50 per proof gallon. (A proof gallon is a liquid gallon consisting of 50% alcohol.) In the case of domestically produced distilled spirits and distilled spirits imported into the United States in bulk containers for domestic bottling, the tax is imposed on removal of the beverage from the distillery (without regard to whether a sale occurs at that time). Bottled distilled spirits that are imported into the United States comprise approximately 15% of the current market for these beverages; tax is imposed on these imports when the distilled spirits are removed from the first customs bonded warehouse in which they are deposited upon entry into the United States. In the case of certain distilled spirits products, a tax credit for alcohol derived from fruit is allowed. This credit reduces the effective tax paid on those beverages. The credit is determined when the tax is paid (i.e., at the distillery or on importation).

New Federal Law

The Act directs the Treasury Department to study options for changing the point at which the distilled spirits excise tax is collected. One option evaluated should be collecting the tax at the point at which the distilled spirits are removed from registered wholesale warehouses. As part of this study, the Treasury is to focus on administrative issues associated with the identified options, including the effects on tax compliance. For example, the Treasury is to evaluate the actual compliance record of wholesale dealers that currently pay the excise tax on imported bottled distilled spirits, and the compliance effects of allowing additional wholesale dealers to be distilled spirits taxpayers. The study also is to address the number of taxpayers involved, the types of financial responsibility requirements that might be needed, and any special requirements regarding segregation of non-tax-paid distilled spirits from other products carried by the potential new taxpayers. The study further is to review the effects of the options on Treasury staffing and other budgetary resources, as well as projections of the time between when tax currently is collected and the time when tax otherwise would be collected. The study is required to be completed and transmitted to the Senate Committee on Finance and the House Committee on Ways and Means no later than March 31, 1998.

Current California Law

No comparable provisions are contained in the parts of the Revenue and Taxation Code administered by the FTB.

Impact on California Revenue

Defer to the Board of Equalization.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
910	Clarification of Authority to Use Semi-Generic Designations on Wine Labels.

New Federal Law (Sec. 5388)

The Act includes provisions regulating the labeling of wine when it is removed from a winery for marketing. In general, these provisions allow the use of semi-generic names for wine that reflect geographic identifications understood in the industry, provided that the labels include clear indication of any deviation from that which is generally understood in the source of the grapes or the process by which the wine is produced.

Current California Law

No comparable provisions are contained in the parts of the Revenue and Taxation Code administered by the FTB.

Effective Date

The federal provision is effective on August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
911	Authority to Postpone Certain Tax-Related Deadlines by Reason of Presidentially-Declared Disaster.

New Federal Law (Sec. 7508A)

The Act provides that, in the case of a taxpayer determined to be affected by a Presidentially-declared disaster, the Secretary of the Treasury may specify that, for a period of up to 90 days, certain taxpayer deadlines are postponed. The deadlines that may be postponed are the same as are postponed by reason of service in a combat zone. The provision does not apply for purposes of determining interest on any overpayment or underpayment.

Current California Law

No comparable provisions are contained in the parts of the Revenue and Taxation Code administered by the FTB. However, California law is conformed to a similar statute, which provides postponement of certain tax-related deadlines during periods of service in combat zones.

California law did pass special legislation that waived the late payment of tax penalty for taxpayers incurring a casualty loss from the January 1994 Northridge Earthquake.

Effective Date

The federal provisions apply to any period for performing an Act that did not expire before August 5, 1997.

Impact on California Revenue

This estimate includes Act Section 912.

Based on a negligible impact projected for the federal law change, conforming to this change would be negligible losses (less than $250,000 annually).

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
912	Use of Certain Appraisals to Establish Amount of Disaster Loss

Background

Under existing state tax law, which conforms to federal law, a taxpayer may claim a loss from a disaster in an area determined by the President of the United States to warrant federal assistance. The taxpayer may elect either to claim the disaster loss in the year the loss occurs or in the year preceding the loss. This election allows the taxpayer to immediately file an amended return for the prior year. For state purposes, this election may be made prior to passage of any state legislation allowing special carryback treatment because California conforms to the federal election.

As with casualty losses, nonbusiness disaster losses not reimbursed by insurance are deductible under state and federal tax law to the extent each loss exceeds $100, and total nonbusiness disaster losses are deductible only to the extent that the total loss amount for the year exceeds 10% of adjusted gross income.

To claim a disaster loss, a taxpayer must establish the amount of the loss. This may, for example, be done through the use of an appraisal.

New Federal Law (Sec. 165(i))

The Act provides that nothing in the Internal Revenue Code should be construed to prohibit Treasury from issuing guidance providing that an appraisal for the purpose of obtaining a federal loan or federal loan guarantee as the result of a Presidentially-declared disaster may be used to establish the amount of a disaster loss.

Current California Law (R&T Secs. 17201, 17207)

As stated above, California law is the same as federal. To claim a disaster loss, a taxpayer must establish the amount of the loss. This may be done through the use of an appraisal. There is no provision in California law that specifically addresses appraisals prepared for emergency federal disaster relief.

Effective Date

The federal provision applies August 5, 1997.

Impact on California Revenue

Included in Act Section 911.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
913	Treatment of Livestock Sold on Account of Weather-Related Conditions

Background

In general, cash-method taxpayers report income in the year it actually is received or is constructively received. However, present law contains two special rules applicable to livestock sold because of drought conditions. Internal Revenue Code section 451(e) provides that a cash-method taxpayer whose principal trade or business is farming and who is forced to sell livestock due to drought conditions may elect to include income from the sale of the livestock in the taxable year following the taxable year of the sale. This elective deferral of income is available only if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for drought conditions that resulted in the area being designated as eligible for federal assistance. This exception is generally intended to put taxpayers that receive an unusually high amount of income in one year in the position they would have been in absent the drought. In addition, the sale of livestock (other than poultry) that is held for draft, breeding, or dairy purposes in excess of the number of livestock that would have been sold but for drought conditions is treated as an involuntary conversion under IRC section 1033(e). Consequently, gain from the sale of such livestock could be deferred by reinvesting the proceeds of the sale in similar property within a two-year period.

New Federal Law (Secs. 451(e) and 1033(e))

The Act amends IRC section 451(e) to extend the special treatment for sale of livestock on account of drought to livestock sold on account of floods and other weather related conditions.

Current California Law (R&T Secs. 17551, 18031, 24661, and 24949.1)

California conforms to the prior federal law relating to the taxable year of inclusion for income from livestock sold because of drought conditions.

Effective Date

The federal provisions apply to sales and exchanges on or after January 1, 1997.

Impact on California Revenue

Based on the impact projected for the federal law change, conforming to this change would be negligible losses less than $250,000 annually.

Revenue losses from this proposal would depend on the amount of income attributable to livestock sales being deferred by a cash-method taxpayers from one year to another, the occurrence of floods or other weather-related conditions that result in areas designated as eligible for federal assistance, and the amount of gains from the sale of livestock in excess of the number of livestock that would have been sold that is deferred due to treatment as involuntary conversions.

Developing estimates of this sort is very speculative due to inherent uncertainties.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
914	Mortgage Financing for Residences Located in Disaster Areas

Background

Qualified mortgage bonds are private activity tax-exempt bonds issued by states and local governments acting as conduits to provide mortgage loans (1) to first-time home buyers, (2) who satisfy specified income limits and (3) who purchase homes that cost less than statutory maximums.

Present law waives the three buyer targeting requirements for a portion of the loans made with proceeds of a qualified mortgage bond issue if the loans are made to finance homes in statutorily prescribed economically distressed areas.

New Federal Law (Sec. 143(k))

The Act allows the waivers of the first-time homebuyer requirement, the income limits, and the purchase price limits for loans to finance homes in certain Presidentially-declared disaster areas. The waiver applies only during the two-year period following the date of disaster declaration.

Current California Law (R&T Secs. 17143 and 24272)

California specifically does not conform to any of the provisions of federal law that 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 loans financed with bonds issued after December 31, 1996 and before January 1, 1999.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
915	Abatement of Interest on Underpayments by Taxpayers in Presidentially-Declared Disaster Areas

Background

In the case of a Presidentially declared disaster, the Secretary of the Treasury has the authority to postpone some tax-related deadlines, but has no authority to abate interest.

New Federal Law (Note to Sec. 6601)

The Act requires the Secretary of the Treasury to abate interest for the same period of time for which the Secretary of the Treasury has provided an extension of time to file tax returns and pay taxes for individuals located in Presidentially declared disaster areas during 1997.

Current California Law (R&T Sec. 19112)

California does not conform to the federal abatement of interest provisions. Instead, California law provides that interest may be waived for any period for which the FTB determines that an individual or fiduciary demonstrates inability to pay that interest solely because of extreme financial hardship caused by significant disability or other catastrophic circumstance.

Effective Date

The federal provision applies to disasters declared only during 1997.

Impact on California Revenue

The amount of interest abated is estimated based on the low level of federal estimates for this provision in H.R. 2014. Conforming to the provision would result in negligible losses of less than $250,000 in 1997-98 and 1998-99.

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 number of individuals who have been given an extension of time to file tax returns for being located in a Presidentially declared disaster area, and the amount of interest attributable to underpayment of their taxes which could be abated.

Using historical data regarding insurance claims, revenue estimates above were based on federal projections and prorated to California based on historic averages for state-to-nation insurance claims for disasters and average marginal tax rates.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
921	Clarification of Standard to be Used in Determining Employment Tax Status of Securities Brokers

Background

Under present federal law, whether a worker is an employee or independent contractor with respect to the Federal Insurance Contributions Act (FICA) generally is determined under a common-law facts and circumstances test. An employer-employee relationship is generally found to exist if the service recipient has not only the right to control the result to be accomplished by the work, but also the means by which the result is to be accomplished. Whether such control exists is determined based on the relevant facts and circumstances. The IRS training manual provides that if a business requires its workers to comply with rules established by a third party (e.g., municipal building codes related to construction), the fact that such rules are imposed should be given little weight in determining the worker's status.

New Federal Law (Note to Sec. 3121(d))

Under the Act, in determining the status for purposes of FICA of a registered representative of a broker-dealer for federal tax purposes, no weight is to be given to instructions from the service recipient which are imposed only in compliance with governmental investor protection standards or investor protection standards imposed by a governing body pursuant to a delegation by a federal or state agency.

Current California Law

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

Effective Date

The federal provisions apply to services performed after December 31, 1997.

Impact on California Revenue

Defer to EDD.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
922	Clarification of Exemption from Self-Employment Tax for Certain Termination of Payments Received by Former Insurance Salesmen.

Background

Under the Self Employment Contributions Act (SECA), taxes are imposed on an individual's net earnings from self employment. In general, net earnings from self employment means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed that are attributable to that trade or business. The SECA tax rate is the same as the combined employer and employee FICA rates (i.e., 12.4% for old age, survivors, and disability income (OASDI) and 2.9% for Medicare Hospital Insurance taxes). The maximum amount of earnings subject to the OASDI portion of SECA taxes is coordinated with and is set at the same level as the maximum level of wages and salaries subject to the OASDI portion of FICA taxes ($65,400 for 1997). There is no limit on the amount of self-employment income subject to the HI portion of the tax. Certain insurance salespersons are independent contractors and therefore subject to tax under SECA. Under case law, certain payments received by a former insurance salesperson who had sold insurance as an independent contractor are not net earnings from self employment and therefore are not subject to SECA. E.g., Jackson v. Comm'r, 108 TC No. 10 (1997); Gump v. U.S., 86 F. 3d 1126 (CA FC 1996); Milligan v. Comm'r, 38 F. 3d 1094 (9th Cir. 1994).

New Federal Law (Sec. 1402)

The Act codifies case law by providing that net earnings from self employment do not include any amount received during the taxable year from an insurance company on account of services performed by such individual as an insurance salesperson for such company if: (1) the amount is received after termination of the individual's agreement to perform services for the company; (2) the individual performs no services for the company after such termination and before the close of the taxable year; (3) the amount of the payment depends solely on policies sold by the individual during the last year of the agreement and the extent to which such policies remain in force for some period after such termination, and does not depend on the length of service or overall earnings from services performed for the company; and (4) the payments are conditioned upon the salesperson agreeing not to compete with the company for at least one year following such termination. The Act also amends the Social Security Act to provide that such termination payments are not treated as earnings for purposes of determining social security benefits. No inference is intended with respect to the SECA tax treatment of payments that are not described in the Act.

Current California Law

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

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Effective Date

The federal provision is effective with respect to payments after December 31, 1997.

Impact on California Revenue

Defer to EDD.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
931	Waiver of Penalty Through June 30, 1998, on Small Businesses Failing to Make Electronic Fund Transfers of Taxes

New Federal Law (Note to Sec. 6302(h))

The Act provides that no penalty shall be imposed solely by reason of a failure to use Electronic Federal Tax Payment System (EFTPS) prior to July 1, 1998, if the taxpayer was first required to use the EFTPS system on or after July 1, 1997.

Current California Law (R&T Sec. 19011)

California law does not conform to the federal law. Instead, California law grants the FTB the authority to waive or not impose the electronic funds transfer penalty in situations in which the FTB determines in its sole discretion that the failure to comply did not jeopardize the state's interests and is not due to willful neglect or any intent not to comply. Each non-imposition or waiver must be determined on a case-by-case basis.

Effective Date

The federal provision is effective on August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
932	Home Office Deduction: Clarification of Definition of Principal Place of Business

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). Code section 280A(c)(1) provides, however, that 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 Internal Revenue Code 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. Under Internal Revenue Service (IRS) rulings, the deductibility of expenses incurred for local transportation between a taxpayer's home and a work location sometimes depends on whether the taxpayer's home office qualifies under section 280A(c)(1) as a principal place of business (see Rev. Rul. 94 47, 1994 29 I.R.B. 6). If an employer provides access to suitable space on the employer's premises for the conduct by an employee of particular duties, then, if the employee opts to conduct such duties at home as a matter of personal preference, the employee's use of the home office is not “for the convenience of the employer.” (e.g., W. Michael Mathes, (1990) T.C. Memo 1990 483.)

Prior to 1976, expenses attributable to the business use of a residence were deductible whenever they were “appropriate and helpful” to the taxpayer's business. In 1976, Congress adopted IRC section 280A, in order to provide a narrower scope for the home office deduction, but did not define the term “principal place of business.” In Commissioner v. Soliman, 113 S.Ct. 701 (1993), the Supreme Court reversed lower court rulings and upheld an IRS interpretation of IRC section 280A that disallowed a home office deduction for a self-employed anesthesiologist who practiced at several hospitals but was not provided office space at the hospitals. Although the anesthesiologist used a room in his home exclusively to perform administrative and management activities for his profession (i.e., he spent two or three hours a day in his home office on bookkeeping, correspondence, reading medical journals, and communicating with surgeons, patients, and insurance companies), the Supreme Court upheld the IRS position that the principal place of business for the taxpayer was not the home office, because the taxpayer performed the “essence of the professional service” at the hospitals. Because the taxpayer did not meet with patients at his home office and the room was not a separate structure, a deduction was not available under the second or third exception under IRC section 280A(c)(1). In response to the Supreme Court's decision in

Soliman, the IRS revised its Publication 587, Business Use of Your Home, to more closely follow the comparative analysis used in Soliman by focusing on the following two primary factors in determining whether a home office is a taxpayer's principal place of business: (1) the relative importance of the Activities performed at each business location; and (2) the amount of time spent at each location.

Section 280A(c)(2) contains 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 or product samples 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. 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 amends Section 280A to specifically provide that a home office qualifies as the “principal place of business” if (1) the office is used by the taxpayer to conduct administrative or management activities of a trade or business and (2) there is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities of the trade or business.

As under present law, deductions will be allowed for a home office meeting the above two-part test only if the office is exclusively used on a regular basis as a place of business by the taxpayer and, in the case of an employee, only if such exclusive use is for the convenience of the employer. Thus, under the Act, a home office deduction is allowed (subject to the present-law “convenience of the employer” rule governing employees) if a portion of a taxpayer's home is exclusively and regularly used to conduct administrative or management activities for a trade or business of the taxpayer, who does not conduct substantial administrative or management activities at any other fixed location of the trade or business, regardless of whether administrative or management activities connected with his trade or business (e.g., billing activities) are performed by others at other locations. The fact that a taxpayer also carries out administrative or management activities at sites that are not fixed locations of the business, such as a car or hotel room, will not affect the taxpayer's ability to claim a home office deduction under the Act. Moreover, if a taxpayer conducts some administrative or management activities at a fixed location of the business outside the home, the taxpayer still is eligible to claim a deduction so long as the administrative or management activities conducted at any fixed location of the business outside the home are not substantial (e.g., the taxpayer occasionally does minimal paperwork at another fixed location of the business). In addition, a taxpayer's eligibility to claim a home office deduction under the Act will not be affected by the fact that the taxpayer conducts substantial non-administrative or non-management business activities at a fixed location of the business outside the home (e.g., meeting with, or providing services to, customers, clients, or patients at a

fixed location of the business away from home). If a taxpayer in fact does not perform substantial administrative or management activities at any fixed location of the business away from home, then the second part of the test will be satisfied, regardless of whether the taxpayer opted not to use an office away from home that was available for the conduct of such activities. However, in the case of an employee, the question whether an employee chose not to use suitable space made available by the employer for administrative activities is relevant to determining whether the present-law "convenience of the employer" test is satisfied. In cases where a taxpayer's use of a home office does not satisfy the provision's two-part test, the taxpayer nonetheless may be able to claim a home office deduction under the present-law "principal place of business" exception or any other provision of section 280A.

Current California Law (R&T Sec. 17201)

The California Personal Income Tax Law is fully conformed to the federal law as it relates to a home office deduction as it read on January 1, 1997.

Effective Date

The federal provision is effective for taxable years beginning after December 31, 1998.

Impact on California Revenue

This proposal is estimated to impact revenues as shown in the following table.

Fiscal Year Cash Flow Taxable Years Beginning After December 31, 1998 $ Millions		
1998-9	1999-0	2000-01
($3)	($8)	($9)

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

The revenue impact for this provision would depend on those individuals who work at home and claim deductions for home office expenses related to administrative activities and the average marginal tax rate applicable to the deduction amounts. The revenue estimate above is based on federal projections.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
933	Averaging of Farm Income Over Three Years

Background

The ability of an individual taxpayer to reduce his or her tax liability by averaging his or her income over a number of years was repealed by the Tax Reform Act of 1986.

New Federal Law (Sec. 1301)

The Act provides that an individual taxpayer is allowed to elect to compute his or her current year tax liability by averaging, over the prior three-year period, all or a portion of his or her taxable income from the trade of business of farming.

The Act provides that the provision operates such that an electing eligible taxpayer (1) designates all or a portion of his or her taxable income from the trade or business of farming from the current year as “elected farm income;” (2) allocates one-third of such elected farm income to each of the prior three taxable years; and (3) determines his or her current year section 1 tax liability by determining the sum of (a) his or her current year section 1 liability without the elected farm income allocated to the three prior taxable years plus (b) the increases in the IRC section 1 tax for each of the three prior taxable years by taking into account the allocable share of the elected farm income for such years. If a taxpayer elects the operation the provision for a taxable year, the allocation of elected farm income among taxable years pursuant to the election shall apply for purposes of any election in a subsequent taxable year. The provision does not apply for employment tax purposes, or to an estate or a trust. Further, the provision does not apply for purposes of the alternative minimum tax under IRC section 55. Finally, the provision does not require the recalculation of the tax liability of any other taxpayer, including a minor child required to use the tax rates of his or her parents under IRC section 1(g). The election shall be made in the manner prescribed by the Secretary of the Treasury and, except as provided by the Secretary, shall be irrevocable. In addition, the Secretary of the Treasury shall prescribe such regulations as are necessary to carry out the purposes of the provision, including regulations regarding the order and manner in which items of income, gain, deduction, loss, and credits (and any limitations thereon) are to be taken into account for purposes of the provision and the application of the provision to any short taxable year. It is expected that such regulations will deny the multiple application of items that carryover from one taxable year to the next (e.g., net operating loss or tax credit carryovers).

Current California Law

California law does not provide for income averaging.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Effective Date

The federal provision applies to taxable years beginning after December 31, 1997, and before January 1, 2001.

Impact on California Revenue

Revenue losses under the Personal Income Tax Law are estimated as follows:

Estimated Revenue Impact Effective January 1, 1998 (in millions)		
1997-8	1998-9	1999-0
* Minor Loss	($2)	($2)

* 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.

Revenue losses would depend on the number of farmers making the election and the reduction in reported taxable income due to three-year averaging of fluctuating income.

The impact above is based on federal estimates.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
934	Increase in Deduction for Health Insurance Costs of Self-Employed Individuals

Background

Prior to the passage of this Act, self-employed individuals were entitled to deduct the amount paid for health insurance for the self-employed individual and the individual's spouse and dependents as follows:

40% in 1997,
45% in 1998 through 2002,
50% in 2003,
60% in 2004,
70% in 2005
80% in 2006, and thereafter.

The deduction for health insurance expenses of self-employed individuals is not available for any month in which the taxpayer is eligible to participate in a subsidized health plan maintained by the employer of the taxpayer or the taxpayer's spouse. Under present law, employees can exclude from income 100% of employee-provided health insurance.

New Federal Law (Sec. 162(l))

The Act increases the deduction for self-employed health insurance as follows:

40% in 1997,
45% in 1998 and 1999,
50% in 2000 and 2001,
60% in 2002,
80% in 2003 through 2005,
90% in 2006, and
100% in 2007 and thereafter.

Current California Law (R&T Sec. 17273)

The California Personal Income Tax Law for taxable years before 1997 was conformed to the federal law as it read on January 1, 1993, thereby providing a deduction of 25%. However, for the 1997 taxable year only, California conformed to the federal changes noted above, thereby providing a 40% deduction for 1997 taxable years. For 1998 and later years, California law specifically provides that the deduction for self-employed individuals for health insurance is 25%.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

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.

Fiscal Year Cash Flow Impact Effective 1/1/97 $ Millions									
1997-8	1998-9	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
(minor*)	($18)	($18)	($23)	($30)	($51)	($76)	($87)	($105)	($140)

* Loss 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.

The revenue impact of this provision would 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 based on personal income data. A $9 million tax loss will occur for 1997-98 due to passage of SB 1233.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
935	Moratorium on Self Employment Taxes of Limited Partners Regulations

New Federal Law (Sec. 1402(a)(13))

Under the Self Employment Contributions Act, taxes are imposed on an individual’s net earnings from self employment. A limited partner's net earnings from self employment include guaranteed payments made to the individual for services actually rendered and do not include a limited partner's distributive share of the income or loss of the partnership. The Department of the Treasury has issued proposed regulations defining a limited partner for this purpose. These regulations provide, among other things, that an individual is not a limited partner if the individual participates in the partnership business for more than 500 hours during the taxable year. The regulations are proposed to be effective beginning with the individual's first taxable year beginning on or after the date the regulations are published as final regulations in the Federal Register.

The Act provides that any regulations relating to the definition of a limited partner for self-employment tax purposes shall not be issued or effective before July 1, 1998.

Current California Law

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

Impact on California Revenue

Defer to EDD.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
941	Expensing of Environmental Remediation Costs ("Brownfields")

Background

IRC section 162 allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business. Treasury Regulations provide that the cost of incidental repairs which neither materially add to the value of property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted currently as a business expense. IRC section 263(a)(1) limits the scope of IRC section 162 by prohibiting a current deduction for certain capital expenditures. Treasury Regulations define "capital expenditures" as amounts paid or incurred to materially add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or to adapt property to a new or different use. Amounts paid for repairs and maintenance do not constitute capital expenditures. The determination of whether an expense is deductible or capitalizable is based on the facts and circumstances of each case.

Treasury regulations provide that capital expenditures include the costs of acquiring or substantially improving buildings, machinery, equipment, furniture, fixtures and similar property having a useful life substantially beyond the current year. In INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039 (1992), the Supreme Court required the capitalization of legal fees incurred by a taxpayer in connection with a friendly takeover by one of its customers on the grounds that the merger would produce significant economic benefits to the taxpayer extending beyond the current year; capitalization of the costs thus would match the expenditures with the income produced. Although Treasury regulations provide that expenditures that materially increase the value of property must be capitalized, they do not set forth a method of determining how and when value has been increased. In Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333 (1962), nonacq., the U.S. Tax Court held that increased value was determined by comparing the value of an asset after the expenditure with its value before the condition necessitating the expenditure. The Tax Court stated that "an expenditure which returns property to the state it was in before the situation prompting the expenditure arose, and which does not make the relevant property more valuable, more useful, or longer-lived, is usually deemed a deductible repair."

In several Technical Advice Memoranda (TAM), the Internal Revenue Service (IRS) declined to apply the Plainfield Union valuation analysis, indicating that the analysis represents just one of several alternative methods of determining increases in the value of an asset. In TAM 9240004 (June 29, 1992), the IRS required certain asbestos removal costs to be capitalized rather than expensed. In that instance, the taxpayer owned equipment that was manufactured with insulation containing asbestos; the taxpayer replaced the asbestos insulation with less thermally efficient, non-asbestos insulation. The IRS concluded that the expenditures resulted in a material increase in the value of the equipment because the asbestos removal eliminated human health risks, reduced the risk of

liability to employees resulting from the contamination, and made the property more marketable. Similarly, in TAM 9411002 (November 19, 1993), the IRS required the capitalization of expenditures to remove and replace asbestos in connection with the conversion of a boiler room to garage and office space. However, the IRS permitted deduction of costs of encapsulating exposed asbestos in an adjacent warehouse.

In 1994, the IRS issued Rev. Rul. 94-38, 1994 1 C.B. 35, holding that soil remediation expenditures and ongoing water treatment expenditures incurred to clean up land and water that a taxpayer contaminated with hazardous waste are deductible. In this ruling, the IRS explicitly accepted the Plainfield Union valuation analysis. However, the IRS also held that costs allocable to constructing a groundwater treatment facility are capital expenditures. Rev. Rul. 94-38 generally rendered moot the holding in TAM 9315004 (December 17, 1992) requiring a taxpayer to capitalize certain costs associated with the remediation of soil contaminated with polychlorinated biphenyls (PCBs).

In 1995, the IRS issued TAM 9541005 (October 13, 1995) requiring a taxpayer to capitalize certain environmental study costs, as well as associated consulting and legal fees. The taxpayer acquired the land and conducted activities causing hazardous waste contamination. After the contamination, but before it was discovered, the company donated the land to the county to be developed into a recreational park. After the county discovered the contamination, it reconveyed the land to the company for $1. The company incurred the costs in developing a remediation strategy. The IRS held that the costs were not deductible under section 162 because the company acquired the land in a contaminated state when it purchased the land from the county. In January, 1996, the IRS revoked and superseded TAM 9541005 (PLR 9627002). Noting that the company's contamination of the land and liability for remediation were unchanged during the break in ownership by the county, the IRS concluded that the break in ownership should not, in and of itself, operate to disallow a deduction under section 162.

New Federal Law (Sec. 198)

The Act provides that taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred. The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site does not constitute a qualified environmental remediation expenditure. However, depreciation deductions allowable for such property that would otherwise be allocated to the site under the principles set forth in Comm'r v. Idaho Power Co. and IRC section 263A are treated as qualified environmental remediation expenditures. (Comm'r v. Idaho Power Co., 418 U.S. 1 (1974) holding that equipment depreciation allocable to the taxpayer's construction of capital facilities must be capitalized under section 263(a)(1)).

A "qualified contaminated site" generally is any property that (1) is held for use in a trade or business, for the production of income, or as inventory; (2) is certified by the appropriate state environmental agency to be located within a targeted area; and (3) contains (or potentially contains) a hazardous substance (so-called "brownfields"). Targeted areas would mean (1) empowerment zones and enterprise communities as designated under present law and under the Act (including any supplemental empowerment zone designated on December 21, 1994); (2) sites announced before February 1997, as being subject to one of the 76 Environmental Protection Agency (EPA) Brownfields Pilots; (3) any population census tract with a poverty rate of 20% or more; and (4) certain industrial and commercial areas that are adjacent to tracts described in (3) above. Both urban and rural sites qualify. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) cannot be targeted areas.

With respect to certification of targeted areas, the Act provides that the chief executive officer of a state may, in consultation with the Administrator of the EPA, designate an appropriate state environmental agency. If no state environmental agency is so designated within 60 days of the date of enactment, the appropriate environmental agency for such state shall be designated by the Administrator of the EPA.

Hazardous substances generally are defined by reference to sections 101(14) and 102 of CERCLA, subject to additional limitations applicable to asbestos and similar substances within buildings, certain naturally occurring substances such as radon, and certain other substances released into drinking water supplies due to deterioration through ordinary use.

The Act further provides that, in the case of property to which a qualified environmental remediation expenditure otherwise would have been capitalized, any deduction allowed under the Act is treated as a depreciation deduction and the property is treated as subject to section 1245 property. Thus, deductions for qualified environmental remediation expenditures would be subject to recapture as ordinary income upon sale or other disposition of the property.

Current California Law (R&T Secs. 17201 and 24343)

California law generally conforms to the federal trade or business expense deduction provisions. In addition, California provides certain special business expense deductions. For instance, a business located in an economic development area may elect to deduct as a business expense a specified amount of the cost of qualified property purchased for exclusive use in the economic development area.

California law is not conformed to the new federal "brownfields" business expense deduction.

Effective Date

The provision applies to eligible expenditures paid or incurred in taxable years ending after August 5, 1997, and before January 1, 2001.

Impact on California Revenue

Revenue losses from this provision are estimated to be:

Estimated Revenue Impact Effective After January 1, 1998 Enactment Assumed After June 30, 1998 (in millions)			
	1998-9	1999-0	2000-1
Personal Income Tax	($1)	($1)	Minor loss
Bank & Corporation Tax	($6)	($5)	($2)
Total	($7)	($6)	($2)

* 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.

The revenue effect for this provision would depend on accelerated deductions taken by taxpayers electing to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred.

The impact above was based on federal estimates. Revenue losses drop off because of depreciation interaction.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
951-56	Additional Empowerment Zones; Modification of Criteria

New Federal Law (Secs. 1391, 1392, 1394, 1396, 1397A, 1397B)

Under the Act, the Secretary of the Department of Housing and Urban Development (HUD) is authorized to designate two additional empowerment zones located in urban areas (thereby increasing to 11 the total number of empowerment zones) with respect to which generally apply the same tax incentives (i.e., the wage credit, additional expensing, and special tax-exempt financing) as are available within the empowerment zones authorized under existing federal law.

In addition, the Act provides for the designation of 20 additional empowerment zones pursuant to slightly expanded eligibility criteria, and includes certain modifications to the definition of an enterprise zone business and the tax-exempt financing rules. Within the 20 additional empowerment zones, qualified "enterprise zone businesses" are eligible to receive up to $20,000 of additional section 179 expensing and to utilize special tax-exempt financing benefits. The "brownfields" tax incentive provided under the Act also is available within all designated empowerment zones. Businesses within the 20 additional empowerment zones are not, however, eligible to receive the present-law wage credit available within the 11 other designated empowerment zones (i.e., the wage credit would be available only in the nine present-law zones and two new urban empowerment zones designated under the Act). The 20 additional empowerment zones are required to be designated before 1999, and the designations generally will remain in effect for 10 years.

The Act allows "new empowerment zone facility bonds" to be issued for qualified enterprise zone businesses in the 20 additional empowerment zones. These bonds are not subject to the state private activity bond volume caps or the special limits on issue size applicable to qualified enterprise zone facility bonds under present law. The maximum amount of these bonds that can be issued is limited to $60 million per rural zone, $130 million per urban zone with a population of less than 100,000, and $230 million per urban zone with a population of 100,000 or more.

The Act modifies the present-law empowerment zone and enterprise community designation criteria under section 1392 so that, in the event that additional empowerment zones or enterprise communities are authorized to be designated in the future, any zones or communities designated in the states of Alaska or Hawaii will not be subject to the general size limitations under section 1392(a)(3), nor will such zones or communities be subject to the general poverty-rate criteria under section 1392(a)(4).

The Act waives until the end of a "startup period" the requirement that 95% or more of the proceeds of bond issue be used by a qualified enterprise zone business. The Act also waives the requirements of an enterprise zone business (other than the requirement that at least 35% of the business' employees be residents of the zone or community) for all years after a prescribed testing

period equal to first three taxable years after the startup period. Further, the Act relaxes the rehabilitation requirement for financing existing property with qualified enterprise zone facility bonds.

The Act modifies the present-law requirement that an entity may qualify as an "enterprise zone business" only if (in addition to the other present-law criteria) at least 80% of the total gross income of such entity is derived from the Active conduct of a qualified business within an empowerment zone or enterprise community. The Act reduces the percentage threshold so that an entity could qualify as an enterprise zone business if at least 50% of the total gross income of such entity is derived from the active conduct of a qualified business within an empowerment zone or enterprise community (assuming that the other criteria of section 1397B are satisfied).

In addition, section 1397B is modified so that rather than requiring that "substantially all" tangible and intangible property (and employee services) of an enterprise zone business be used (and performed) within a designated zone or community, a "substantial portion" of tangible and intangible property (and employee services) of an enterprise zone business would be required to be used (and performed) within a designated zone or community. Moreover, the Act further amends the IRC section 1397B rule governing intangible assets so that a substantial portion of an entity's intangible property must be used in the active conduct of a qualified business within a zone or community, but there is no need (as under present law) to determine whether the use of such assets is "exclusively related to" such business. However, the present-law rule of section 1397B(d)(4) continues to apply, such that a qualified business would not include any trade or business consisting predominantly of the development or holding or intangibles for sale or license. The Act also clarifies that an enterprise zone business that leases to others commercial property within a zone or community may rely on a lessee's certification that the lessee is an enterprise zone business.

Finally, the Act provides that the rental to others of tangible personal property shall be treated as a qualified business if and only if at least 50% of the rental of such property is by enterprise zone businesses or by residents of a zone or community (rather than the present-law requirement that "substantially all" tangible personal property rentals of an enterprise zone business satisfy this test). This modified "enterprise zone business" definition applies to all previously designated empowerment zones and enterprise communities, the two urban empowerment zones designated under the Act, as well as to the 20 additional empowerment zones authorized to be designated pursuant to the Act.

Current California Law

Existing state law does not conform to the federal economic development area provisions. Instead, California provides for the designation of the following economic development areas: 39 enterprise zones, five local agency military base recovery areas, one targeted tax area, and two manufacturing enhancement

areas. California allows the following tax incentives to qualifying businesses operating in economic development areas:

Types of Incentives	EZ	LAMBRA	TTA	MEA
Sales or Use Tax Credit	X	X	X	
Hiring Credit	X	X	X	X
Construction Hiring Credit				
Employee Wage Credit	X			
Business Expense Deduction	X	X	X	
Net Interest Deduction	X			
Net Operating Loss	X	X	X	

Effective Date

The two additional urban empowerment zones must be designated by February 1, 1998, but the designation will not take effect before January 1, 2000. The 20 additional empowerment zones are to be designated after August 5, 1997, but prior to January 1, 1999. For purposes of the additional IRC section 179 expensing available within empowerment zones. The modifications to the definition of “enterprise zone business” are effective for taxable years beginning on or August 5, 1997. The changes to the tax-exempt financing rules are effective for qualified enterprise zone facility bonds and the new empowerment zone facility bonds issued after August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
961	Shrinkage Estimates for Inventory Accounting

Background

IRC Section 471(a) provides that "whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income." Where a taxpayer maintains book inventories in accordance with a sound accounting system, the net value of the inventory will be deemed to be the cost basis of the inventory, provided that such book inventories are verified by physical inventories at reasonable intervals and adjusted to conform therewith. The physical count is used to determine and adjust for certain items, such as undetected theft, breakage, and bookkeeping errors, collectively referred to as "shrinkage."

Some taxpayers verify and adjust their book inventories by a physical count taken on the last day of the taxable year. Other taxpayers may verify and adjust their inventories by physical counts taken at other times during the year. Still other taxpayers take physical counts at different locations at different times during the taxable year (cycle counting).

If a physical inventory is taken at year-end, the amount of shrinkage for the year is known. If a physical inventory is not taken at year-end, shrinkage through year-end will have to be based on an estimate, or not taken into account until the following year. In the first decision in Dayton Hudson v. Commissioner , 101 T.C. 462 (1993), the U.S. Tax Court held that a taxpayer's method of accounting may include the use of an estimate of shrinkage occurring through year-end, provided the method is sound and clearly reflects income. In the second decision in Dayton Hudson v. Commissioner, the U.S. Tax Court adhered to this holding. However, the U.S. Tax Court in the second decision determined that this taxpayer had not established that its method of accounting clearly reflected income. Other cases decided by the U.S. Tax Court have held that taxpayers' methods of accounting that included shrinkage estimates do clearly reflect income.

The U.S. Tax Court in the second Dayton Hudson opinion noted, "In most cases, generally accepted accounting principles (GAAP), consistently applied, will pass muster for tax purposes. The Supreme Court has made clear, however, that GAAP does not enjoy a presumption of accuracy that must be rebutted by the Commissioner."

New Federal Law (Sec. 471(b))

The Act provides that a method of keeping inventories will not be considered unsound, or to fail to clearly reflect income, solely because it includes an adjustment for the shrinkage estimated to occur through year-end, based on inventories taken other than at year-end. Such an estimate must be based on actual physical counts. Where such an estimate is used in determining ending inventory balances, the taxpayer is required to take a physical count of inventories at each location on a regular and consistent basis. A taxpayer is required to adjust its ending inventory to take into account all physical counts performed through the end of its taxable year.

The Joint Committee on Taxation expects that the Secretary of the Treasury will issue guidance establishing one or more safe harbor methods for the estimation of inventory shrinkage that will be deemed to result in a clear reflection of income, provided such safe harbor method is consistently applied and the taxpayer's inventory methods otherwise satisfy the clear reflection of income standard. The Joint Committee Report states that in the case of taxpayers primarily engaged in retail trade (the resale of personal property to the general public), where physical inventories are normally taken at each location at least annually, the conferees anticipate that a safe harbor method will be established that will use a historical ratio of shrinkage to sales, multiplied by total sales between the date of the last physical inventory and year-end. This historical ratio is based on the actual shrinkage established by all physical inventories taken during the most recent three taxable years and the sales for related periods. The historical ratio should be separately determined for each store or department in a store of the taxpayer. The historical ratio, or estimated shrinkage determined using the historical ratio, cannot be adjusted by judgmental or other factors (e.g., floors or caps). Estimated shrinkage determined in accordance with the consistent application of the safe harbor method will not be required to be recalculated, through a lookback adjustment or otherwise, to reflect the results of physical inventories taken after year-end. In the case of a new store or department in a store that has not verified shrinkage by a physical inventory in each of the most recent three taxable years, the historical ratio is the average of the historical ratios of the retailer's other stores or departments. Retailers using last in, first out (LIFO) methods of inventory are expected to be required to allocate shrinkage among their various inventory pools in a reasonable and consistent manner. The federal conference committee report states that procedures will be provided allowing an automatic election of such method of accounting for a taxpayer's first taxable year ending after August 5, 1997.

The committee reports indicate that no inference is intended by the adoption of this provision with regard to whether any particular method of accounting for inventories is permissible under present law.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Current California Law (R&T Secs. 17551, 24701)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to the valuation of inventory.

Effective Date

The provision is effective for taxable years ending after August 5, 1997. A taxpayer is permitted to change its method of accounting by this section if the taxpayer is currently using a method that does not utilize estimates of inventory shrinkage and wishes to change to a method for inventories that includes shrinkage estimates based on physical inventories taken other than at year-end. Such a change is treated as a voluntary change in method of accounting, initiated by the taxpayer with the consent of the Secretary of the Treasury, provided the taxpayer changes to a permissible method of accounting and any adjustment required by section 481 as a result of the change in method of accounting generally will be taken into account over a period of four years.

Impact on California Revenue

Estimated revenue losses are projected as follows:

Estimated Revenue Impact of Sec. 961 Inventory Shrinkage Allowance Federal Enactment Date (In $Millions)			
Fiscal Years	1997-8	1998-9	1999-0
Revenue Impact	(minor)	($1)	($1)

(Minor means less than $500,000)

Revenue losses will depend on the amount of shrinkage estimates used to adjust inventories in any given tax year, the impact on reported income, and the marginal tax rates of retailers. State estimates are based on federal projections.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
962	Treatment of Worker’s Compensation Liability under Rules for Certain Personal Injury Liability Assignments

Background

An exclusion from gross income is provided for amounts received for agreeing to a qualified assignment to the extent that the amount received does not exceed the aggregate cost of any qualified funding asset. A qualified assignment means any assignment of a liability to make periodic payments as damages (whether by suit or agreement) on account of a personal injury or sickness (in a case involving physical injury or physical sickness), provided the liability is assumed from a person who is a party to the suit or agreement, and the terms of the assignment satisfy certain requirements. Generally, these requirements are that: (1) the periodic payments are fixed as to amount and time; (2) the payments cannot be accelerated, deferred, increased, or decreased by the recipient; (3) the assignee's obligation is no greater than that of the assignor; and (4) the payments are excludable by the recipient under section 104(a)(2) as damages on account of personal injuries or sickness.

Federal law provides a separate exclusion under section 104(a)(1) for the recipient of amounts received under worker’s compensation acts as compensation for personal injuries or sickness, but a qualified assignment under section 130 does not include the assignment of a liability to make such payments.

New Federal Law (Sec. 130)

The Act extends the exclusion for qualified assignments under Code section 130 to amounts assigned for assuming a liability to pay compensation under any worker’s compensation act. The provision requires that the assignee assume the liability from a person who is a party to the worker’s compensation claim, and requires that the periodic payment be excludable from the recipient's gross income under section 104(a)(1), in addition to the requirements of present law.

Current California Law (R&T Sec. 17131)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to exclusion of worker’s compensation claims.

Effective Date

Effective for worker’s compensation claims filed after August 5, 1997.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Impact on California Revenue

Based on the impact projected for the federal law change, conforming to this change would be minor, losses less than $500,000 annually.

Revenue losses would depend on the amount of additional worker's compensation excluded in any given tax year under structured settlements and the marginal tax rates of affected recipients. The revenue impact was based on federal projections.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
963	Tax-Exempt Status for State Worker's Compensation Act Companies

Background

In general, the IRS takes the position that organizations that provide insurance for their members or other individuals are not considered to be engaged in a tax-exempt activity. The IRS maintains that such insurance activity is either (1) a regular business of a kind ordinarily carried on for profit, or (2) an economy or convenience in the conduct of members' businesses because it relieves the members from obtaining insurance on an individual basis. However, certain insurance risk pools have qualified for tax exemption under Code section 501(c)(6). In general, these organizations (1) assign any insurance policies and administrative functions to their member organizations (although they may reimburse their members for amounts paid and expenses), (2) serve an important common business interest of their members, and (3) must be membership organizations financed, at least in part, by membership dues. State insurance risk pools may also qualify for tax exempt status under section 501(c)(4) as a social welfare organizations or under section 115 as serving an essential governmental function of a state. In seeking qualification under section 501(c)(4), insurance organizations generally are constrained by the restrictions on the provision of commercial-type insurance contained in section 501(m). Section 115 generally provides that gross income of a state or political subdivision thereof does not include income derived from the exercise of any essential governmental function and accruing to a state or any political subdivision thereof.

New Federal Law (Sec. 501)

The Act clarifies the tax-exempt status of any organization that is created by state law and organized and operated exclusively to provide worker's compensation insurance and related coverage that is incidental to worker's compensation insurance. The worker's compensation insurance must be required by state law, or be insurance with respect to which state law provides significant disincentives if it is not purchased by an employer (such as loss of exclusive remedy or forfeiture of affirmative defenses such as contributory negligence). The organization must provide worker's compensation to any employer in the state (for employees in the state or temporarily assigned out-of-state) seeking such insurance and meeting other reasonable requirements. The state must extend its full faith and credit to the initial debt of the organization. For this purpose, the initial operating capital can be provided from the proceeds of bonds issued by a state authority; the bonds may be repaid through exercise of the state's taxing authority, for example. For periods after August 5, 1997, either the assets of the organization must revert to the state upon dissolution, or state law must not permit the dissolution of the organization, absent an act of the state legislature. Should dissolution of the organization become permissible under applicable state law, then the the assets of the organization are required to revert to the state upon dissolution. Finally, the majority of the board of directors (or comparable

oversight body) of the organization must be appointed by an official of the executive branch of the state or by the state legislature, or by both.

Many organizations described in the provision have been operating as organizations that are exempt from tax (e.g., as an organization that is exempt from tax because it is serving an essential governmental function of a state). No inference is intended that organizations described in the provision are not exempt from tax under present law. In addition, no inference is intended that the benefit plans of such organizations are not properly maintained by the organization. It is anticipated that federal regulatory agencies will take appropriate action to address transition issues faced by organizations to conform to their benefit plans under the provision. For example, it is intended that an organization that has been maintaining a section 457 plan as an agency or instrumentality of a state could (without creating any inference with respect to present-law treatment) freeze future contributions to the section 457 plan and establish a retirement arrangement (e.g., a section 401(k) plan) that is consistent with the treatment of the organization as a tax-exempt employer under the provision.

Current California Law

California law has stand alone language as it relates to the exempt status of an organization. California law does not assess income or franchise taxes on insurance companies. A gross premiums tax administered by the State Board of Equalization is assessed on an insurance company.

Effective Date

Taxable years beginning after December 31, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
964	Publicly Traded Partnerships - Continuation of Partnership Treatment

Background

The federal Revenue Reconciliation Act of 1987 created publicly traded partnerships (PTP) to which California conformed without exception in 1990. Under both current federal and California law, a PTP is a partnership whose interests are (1) traded on an established securities market or (2) “readily tradable on a secondary market” (or the substantial equivalent thereof). Generally, an interest is treated as readily tradable on a secondary market or its substantial equivalent if, taking into account all of the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market.

A PTP generally is treated as a corporation for tax purposes (taxed as a corporation). An exception to the rule treating the partnership as a corporation applies if 90% of the partnership's gross income consists of passive-type income, which includes (1) certain interest, (2) dividends, (3) certain real property rents, (4) gain from the sale or other disposition of real property, (5) certain income and gains relating to minerals and natural resources, and (6) gain from the sale or disposition of certain assets held for the production of income of the foregoing types (subject to an exception for certain commodities income). Other rules apply to “regulated investment companies” (RICs).

When the federal PTP rules were enacted in 1987, a 10-year grandfather rule provided that corporate tax treatment would not apply to certain “existing PTPs” only for taxable years beginning before January 1, 1998. An existing PTP was defined as any partnership if (1) it was a PTP on December 17, 1987, (2) a registration statement indicating that the partnership was to be a PTP was filed with the Securities and Exchange Commission with respect to the partnership on or before December 17, 1987, or (3) with respect to the partnership, an application was filed with a state regulatory commission on or before December 17, 1987, seeking permission to restructure a portion of a corporation as a PTP. A partnership that otherwise would be treated as an existing PTP ceases to be so treated as of the first day after December 17, 1987, on which there has been an addition of a substantial new line of business with respect to such partnership. A coordination rule (between the grandfather rule and 90% of passive-type income exception) provides that the gross income exception applies only after the grandfather rule expires.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

New Federal Law (Sec. 7704)

Effective for taxable years beginning after December 31, 1997, the Actprovides that a "existing PTP" that is presently exempt from corporate tax under the grandfather rule may elect to continue its partnership status indefinitely. An "electing 1987 partnership" would lose its partnership status on the first day it adds a substantial new line of business. A PTP that previously used the 90% of passive-type income exception cannot elect to continue to be treated as a partnership (but still may qualify for the 90% of passive-type income exception).

The Act provides that an electing 1987 partnership must consent to pay an annual tax of 3.5% of its trade or business gross income. The tax cannot be offset by any credits. Trade or business gross income includes the electing 1987 partnership's distributive share of the trade or business income of any other partnership in which the electing 1987 partnership has an interest. A similar applies rule to lower-tiered partnerships. The election to remain a partnership and the consent to be taxed on gross income remains in effect until revoked by the partnership (the Internal Revenue Service's consent is not required). Once revoked, the election cannot be reinstated.

Current California Law (R&T Secs. 17008.5, 23038.53)

SB 455 (Stat. 1997, Ch 611) conformed California law to federal law changes made by the Taxpayer Relief Act of 1997 as it relates to electing 1987 partnerships. California law conformed with one exception; in lieu of the 3.5% federal tax, a 1% tax on trade or business gross income will be assessed. California law also requires that the federal treatment of a PTP (corporation or partnership) be binding for California purposes, so that no separate state election is permitted.

Effective Date

Effective for taxable years beginning after December 31, 1997.

Impact on California Revenue

This provision was conformed to in SB 455.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
965	Exclusion from UBIT for Certain Corporate Sponsorship Payments

Background

Although generally exempt from Federal income tax, tax-exempt organizations 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. Contributions or gifts received by tax-exempt organizations generally are not subject to the UBIT. However, present-law section 513(c) provides that an activity (such as advertising) does not lose its identity as a separate trade or business merely because it is carried on within a larger complex of other endeavors. If a tax-exempt organization receives sponsorship payments in connection with an event or other activity, the solicitation and receipt of such sponsorship payments may be treated as a separate activity. The Internal Revenue Service (IRS) has taken the position that, under some circumstances, such sponsorship payments are subject to the UBIT. (See United States v. American College of Physicians, 475 U.S. 834 (1986), holding that theactivity of selling advertising in medical journals was not substantially related to the organization's exempt purposes and, as a separate business under section 513(c), was subject to tax). See Prop. Treas. Reg. sec. 1.513-4 (issued January 19, 1993). This proposed regulation generally excludes from the UBIT financial arrangements under which the tax-exempt organization provides so-called “institutional” or “good will” advertising to a sponsor (i.e., arrangements under which a sponsor's name, logo, or product line is acknowledged by the tax-exempt organization). However, specific product advertising (e.g., comparative or qualitative descriptions of the sponsor's products) provided by a tax-exempt organization on behalf of a sponsor is not shielded from the UBIT under the proposed regulations.

New Federal Law (Sec. 513(i))

Under the Act, “qualified sponsorship payments” received by a tax-exempt organization (or state college or university described in section 511(a)(2)(B)) are exempt from the UBIT. Qualified sponsorship payments are defined as any payment made by a person engaged in a trade or business with respect to which the person will receive no substantial return benefit other than the use or acknowledgment of the name or logo (or product lines) of the person's trade or business in connection with the organization's activities. Such a use or acknowledgment does not include advertising of such person's products or services--meaning qualitative or comparative language, price information or other indications of savings or value, or an endorsement or other inducement to purchase, sell, or use such products or services. Thus, for example, if, in return for receiving a sponsorship payment, an organization promises to use the sponsor's name or logo in acknowledging the sponsor's support for an educational or fundraising event conducted by the organization, such payment will not be subject to the UBIT. In contrast, if the organization provides advertising of a sponsor's products, the payment made to the organization by

the sponsor in order to receive such advertising will be subject to the UBIT (provided that the other, present-law requirements for UBIT liability are satisfied). In determining whether a payment is a qualified sponsorship payment, it is irrelevant whether the sponsored activity is related or unrelated to the organization's exempt purpose.

The Act specifically provides that a qualified sponsorship payment does not include any payment where the amount of such payment is contingent, by contract or otherwise, upon the level of attendance at an event, broadcast ratings, or other factors indicating the degree of public exposure to an activity. However, the fact that a sponsorship payment is contingent upon an event actually taking place or being broadcast, in and of itself, will not cause the payment to fail to be a qualified sponsorship payment. Moreover, mere distribution or display of a sponsor's products by the sponsor or the tax-exempt organization to the general public at a sponsored event, whether for free or for remuneration, will be considered to be “use or acknowledgment” of the sponsor's product lines (as opposed to advertising), and thus will not affect the determination of whether a payment made by the sponsor is a qualified sponsorship payment. The provision does not apply to the sale of advertising or acknowledgments in tax-exempt organization periodicals. For this purpose, the term ”periodical” means regularly scheduled and printed material published by (or on behalf of) the payee organization that is not related to and primarily distributed in connection with a specific event conducted by the payee organization. For example, the provision will not apply to payments that lead to acknowledgments in a monthly journal, but will apply if a sponsor receives an acknowledgment in a program or brochure distributed at a sponsored event. The determination if a payment for a logo or a product line acknowledgment in an organization’s periodical is subject to UBIT is made under law existing prior (and subsequent) to the passage of the TRA of 1997.

The provision specifically provides that, to the extent that a portion of a payment would (if made as a separate payment) be a qualified sponsorship payment, such portion of the payment will be treated as a separate payment. Thus, if a sponsorship payment made to a tax-exempt organization entitles the sponsor to both product advertising and use or acknowledgment of the sponsor's name or logo by the organization, then the UBIT will not apply to the amount of such payment that exceeds the fair market value of the product advertising provided to the sponsor. Moreover, the provision of facilities, services or other privileges by an exempt organization to a sponsor or the sponsor's designees (e.g., complimentary tickets, pro-am playing spots in golf tournaments, or receptions for major donors) in connection with a sponsorship payment will not affect the determination of whether the payment is a qualified sponsorship payment. Rather, the provision of such goods or services will be evaluated as a separate transaction in determining whether the organization has unrelated business taxable income from the event. In general, if such services or facilities do not constitute a substantial return benefit or if the provision of such services or facilities is a related business activity, then the payments attributable to such services or facilities will not be subject to the UBIT. Moreover, just as the provision of facilities, services or other privileges by a tax-exempt organization to a sponsor or the sponsor's designees

(complimentary tickets, pro-am playing spots in golf tournaments, or receptions for major donors) will be treated as a separate transaction that does not affect the determination of whether a sponsorship payment is a qualified sponsorship payment, a sponsor's receipt of a license to use an intangible asset (e.g., trademark, logo, or designation) of the tax-exempt organization likewise will be treated as separate from the qualified sponsorship transaction in determining whether the organization has unrelated business taxable income. The exemption provided by the provision will be in addition to other present-law exceptions from the UBIT (e.g., the exceptions for activities substantially all the work for which is performed by volunteers and for activities not regularly carried on). No inference is intended as to whether any sponsorship payment received prior to 1998 was subject to the UBIT.

In the interest of administrative convenience, the Joint Committee on Taxation encourages the Treasury Department to permit tax-exempt entities to provide combined reporting of payments that are both qualified sponsorship payments and nontaxable payments made in exchange for donor acknowledgements in a periodical or in connection with a qualified convention or trade show. In addition, to the extent tax-exempt entities are required to allocate portions of payments, the conferees encourage the Treasury Department to minimize the reporting burden associated with any such allocation. As a further clarification, the conferees intend that, as provided under Prop. Treas. Reg. sec. 1.513-4, the use of promotional logos or slogans that are an established part of the sponsor's identity would not, by itself, constitute advertising for purposes of determining whether a payment is a qualified sponsorship payment.

Current California Law (R&T Sec. 23734)

California law is in conformity with federal law as it read on January 1, 1997, as it relates to “unrelated business income” of an exempt organization and the receipt of sponsor payments.

Effective Date

The provision applies to qualified sponsorship payments solicited or received after December 31, 1997.

Impact on California Revenue

The federal estimate is cast as a negligible revenue effect. Conforming to the federal provision would have a negligible revenue effect. It is assumed the provision would be effective with payments solicited or received after December 31, 1997.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
966	Timeshare Associations

Background

Taxation of Homeowners Associations Making the Section 528 Election.

Under present law, condominium management associations and residential real estate management associations may elect to be taxable at a 30% rate on their "homeowners association income" if they meet certain income, expenditure, and organizational requirements. "Homeowners association income" is the excess of the association's gross income, excluding "exempt function income," over allowable deductions directly connected with nonexempt function gross income. Exempt function income includes membership dues, fees, and assessments for a common activity undertaken by association members or owners of residential units in the condominium or subdivision. Homeowners association income includes passive income (e.g., interest and dividends) earned on reserves and fees for use of association property (e.g., swimming pools, meeting rooms, etc.).

For an association to qualify for this treatment: (1) at least 60% of the association's gross income must consist of membership dues, fees, or assessments on owners; (2) at least 90% of its expenditures must be for the acquisition, management, maintenance, or care of "association property"; and (3) no part of its net earnings can inure to the benefit of any private shareholder. Association property means: (1) property held by the association; (2) property commonly held by association members; (3) property within the association privately held by association members; and (4) property held by a governmental unit for the benefit of association members. In addition to these statutory requirements, Treasury regulations require that the units of the association be used for residential purposes. Use is not a residential use if the unit is occupied by a person or series of persons for less than 30 days for more than half of the association's taxable year.

Taxation of Homeowners Associations Not Making the Section 528 Election.

Homeowners associations that do not (or cannot) make the section 528 election are taxed either as a tax-exempt social welfare organization under section 501(c)(4) or as a regular C corporation. In order for an organization to qualify as a tax-exempt social welfare organization, the organization must meet the following three requirements: (1) the association must serve a community which bears a reasonable, recognizable relationship to an area ordinarily identified as a governmental subdivision or unit; (2) the association may not conduct activities directed to exterior maintenance of any private residence, and (3) common areas of association facilities must be for the use and enjoyment of the general public. Non-exempt homeowners associations are taxed as C corporations, except that: (1) the association may exclude excess assessments that it refunds to its members or applies to the subsequent year's assessments; (2) gross income does not include special assessments held in a

special bank account; and (3) assessments for capital improvements are treated as non-taxable contributions to capital.

Taxation of Timeshare Associations.

Timeshare associations, prior to the passage of this Act, were taxed as regular C corporations because (1) they cannot meet the requirement of the Treasury regulations for the section 528 election that the units be used for residential purposes (i.e., the 30-day rule) and they have relatively large amount of services performed for its owners (e.g., maid and janitorial services) and (2) they cannot meet any of requirements of Rev. Rul. 74-99 for tax-exempt status under section 501(c)(4).

New Federal Law (Sec. 528)

The Act amends section 528 to permit timeshare associations to qualify for taxation under that section. Timeshare associations will have to meet the requirements of section 528 (e.g., the 60% gross income, 90% expenditure, and the non-profit organizational and operational requirements). Timeshare associations electing to be taxed under section 528 are subject to a tax on their timeshare association income at a rate of 32%.

60-Percent Test.

A qualified timeshare association must receive at least 60% of its income from membership dues, fees and assessments from owners of either (a) timeshare rights to use of, or (b) timeshare ownership in, the timeshare association property.

90-Percent Test.

At least 90% of the expenditures of the timeshare association must be for the acquisition, management, maintenance, or care of association property, and activities provided by the association to, or on behalf of, members of the timeshare association. Activities provided to or on behalf of members of the timeshare association includes events located on association property (e.g., member's meetings at the association's meeting room, parties at the association's swimming pool, golf lessons on association's golf range, transportation to and from association property, etc.).

Organizational and Operational Tests.

The Act provides that association property includes property in which a timeshare association or members of the association have rights arising out of recorded easements, covenants, and other recorded instruments to use property related to the timeshare project. No part of the net earnings of the timeshare association can inure to the benefit (other than by acquiring, constructing, or providing management, maintenance, and care of property of the timeshare association or rebate of excess membership dues, fees, or assessments) of any private shareholder or individual. A member of a qualified timeshare

association must hold a timeshare right to use (or timeshare ownership in) real property of the association. A qualified timeshare association cannot be a condominium management association. The timeshare association must elect to be taxed under section 528.

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

California law is in conformity with federal law as it relates to the taxation of homeowner associations. California treats timeshare associations as C corporations.

Effective Date

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

Impact on California Revenue

With conformity, qualifying timeshare associations would be treated similarly to homeowners associations and no longer be taxed on capital reserves, refunds of excess assessments, and prepaid assessments. This provision would result in negligible tax revenue losses, probably less than $250,000 per year, based on federal projections adjusted to reflect the state’s 8.84% tax rate.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
969	Increased Deduction for Business Meals for Individuals under Department of Transportation Limitations

Background

Ordinary and necessary business expenses, as well as expenses incurred for the production of income, are generally deductible, subject to a number of restrictions and limitations. Generally, the amount allowable as a deduction for food and beverage is limited to 50% of the otherwise deductible amount. Exceptions to this 50% rule are provided for food and beverages provided to the crew of certain vessels and offshore oil or gas platforms or drilling rigs.

New Federal Law (Sec. 274(n))

The Act increases to 80% the deductible percentage of the cost of food and beverages consumed while away from home by an individual during, or incident to, a period of duty subject to the hours of service limitations of the Department of Transportation. Individuals subject to the hours of service limitations of the Department of Transportation include:

(1) certain air transportation employees such as pilots, crew, dispatchers, mechanics, and control tower operators pursuant to Federal Aviation Administration regulations,
(2) interstate truck operators and interstate bus drivers pursuant to Department of Transportation regulations,
(3) certain railroad employees such as engineers, conductors, train crews, dispatchers and control operations personnel pursuant to Federal Railroad Administration regulations, and
(4) certain merchant mariners pursuant to Coast Guard regulations.

The increase in the deductible percentage is phased in according to the following schedule:

Taxable Years Beginning In	Deductible Percentage
1998, 1999	55
2000, 2001	60
2002, 2003	65
2004, 2005	70
2006, 2007	75
2008 and thereafter	80

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Current California Law (R&T Sec.17201)

California law is in conformity with federal law as it read on January 1, 1997, as it relates to the deduction of meals.

Effective Date

The provision is effective for taxable years beginning after 1997.

Impact on California Revenue

This revenie estimate covers Act sections 969-970.

The revenue loss of this provision under the Personal Income Tax Law is estimated as follows:

Estimated Revenue Impact		
Effective January 1, 1998		
(in millions)		
1997-8	1998-9	1999-0
* Minor Loss	($1)	($1)

* Less Than $500,000

The estimate is based on a proration of federal estimates.

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

Revenue losses from this provision would depend on the additional amount of business meal expenses that relate to individuals operating under Department of Transportation hours of service limitation that would be deductible from gross income and the average marginal tax rates of claimants.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
970	Deductibility of Meals Provided for the Convenience of the Employer

Background

In general, subject to several exceptions, only 50% of business meal and entertainment expenses are allowed as a deduction. Under one exception, the value of meals that are excludable from employees' incomes as a de minimis fringe benefit are fully deductible by the employer. In addition, the courts that have considered the issue have held that if meals are provided for the convenience of the employer pursuant to section 119, then they are fully deductible pursuant to section 274(n)(2)(B), provided they satisfy the relevant section 132 requirements.

New Federal Law (Sec. 132(e))

The Act provides that meals that are excludable from employees' incomes because they are provided for the convenience of the employer pursuant to section 119 of the code are excludable as a de minimis fringe benefit and therefore are fully deductible by the employer, provided they satisfy the relevant section 132 requirements. No inference is intended as to whether such meals were fully deductible under prior law.

Current California Law (R&T Sec. 17201)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to the deductibility of meals.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

Impact on California Revenue

Revenue estimate is included in the estimate for Act section 969.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
971	Modify Limits on Depreciation of Luxury Automobiles for Clean-Burning Fuel and Electric Vehicles

Background

The amount the taxpayer may claim as a depreciation deduction for any passenger automobile is limited to: $2,560 for the first taxable year in the recovery period; $4,100 for the second taxable year in the recovery period; $2,450 for the third taxable year in the recovery period; and $1,475 for each succeeding taxable year in the recovery period. Each of the dollar limitations is indexed for inflation after October 1987 by the automobile component of the Consumer Price Index. Consequently, the limitations applicable for 1997 are $3,160, $5,000, $3,050, and $1,775.

New Federal Law (Sec. 280F)

The Act modifies the present-law limitation on depreciation in the case of qualified clean-burning fuel vehicles and certain electric vehicles. With respect to qualified clean-burning fuel vehicles, that are modified to permit such vehicle to be propelled by a clean burning fuel, the Act generally modifies present-law by applying the current limitation to that portion of the vehicle's cost not represented by the installed qualified clean-burning fuel property. The taxpayer may claim an amount otherwise allowable as a depreciation deduction on the installed qualified clean-burning fuel, without regard to the present-law limitation. Generally, this has the same effect as subjecting only the cost of the vehicle before modification to the present-law limitations.

In the case of a passenger vehicle designed to be propelled primarily by electricity and built by an original equipment manufacturer, the base-year limitation amounts of $2,560 for the first taxable year in the recovery period, $4,100 for the second taxable year in the recovery period, $2,450 for the third taxable year in the recovery period, and $1,475 for each succeeding taxable year in the recovery period are tripled to $7,680, $12,300, $7,350, and $4,425, respectively, and then adjusted for inflation after October 1987 by the automobile component of the Consumer Price Index.

Current California Law (R&T Sec. 17201)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to depreciation of "luxury" automobiles.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Effective Date

The provision is effective for property placed in service after August5, 1997, and before January 1, 2005.

Impact on California Revenue

Based on the minor impact projected for the federal law change, conforming to this change would result in revenue losses of less than $250,000 annually beginning in 1997-8.

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

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
972	Suspension of Income Limitations on Percentage Depletion for Production from Marginal Wells

Background

The IRC permits taxpayers to recover their investments in oil and gas wells through depletion deductions. In the case of certain properties, the deductions may be determined using the percentage depletion method. Certain limitations apply in calculating percentage depletion deductions. One limitation is a restriction that these deductions may not exceed 65% of the taxpayer's taxable income. Another limitation is a restriction that the amount deducted may not exceed 100% of the net income from that property in any year. Specific percentage depletion rules apply to oil and gas production from “marginal properties. Marginal production is defined as domestic crude oil and natural gas production from stripper well property or from property from which substantially all of the production during the calendar year is heavy oil. Stripper well property is property from which the average daily production is 15 barrel equivalents or less, determined by dividing the average daily production of domestic crude oil and domestic natural gas from producing wells on the property for the calendar year by the number of wells. Heavy oil is domestic crude oil with a weighted average gravity of 20 degrees API or less (corrected to 60 degrees Fahrenheit).

New Federal Law (Sec. 613A)

The 100% of net income property limitation is suspended for domestic oil and gas production from marginal properties during taxable years beginning after December 31, 1997, and before January 1, 2000.

Current California Law (R&T Secs. 17681, 24831)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to percentage depletion of oil and gas wells.

Effective Date

The provision is effective on August 5, 1997.

Impact on California Revenue

For tax years beginning after December 31, 1997 and before January 1, 2000, this bill would suspend the 100% of net income limitation on percentage depletion for oil and gas production for marginal producers.

Estimated revenue losses are projected as follows:

Estimated Revenue Impact of Sec. 972 Income Limit Suspension for Marginal Wells Depletion Federal Enactment Date (In $Millions)			
Fiscal Years	1997-8	1998-9	1999-0
Revenue Impact	(0.5)	(1)	(0.5)

Revenue losses would depend on the additional amount of depletion deductions reported for marginal production in any particular tax year. The revenue impact was based on federal projections.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
973	Increase in Standard Mileage Rate for Purposes of Computing Charitable Deduction

Background

In general, individuals who itemize their deductions may deduct charitable contributions. For this purpose, charitable contributions include the amount of any mileage expenses incurred in connection with the charitable activities. For purposes of computing the charitable deduction for the use of a passenger automobile, the standard mileage rate is 12 cents per mile.

New Federal Law (Sec. 170(i))

The Act increases this mileage rate to 14 cents per mile.

Current California Law (R&T Sec. 17201)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to the mileage rate used for charitable contributions.

Effective Date

The provision is effective for taxable years beginning after December31, 1997.

Impact on California Revenue

The revenue loss of this provision under the Personal Income Tax Law is estimated as follows:

Estimated Revenue Impact Effective January 1, 1998 (in millions)		
1997-8	1998-9	1999-0
* Minor Loss	($2)	($2)

* Less Than $500,000

The estimate is based on a proration of federal estimates.

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

Revenue losses from this provision would depend on mileage claimed for purposes of computing the charitable deduction and the average marginal tax rates of claimants.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
974	Purchasing of Receivables by Tax-Exempt Hospital Cooperative Service Organizations

Background

Section 501(e) provides that an organization organized on a cooperative basis by tax-exempt hospitals will itself be tax-exempt if the organization is operated solely to perform, on a centralized basis, one or more of certain enumerated services for its members. These services are: data processing, purchasing (including the purchase of insurance on a group basis), warehousing, billing and collection, food, clinical, industrial engineering, laboratory, printing, communications, record center, and personnel services. An organization does not qualify under section 501(e) if it performs services other than the enumerated services.

New Federal Law (Sec. 501(e))

The Act clarifies that, for purposes of section 501(e), billing and collection services include the purchase of patron accounts receivable on a recourse basis. Thus, hospital cooperative service organizations are permitted to advance cash on the basis of member accounts receivable, provided that each member hospital retains the risk of non-payment with respect to its accounts receivable. No inference is intended with respect to taxable years prior to the effective date of this change.

Current California Law (R&T Sec. 23704)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to hospital cooperatives.

Effective Date

The provision is effective for taxable years beginning after December31, 1996.

Impact on California Revenue

Based on a negligible impact projected for the federal law change, conforming to this change would result in revenue losses of less than $250,000 annually beginning in 1997-8.

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

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
975	Provide Above-the-Line Deduction for Certain Business Expenses

Background

Under federal and state law, individuals may generally deduct ordinary and necessary business expenses in determining adjusted gross income (AGI). This deduction does not apply in the case of an individual performing services as an employee. Employee business expenses are generally deductible only as a miscellaneous itemized deduction, i.e., only to the extent all of the taxpayer's miscellaneous itemized deductions exceed 2% of the taxpayer's AGI. Employee business expenses are not allowed as a deduction for alternative minimum tax purposes.

New Federal Law (Sec. 62)

Employee business expenses relating to service as an official of a state or local government (or political subdivision thereof) are deductible in computing AGI (above the line), provided the official is compensated in whole or in part on a fee basis. Consequently, such expenses are also deductible for alternative minimum tax tax purposes.

Current California Law (R&T Sec. 17201)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to the deductibility of employee business expenses.

Effective Date

The provision is effective with respect to expenses paid or incurred in taxable years beginning after December 31, 1986.

Impact on California Revenue

Revenue losses from this provision are estimated as follows:

Estimated Revenue Impact Retroactive to 1987 (in millions)		
1997-8	1998-9	1999-0
($1)	*Minor Loss	*Minor Loss

* Loss less than $500,000

Based on the minor impact projected for the federal law change, conforming to this change would be a loss of $1 million for the first fiscal year, which includes expenses retroactive to January 1, 1987, and minor, less than $500,000, thereafter.

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

Revenue losses from this provision would depend on the additional amount of employee business expenses that relate to service of qualified officials of a state or local government that would be deductible from gross income and the average marginal tax rates of claimants.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
977	Elective Carryback of Existing Net Operating Losses of the Amtrak

Background

Generally, under prior federal law net operating losses (NOL) could be carried back to the three taxable years of the taxpayer that precede the year of the loss. Under prior federal law an NOL could also be carried forward 15 years. Section 1082 of the Act limits this carryback period to two years and extends the carryforward period to 20 years for losses arising in taxable years beginning after August 5, 1997

New Federal Law

The Act provides elective procedures that allows Amtrak to consider the tax attributes of its predecessors, which include those railroads that were relieved of their responsibility to provide intercity rail passenger service as a result of the Rail Passenger Service Act of 1970, in the use of Amtrak’s net operating losses. The benefit allowable under these procedures is limited to the lesser of: (1) 35% of Amtrak's existing qualified carryovers, (2) the net tax liability for the carryback period, or (3) $2,323,000,000. One half of the amount so calculated will be treated as a payment of the tax imposed by chapter 1 of the Internal Revenue Code of 1986 for each of the first two taxable years ending after the date of enactment.

The existing qualified carryovers are the net operating loss carryovers that are available under section 172(b) in Amtrak's first taxable year ending after September 30, 1997. The net tax liability for the carryback period is the aggregate of the net tax liability of Amtrak's railroad predecessors for all taxable years beginning before January 1, 1971, for which there is a net federal tax liability. In the case of a railroad predecessor who joined in the filing of a consolidated tax return, the net tax liability of the predecessor will be the net tax liability of the consolidated group. The net operating losses of Amtrak are required to be reduced by an amount equal to the amount obtained by Amtrak under this provision, divided by 0.35.

The Secretary of the Treasury is to adjust, as he deems appropriate, the tax account of each predecessor railroad for the carryback period to reflect the utilization of the net operating losses. The amount of the adjustment is equal to the amount of the benefit and is to be taken into consideration on the tax accounts of the predecessor railroads on a first-in, first-out basis, starting with balances for the earliest year for which any predecessor railroad has a net tax liability. No additional refund to any taxpayer other than Amtrak is to be allowed as a result of these adjustments.

The availability of the elective procedures is conditioned on Amtrak (1) agreeing to make payments of 1% of the amount it receives to each of the non-Amtrak states to offset certain transportation related expenditures and (2) using the balance for certain qualified expenses. Non-Amtrak states are those

states that are not receiving Amtrak service at any time during the period beginning on the date of enactment and ending on the date of payment. No deduction is allowed with respect to any qualified expense whose payment is attributable to the proceeds made available as a result of this provision. The basis of any property must be reduced by the portion of its cost that is attributable to such proceeds. An item of cost or expense is attributable to such proceeds if it is (1) paid from the proceeds of the refund or (2) to the extent the principal and interest of any borrowings are paid from the proceeds of the refund, from the proceeds of such borrowings. Amtrak's earnings and profits will be increased by the amount of the refund. However, Congress expects that this amount will not be included in adjusted current earnings for alternative minimum tax purposes, consistent with Treas. Reg. sec. 1.56(g)-1(c)(4)(ii).

Current California Law (R&T Sec. 24416)

Existing state law generally conforms to the computation of federal NOLs. California does not allow NOL carrybacks. The type of taxpayer and how the NOL is generated determines the amount of the NOL that is eligible to be carried forward and the number of years it can be carried forward:

Type of NOL	NOL % Allowed to be Carried Over	Carryover Period
General NOL	50%	5 Years
New Business Year 1 Year 2 Year 3	100% 100% 100%	8 Years 7 Years 6 Years
Eligible Small Business	100%	5 Years
Specified Disaster Loss	100% 50%	5 Years 10 Years
LARZ, LAMBRA & EZ	100%	15 Years

Effective Date

The provision is effective on August 5, 1997. However, no refund shall be made as a result of this provision earlier than December 2, 1997, the date of enactment of the Amtrak Reform and Accountability Act of 1997. No interest shall accrue with respect to the payment of any refund until 45 days after the later of (1) the enactment of such reform legislation, or (2) the filing by Amtrak of a federal income tax return which includes the election to use the procedures described in this provision.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1001(a)	Required Recognition of Gain on Certain Appreciated Financial Positions in Personal Property

Background

In general, gain or loss is taken into account for tax purposes when realized. Gain or loss generally is realized with respect to a capital asset at the time the asset is sold, exchanged, or otherwise disposed of. Special rules under the code can defer or accelerate recognition in certain circumstances. Transactions designed to reduce or eliminate risk of loss, such as a “short sale against the box,” or an “equity swap,” generally do not cause realization.

New Federal Law (Sec. 1259)

The Act requires recognition of gain (but not loss) upon a constructive sale of any “appreciated financial position” in stock, a partnership interest or debt other than certain “straight” debt instruments. A constructive sale occurs when the taxpayer enters into one of the following transactions with respect to the same or substantially identical property: (1) a short sale, (2) an offsetting notional principal contract, or (3) a futures or forward contract. For a taxpayer who has one of these transactions, a constructive sale occurs when it acquires the related long position. Other transactions will be treated as constructive sales to the extent provided in Treasury regulations.

The Act provides an exception for certain short term hedges that would otherwise be treated as a constructive sale if all three conditions are met:

- the transaction is closed before the end of the 30th day after the close of the taxable year.
- the taxpayer holds the appreciated financial position.
- at no time during a 60-day period is the taxpayer's risk of loss reduced by holding certain other positions.

The Act provides that the types of debt instruments excluded from the definition of “appreciated financial position” are instruments that are not convertible and the interest on which is either fixed, payable at certain variable rates or based on certain interest payments on a pool of mortgages. In addition, the Act provides an exception for transactions closed during the 90-day period ending on the 30th day after the close of the taxable year and reestablished during such period, so long as the normal requirements for positions closed within such 90-day period are met by the reestablished position.

A trust instrument that is actively traded is generally treated as stock for purposes of determining whether the instrument is an appreciated financial position. The Act provides that a trust instrument will not be treated as stock if substantially all (by value) of the property held by the trust is debt

that qualifies for the exception to the definition of appreciated financial position for certain debt instruments. In addition, the Act clarifies that only debt instruments that entitle the holder to receive an unconditional principal amount qualify for the exception.

The Joint Committee on Taxation's report clarifies some aspects of the application of the provision. Congress does not intend that an agreement that is not a contract for purposes of applicable contract law will be treated as a forward contract. Thus, contingencies to which the contract is subject will generally be taken into account. Congress intends that the constructive sale provision generally will apply to transactions that are identified hedging or straddle transactions under other code provisions. Where either position in such an identified transaction is an appreciated financial position and a constructive sale of such position results from the other position, the conferees intend that the constructive sale will be treated as having occurred immediately before the identified transaction. The constructive sale will not, however, prevent qualification of the transaction as an identified hedging or straddle transaction. Where, after the establishment of such an identified transaction, there is a constructive sale of either position in the transaction, gain will generally be recognized and accounted for under the relevant hedging or straddle provision. However, Congress intends that future Treasury regulations may except certain transactions from the constructive sale provision where the gain recognized would be deferred under an identified hedging or straddle provision.

The Joint Committee on Taxation's report urges that the Treasury issue prompt guidance, including safe harbors, with respect to common transactions entered into by taxpayers. The legislative history to both the House bill and the Senate amendment describe "collar" transactions and recommend that Treasury regulations provide standards for determining which collar transactions result in constructive sales. The Joint Committee on Taxation Report expects that these Treasury regulations with respect to collars will be applied prospectively, except in cases to prevent abuse. The legislative history states that, under the regulations to be issued by the Treasury, either a taxpayer's appreciated financial position or an offsetting transaction may in certain circumstances be considered on a disaggregated basis for purposes of the constructive sale determination. The Joint Committee on Taxation Report clarifies that this authority is intended to be used only where such disaggregated treatment reflects the economic reality of the transaction and is administratively feasible. For example, one transaction for which disaggregated treatment might be appropriate is an equity swap that references a small group of stocks, where the transaction is entered into by a taxpayer owning only one of the stocks.

Current California Law (R&T Secs. 18151, 24990)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to "short sales" and "equity swaps."

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Effective Date

The constructive sale provision is effective for constructive sales entered into after June 8, 1997. Special rules apply to decedents and for transactions entered into before June 8, 1997, that in some circumstances prevent such transactions from resulting in constructive sales after the effective date.

Impact on California Revenue

This revenue estimate covers Act sections 1001(a), 1001(b) and 1002.

It is anticipated that the total impact would occur automatically (i.e., baseline) as taxpayers avoid complexity and report the same way for state tax purposes.

Fiscal Year Estimate Effective 8/5/97 [$ In Millions]			
Impact	1997-98	1998-99	1999-00
Baseline	$10	$4	$2

It is assumed the provision would be effective with respect to transactions entered into after June 8, 1997. Revenue gains drop off because tax revenues attributed to underlying property that would have been realized subsequently are offset.

The revenue estimate was based on federal projections for this provision.

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

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1001(b)	Election of Mark-to-Market for Securities and Commodities Traders

Background

A dealer in securities must compute its income pursuant to the mark-to-market method of accounting. Mark-to-market treatment does not apply to traders in securities or dealers in other property.

New Federal Law (Sec. 475)

The Act allows securities traders and commodities traders and dealers to elect mark-to-market accounting similar to that currently required for securities dealers. All securities held by an electing taxpayer in connection with a trade or business as a securities trader, and all commodities held by an electing taxpayer in connection with a trade or business as a commodities dealer or trader, are subject to mark-to-market treatment. Property not held in connection with its trade or business is not subject to the election provided that it is identified by the taxpayer under rules similar to the present law rules for securities dealers. An exception is provided for securities that have no connection with activities as a trader and that are identified on the day acquired (or at such other times as provided in Treasury regulations). Gain or loss recognized by an electing taxpayer under the provision is ordinary gain or loss. Under the Act, commodities for purposes of the provision would include only commodities of a kind customarily dealt in on an organized commodities exchange.

Similar rules apply to commodities traders. The Act expands the definition of a commodity for purposes of the provision to include any commodity that is actively traded (within the meaning of section 1092(d)(1)), any option, forward contract, futures contract, short position, notional principal contract or derivative instrument that references such a commodity, and any other evidence of an interest in such a commodity. Also included are positions that hedge the listed items and that are identified by the taxpayer under rules similar to the rules for securities. Congress anticipates that Treasury regulations applying section 475(b)(4), which prevents a dealer from treating certain notional principal contracts and other derivative financial instruments as held for investment will, in the case of a commodities trader or dealer, apply only to contracts and instruments referenced to commodities.

The Joint Committee on Taxation’s report states that Congress does not intend that an electing taxpayer can mark-to-market loans made to customers or receivables or debt instruments acquired from customers that are not received or acquired in connection with a trade or business as a securities trader. Because Congress is concerned about issues of taxpayer selectivity, Congress intends that an electing taxpayer must be able to demonstrate by clear and convincing evidence that a security bears no relation to activities as a trader in order to be identified as not subject to the mark-to-market regime. Any

security that hedges another security that is held in connection with the taxpayer's trade or business as a trader will be treated as so held. Any position that is properly subject to the mark-to-market regime will not be taken into account for purposes of the constructive sale rules of section 1259.

Current California Law (R&T Secs. 17551, 17571, 24710)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to mark-to-market method of accounting for security dealers.

Effective Date

The election applies to taxable years of traders or dealers ending after August 5, 1997. A special rule with respect to the section 481 adjustment applies to taxpayers making the election for the taxable year which includes the date of enactment. Any elections made thereafter will be governed by rules and procedures established by the Secretary of the Treasury.

Impact on California Revenue

The revenue estimation for this provision is included in Act section 1001(a) above.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1002	Limitation on Exception for Investment Companies under Section 351

Background

A contribution of property to a corporation does not result in immediate gain or loss recognition to the shareholder contributor if that contributor is part of a group of contributors who have 80% control of the corporation. However, gain or loss is recognized upon a contribution by a shareholder to a corporation that is an investment company. Gain, but not loss, is recognized upon a contribution by a partner to a partnership that would be treated as an investment company. Under Treasury regulations, a contribution of property is treated as made to an investment company only if (1) the contribution results, directly or indirectly, in a diversification of the transferor's interest and (2) the transferee is (a) a regulated investment company (RIC), (b) a real estate investment trust (REIT) or (c) a corporation more than 80% of the assets of which by value (excluding cash and non-convertible debt instruments) are readily marketable stocks or securities or interests in RICs or REITs that are held for investment

New Federal Law (Secs. 1233(h), 1234A, 1271(b))

The Act modifies the definition of an investment company by requiring that the following assets also be taken into account for purposes of the 80% test: money, financial instruments, foreign currency, and interests in RICs, REITs, common trust funds, publicly-traded partnerships and precious metals. The Act provides an exception for precious metals that are produced, used or held in an active trade or business. The Act also provides “look through” rules for certain entities that hold the above-listed items. The Act also provides the Treasury with regulatory authority to remove items from the list in appropriate circumstances.

Current California Law (R&T Secs. 18151, 24990)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to contributions to “investment companies”.

Effective Date

The provision is effective for transfers after June 8, 1997, in taxable years ending after such date, with an exception for transfers pursuant to certain binding written contracts in effect on that date.

Impact on California Revenue

The revenue estimation for this provision is included in Act section 1001(a) above.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1003	Gains and Losses from Certain Terminations with Respect to Property

Background

The definition of capital gains and losses in section 1222 requires a "sale or exchange" of a capital asset. Court decisions interpreted this requirement to mean that when a disposition is not a sale or exchange of a capital asset, for example, a lapse, cancellation, or abandonment, the disposition produces ordinary income or loss.

Extinguishment Treated as Sale or Exchange.

Under section 1234A, gains and losses attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to certain personal property are treated as gains or losses from the deemed sale of a capital asset. Personal property subject to this rule is (1) personal property (other than stock that is not part of straddle or of a corporation that is not formed or availed of to take positions which offset positions in personal property of its shareholders) of a type which is actively traded and which is, or would be on acquisition, a capital asset in the hands of the taxpayer and (2) a "section 1256 contract", which is (1) any regulated futures contract, (2) foreign currency contract, (3) nonequity option, or (4) dealer equity option.

Character of Gain on Retirement of Debt Obligations.

Amounts received on the retirement of any debt instrument are treated as amounts received in exchange therefor (sec. 1271(a)(1)). In addition, gain on the sale or exchange of a debt instrument with original issued discount (OID) generally is treated as ordinary income to the extent of its OID if there was an intention at the time of its issuance to call the debt instrument before maturity. These rules do not apply to (1) debt issued by a natural person or (2) debt issued before July 2, 1982, by a noncorporate or nongovernment issuer. The issuer of a debt instrument with OID generally accrues and deducts the discount, as interest, over the life of the obligation even though the amount of such interest is not paid until the debt matures. The holder of such a debt instrument also generally includes the OID amounts in income as it accrues as interest. The mandatory current inclusion of OID in income does not apply, among other exceptions, to debt obligations issued by natural persons before March 2, 1984, and loans of less than $10,000 between natural persons if such loan is not made in the ordinary course of business of the lender.

New Federal Law (Secs. 1233(h), 1234A, 1271(b))

Extension of Relinquishment Rule to All Types of Property.

The Act extends to all types of property, the rule which treats gain or loss from the cancellation, lapse, expiration, or other termination of a right or

obligation as (or on acquisition would be) a capital asset in the hands of the taxpayer

Character of Gain on Retirement of Debt Obligations Issued by Natural Persons.

The Act repeals the provision that exempts debt obligations issued by natural persons from the rule which treats gain realized on retirement of the debt as sold or exchanged. Thus, gain or loss on the retirement of such debt will be capital gain or loss if the debt is a capital asset. The Act retains the present-law exceptions for debt issued before July 2, 1982, by noncorporations or nongovernments.

Short Positions that Become Substantially Worthless.

In addition, the Act provides that if a taxpayer enters into a short sale of property and such property becomes substantially worthless, the taxpayer shall recognize gain as if the short sale were closed when the property becomes substantially worthless. The Act also extends the statute of limitations with respect to such gain recognition to the earlier of: (1) three years after the Treasury Secretary is notified that the position has become substantially worthless; or (2) six years after the date of filing of the income tax return for the taxable year during which the position became substantially worthless. To the extent provided in Treasury regulations, similar gain recognition rules shall apply to any option with respect to property, any offsetting notional principal contract with respect to property, any futures or forward contract to deliver property, or with respect to any similar transaction or position that becomes substantially worthless.

No inference is intended as to the proper treatment of these or similar transactions or positions under prior law.

Current California Law (R&T Secs. 18151, 24990)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to the extinguishment rule.

Effective Date

The extension of the extinguishment rule applies to property acquired or positions established after September 4, 1997. The repeal of the exception to the character of gain on retirement of debt instruments issued by natural persons or obligations issued before July 2, 1982, applies to debt issued or purchased (within the meaning of section 1272(d)(1)) after June 8, 1997. Thus, the repeal of the exception to the character of gain on retirement of debt instruments issued by natural persons or obligations issued before July 2, 1982, does not apply to transfers after June 8, 1997, where the basis of the debt instrument to the transferee is determined in whole or in part by reference to the adjusted basis of that instrument in the hands of the

transferor (i.e., the basis to the transferee is a carryover basis). However, the repeal of the exception to the character of gain on retirement of debt instruments issued by natural persons applies to any debt instruments issued after June 8, 1997.

Impact on California Revenue

Conforming to the federal provision would result in net revenue gains estimated as shown below:

Fiscal Year Estimate Effective 9/5/97 [$ In Millions]		
1997-98	1998-99	1999-00
minor gain	$1	$1

Minor gain is less than $500,000. It is assumed the extension of the contract termination rule would apply to terminations after September 5, 1997; short sales provision would apply to property that becomes substantially worthless after August 5, 1997; and repeal of the exception for debt issued by natural persons applies to debt issued or purchased after June 8, 1997.

Estimates above were based on federal projections for this provision.

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

The revenue impact of this provision would be determined by the net tax differential of capital gain or loss treatment rather than ordinary income treatment of (1) contract terminations with respect to property that is a capital asset in the hands of the holder; (2) short sales of property that become substantially worthless; and (3) retirement of debt issued by natural persons if the debt is a capital asset.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1004	Determination of Original Issue Discount Where Pooled Debt Obligations Subject to Acceleration

Background

A taxpayer generally must include in gross income the amount of interest received or accrued within the taxable year on indebtedness held by the taxpayer. If the principal amount of an indebtedness may be paid without interest by a specified date (as is the case with certain credit card balances), under present law, the holder of the indebtedness is not required to accrue interest until after the specified date has passed.

The holder of a debt instrument with original issue discount (OID) generally accrues and includes in gross income, as interest, the OID over the life of the obligation, even though the amount of the interest may not be received until the maturity of the instrument. Special rules for determining the amount of OID allocated to a period apply to certain instruments that may be subject to prepayment. First, if a borrower can reduce the yield on a debt by exercising a prepayment option, the OID rules assume that the borrower will prepay the debt. In addition, in the case of (1) any regular interest in a real estate mortgage investment conduit (REMIC), (2) qualified mortgages held by a REMIC, or (3) any other debt instrument if payments under the instrument may be accelerated by reason of prepayments of other obligations securing the instrument, the daily portions of the OID on such debt instruments are determined by taking into account an assumption regarding the prepayment of principal for such instruments.

New Federal Law (Sec. 1272)

The Act applies the special OID rule applicable to any regular interest in a REMIC, qualified mortgages held by a REMIC, or certain other debt instruments to any pool of debt instruments the yield on which may be reduced by reason of prepayments. Thus, under the Act, if a taxpayer holds a pool of credit card receivables that require interest to be paid if the borrowers do not pay their accounts by a specified date, the taxpayer would be required to accrue interest or OID on such pool based upon a reasonable assumption regarding the timing of the payments of the accounts in the pool. In addition, the Secretary of the Treasury is authorized to provide appropriate exemptions from the provision, including exemptions for taxpayers that hold a limited amount of debt instruments, such as small retailers.

Current California Law (R&T Secs. 18178, 24994)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to OID income.

Effective Date

The provision is effective for taxable years beginning August 5, 1997. If a taxpayer is required to change its method of accounting under the Act, such change would be treated as initiated by the taxpayer with the consent of the Secretary of the Treasury and any section 481 adjustment would be included in income ratably over a four-year period. It is understood that some taxpayers presently use a method of accounting similar to the method required to be used under the Act and have asked the Secretary of the Treasury for permission to change to a different method for pre-effective date years. It is in the discretion of the Secretary whether to grant these pending requests.

Impact on California Revenue

Conforming to this federal provision would result in revenue gains estimated as shown below:

Fiscal Year Estimate Effective 8/5/97 [$ In Millions]		
1997-98	1998-99	1999-00
minor gain	$10	$11

Minor gain is less than $500,000. It is assumed the provision would be effective with taxable years beginning after August 5, 1997.

Estimates above were based on federal projections for this provision.

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

The revenue impact of this provision would be determined by the amount of OID accrued on additionally affected obligations, apportionment factors, and effective tax rates.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1005	Deny Interest Deduction on Certain Debt Instruments

Background

Whether an instrument qualifies for tax purposes as debt or equity is determined under all the facts and circumstances based on principles developed in case law. If an instrument qualifies as equity, the issuer generally does not receive a deduction for dividends paid and the holder generally includes such dividends in income (although corporate holders generally may obtain a dividends-received deduction of at least 70% of the amount of the dividend). If an instrument qualifies as debt, the issuer may receive a deduction for accrued interest, and the holder generally includes the interest in income, subject to certain limitations.

Original issue discount (OID) on a debt instrument is the excess of the stated redemption price at maturity over the issue price of the instrument. An issuer of a debt instrument with OID generally accrues and deducts the discount as interest over the life of the instrument even though interest may not be paid until the instrument matures. The holder of such a debt instrument also generally includes the OID in income on an accrual basis.

New Federal Law (Sec. 163(c))

Under theAct, no deduction is allowed for interest or OID on an instrument issued by a corporation (or issued by a partnership to the extent of its corporate partners) that is payable in stock of the issuer or a related party (within the meaning of sections 267(b) and 707(b)), including an instrument a substantial portion of which is mandatorily convertible or convertible at the issuer's option into stock of the issuer or a related party. In addition, an instrument is to be treated as payable in stock if a substantial portion of the principal or interest is required to be determined, or may be determined at the option of the issuer or related party, by reference to the value of stock of the issuer or related party. An instrument also is treated as payable in stock if it is part of an arrangement designed to result in such payment of the instrument with or by reference to such stock, such as in the case of certain issuances of a forward contract in connection with the issuance of debt, nonrecourse debt that is secured principally by such stock, or certain debt instruments that are convertible at the holder's option when it is substantially certain that the right will be exercised.

For example, it is not expected that the provision will affect debt with a conversion feature where the conversion price is significantly higher than the market price of the stock on the issue date of the debt. The Act does not affect the treatment of a holder of an instrument. The Act is not intended to affect the characterization of instruments as debt or equity under present law.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Current California Law (R&T Secs. 17201, 24344)

California law is in conformity with federal law as it read on January 1, 1997, as it relates to interest deductions.

Effective Date

The provision is effective for instruments issued after June 8, 1997, but will not apply to such instruments (1) issued pursuant to a written agreement which was binding on such date and at all times thereafter, (2) described in a ruling request submitted to the Internal Revenue Service on or before such date, or (3) described in a public announcement or filing with the Securities and Exchange Commission on or before such date.

Impact on California Revenue

Baseline revenue gains of $1 million annually would occur as taxpayers structure debt instruments in response to the federal law change and report in the same manner for state tax purposes. Any revenue gains that would only occur if conformity legislation is enacted would be insignificant.

The revenue estimate was based on federal projections for this provision. The impact would be under 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.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1011	Require Gain Recognition for Certain Extraordinary Dividends

Background

A corporate shareholder generally can deduct at least 70% of a dividend received from another C corporation. This dividends received deduction is 80% if the corporate shareholder owns at least 20% of the distributing corporation and generally 100% if the shareholder owns at least 80% of the distributing corporation. Section 1059 of the code requires a corporate shareholder that receives an “extraordinary dividend” to reduce the basis of the stock with respect to which the dividend was received by the non-taxed portion of the dividend. Whether a dividend is “extraordinary” is determined, among other things, by reference to the size of the dividend in relation to the adjusted basis of the shareholder's stock. Also, a dividend resulting from a non pro rata redemption or a partial liquidation is an extraordinary dividend. If the reduction in basis of stock exceeds the basis in the stock with respect to which an extraordinary dividend is received, the excess is taxed as gain on the sale or disposition of such stock, but not until that time. The reduction in basis for this purpose occurs immediately before any sale or disposition of the stock. The Treasury Department has general regulatory authority to carry out the purposes of this section.

Except as provided in regulations, the extraordinary dividend provisions do not apply if they result in a double reduction in basis in the case of distributions between members of an affiliated group filing consolidated returns where the dividend is eliminated or excluded under the consolidated return regulations. Double inclusion of earnings and profits (i.e., from both the dividend and from gain on the disposition of stock with a reduced basis) also should generally be prevented. Treasury regulations provide for application of the provision when a corporation is a partner in a partnership that receives a distribution.

In general, a distribution in redemption of stock is treated as a dividend, rather than as a sale of the stock, if it is essentially equivalent to a dividend. A redemption of the stock of a shareholder generally is essentially equivalent to a dividend if it does not result in a meaningful reduction in the shareholder's proportionate interest in the distributing corporation. Section 302(b) also contains several specific tests (e.g., a substantial reduction in interest computation and a complete termination of interest test) to identify redemptions that are not essentially equivalent to dividends. The determination whether a redemption is essentially equivalent to a dividend includes reference to the constructive ownership rules of section 318, including the option attribution rules of section 318(a)(4). The rules relating to treatment of cash or other property received in a reorganization contain a similar reference.

New Federal Law (Sec. 1059)

Under the Act, except as provided in regulations, a corporate shareholder recognizes gain immediately with respect to any redemption treated as a dividend (in whole or in part) when the non-taxed portion of the dividend exceeds the basis of the shares surrendered, if the redemption is treated as a dividend due to options being counted as stock ownership. Thus, for example, where a portion of such a distribution would not have been treated as a dividend due to insufficient earnings and profits, the rule applies to the portion treated as a dividend. In addition, the Act requires immediate gain recognition whenever the basis of stock with respect to which any extraordinary dividend was received is reduced below zero. The reduction in basis of stock would be treated as occurring at the beginning of the ex-dividend date of the extraordinary dividend to which the reduction relates.

Reorganizations or other exchanges involving amounts that are treated as dividends under section 356 of the code are treated as redemptions for purposes of applying the rules relating to redemptions under section 1059(e). For example, if a recapitalization or other transaction that involves a dividend under section 356 has the effect of a non pro rata redemption or is treated as a dividend due to options being counted as stock, the rules of section 1059 apply. Redemptions of shares, or other extraordinary dividends on shares, held by a partnership will be subject to section 1059 to the extent there are corporate partners (e.g., appropriate adjustments to the basis of the shares held by the partnership and to the basis of the corporate partner's partnership interest will be required).

Under section 1059(g) of present law, the Treasury Department is authorized to issue regulations where necessary to carry out the purposes and prevent the avoidance of these provisions.

The committee reports indicate that no inference is intended regarding the tax treatment under prior law of any transaction within the scope of the provision, including transactions utilizing options. In addition, no inference is intended regarding the rules under prior law (or in any case where the treatment is not specified in the provision) for determining the shares of stock with respect to which a dividend is received or that experience a basis reduction.

Current California Law (R&T Sec. 24966)

California law provides for deduction of a portion of the dividends received during the year declared from income which has been included in the measure of tax for California franchise, corporate income or alternative minimum tax purposes. Special rules apply for dividends received from insurance company subsidiaries and dividends received by taxpayers with a water’s edge election in effect.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

California law is in conformity with federal law as it read on January 1, 1997, as it relates to the treatment of extraordinary dividends and the basis of the subsidiary's stock.

Effective Date

The provision generally is effective for distributions after May 3, 1995, unless made pursuant to the terms of a written binding contract in effect on May 3, 1995, and at all times thereafter before such distribution, or a tender offer outstanding on May 3, 1995. Thus, for example, in the case of a distribution prior to the effective date, the provisions of present law would continue to apply, including the provisions of present-law sections 1059(a) and 1059(d)(1), requiring reduction in basis immediately before any sale or disposition of the stock, and requiring recognition of gain at the time of such sale or disposition.

However, in applying the new gain recognition rules to any distribution that is not a partial liquidation, a non pro rata redemption, or a redemption that is treated as a dividend by reason of options, September 13, 1995, is substituted for May 3, 1995, in applying the transition rules.

Impact on California Revenue

Conforming to this federal provision would result in the estimated net revenue impact shown below:

Fiscal Year Estimate Effective 5/3/95 [$ In Millions]		
1997-98	1998-99	1999-00
minor gain	$10	$2

Minor gain is less than $500,000. Net gains drop-off for 1999-00 due to earlier receipt of tax payments. It is assumed the provision would be effective for distributions after May 3, 1995. A transition rule provides that, in certain types of cases, September 13, 1995 is substituted for May 3, 1995.

Estimates above were based on federal projections for this provision. Allowance was made for some payers of extraordinary dividends not having a California filing requirement.

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

The revenue impact of this provision would be determined by the amount of gain recognized immediately for certain extraordinary dividends, apportionment factors, and the franchise tax rate.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1012	Require Gain Recognition on Certain Distributions of Controlled Corporation Stock (Morris Trust Transaction)

Background

A corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) as if such property had been sold for its fair market value. The shareholders generally treat the receipt of property as a taxable event as well.

Section 355 of the Internal Revenue Code provides an exception to this rule for, among other transactions, certain “spin-off” type distributions of stock of a controlled corporation, provided that various requirements are met, including restrictions relating to acquisitions and dispositions of stock of the distributing corporation (distributing) or the controlled corporation (controlled) prior and subsequent to a distribution.

In cases where the form of the transaction involves a contribution of assets to the particular controlled corporation that is distributed in connection with the distribution, there are specific Internal Revenue Code requirements that the distributing corporation's shareholders are “in control” of the distributed corporation immediately after the distribution. Control is defined for this purpose as 80% of the voting power of all classes of stock entitled to vote and 80% of each other class of stock. In addition, it is a requirement for qualification of any IRC section 355 distribution that the distributing corporation distribute control of the controlled corporation in the transaction (defined by reference to the same 80% test). If a controlled corporation is acquired after a distribution, an issue may arise whether the acquisition can be viewed under step-transaction concepts as having occurred before the distribution, with the result that the distributing corporation would not be viewed as having distributed the necessary 80% control. The Internal Revenue Service had indicated that it would not rule on requests for section 355 treatment in cases in which there have been negotiations, agreements, or arrangements with respect to transactions or events which, if consummated before the distribution, would result in the distribution of stock or securities of a corporation which is not “controlled” by the distributing corporation.

Prior law has the effect of imposing more restrictive requirements on certain types of acquisitions or other transfers following a distribution if the company acquired is the controlled corporation rather than the distributing corporation.

After a spin-off transaction, the amount of a stockholder's basis in the stock of the distributing corporation is generally allocated between the stock of the distributing corporation and controlled corporation received by that shareholder in proportion to their relative fair market values. In the case of an affiliated group of corporations filing a consolidated return, this basis

allocation rule generally eliminates any excess loss account in the stock of a controlled corporation that is distributed within the group, and its basis is generally determined with reference to the basis of the distributing corporation. Excess loss accounts in consolidated return groups generally are created when a subsidiary corporation makes a distribution (or has a loss that is used by other members of the group) that exceeds the parent's basis in the stock of the subsidiary. In general, such excess loss accounts in consolidated return groups are permitted to be deferred rather than causing immediate taxable gain. Nevertheless, they are recaptured when a subsidiary leaves the group or in certain other situations. However, such excess loss accounts are not recaptured in certain cases where there is an internal spin-off prior to the subsidiary leaving the group. In addition, an excess loss account may not be created at all in certain cases that are similar economically to a distribution that would reduce the stock basis of the distributing subsidiary corporation, if the distribution from the subsidiary is structured to meet the form of a section 355 distribution.

The treatment of basis of the distributing and controlled corporations in a section 355 distribution differs from a distribution of stock that is not a qualified section 355 spin-off. In a non-qualified distribution within an affiliated group of corporations filing a consolidated return, not only is gain generally recognized (though deferred) on the excess of value over basis at the distributing corporation level, the basis of the distributing corporation's stock is increased by any gain recognized in the distribution (when that gain is taken into account under the relevant regulations), and reduced by the fair market value of the distribution if the distribution is within an affiliated group filing a consolidated return. The basis of the stock of the distributed corporation within the group is a fair market value basis. In the case of a nonqualified distribution between members of an affiliated group that is not filing a consolidated return, the distribution causes a reduction of basis of the distributing corporation only to the extent it exceeds the earnings and profits of the distributing corporation or it is an “extraordinary dividend.”

New Federal Law (Secs. 351, 355, 358, 368(a))

The Act adopts additional restrictions under section 355 on acquisitions and dispositions of the stock of the distributing or controlled corporation.

Under the Act, if either the controlled or distributing corporation is acquired pursuant to a plan or arrangement in existence on the date of distribution, gain is recognized as of the date of the distribution.

In the case of an acquisition of either the distributing corporation or the controlled corporation, the amount of gain recognized is the amount that the distributing corporation would have recognized had the stock of the controlled corporation been sold for fair market value on the date of the distribution. Such gain is recognized immediately before the distribution and is treated as long-term capital gain. No adjustment to the basis of the stock or assets of either corporation is allowed by reason of the recognition of the gain. The committee reports indicate that there is no intention to limit the otherwise

applicable Treasury regulatory authority under section 336(e) of the Code. There is also no intention to limit the otherwise applicable provisions of section 1367 with respect to the effect on shareholder stock basis of gain recognized by an S corporation under this provision.

Whether a corporation is acquired is determined under rules similar to those of present law section 355(d), except that acquisitions would not be restricted to "purchase" transactions. Thus, an acquisition occurs if one or more persons acquire 50% or more of the vote or value of the stock of the controlled or distributing corporation pursuant to a plan or arrangement. For example, assume a corporation ("P") distributes the stock of its wholly-owned subsidiary ("S") to its shareholders in a transaction that otherwise qualifies as a section 355 spin-off. If, pursuant to a plan or arrangement, 50% or more of the vote or value of either P or S is acquired by one or more persons, the Act requires gain recognition by the distributing corporation. Except as provided in Treasury regulations, if the assets of the distributing or controlled corporation are acquired by a successor in a merger or other transaction under section 368(a)(1)(A), (C) or (D) of the Internal Revenue Code, the shareholders (immediately before the acquisition) of the corporation acquiring such assets are treated as acquiring stock in the corporation from which the assets were acquired. Under Treasury regulations, other asset transfers also could be subject to this rule.

Under the Act, certain aggregation and attribution rules apply for determining whether one or more persons has acquired a 50% or greater interest in the distributing or controlled corporation. The aggregation rules of section 355(d)(7)(A) apply. In addition, except as provided in regulations, section 318(a)(2)(C) applies without regard to the amount of stock ownership of the corporation.

A public offering of sufficient size can result in an acquisition that causes gain recognition under the provision.

Acquisitions occurring within the four-year period beginning two years before the date of distribution and ending two years after the date of distribution are presumed to have occurred pursuant to a plan or arrangement. Taxpayers can avoid gain recognition by showing that an acquisition occurring during this four-year period was unrelated to the distribution.

The Treasury Department is authorized to prescribe regulations as necessary to carry out the purposes of the Act, including regulations to provide for the application of the changes made by the Act in the case of multiple transactions.

Certain Transactions Not Considered Acquisitions.

Under the Act, certain specific types of transactions do not cause gain recognition or are not treated as acquisitions for purposes of determining whether there has been an acquisition of a 50% or greater interest in the distributing or the controlled corporation.

Single Affiliated Group.

Under the Act, a plan (or series of related transactions) is not one that will cause gain recognition if, immediately after the completion of such plan or transactions, the distributing corporation and all controlled corporations are members of a single affiliated group of corporations (as defined in section 1504 without regard to subsection (b) thereof).

Example 1: P corporation is a member of an affiliated group of corporations that includes subsidiary corporation S and subsidiary corporation S1. P owns all the stock of S. S owns all the stock of S1. P corporation is merged into unrelated X corporation in a transaction in which the former shareholders of X corporation will own 50% or more of the vote or value of the stock of surviving X corporation after the merger. As part of the plan of merger, the stock of S1 will be distributed by S to X in a transaction that otherwise qualifies under section 355. After this distribution, S, S1, and X will remain members of a single affiliated group of corporations under section 1504 (without regard to whether any of the corporations is a foreign corporation, an insurance company, a tax exempt organization, or an electing section 936 company). Even though there has been an acquisition of P, S, and S1 by X, and a distribution of S1 by S that is part of a plan or series of related transactions, the plan is not treated as one that requires gain recognition on the distribution of S1 to X. This is because the distributing corporation S and the controlled corporation S1 remain within a single affiliated group after the distribution (even though the P group has changed ownership).

Continuing Direct or Indirect Ownership.

Under the Act, except as provided in Treasury regulations, certain acquisitions are not taken into account in determining whether a 50% or greater interest in the distributing or controlled corporation has been acquired. Generally, in any transaction, stock received directly or indirectly by former shareholders of the distributing or controlled corporation, in a successor or new controlling corporation of either, is not treated as acquired stock if it is attributable to such shareholders' stock in the distributing or controlled corporation that was not acquired as part of a plan or arrangement to acquire 50% or more of such successor or other corporation.

IRC Section 355(e)(3)(A)(iv), as originally enacted, provided that an acquisition does not require gain recognition if the same persons own 50% or more of both corporations, directly or indirectly (rather than merely indirectly, as in the House bill and Senate amendment), before and after the acquisition and distribution, provided the stock owned before the acquisition was not acquired as part of a plan (or series of related transactions) to acquire a 50% or greater interest in either the distributing or controlled corporation.

Example 2: Individual A owns all the stock of P corporation. P owns all the stock of a subsidiary corporation, S. Subsidiary S is distributed to

individual A in a transaction that otherwise qualifies under section 355. As part of a plan, P then merges with corporation X, also owned entirely by individual A. There is not an acquisition that requires gain recognition under the provision, because individual A owns directly or indirectly 100% of all the stock of both X, the successor to P, and S before and after the transaction. The example assumes that A did not acquire his or her stock in P as part of a plan or series of related transactions that results in the direct or indirect ownership of 50% or more of S or P separately by A. If A's stock in P was acquired as part of such a plan, the transaction would be one requiring gain recognition on the spin-off of S. The same result would occur if P were contributed to a holding company, all the stock of which is owned by A.

Example 3: Assume the facts are the same as in Example 2 except that corporations P and X are each owned by the same 20 individual 5% shareholders (rather than wholly by individual A). The transaction described in Example 2, in which S is spun off by P to P's shareholders and P is acquired by X, would not cause gain recognition, because each shareholder that owned stock of the distributing and controlled corporation before the transaction continues to own the same percentage of stock of each corporation after the transaction.

Example 4: Shareholder A owns 10% of the vote and value of the stock of corporation D (which owns all of corporation C). There are nine other equal shareholders of D. A also owns 100% of the vote and value of the stock of unrelated corporation P. D distributes C pro rata to all the shareholders of D. Thereafter, pursuant to a plan or series of related transactions, D (worth 100x) merges with corporation P (worth 900x). After the merger, each of the former shareholders of corporation D owns stock of the merged entity reflecting the vote and value attributable to that shareholder's respective 10% former stock ownership in D. Each of the former shareholders of D owns 1% of the stock of the merged corporation, except that shareholder A (who owned 100% of corporation P and 10% of corporation D before the merger) now owns 91% of the stock of the merged corporation. In determining whether a 50% or greater interest in D has been acquired, the interest of each of the continuing shareholders is disregarded only to the extent there has been no decrease in such shareholder's direct or indirect ownership. Thus, the 10% interest of A, and the 1% interest of each of the nine other former shareholders of D, is not counted. The remaining 81% ownership of the merged corporation, representing a decrease of 9% in the interests of each of the nine former shareholders other than A, is counted in determining the extent of an acquisition. Therefore, a 50% or greater interest in D has been acquired. (Note: This example reflects the technical correction contained in Title VI (sec. 609(b)(2)) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.)

Except as provided in Treasury regulations, certain other acquisitions also are not taken into account. For example, under section 355(e)(3)(A), the following other types of acquisitions of stock are not subject to the provision, provided that the stock owned before the acquisition was not acquired pursuant to a plan or series of related transactions to acquire a 50% or greater ownership interest in either distributing or controlled corporation:

First, the acquisition of stock in the controlled corporation by the distributing corporation (as one example, in the case of a contribution of property by the distributing corporation to the controlled corporation in exchange for the stock of the controlled corporation);

Second, the acquisition by a person of stock in any controlled corporation by reason of holding stock or securities in the distributing corporation (as one example, the receipt by a distributing corporation shareholder of controlled corporation stock in a distribution--including a split-off distribution in which a shareholder that did not own 50% of the stock of distributing owns 50% or more of the stock of the controlled corporation); and

Third, the acquisition by a person of stock in any successor corporation of the distributing corporation or any controlled corporation by reason of holding stock or securities in such distributing or controlled corporation (for example, the receipt by former shareholders of the distributing corporation of 50% or more of the stock of a successor corporation in a merger involving the distributing).

The Act does not apply to distributions that would otherwise be subject to section 355(d) of present law, which imposes corporate level tax on certain disqualified distributions.

The Act does not apply to a distribution pursuant to a title 11 or similar case.

IRC Section 355(f).

The Act provides that, except as provided in Treasury regulations, section 355 (or so much of section 356 as relates to section 355) shall not apply to the distribution of stock from one member of an affiliated group of corporations (as defined in section 1504(a)) to another member of such group (an “intragroup spin-off”) if such distribution is part of a plan (or series of related transactions) described in subsection 355 (e)(2)(A)(ii), pursuant to which one or more persons acquire directly or indirectly stock representing a 50% or greater interest in the distributing corporation or any controlled corporation.

Example 5: P corporation owns all the stock of subsidiary corporation S. S owns all the stock of subsidiary corporation T. S distributes the stock of T corporation to P as part of a plan or series of related transactions in which P then distributes S to its shareholders and then P is merged into unrelated X corporation. After the merger, former shareholders of X corporation own 50% or more of the voting power or value of the stock of the merged corporation. Because the distribution of T by S is part of a plan or series of related transactions in which S is distributed by P outside the P affiliated group and P is then acquired under section 355(e), section 355 in its entirety does not apply to the intragroup spin-off of T to P, under section 355(f). Also, the distribution of S by P is subject to section 355(e).

In determining whether an acquisition described in subsection 355 (e)(2)(A)(ii) occurs, all the new provisions of subsection 355(e) are applied. For example, an intragroup spin-off in connection with an overall transaction that does not cause gain recognition under section 355(e) because it is described in section 355(e)(2)(C), or because of section 355(e)(3), or because of the effective date of section 355(e), is not subject to the rule of section 355(f).

The Treasury Department has regulatory authority to vary the result that the intragroup distribution under section 355(f) does not qualify for section 355 treatment. In this connection, the Treasury Department could by regulation eliminate some or all of the gain recognition required under section 355(f) in connection with the issuance of regulations that would cause appropriate basis results with respect to the stock of S and T in the above example so that concerns regarding present law section 355 basis rules (described below in connection with section 358(c)) would be eliminated. Examples of approaches that the Treasury Department may consider are discussed in connection with section 358(g), infra.

Treasury Regulatory Authority Under Section 358(g)

The Act provides that in the case of any distribution of stock of one member of an affiliated group of corporations to another member under section 355 (“intragroup spin-off”), the Secretary of the Treasury is authorized under section 358(g) to provide adjustments to the basis of any stock in a corporation which is a member of such group, to reflect appropriately the proper treatment of such distribution. It is understood that the approach of any such regulations applied to intragroup spin-offs that do not involve an acquisition may also be applied under the Treasury regulatory authority to modify the rule of section 355(f) as may be appropriate.

Congress believed that the concerns relating to basis adjustments in the case of intragroup spin-offs are essentially similar, regardless of whether an acquisition is currently intended as part of a plan or series of related transactions. The concerns include the following:

First, under present law consolidated return regulations, it is possible that an excess loss account of a lower tier subsidiary may be eliminated. This creates the potential for the subsidiary to leave the group without recapture of the excess loss account, even though the group has benefited from the losses or distributions in excess of basis that led to the existence of the excess loss account.

Second, under present law, a shareholder's stock basis in its stock of the distributing corporation is allocated after a spin-off between the stock of the distributing and controlled corporations, in proportion to the relative fair market values of the stock of those companies. If a disproportionate amount of asset basis (as compared to value) is in one of the companies (including but not limited to a shift of value and basis through a borrowing by one company and contribution of the borrowed cash to the other), present law rules under section 358(c) can produce an increase in stock basis relative to asset basis

in one corporation, and a corresponding decrease in stock basis relative to asset basis in the other company. Because the spin-off has occurred within the corporate group, the group can continue to benefit from high inside asset basis either for purposes of sale or depreciation, while also choosing to benefit from the disproportionately high stock basis in the other corporation. If, for example, both corporations were sold at a later date, a prior distribution can result in a significant decrease in the amount of gain recognized that would have occurred if the two corporations had been sold together without a prior spin off (or separately, without a prior spin-off).

Example 6: P owns all the stock of S1 and S1 owns all the stock of S2. P's basis in the stock of S1 is 50; the inside asset basis of S1's assets is 50; and the total value of S1's stock and assets (including the value of S2) is 150. S1's basis in the stock of S2 is 0; the inside basis of S2's assets is 0; and the value of S2's stock and assets is 100. If S1 were sold, holding S2, the total gain would be 100. S1 distributes S2 to P in a section 355 transaction. After this spin-off, under present law, P's basis in the stock of S1 is approximately 17 (50/150 times the total 50 stock basis in S1 prior to the spin-off) and the inside asset basis of S1 is 50. P's basis in the stock of S2 is 33 (100/150 times the total 50 stock basis in S1 prior to the spin-off) and the inside asset basis of S2 is 0. After a period of time, S2 can be sold for its value of 100, with a gain of 67 rather than 100. Also, since S1 remains in the corporate group, the full 50 inside asset basis can continue to be used. S1's assets could be sold for 50 with no gain or loss. Thus, S1 and S2 can be sold later at a total gain of 67, rather than the total gain of 100 that would have occurred had they been sold without the spin-off.

As one variation on the foregoing concern, taxpayers have attempted to utilize spin-offs to extract significant amounts of asset value and basis (including but not limited to transactions in which one corporation decreases its value by incurring debt, and increases the asset basis and value of the other corporation by contributing the proceeds of the debt to the other corporation) without creation of an excess loss account or triggering of gain, even when the extraction is in excess of the basis in the distributing corporation's stock.

The Treasury Department may promulgate any regulations necessary to address these concerns and other collateral issues. As one example, the Treasury Department may consider providing rules that require a carryover basis within the group (or stock basis conforming to asset basis as appropriate) for the distributed corporation (including a carryover of an excess loss account, if any, in a consolidated return). Similarly, the Treasury Department may provide a reduction in the basis of the stock of the distributing corporation to reflect the change in the value and basis of the distributing corporation's assets. The Treasury Department may determine that the aggregate stock basis of the distributing and controlled corporation after the distribution may be adjusted to an amount that is less than the aggregate basis of the stock of the distributing corporation before the distribution, to prevent inappropriate potential for artificial losses or diminishment of gain on disposition of any of the corporations involved in the spin-off. The Treasury Department may provide separate regulations for corporations in affiliated groups filing a

consolidated return and for affiliated groups not filing a consolidated return, as appropriate to each situation.

Control Requirement for Certain Transactions.

The Act also modifies certain rules for determining control immediately after a distribution in the case of certain divisive transactions in which a controlled corporation is distributed and the transaction meets the requirements of section 355. In such cases, under section 351 and modified section 368(a)(2)(H) with respect to certain reorganizations under section 368(a)(1)(D), those shareholders receiving stock in the distributed corporation are treated as in control of the distributed corporation immediately after the distribution if they hold stock representing a greater than 50% interest in the vote and value of stock of the distributed corporation.

The Act does not change the present-law requirement under section 355 that the distributing corporation must distribute 80% of the voting power and 80% of each other class of stock of the controlled corporation. It is expected that this requirement will be applied by the Internal Revenue Service taking account of the provisions of the Act regarding plans that permit certain types of planned restructuring of the distributing corporation following the distribution, and to treat similar restructurings of the controlled corporation in a similar manner. Thus, the 80% control requirement is expected to be administered in a manner that would prevent the tax-free spin-off of a less-than-80% controlled subsidiary, but generally would not impose additional restrictions on post-distribution restructurings of the controlled corporation if such restrictions would not apply to the distributing corporation.

Current California Law (R&T Secs. 23251, 24451)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to distributions of controlled corporations.

Effective Date

The provision is generally effective for distributions after April 16, 1997. However, the part of the provision providing a greater-than-50% control requirement immediately after certain sections 351 and 368(a)(1)(D) distributions is effective for transfers after August 5, 1997.

The provision does not apply to a distribution after April 16, 1997 that is part of an acquisition that would otherwise cause gain recognition to the distributing or controlled corporation under new section 355(e) or (f), if such acquisition is (1) made pursuant to a written agreement which was binding on April 16, 1997 and at all times thereafter; (2) described in a ruling request submitted to the Internal Revenue Service on or before such date; or (3) described on or before such date in a public announcement or in a filing with the Securities and Exchange Commission (SEC) required solely by reason of the distribution or acquisition. Any written agreement, ruling request, or public announcement or SEC filing is not within the scope of these transition

provisions unless it identifies the acquiror of the distributing corporation or of any controlled corporation, whichever is applicable.

The part of the provision providing a greater-than-50% control provision for certain transfers after the date of enactment will not apply if such transfer meets the requirements of (1), (2), or (3) of the preceding paragraph.

An acquisition of stock that occurs on or before April 16, 1997, will not cause gain recognition under the provision, even if there is a distribution after that date that is part of a plan or series of related transactions that would otherwise be subject to the provision.

Any contract that is, in fact, binding under state law as of April 16, 1997, even though not written, is eligible for transition relief. It would be expected, in such a case, that some form of contemporaneous written evidence of such contract would be in existence. As one example, if under state law acceptance of the terms and conditions of a contract by a corporate board of directors creates a binding contract with an acquiror, then such contract, and the terms and conditions presented to the board, could satisfy the requirement for binding contract transitional relief under the conference agreement. If there was such an offer and acceptance on or before April 16, 1997, and a ruling request filed on or before April 16, 1997, with respect to a proposed spin-off and acquisition, which identifies the acquiror as one of a list of prospective acquirors, then the transaction may be eligible for relief under the transition rules.

Finally, with respect to the Treasury Department regulatory authority under section 358(g) as applied to intragroup spin-off transactions that are not part of a plan or series of related transactions under new section 355(f), the provision applies to distributions after April 16, 1997. A technical correction may be needed so that the statute reflects this result. See Title VI (sec. 609(b)(1)) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997. However, Congress expects that any Treasury regulations will be applied prospectively, except in cases to prevent abuse.

Impact on California Revenue

This change is primarily a baseline issue as explained below. Any additional impact from conforming to the federal provision would be minor as shown below.

Fiscal Year Estimate Effective 4/16/97 [$ In Millions]			
Impact	1997-98	1998-99	1999-00
Baseline	$7.5	$7.5	$6.5
Conformity	Minor	Minor	Minor

It is assumed the provision would be effective with respect to distributions occurring on or after April 16, 1997, pursuant to an acquisition occurring after that date. Transition relief would be available in cases where a distribution or transfer is made pursuant to an acquisition that is: (1) made pursuant to a written agreement which was binding on April 16, 1997 and at all times thereafter; (2) described in a ruling request that identifies the acquirer and is filed with the IRS on or before April 16, 1997; or (3) described on or before April 16, 1997, in a public announcement or SEC filing required solely by reason of the acquisition or transfer. It is assumed that the provisions relating to the greater than 50% control requirement would be effective August 5, 1997.

The revenue impact of this provision will be determined by the amount of gain recognized by distributing companies and the corporate tax rate. Transactions remain tax-free at the shareholder level.

Revenue estimates above were based on federal projections. In most cases, spin-offs of this type either will not occur or other spin-off arrangements will be used which have corporate tax consequences under current law. These taxpayer actions will result in baseline revenue gains for state purposes.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1013	Reform Tax Treatment of Certain Corporate Stock Transfers

Background

Under section 304, if one corporation purchases stock of a related corporation, the transaction generally is recharacterized as a redemption. In determining whether a transaction so recharacterized is treated as a sale (thereby generating capital gain or loss) or a dividend, reference is made to the changes in the selling corporation's ownership of stock in the issuing corporation (applying the constructive ownership rules of section 318(a) with modifications under section 304(c)). Sales proceeds received by a corporate transferor that are characterized as a dividend may qualify for the dividends-received deduction under section 243, and such dividend may bring with it foreign tax credits under section 902.

Section 304 does not apply to transfers of stock between members of a consolidated group. Section 1059 applies to “extraordinary dividends,” including certain redemption transactions treated as dividends qualifying for the dividends-received deduction. If a redemption results in an extraordinary dividend, section 1059 generally requires the shareholder to reduce its basis in the stock of the redeeming corporation by the non-taxed portion of such dividend.

New Federal Law (Secs. 304, 1059)

Under the Act, to the extent that a section 304 transaction is treated as a distribution under section 301, the transferor and the acquiring corporation are treated as if (1) the transferor had transferred the stock involved in the transaction to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and (2) the acquiring corporation had then redeemed the stock it is treated as having issued. Thus, the acquiring corporation is treated for all purposes as having redeemed the stock it is treated as having issued to the transferor. In addition, the Act amends section 1059 so that, if the section 304 transaction is treated as a dividend to which the dividends received deduction applies, the dividend is treated as an extraordinary dividend in which only the basis of the transferred shares would be taken into account under section 1059.

A special rule applies to section 304 transactions involving acquisitions by foreign corporations. The Act limits the earnings and profits of the acquiring foreign corporation that are taken into account in applying section 304. The earnings and profits of the acquiring foreign corporation to be taken into account will not exceed the portion of such earnings and profits that (1) is attributable to stock of such acquiring corporation held by a corporation or individual who is the transferor (or a person related thereto) and who is a U.S. shareholder (within the meaning of sec., 951(b)) of such corporation, and (2) was accumulated during periods in which such stock was owned by such person while such acquiring corporation was a controlled foreign corporation. For

purposes of this rule, except as otherwise provided by the Secretary of the Treasury, the rules of section 1248(d) (relating to certain exclusions from earnings and profits with respect to foreign corporations) would apply. The Secretary of the Treasury is to prescribe regulations as appropriate, including regulations determining the earnings and profits that are attributable to particular stock of the acquiring corporation.

The committee reports indicate that no inference is intended as to the treatment of any transaction under present law.

Current California Law (R&T Secs. 24451, 24966)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to corporate stock transfers.

Effective Date

The provision is effective for distributions or acquisitions after June 8, 1997, except that the provision will not apply to any such distribution or acquisition (1) made pursuant to a written agreement which was binding on such date and at all times thereafter, (2) described in a ruling request submitted to the Internal Revenue Service on or before such date, or (3) described in a public announcement or filing with the Securities and Exchange Commission on or before such date.

Impact on California Revenue

The revenue impact of this provision would be determined by amounts of deemed redemptions by acquiring corporations treated as dividends or as sale or exchange transactions.

Based on the very low level of federal estimates, conforming to the provision would result in minor revenue gains of $500,000 annually. It is assumed the provision would apply to distributions or acquisitions after June 8, 1997, except in specified circumstances.

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

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1014	Treat Certain Preferred Stock as “Boot”

Background

In reorganization transactions qualifying under IRC section 368 and certain other restructurings, no gain or loss is recognized except to the extent “other property” (often called “boot”) is received, that is, property other than certain stock, including preferred stock. Thus, preferred stock could be received tax-free in a reorganization. Upon the receipt of “other property,” gain (or in some instances loss) can be recognized. A special rule permits debt securities to be received tax-free, but only to the extent debt securities of no lesser principal amount are surrendered in the exchange. Other than this securities -for-securities rule, similar rules generally apply to transactions under section 351.

New Federal Law (Secs. 351, 354, 355, 356, 1036)

The Act amends the relevant provisions to treat certain preferred stock as “other property” (i.e., “boot”) subject to certain exceptions. Thus, when a taxpayer exchanges property for this preferred stock in a transaction that qualifies under either section 351, 355, 368, or 1036, gain (or in some instances loss) is recognized.

The Act applies to preferred stock (i.e., stock that is limited and preferred as to dividends and does not participate, including through a conversion privilege, in corporate growth to any significant extent), where (1) the holder has the right to require the issuer or a related person (within the meaning of secs. 267(b) and 707(b)) to redeem or purchase the stock, (2) the issuer or a related person is required to redeem or purchase the stock, (3) the issuer (or a related person) has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, or (4) the dividend rate on the stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices, regardless of whether such varying rate is provided as an express term of the stock (for example, in the case of an adjustable rate stock) or as a practical result of other aspects of the stock (for example, in the case of auction rate stock). For this purpose, the rules of (1), (2), and (3) apply if the right or obligation may be exercised within 20 years of the date the instrument is issued and such right or obligation is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase.

In addition, if neither the stock surrendered nor the stock received in the exchange is stock of a corporation any class of stock of which (or of a related corporation) is publicly traded, a right or obligation is disregarded if it may be exercised only upon the death, disability, or mental incompetency of the

holder. Also, a right or obligation is disregarded in the case of stock transferred in connection with the performance of services if it may be exercised only upon the holder's separation from service.

The following exchanges are excluded from this gain recognition: (1) certain exchanges of preferred stock for comparable preferred stock of the same or lesser value; (2) an exchange of preferred stock for common stock; (3) certain exchanges of debt securities for preferred stock of the same or lesser value; and (4) exchanges of stock in certain recapitalization of family-owned corporations. For this purpose, a family-owned corporation is defined as any corporation if at least 50% of the total voting power and value of the stock of such corporation is owned by members of the same family for five years preceding the recapitalization. In addition, a recapitalization does not qualify for the exception if the same family does not own 50% of the total voting power and value of the stock throughout the three-year period following the recapitalization. Members of the same family are defined by reference to the definition in section 447(e). Thus, a family includes children, parents, brothers, sisters, and spouses, with a limited attribution for directly and indirectly owned stock of the corporation. Shares held by a family member are treated as not held by a family member to the extent a non-family member had a right, option or agreement to acquire the shares (directly or indirectly, for example, through redemptions by the issuer), or with respect to shares as to which a family member has reduced its risk of loss with respect to the share, for example, through an equity swap. Even though the provision excepts certain family recapitalizations, the special valuation rules of section 2701 for estate and gift tax consequences continue to apply. An exchange of nonqualified preferred stock for nonqualified preferred stock in an acquiring corporation may qualify for tax-free treatment under section 354, but not section 351.

In cases in which both sections 354 and 351 may apply to a transaction, section 354 generally will apply for purposes of this provision. Thus, in that situation, the exchange would be tax free.

The Act also clarifies the treatment of certain conversion or exchange rights, by deleting any statutory reference to the existence of a “conversion privilege.” The conferees wish to clarify that in no event will a conversion privilege into stock of the issuer automatically be considered to constitute participation in corporate growth to any significant extent.

The Joint Committee on Taxation report also clarifies that stock that is convertible or exchangeable into stock of a corporation other than the issuer (including, for example, stock of a parent corporation or other related corporation) is not considered to be stock that participates in corporate growth to any significant extent for purposes of the provision.

The Treasury Secretary has regulatory authority to (1) apply installment sale-type rules to preferred stock that is subject to this proposal in appropriate

cases and (2) prescribe treatment of preferred stock subject to this provision under other provisions of the Code (e.g., secs. 304, 306, 318, and 368(c)). Until regulations are issued, preferred stock that is subject to the proposal shall continue to be treated as stock under other provisions of the code.

Current California Law (R&T Secs. 24451, 24951)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to “boot” received in a reorganization.

Effective Date

The provision is effective for transactions after June 8, 1997, but will not apply to such transactions (1) made pursuant to a written agreement which was binding on such date and at all times thereafter, (2) described in a ruling request submitted to the Internal Revenue Service on or before such date, or (3) described in a public announcement or filing with the Securities and Exchange Commission on or before such date.

Impact on California Revenue

Conforming to this federal provision would result in revenue gains estimated as shown below:

Fiscal Year Estimate Effective 6/8/97 [$ In Millions]		
1997-98	1998-99	1999-00
minor gain	$2	$1

Minor gain is less than $500,000. It is assumed the provision would be effective with transactions after June 8, 1997. The revenue impact of this provision would be determined by the amount of gain recognized on the exchange of property for nonqualified preferred stock. These estimates above were based on federal projections for this provision.

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

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1015	Modify Holding Period for Dividends-Received Deduction

Background

If an instrument issued by a U.S. corporation is classified for tax purposes as stock, a corporate holder of the instrument generally is entitled to a dividends-received deduction for dividends received on that instrument. This deduction is 70% of dividends received if the recipient owns less than 20% (by vote and value) of stock of the payor. If the recipient owns more than 20% of the stock the deduction is increased to 80%. If the recipient owns more than 80% of the payor's stock, the deduction is further increased to 100% for qualifying dividends.

The dividends-received deduction is allowed to a corporate shareholder only if the shareholder satisfies a 46-day holding period for the dividend-paying stock (or a 91-day period for certain dividends on preferred stock). The 46 or 91 day holding period generally does not include any time in which the shareholder is protected from the risk of loss otherwise inherent in the ownership of an equity interest. The holding period must be satisfied only once, rather than with respect to each dividend received.

New Federal Law (Sec. 246(c))

The Act provides that a taxpayer is not entitled to a dividends-received deduction if the taxpayer's holding period for the dividend-paying stock is not satisfied over a period immediately before or immediately after the taxpayer becomes entitled to receive the dividend.

Current California Law (R&T Secs. 24401, 24402)

California law is similar to with federal law as it read on January 1, 1997, as it relates to the dividends received deduction with modification to reflect state apportionment rules. California law provides for the elimination of a portion of the dividends received during the year that are paid from income which has been previously included in the measure of income for California franchise, corporate or alternative tax purposes. Special rules apply for dividends received from insurance company subsidiaries and dividends received by taxpayers making a water’s-edge election.

Effective Date

The provision is generally effective for dividends paid or accrued after the 30th day after August 5, 1997. However, the provision will not apply to dividends received within two years of August 5, 1997, if: (1) the dividend is paid with respect to stock held on June 8, 1997, and all times thereafter until the dividend is received; (2) the stock is continuously subject to a position described in section 246(c)(4) on June 8, 1997, and all times thereafter until the dividend is received; and (3) such stock and related position is identified by the taxpayer within 30 days after enactment of this Act. A stock will not be considered to be continuously subject to a position if such position is sold, closed or otherwise terminated and is reestablished.

Impact on California Revenue

The number of taxpayers ineligible for the dividends received deduction (because they failed to satisfy a holding period requirement) and the sum of foregone deductions would determine the revenue impact of this provision. Based on the very low level of federal estimates, conforming to the provision would result in revenue gains of less than $500,000 annually beginning in 1998-99. It is assumed the provision would apply to dividends paid or accrued after September 5, 1997.

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

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1021	Reporting of Certain Payments Made to Attorneys

Background

Information reporting generally is required by persons engaged in a trade or business and making payments in the course of that trade or business of “rent, salaries, wages, or other fixed or determinable gains, profits, and income” (miscellaneous payments). Thus, attorney's fees are required to be reported if they are for legal services paid by a person in a trade or business in the course of a trade or business. Treasury regulation section 1.6041-3(c) generally exempts payments made to corporations from the 1099-MISC information reporting requirement.

Information returns are also required of every person doing business as a broker, as defined. This reporting is regarding gross proceeds and done on Form 1099B.

IRS has a combined information return filing program. Under this program, IRS copies the information returns and sends the information via magnetic media to the particular state designated by the person filing the information return. To simplify filing requirements for California payers and because a copy of the IRS information return can be filed as a substitute for California purposes, FTB participates in the IRS combined information return filing program. However, the IRS has excepted several types of information returns from the combined filing program, such as the information returns of brokers. For certain filing information returns that are filed on paper, IRS has agreed to scan those Form 1099s and send to FTB by magnetic media the information on all California payees.

Additionally, IRS and FTB have a reciprocal exchange of information program to share IRS records for tax administration purposes.

New Federal Law (Sec. 6045)

The Act requires gross proceeds reporting on all payments to attorneys, including corporations, in connection with legal services made by a trade or business in the course of that trade or business. It is anticipated that gross proceeds reporting would be required on Form 1099B (used by brokers to report gross proceeds). In addition, payments made by a trade or business to any person, including corporations, for legal services must be reported on the 1099-MISC (even though under the Treasury regulation section 1.6041-3(c) previously the reporting of such payments made to corporations would otherwise have been exempt). The only exception to the new reporting requirement under section 6045 would be for payments reported on either Form 1099-Misc under section 6041 (reports of payment of income) or on Form W-2 under section 6051 (payments of wages).

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Current California Law (R&T Secs. 18637, 18641)

California in general conforms to the federal law regarding the requirement to file information returns by “stand alone” provisions that pertain to the particular type of information return required, including the miscellaneous information returns. In most cases the “stand alone” California law allows a copy of the federal information return to satisfy California’s filing requirements. Although FTB participates in the IRS’s combined information return filing program, because brokers are excepted from the combined federal program, brokers must file either on magnetic media with FTB or a paper document that will be scanned by IRS, unless the payer is out of state or the reported amounts differ for federal and state purposes, in which case the paper document is processed by FTB. In addition, FTB uses the IRS reciprocal exchange of information agreement to receive IRS information return records for tax administration purposes. Without the express authority that authorizes FTB to require a particular type of information return, it is unclear whether FTB may clearly rely on the reciprocal agreement to obtain IRS information return records.

Effective Date

The federal provision is effective for payments made after December 31, 1997. Consequently, the first information reports will be filed with the IRS (and copies will be provided to recipients of the payments) in 1999, with respect to payments made in 1998.

Impact on California Revenue

Based on the minor impact projected for the federal law change, revenue gains would be negligible (less than $250,000), beginning in 1998-9, and largely as a result of the federal reporting requirement alone (i.e. baseline).

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1022	Reporting Payments to Corporations Made by Federal Executive Agencies

Background

Generally, a service recipient (i.e., a person for whom services are performed) engaged in a trade or business who makes payments of remuneration in the course of that trade or business to any person for services performed must file with the IRS an information return reporting such payments (and the name, address, and taxpayer identification number of the recipient) if the remuneration paid to the person during the calendar year is $600 or more (sec. 6041A(a)). A similar statement must also be furnished to the person to whom such payments were made (sec. 6041A(e)). Treasury regulations generally exempt from this reporting requirement payments made to a corporation (Treas. reg. sec. 1.6041A-1(d)(2)).

The head of each federal executive agency must file an information return indicating the name, address, and taxpayer identification number (TIN) of each person (including corporations) with which the agency enters into a contract (sec. 6050M). The Secretary of the Treasury has the authority to require that the returns be in such form and be made at such time as is necessary to make the returns useful as a source of information for collection purposes. The Secretary is given the authority both to establish minimum amounts for which no reporting is necessary as well as to extend the reporting requirements to Federal license grantors and subcontractors of federal contracts. Treasury regulations generally provides that no reporting is required if the contract is for $25,000 or less (Treas. Reg. Sec. 1.6050M-1(c)(1)(i)).

As discussed previously, the IRS has various programs for exchanging information return records with states, including the combined filing program and the reciprocal exchange of information.

New Federal Law (Sec. 6041A)

A Federal executive agency making any payments of $600 or more made to any person (including a corporation) for services must file an information return. In addition, the provision requires that a copy of the information return be sent by the federal agency to the recipient of the payment. An exception is provided for certain classified or confidential contracts.

Current California Law (R&T Secs 18638)

FTB has specific “stand alone” authority to conform to the information return requirement for service recipients provided by section 6041A prior to the TRA 97 change. Generally, FTB obtains the information through the IRS’ combined filing program or IRS’ scanning of paper information returns. FTB does not have specific authority to receive information returns from federal executive agencies comparable to that provided IRS under IRC section 6050M. To receive

these information return records, FTB relies on the reciprocal exchange of information agreement. Without the express authority that allows FTB to require a particular type of information return, it is unclear whether FTB may clearly rely on the reciprocal agreement to obtain IRS information return records.

Effective Date

The new federal provision is effective for returns that are due (without regard to extensions) after November 5, 1997.

Impact on California Revenue

Based on the minor impact projected for the federal law change, revenue gains would be negligible (less than $250,000), beginning in 1998-9, and largely as a result of the federal reporting requirement alone (i.e. baseline).

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1023	Disclosure of Tax Information to Department of Veterans Affairs

Background

The Internal Revenue Code prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the Internal Revenue Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431). No tax information may be furnished by the Internal Revenue Service (IRS) to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

Among the disclosures permitted under the Code is disclosure to the Department of Veterans Affairs (DVA) of self-employment tax information and certain tax information supplied to the Internal Revenue Service and Social Security Administration by third parties. Disclosure is permitted to assist DVA in determining eligibility for, and establishing correct benefit amounts under, certain of its needs-based pension, health care, and other programs (sec. 6103(l)(7)(D)(viii)). The income tax returns filed by the veterans themselves are not disclosed to DVA. The DVA is required to comply with the safeguards currently contained in the Code and in section 1137(c) of the Social Security Act (governing the use of disclosed tax information). These safeguards include independent verification of tax data, notification to the individual concerned, and the opportunity to contest agency findings based on such information.

Prior to the Act these disclosure provisions were scheduled to expire September 30, 1998.

New Federal Law (Sec. 6103(l)(7))

The DVA disclosure provisions were extended through September 30, 2003.

Current California Law (R&T Sec. 19542, et seq.)

FTB is authorized to disclose information only as expressly provided by law. FTB does not have the authority to disclose information to the DVA.

Effective Date

The new federal provision is effective on August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1024	Continuous Levy on Certain Payments

Background

If any person is liable for any internal revenue tax and does not pay it within 10 days after notice and demand by the IRS, the IRS may then collect the tax by levy upon all property and rights to property belonging to the person, unless there is an explicit statutory restriction on doing so. A levy is the seizure of the person's property or rights to property. Property that is not cash is sold pursuant to statutory requirements. Certain payments or property are exempt from levy, and there is a minimum exemption for salary and wages.

In general, a levy does not apply to property acquired after the date of the levy, regardless of whether the property is held by the taxpayer or by a third party (such as a bank) on behalf of a taxpayer. Successive seizures may be necessary if the initial seizure is insufficient to satisfy the liability. The only exception to this rule is for salary and wages, which is continuous from the date it is first made until the date it is fully paid or becomes unenforceable.

New Federal Law (Sec. 6331)

The IRS is authorized to issue a continuous levy of up to 15% of the specific payments for certain payments issued by the federal government (e.g. social security payments), railroad retirement, unemployment benefits, worker’s compensation and certain public assistance payments. The remaining portion of the payment is exempt from levy. Additionally, the exemption for minimum salary and wages is changed from a variable amount determined using the standard and personal exemption amounts to an amount up to 15% of the specific payment. This rule explicitly replaces the other specifically enumerated exemptions from levy in the IRC.

Current California Law (R&T Sec.18671)

FTB, in concept, basically has the same collection remedies as the IRS. To levy on property of a tax debtor, FTB has the authority to issue orders to withhold to seize cash and cash equivalents and use warrants to have the property seized and sold. However, for California purposes, property or the value of property that is exempt from levy is provided under the Code of Civil Procedure, which is applicable to California judgment creditors, and for purposes of tax debts is subject to inflation adjustments under the Taxpayers’ Bill of Rights. To garnish wages, which in essence is a continuous levy, FTB must follow the California Wage Garnishment Law that is applicable to California judgment creditors and generally limits the garnishment to 25% of each payment, with certain minimum wage restrictions, as required under federal law (75% of wages/salary is exempt from levy). In addition, FTB has the authority to issue continuous levies for 25% of the specific payment due or becoming due an individual (75% is exempt from levy) or 100% of the specific

payment due or becoming due a corporate taxpayer (no payment is exempt from levy but a levy may be released due to hardship). The specific payments addressed in the new federal law (social security payments, railroad retirement, unemployment benefits, worker's compensation and certain public assistance) are basically 100% exempt from levy for California income or franchise tax collection purposes by virtue of the underlying federal laws that provide the benefits.

Effective Date

The new federal provision is effective for levies issued after August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1025	Modification of Levy Exemption

New Federal Law (Sec. 6334)

The Secretary of the Treasury has the authority to override the exemption from levy for payments of railroad retirement, unemployment benefits, worker's compensation and certain public assistance.

Current California Law

These specific payments (railroad retirement, unemployment benefits, worker's compensation and certain public assistance) are exempt from levy for California income or franchise tax collection purposes by virtue of the underlying laws that provide the benefit. The above specified payments are protected by the underlying federal law providing the benefit. California does not have the authority to override these protections.

Effective Date

The new federal provision applies to levies issued after August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1026	Disclose Tax Information to Federal Financial Management Services

New Federal Law (Sec. 6103)

IRS may disclose otherwise confidential tax return information to the Treasury Department's Financial Management Service only for purposes of, and to the extent necessary in, implementing the new federal levy provisions previously discussed.

Current California Law

Under the underlying federal laws that provide the benefits, California, for purposes of income or franchise tax administration purposes, is precluded from issuing levies on the property at issue.

Effective Date

The new federal provisions apply to levies issued after August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1027	Returns of Beneficiaries of Estates and Trusts

Background

An S corporation is required to file a return for the taxable year and is required to furnish to its shareholders a copy of certain information shown on such return. The shareholder is required to file its return in a manner that is consistent with the information received from the S corporation, unless the shareholder files with the Secretary of the Treasury a notification of inconsistent treatment (sec. 6037(c)). Similar rules apply in the case of partnerships and their partners (sec. 6222).

The fiduciary of an estate or trust that is required to file a return for any taxable year is required to furnish to beneficiaries certain information shown on such return (generally via a Schedule K-1) (sec. 6034A). In addition, a U.S. person that is treated as the owner of any portion of a foreign trust is required to ensure that the trust files a return for the taxable year and furnishes certain required information to each U.S. person who is treated as an owner of a portion of the trust or who receives any distribution from the trust (sec. 6048(b)).

New Federal Law (Sec. 6034A)

Under the Act, the beneficiaries and owners of the above referenced trusts are required to file their returns in a manner that is consistent with the information received from the estate or trust, unless the beneficiary files with its return a notification of inconsistent treatment identifying the inconsistency.

Current California Law (R&T Secs. 18505, 18633, 23800)

California in concept conforms to the federal requirement that informational or tax returns be filed by entities that pass income items through to other persons. For S corporations and shareholders, California conforms to the federal law that requires shareholders to report consistently with the treatment of items on the S corporation tax return, unless the inconsistency is reported on a statement attached to the return. Under the conformed California law, any unreported inconsistencies are treated as a math error. California has not expressly conformed for purposes of partnerships and trusts.

California does not have specific provisions for foreign trusts.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Effective Date

The new federal provision is effective for returns filed after August 5, 1997.

Impact on California Revenue

Based on the minor impact projected for the federal law change, the effects of the federal requirement would result in negligible revenue gains (less than $250,000), beginning in 1998-9.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1028	Registration and Penalties For Confidential Corporate Tax Shelters

Background

An organizer of a tax shelter is required to register the shelter with the Internal Revenue Service (IRS) (sec. 6111). If the principal organizer does not do so, the duty may fall upon any other participant in the organization of the shelter or any person participating in its sale or management. The shelter's identification number must be furnished to each investor who purchases or acquires an interest in the shelter. Failure to furnish this number to the tax shelter investors will subject the organizer to a $100 penalty for each such failure (sec. 6707). A penalty may be imposed against an organizer who fails without reasonable cause to timely register the shelter or who provides false or incomplete information with respect to it. The penalty is the greater of 1% of the aggregate amount invested in the shelter or $500. Persons claiming any tax benefit with respect to a shelter must report its registration number on their returns. Failure to do so without reasonable cause will subject a person to a $250 penalty.

A person who organizes or sells an interest in a tax shelter subject to the registration rule or in any other potentially abusive plan or arrangement must maintain a list of the investors. A $50 penalty may be assessed for each name omitted from the list. The maximum penalty per year is $100,000. For this purpose, a tax shelter is defined as any investment that meets two requirements. First, the investment must be (1) required to be registered under a federal or state law regulating securities, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a federal or state agency regulating the offering or sale of securities, or (3) a substantial investment. Second, it must be reasonable to infer that the ratio of deductions and 50% of credits to investment for any investor (i.e., the tax shelter ratio) may be greater than two to one as of the close of any of the first five years ending after the date on which the investment is offered for sale. An investment that meets these requirements will be considered a tax shelter regardless of whether it is marketed or customarily designated as a tax shelter.

Accuracy-Related Penalty.

The accuracy-related penalty, which is imposed at a rate of 20%, applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. The substantial understatement penalty applies in the following manner: If the correct income tax liability of a taxpayer for a taxable year exceeds that reported by the taxpayer by the greater of 10% of the correct tax or $5,000 ($10,000 in the case of most corporations), then a substantial understatement exists and a penalty may be imposed equal to 20% of the underpayment of tax attributable to

the understatement. In determining whether a substantial understatement exists, the amount of the understatement is reduced by any portion attributable to an item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return and there was a reasonable basis for the tax treatment of the item. Special rules apply to tax shelters.

With respect to tax shelter items of non-corporate taxpayers, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for his position, he reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters. The reduction in the understatement for items disclosed on the return is inapplicable to both corporate and non-corporate tax shelters. For this purpose, a tax shelter is a partnership or other entity, plan, or arrangement the principal purpose of which is the avoidance or evasion of Federal income tax. The Secretary may waive the penalty with respect to any item if the taxpayer establishes reasonable cause for his treatment of the item and that he acted in good faith.

New Federal Law (Secs. 6111, 6707, 6662)

Under the Act a promoter of a corporate tax shelter must register the shelter with the Secretary. Registration is required not later than the next business day after the day when the tax shelter is first offered to potential investors. If the promoter is not a U.S. person, or if a required registration is not otherwise made, then any U.S. participant is required to register the shelter. An exception to this special rule provides that registration would not be required if the U.S. participant notifies the promoter in writing not later than 90 days after discussions began that the U.S. participant will not participate in the shelter and the U.S. person does not in fact participate in the shelter.

A corporate tax shelter includes any investment, plan, arrangement or transaction (1) a significant purpose of the structure of which is tax avoidance or evasion by a corporate participant, (2) that is offered to any potential participant under conditions of confidentiality, and (3) for which the tax shelter promoters may receive total fees in excess of $100,000. A transaction is offered under conditions of confidentiality if: (1) an offeree (or any person acting on its behalf) has an understanding or agreement with or for the benefit of any promoter to restrict or limit its disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter claims, knows or has reason to know (or the promoter causes another person to claim or otherwise knows or has reason to know that a party other than the potential offeree claims) that the transaction (or one or more aspects of its structure) is proprietary to the promoter or any party other than the offeree, or is otherwise protected from disclosure or use. The promoter includes specified related parties.

Registration will require the submission of information identifying and describing the tax shelter and the tax benefits of the tax shelter, as well as such other information as the Treasury Department may require.

Tax shelter promoters are required to maintain lists of those who have signed confidentiality agreements, or otherwise have been subjected to nondisclosure requirements, with respect to particular tax shelters. In addition, promoters must retain lists of those paying fees with respect to plans or arrangements that have previously been registered (even though the particular party may not have been subject to confidentiality restrictions).

All registrations will be treated as taxpayer information under the provisions of section 6103 and will therefore not be subject to any public disclosure.

The penalty for failing to timely register a corporate tax shelter is the greater of $10,000 or 50% of the fees payable to any promoter with respect to offerings prior to the date of late registration (i.e., this part of the penalty does not apply to fee payments with respect to offerings after late registration). A similar penalty is applicable to actual participants in any corporate tax shelter who were required to register the tax shelter but did not. With respect to participants, however, the 50% penalty is based only on fees paid by that participant. Intentional disregard of the requirement to register by either a promoter or a participant increases the 50% penalty to 75% of the applicable fees.

Substantial Understatement Penalty.

In determining whether a substantial understatement exists, the Act amendment provides that in no event would a corporation have a reasonable basis for its tax treatment of an item attributable to a multi-party financing transaction if such treatment does not clearly reflect the income of the corporation. No inference is intended that such a multi-party financing transaction could not also be a tax shelter as defined under the modification described below or under present law. Additionally the Act amendments, for purposes of the special rules to determine whether there is a significant underpayment by a tax shelter, changes the definition of a tax shelter to be consistent with the registration provisions for tax shelters so that it is an entity the significant purpose (rather than principal purpose) of which is the avoidance or evasion of federal income tax.

Treasury Report.

The Treasury Department is directed, in consultation with the Department of Justice, to issue a report no later than August 5, 1998, to the tax-writing committees on the following tax shelter issues: (1) a description of enforcement efforts under section 7408 of the Code (relating to actions to enjoin promoters of abusive tax shelters) with respect to corporate tax shelters and the lawyers, accountants, and others who provide opinions (regardless of whether directly addressed to the taxpayer) regarding aspects of corporate tax shelters; (2) an evaluation of whether the penalties regarding

corporate tax shelters are generally sufficient; and (3) an evaluation of whether confidential tax shelter registration should be extended to transactions where the investor (or potential investor) is not a corporation.

Current California Law (R&T Secs. 18547, 19182, 19164)

California conforms to the pre-TRA 97 law treatment for the purposes of registration requirements for tax shelters, the filing of information returns and the significant underpayment penalty via “stand-alone” provisions that make reference to the relevant federal law sections.

Effective Date

The tax shelter registration provision applies to any tax shelter offered to potential participants after the date the Treasury Department issues guidance with respect to the filing requirements. The modifications to the substantial understatement penalty apply to items with respect to transactions entered into after August 5, 1997.

Impact on California Revenue

Based on federal estimates, conforming to the provision would result in penalty assessments estimated to be $1 million annually beginning in 1998-99.

It is assumed the “confidential corporate tax shelter” registration provision applies to any tax shelter interests offered to potential participants after the date the IRS issues guidance with respect to the filing and other requirements; the modification to the substantial understatement penalty applies to items with respect to transactions entered into after August 5, 1997.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1031	Airport and Airway Trust Fund Excise Taxes

New Federal Law (Secs. 4091, 4081, 4041, 4261, 4271, 9502)

In general. – The following Airport and Airway Trust Fund excise taxes are extended for 10 years, through September 30, 2007: the domestic and international air passenger excise tax, the air cargo excise tax, aviation fuel tax, aviation gasoline tax and the noncommercial aviation fuels tax. The imposition of the domestic and international air passenger excise tax and the air cargo excise tax also are modified.

Additionally, certain excise tax on aviation gasoline and jet fuel will be deposited into the Airport and Airway Trust Fund, instead of the General Fund and certain payments will be delayed.

Current California Law

California fuel taxes are administered by Board of Equalization (BOE). Defer to BOE.

Effective Date

The new federal provisions generally are effective on or after October 1, 1997, with certain exceptions.

Impact on California Revenue

Defer to BOE.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1032	Kerosene Taxed as Diesel Fuel

New Federal Law (Secs. 4081, 4083, 4082, and 4101)

The diesel fuel excise tax provisions generally are extended to apply to kerosene.

Current California Law

California fuel taxes are administered by Board of Equalization (BOE). Defer to BOE.

Effective Date

The new federal provisions are effective on July 1, 1998.

Impact on California Revenue

Defer to BOE.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1033	Restoration of Leaking Underground Storage Tank Trust Fund

New Federal Law (Sec. 4081)

The Act amendment reinstates for seven and one-half years a 0.1-cent-per-gallon excise tax imposed on gasoline, diesel fuel, special motor fuels, aviation fuels, and inland waterway fuels, which had sunset January 1, 1996. Revenues are transferred to a Leaking Underground Storage Tank Trust Fund to finance cleanup of damage from leaking underground storage tanks.

Current California Law

California fuel taxes and the Petroleum Underground Storage Tank Fees are administered by Board of Equalization (BOE). Defer to BOE.

Effective Date

The new federal law reinstates the tax from October 1, 1997, through March 31, 2005.

Impact on California Revenue

Defer to BOE.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1034	Application of Communications Tax to Prepaid Telephone Cards

New Federal Law (Sec. 4251)

Under the Act, the 3% excise tax imposed on amounts paid for local and toll (long-distance) telephone service and teletypewriter exchange service also applies to any amounts paid to communications service providers (in cash or in kind) for the right to award or otherwise distribute free or reduced-rate long-distance telephone service. The communications tax applies in the case of prepaid telephone cards and similar arrangements to the retail value of the service provided by the use of the card or arrangement. Examples of these taxable amounts include (1) prepaid telephone cards offered through service stations, convenience stores and other businesses to their customers and others, and (2) amounts received by communication service providers pursuant to joint venture credit card or other marketing arrangements. The Treasury Department is authorized specifically to disregard accounting allocations or other arrangements that have the effect of reducing artificially the base to which the 3% tax is applied. The committee reports indicate that no inference is intended from this provision as to the proper treatment of these payments under previous law.

Prepaid telephone cards are offered to the public in two forms for which the 3% tax applies:

1. “Dollar value cards,” which means the final customer purchases a card or account which allows him to utilize $X worth of telephone service provided by an underlying telecommunications carrier. In this case, the 3% tax applies to the value X at the time the prepaid telephone card is sold by a telecommunications carrier to a person who is not a telecommunications carrier.

2. “Unit cards” or “minute cards,” which means the final customer purchases a card or account which allows him to use Y number of units or minutes of telephone service provided by an underlying telecommunications carrier. In this case, the 3% tax is based on the retail value of the telephone service offered to a consumer.

To achieve neutral treatment of “dollar cards” or “unit or minute cards,” the Treasury Department is authorized to determine the appropriate retail value of the units or minutes of service offered on such cards

Prepaid communication services do not constitute payment for purposes of this 3% tax if the customer is entitled to a full refund, in cash, for the value of any unused service. The committee reports indicate that no inference is intended from this provision as to the proper treatment of payments received by communications service providers for prepaid telephone cards and amounts received by communication service providers pursuant to joint venture credit card or other marketing arrangements under prior law.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Current California Law

Taxes on interstate telephone communication services are administered by Board of Equalization (BOE). Defer to BOE.

Effective Date

The new federal provision is effective for amounts paid on or after August 5, 1997.

Impact on California Revenue

Defer to BOE.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1035	Extension of Temporary Unemployment Tax

Background

The Federal Unemployment Tax Act (FUTA) imposes a 6.2% gross tax rate on the first $7,000 paid annually by covered employers to each employee. Employers in states with programs approved by the federal government and with no delinquent federal loans may credit 5.4-percentage points against the 6.2% tax rate, making the minimum, net federal unemployment tax rate 0.8 percent. Since all states have approved programs, 0.8% is the federal tax rate that generally applies. This Federal revenue finances administration of the system, half of the federal-state extended benefits program, and a federal account for state loans.

In 1976, Congress passed a temporary surtax of 0.2% of taxable wages to be added to the permanent FUTA tax rate. Thus, the current 0.8% FUTA tax rate has two components: a permanent tax rate of 0.6 percent, and a temporary surtax rate of 0.2 percent.

New Federal Law (Sec. 3301)

The Act extends the temporary surtax rate, which otherwise would have expired December 31, 1998, through December 31, 2007.

Current California Law

The state unemployment taxes collected by California from employers within the state are held in trust and are used to fund unemployment insurance benefits for unemployed workers in the state. Employment Development Department (EDD) administers California’s employment related taxes.

Effective Date

The extension is effective for labor performed on or after January 1, 1999.

Impact on California Revenue

Defer to EDD.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1041	Extend UBIT Rules to Second-Tier Subsidiaries and Amend Control Test

Background

In general, interest, rents, royalties and annuities are excluded from unrelated taxable business income (UBTI) of tax-exempt organizations. However, section 512(b)(13) treats otherwise excluded rent, royalty, annuity, and interest income as UBTI if such income is received from a taxable or tax-exempt subsidiary that is 80%-controlled by the parent tax-exempt organization. For this purpose, a “controlled organization” is defined under section 368(c). In the case of a stock subsidiary, the 80% control test is met if the parent organization owns 80% or more of the voting stock and all other classes of stock of the subsidiary. In the case of a non-stock subsidiary, the applicable Treasury regulations look to factors such as the representation of the parent corporation on the board of directors of the nonstock subsidiary, or the power of the parent corporation to appoint or remove the board of directors of the subsidiary.

Under federal law prior to the passage of the Act, rent, royalty, annuity, and interest payments are treated as UBTI when received by the parent organization based on the percentage of the subsidiary's income that is UBTI (either in the hands of the subsidiary if the subsidiary is tax-exempt, or in the hands of the parent organization if the subsidiary is taxable).

The control test under section 512(b)(13) does not, however, incorporate any indirect ownership rules. PLR 9338003 (June 16, 1993) held that because no indirect ownership rules are applicable under section 512(b)(13), rents paid by a second-tier taxable subsidiary are not UBTI to a tax-exempt parent organization. In contrast, an example of an indirect ownership rule can be found in code section 318. Section 318(a)(2)(C) provides that if 50% or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly by or for such corporation, in the proportion the value of the person's stock ownership bears to the total value of all stock in the corporation. Consequently, rents, royalties, annuities and interest derived from second-tier subsidiaries generally do not constitute UBTI to the tax-exempt parent organization. PLR 9542045 (July 28, 1995) held that first-tier holding company and second-tier operating subsidiary were organized with bona fide business functions and were not agents of the tax-exempt parent organization; therefore, rents, royalties, and interest received by tax-exempt parent organization from second-tier subsidiary were not UBTI.

New Federal Law (Sec. 512(b))

The Act modifies the test for determining control for purposes of section 512(b)(13). Under the Act, “control” means (in the case of a stock corporation) ownership by vote or value of more than 50% of the stock. In the case of a partnership or other entity, control means ownership of more than 50%

of the profits, capital or beneficial interests. In addition, the Act applies the constructive ownership rules of section 318 for purposes of section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50% of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second or lower-tier subsidiary).

The Act also makes technical modifications to the method provided in section 512(b)(13) for determining how much of an interest, rent, annuity, or royalty payment made by a controlled entity to a tax-exempt organization is includible in the latter organization's UBTI. Such payments are subject to the unrelated business income tax to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity.

Current California Law (R&T Sec. 23732)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to UBTI of tax-exempt organizations.

Effective Date

The provision generally applies to taxable beginning after August 5, 1997. The provision does not apply to payments made during the first two taxable years beginning on or after the date of enactment if such payments are made pursuant to a binding written contract in effect as of June 8, 1997, and at all times thereafter before such payment.

Impact on California Revenue

Based on the low level of federal estimates, conforming to the provision would result in minor revenue gains of less than $500,000 annually. It is assumed the provision would apply generally for taxable years after August 5, 1997.

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

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1042	Repeal Grandfather Rule with Respect to Pension Business of Certain Insurers

Background

Present law provides that an organization described in section 501(c)(3) or (4) of the Code is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance. When this rule was enacted in 1986, certain specialtreatment (described below) applied to Blue Cross and Blue Shield organizations providing health insurance that (1) were in existence on August 16, 1986; (2) were determined at any time to be tax-exempt under a determination that had not been revoked; and (3) were tax-exempt for the last taxable year beginning before January 1, 1987 (when the present-law rule became effective), provided that no material change occurred in the structure or operations of the organizations after August 16, 1986, and before the close of 1986 or any subsequent taxable year.

The treatment applicable to such organizations, which became taxable organizations under the provision, is as follows: A special deduction applies with respect to health business equal to 25% of the claims and expenses incurred during the taxable year less the adjusted surplus at the beginning of the year. An exception is provided for such organizations from the application of the 20% reduction in the deduction for increases in unearned premiums that applies generally to property and casualty insurance companies. A fresh start was provided with respect to changes in accounting methods resulting from the change from tax-exempt to taxable status. Thus, no adjustment was made under section 481 on account of an accounting method change. Such an organization was required to compute its ending 1986 loss reserves without artificial changes that would reduce 1987 income. Thus, any reserve weakening after August 16, 1986 was treated as occurring in the organization's first taxable year beginning after December 31, 1986. The basis of such an organization's assets was deemed to be equal to the amount of the assets' fair market value on the first day of the organization's taxable year beginning after December 31, 1986, for purposes of determining gain or loss (but not for determining depreciation or for other purposes).

Grandfather rules were provided in the 1986 Act relating to the provision. The provision dod not apply to that portion of the business of the Teachers Insurance Annuity Association-College Retirement Equities Fund which is attributable to pension business, nor does the provision apply with respect to that portion of the business of Mutual of America which is attributable to pension business. Pension business means the administration of any plan described in section 401(a) of the Code which includes a trust exempt from tax under section 501(a), any plan under which amounts are contributed by an individual's employer for an annuity contract described in section 403(b) of the code, any individual retirement plan described in section 408 of the code, and any eligible deferred compensation plan to which section 457(a) of the code applies.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

New Federal Law (Amending Sec. 1012(c) of the Tax Reform Act of 1986)

The Act repeals the grandfather rules applicable to that portion of the business of the Teachers Insurance Annuity Association-College Retirement Equities Fund which is attributable to pension business and to that portion of the business of Mutual of America which is attributable to pension business. The Teachers Insurance Annuity Association and College Retirement Equities Fund and Mutual of America are to be treated for federal tax purposes as life insurance companies.

A fresh start is provided with respect to changes in accounting methods resulting from the change from tax-exempt to taxable status. Thus, no adjustment is made under section 481 on account of an accounting method change. The Teachers Insurance Annuity Association and College Retirement Equities Fund and Mutual of America are required to compute ending 1997 loss reserves without artificial changes that would reduce 1998 income. Thus, any reserve weakening after June 8, 1997, is treated as occurring in the organization's first taxable year beginning after December 31, 1997. The basis of assets of Teachers Insurance Annuity Association and College Retirement Equities Fund and Mutual of America is deemed to be equal to the amount of the assets' fair market value on the first day of the organization's taxable year beginning after December 31, 1997, for purposes of determining gain or loss (but not for determining depreciation or for other purposes).

Current 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 during the year from business transacted in California. The gross premiums tax rate is set each year by the State Board of Equalization. Since 1990, the tax has been set at 2.35%.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1051	Certain Sales of Inventory Treated as U.S. Source Income

Background

Under the subpart F rules, the U.S. 10% shareholders of a controlled foreign corporation (CFC) are subject to U.S. tax on certain income earned by the CFC, regardless of whether or not such income is actually distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, "foreign personal holding company income."

Foreign personal holding company income generally consists of the following: dividends, interest, royalties, rents and annuities; net gains from sales or exchanges of (1) property that gives rise to the foregoing types of income, (2) property that does not give rise to income, and (3) interests in trusts, partnerships, and REMICs; net gains from commodities transactions; net gains from foreign currency transactions; and income that is equivalent to interest. Income from notional principal contracts referenced to commodities, foreign currency, interest rates, or indices thereon is treated as foreign personal holding company income, whereas income from equity swaps or other types of notional principal contracts is not treated as foreign personal holding company income. Income derived from transfers of debt securities (but not equity securities) pursuant to the rules governing securities lending transactions (sec. 1058) is treated as foreign personal holding company income.

Income earned by a CFC that is a regular dealer in the property sold or exchanged generally is excluded from the definition of foreign personal holding company income. However, no exception is available for a CFC that is a regular dealer in financial instruments referenced to commodities.

A U.S. shareholder of a passive foreign investment company (PFIC) is subject to U.S. tax and an interest charge with respect to certain distributions from the PFIC and gains on dispositions of the stock of the PFIC, unless the shareholder elects to include in income currently for U.S. tax purposes its share of the earnings of the PFIC. A foreign corporation is a PFIC if it satisfies either a passive income test or a passive assets test. For this purpose, passive income is defined by reference to foreign personal holding company income.

New Federal Law (Sec. 954(c))

The Act treats net income from all types of notional principal contracts as a new category of foreign personal holding company income. However, income, gain, deduction or loss from a notional principal contract entered into to hedge an item of income in another category of foreign personal holding company income is included in that other category.

The Act treats payments in lieu of dividends derived from equity securities lending transactions pursuant to section 1058 as another new category of foreign personal holding company income. The Act provides an exception from

foreign personal holding company income for certain income, gain, deduction, or loss from transactions (including hedging transactions) entered into in the ordinary course of a CFC's business as a regular dealer in property, forward contracts, options, notional principal contracts, or similar financial instruments (including instruments referenced to commodities). These modifications to the definition of foreign personal holding company income apply for purposes of determining a foreign corporation's status as a PFIC.

The conference committee report indicates that the conferees wish to clarify the treatment of notional principal contracts under the provision. Although net income from notional principal contracts is added as a new category of foreign personal holding company income, amounts with respect to a notional principal contract entered into to hedge an item described in another category of foreign personal holding company income are taken into account under the rules of such other category. In this regard, gains and losses from transactions in inventory property are covered by an exclusion from the category of personal holding company income for net gains from property transactions; income from a notional principal contract entered into to hedge inventory property is taken into account under such category and thus similarly is excluded from foreign personal holding company income.

Current California Law (R&T Sec. 25110)

California does not generally conform to the federal rules for sourcing the income of foreign corporations, except for certain foreign corporations doing business in California. Those corporations which have a water’s-edge election in force are required to use federal rules to determine United States source income, including rules for foreign corporations.

With respect to banks and corporations, other than water’s-edge corporations, California uses the world wide combined reporting (WWCR) method of determining the income subject to California tax.

Effective Date

The provision applies to taxable years beginning after August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1052	Restrict Like-Kind Exchange Rules

Background

An exchange of property generally is a taxable event. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like-kind" which is to be held for productive use in a trade or business or for investment (sec. 1031). In general, any kind of real estate is treated as of a like-kind with other real property as long as the properties are both located either within or outside the United States. In addition, certain types of property, such as inventory, stocks and bonds, and partnership interests, are not eligible for nonrecognition treatment under section 1031.

If section 1031 applies to an exchange of properties, the basis of the property received in the exchange is equal to the basis of the property transferred, decreased by any money received by the taxpayer, and further adjusted for any gain or loss recognized on the exchange.

New Federal Law (Sec. 1031(h))

The Act provides that personal property predominantly used within the United States and personal property predominantly used outside the United States are not "like-kind" properties. For this purpose, the use of the property surrendered in the exchange will be determined based upon its use during the 24 months immediately prior to the exchange. Similarly, for section 1031 to apply, property received in the exchange must continue in the same use (i.e., foreign or domestic) for the 24 months immediately after the exchange. The 24-month period is reduced to such lesser time as the taxpayer held the property, unless such shorter holding period is a result of a transaction (or series of transactions) structured to avoid the purposes of the provision. Property described in section 168(g)(4) (generally, property used both within and without the United States that is eligible for accelerated depreciation as if used in the United States) will be treated as property predominantly used in the United States.

Current California Law (R&T Secs. 18031, 18043, and 24941)

In general, California is conformed to the federal like-kind exchange provision as it read January 1, 1997, with specified modifications regarding effective dates. California currently does not require that the exchange property be located in a particular state or country to qualify as "like-kind" property.

Effective Date

The provision is effective for exchanges after June 8, 1997, unless the exchange is pursuant to a binding contract in effect on such date and all times thereafter. A contract will not fail to be considered to be binding solely because (1) it provides for a sale in lieu of an exchange or (2) either the property to be disposed of as relinquished property or the property to be acquired as replacement property (whichever is applicable) was not identified under the contract before June 9, 1997.

Impact on California Revenue

Based on the low impact projected for the federal law, conforming to this change would produce minor revenue gains (on the order of $500,000 annually).

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

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1053	Foreign Tax Credit – Dividend Holding Period Requirement

Background

A U.S. person that receives a dividend from a foreign corporation generally is entitled to a credit for foreign income taxes paid on the dividend, regardless of the shareholder's holding period for the stock. If a regulated investment company ("RIC") elects, U.S. persons that receive dividends from the RIC generally are entitled to an indirect credit for foreign taxes paid by the RIC, regardless of the shareholder's holding period for the RIC stock. A U.S. corporation that receives a dividend from a foreign corporation in which it has a 10% or greater voting interest generally is entitled to an indirect credit for foreign taxes paid by the foreign corporation, also regardless of the shareholder's holding period.

New Federal Law (Sec. 901(k))

The Act disallows the foreign tax credits normally available with respect to a dividend from a corporation or RIC if the shareholder has not held the stock for 16 days in the case of common stock and 46 days in the case of preferred stock. The disallowance applies both to foreign tax credits for foreign withholding taxes that are paid on the dividend where the dividend-paying stock is held for less than these holding periods, and to indirect foreign tax credits for taxes paid by a lower-tier foreign corporation or a RIC, where any of the required stock in the chain of ownership is held for less than these holding periods.

Periods during which a taxpayer is protected from risk of loss generally are not counted toward the holding period requirement. In the case of a bona fide contract to sell stock, a special rule applies for purposes of indirect foreign tax credits. The Act also provides an exception for active securities dealers.

Current California Law

California does not have a comparable credit.

Effective Date

This provision is effective for dividends paid or accrued more than 30 days after August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1054	Limitation on Treaty Benefits for Payments to Hybrid Entities

Background

Nonresident alien individuals and foreign corporations (collectively, foreign persons) that are engaged in business in the United States are subject to U.S. tax on the income from such business in the same manner as a U.S. person. In addition, the United States imposes tax on certain types of U.S.-source income, including interest, dividends and royalties, of foreign persons not engaged in business in the United States. Such tax is imposed on a gross basis and is collected through withholding. The statutory rate of this withholding tax is 30%. However, most U.S. income tax treaties provide for a reduction in rate, or elimination, of this withholding tax. Withholding tax rates differ for different types of income and differ among treaties. The specific withholding tax rates pursuant to a treaty are the result of negotiations between the United States and the treaty partner.

The application of the withholding tax is more complicated in the case of income derived through an entity, such as a limited liability company, that is treated as a partnership for U.S. tax purposes but may be treated as a corporation for purposes of the tax laws of a treaty partner. The Treasury regulations include specific rules that apply in the case of income derived through an entity that is treated as a partnership for U.S. tax purposes. In the case of a payment of an item of U.S. source income to a U.S. partnership, the partnership is required to impose the withholding tax to the extent the item of income is includable in the distributive share of a partner who is a foreign person. Tax-avoidance opportunities may arise in applying the reduced rates of withholding tax provided under a treaty to cases involving income derived through a limited liability company or other hybrid entity (e.g., an entity that is treated as a partnership for U.S. tax purposes but as a corporation for purposes of the treaty partner's tax laws).

New Federal Law (Sec. 894(c))

The Act limits the availability of a reduced rate of withholding tax pursuant to an income tax treaty in order to prevent tax avoidance. A foreign person is not entitled to a reduced rate of withholding tax under a treaty with a foreign country on an item of income derived through an entity that is treated as a partnership (or is otherwise treated as fiscally transparent) for U.S. tax purposes if:

(i) such item is not treated for purposes of the taxation laws of such foreign country as an item of income of such person;
(ii) the foreign country does not impose tax on an actual distribution of such item of income from such entity to such person; and
(iii) the treaty itself does not contain a provision addressing the applicability of the treaty in the case of income derived through a partnership or other fiscally transparent entity.

The Act addresses a potential tax-avoidance opportunity for Canadian corporations with U.S. subsidiaries that arises because of the interaction between the U.S. tax law, the Canadian tax law, and the income tax treaty between the United States and Canada. Through the use of an U.S. limited liability company, which is treated as a partnership for U.S. tax purposes but as a corporation for Canadian tax purposes, a payment of interest (which is deductible for U.S. tax purposes) may be converted into a dividend (which is excludable for Canadian tax purposes). Accordingly, interest paid by a U.S. subsidiary through a U.S. limited liability company to a Canadian parent corporation would be deducted by the U.S. subsidiary for U.S. tax purposes and would be excluded by the Canadian parent corporation for Canadian tax purposes; the only tax on such interest would be a U.S. withholding tax, which may be imposed at a reduced rate of 10% pursuant to the income tax treaty between the United States and Canada. Under the Act, withholding tax is imposed at the full statutory rate of 30% in such case. The provision would not apply if the U.S.-Canadian income tax treaty is amended to include a provision reaching a similar result. In this regard, the United States and Canada recently negotiated a proposed protocol that would amend the provision in the treaty governing cross-border social security payments, and this issue could be addressed in the context of that protocol or an additional protocol. Moreover, the provision would not apply if Canada were to impose tax on the Canadian parent on dividends received from the U.S. limited liability company. It is believed that the provision generally is consistent with U.S. treaty obligations, including the U.S.-Canada treaty. The United States has recognized authority to implement its tax treaties so as to avoid abuses.

The Act provides regulatory authority to address the availability of treaty benefits in situations that involve hybrid entities but that are not covered by the denial of benefits specifically provided by the provision. On June 30, 1997 the Secretary issued proposed and temporary regulations addressing the availability of treaty benefits in cases involving hybrid entities. The conference committee report approves the recently issued Temp. Reg. Sec. 1.894-1T and indicates that the regulations are consistent with U.S. treaty obligations. Such provision and regulations represent interpretations of U.S. treaties clarifying those situations involving hybrid entities in which taxpayers are entitled to treaty benefits and those situations in which they are not.

Current California Law

California has not conformed to federal provisions relating to treaty benefits.

Effective Date

The provision is effective on August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1055	Interest on Underpayments Not Reduced by Foreign Tax Credit Carryover

Background

U.S. persons may credit foreign taxes against U.S. tax on foreign source income. The amount of foreign tax credits that can be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. Separate limitations are applied to specific categories of income. The amount of creditable taxes paid or accrued in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back two years and carried forward five years.

For purposes of the computation of interest on overpayments of tax, if an overpayment for a taxable year results from a foreign tax credit carryback from a subsequent taxable year, the overpayment is deemed not to arise prior to the filing date for the subsequent taxable year in which the foreign taxes were paid or accrued (sec. 6611(g)). Accordingly, interest does not accrue on the overpayment prior to the filing date for the year of the carryback that effectively created such overpayment. In Fluor Corp. v. United States, 35 Fed. Cl. 520 (1996), the court held that in the case of an underpayment of tax (rather than an overpayment) for a taxable year that is eliminated by a foreign tax credit carryback from a subsequent taxable year, interest does not accrue on the underpayment that is eliminated by the foreign tax credit carryback. The IRS has filed an appeal in the Fluor case.

New Federal Law (Secs. 6601(d), 6601(f), 6611(f),6611(g)&(h)

This Act extends the restricted interest rule applicable to an overpayment of tax created by a foreign tax credit carryback to an underpayment of tax that is offset by a foreign tax credit carryback.

Current California Law

California does not have a comparable tax credit.

Effective Date

The provision applies to foreign tax credit carrybacks arising in tax years beginning after August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1056	Clarification of Period for Filing Claims for Refund

Background

The excess foreign tax credit may be carried back two years and carried forward five years. The statute of limitations on filing claims for credit or refund of an overpayment attributable to foreign tax credits is ten years from the filing date for the taxable year with respect to which the claim is made.

Under prior law, it was unclear whether the period of limitations for filing a claim attributable to a foreign tax credit carryforward was the year in which the foreign taxes were paid or accrued or the year to which the foreign tax credits were carried. The Internal Revenue Service had taken the position that the period of limitations is determined by reference to the year in which the foreign taxes were paid or accrued Rev. Rul. 84-125). However, the court held in Ampex Corp. v. United States, 620 F.2d 853 (1980), that the period of limitations is determined by reference to the year to which the foreign tax credits are carried.

New Federal Law (Sec. 6511(d)(3)(A)

This Act reverses the decision in Ampex. The limitations period of a claim relating to an overpayment attributable to foreign tax credits is determined by reference to the year in which the foreign taxes were paid or accrued (and not the year to which the foreign tax credits are carried). The committee reports indicate that no inference is intended regarding the determination of such limitations period under present law.

Current California Law

California does not have a comparable tax credit.

Effective Date

The provision is effective for foreign taxes paid or accrued in taxable years beginning after August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1057	Repeal Special AMT Exception to Foreign Tax Credit limitation

Background

Present law imposes a minimum tax on a corporation to the extent the taxpayer's minimum tax liability exceeds its regular tax liability. The corporate minimum tax is imposed at a rate of 20% on alternative minimum taxable income in excess of a phased-out $40,000 exemption amount. The combination of the taxpayer's net operating loss carryover and foreign tax credits cannot reduce the taxpayer's alternative minimum tax liability by more than 90% of the amount determined without these items.

The Omnibus Budget Reconciliation Act of 1989 (1989 Act) provided a special exception to the limitation on the use of the foreign tax credit against the tentative minimum tax. In order to qualify for this exception, a corporation must meet four requirements. First, more than 50% of both the voting power and value of the stock of the corporation must be owned by U.S. persons who are not members of an affiliated group which includes such corporation. Second, all of the activities of the corporation must be conducted in one foreign country with which the United States has an income tax treaty in effect and such treaty must provide for the exchange of information between such country and the United States. Third, the corporation generally must distribute to its shareholders all current earnings and profits (except for certain amounts utilized for normal maintenance or capital expenditures related to its existing business). Fourth, all of such distributions which are received by U.S. persons must be utilized by such persons in a U.S. trade or business. This exception applies to taxable years beginning after March 31, 1990 (with a proration rule effective for certain taxable years which include March 31, 1990).

New Federal Law (Sec. 59(a))

The special exception regarding the use of foreign tax credits for purposes of the alternative minimum tax, as provided by the 1989 Act, is repealed.

Current California Law

California does not have a comparable credit.

Effective Date

The provision is effective for taxable years beginning after the date of enactment.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1061	Allocation of Basis Among Properties Distributed by Partnership

Background

The partnership provisions of present law generally permit partners to receive distributions of partnership property without recognition of gain or loss. Rules are provided for determining the basis of the distributed property in the hands of the distributee and for allocating basis among multiple properties distributed, as well as for determining adjustments to the distributee partner's basis in its partnership interest. Property distributions are tax-free to a partnership. Adjustments to the basis of the partnership's remaining undistributed assets are not required unless the partnership has made an election that requires basis adjustments both upon partnership distributions and upon transfers of partnership interests. Exceptions to this nonrecognition rule (partners receive distributions of partnership property without recognition of gain or loss) apply: (1) when money (and the fair market value of marketable securities) received exceeds a partner's adjusted basis in the partnership; (2) when only money, inventory and unrealized receivables are received in liquidation of a partner's interest and loss is realized; (3) to certain disproportionate distributions involving inventory and unrealized receivables; and (4) to certain distributions relating to contributed property. In addition, if a partner engages in a transaction with a partnership other than in its capacity as a member of the partnership, the transaction generally is considered as occurring between the partnership and one who is not a partner.

Present law provides two different rules for determining a partner's basis in distributed property, depending on whether the distribution is in liquidation of the partner's interest in the partnership. Generally, a substituted basis rule applies to property distributed to a partner in liquidation. Thus, the basis of property distributed in liquidation of a partner's interest is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction).

By contrast, generally, a carryover basis rule applies to property distributed to a partner other than in liquidation of its partnership interest, subject to a cap. Thus, in a non-liquidating distribution, the distributee partner's basis in the property is equal to the partnership's adjusted basis in the property immediately before the distribution, but not to exceed the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction). In a non-liquidating distribution, the partner's basis in its partnership interest is reduced by the amount of the basis to the distributee partner of the property distributed and is reduced by the amount of any money distributed.

In the event that multiple properties are distributed by a partnership, present law provides allocation rules for determining their bases in the distributee partner's hands. An allocation rule is needed when the substituted basis rule

for liquidating distributions applies, in order to assign a portion of the partner's basis in its partnership interest to each distributed asset. An allocation rule is also needed in a non-liquidating distribution of multiple assets when the total carryover basis would exceed the partner's basis in its partnership interest, so a portion of the partner's basis in its partnership interest is assigned to each distributed asset.

Prior law also provides for allocation in proportion to the partnership's adjusted basis. The rule allocates basis first to unrealized receivables and inventory items in an amount equal to the partnership's adjusted basis (or if the allocated basis is less than partnership basis, then in proportion to the partnership's basis), and then among other properties in proportion to their adjusted bases to the partnership. Under this allocation rule, in the case of a liquidating distribution, the distributee partner can have a basis in the distributed property that exceeds the partnership's basis in the property.

A special rule allows a partner that acquired a partnership interest by transfer within two years of a distribution to elect to allocate the basis of property received in the distribution as if the partnership had a section 754 election in effect. The special rule also allows the IRS to require such an allocation where the value at the time of transfer of the property received exceeds 110% of its adjusted basis to the partnership (sec. 732(d)). Treas. Reg. sec. 1.732-1(d)(4) generally requires the application of section 732(d) where the allocation of basis under section 732(c) upon a liquidation of the partner's interest would have resulted in a shift of basis from non-depreciable property to depreciable property.

New Federal Law (Secs. 732 and 751)

The Act modifies the basis allocation rules for distributee partners. It allocates a distributee partner's basis adjustment among distributed assets first to unrealized receivables and inventory items in an amount equal to the partnership's basis in each such property (as under present law). If the basis to be allocated is less than the sum of the adjusted bases of the properties to the partnership, then, to the extent a decrease is required to make the total adjusted bases of the properties equal the total basis to be allocated, the decrease is allocated as described below for adjustments that are decreases.

Basis is allocated first to the extent of each distributed property's adjusted basis to the partnership. Any remaining basis adjustment, if an increase, is allocated among properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation (to the extent of each property's appreciation), and then in proportion to their respective fair market values. For example, assume that a partnership with two assets, A and B, distributes them both in liquidation to a partner whose basis in its interest is 55 Neither asset consists of inventory or unrealized receivables. Asset A has a basis to the partnership of 5 and a fair market value of 40, and asset B has a basis to the partnership of 10 and a fair market value of 10. Under the provision, basis is first allocated to asset A in the amount of 5 and to asset B in the amount of 10 (their adjusted bases to the partnership). The remaining

basis adjustment is an increase totaling 40 (the partner's 55 basis minus the partnership's total basis in distributed assets of 15). Basis is then allocated to asset A in the amount of 35, its unrealized appreciation, with no allocation to asset B attributable to unrealized appreciation because its fair market value equals the partnership's adjusted basis. The remaining basis adjustment of 5 is allocated in the ratio of the assets' fair market values, i.e., 4 to asset A (for a total basis of 44) and 1 to asset B (for a total basis of 11).

If the remaining basis adjustment is a decrease, it is allocated among properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation (to the extent of each property's depreciation), and then in proportion to their respective adjusted bases (taking into account the adjustments already made). A remaining basis adjustment that is a decrease arises under the provision when the partnership's total adjusted basis in the distributed properties exceeds the amount of the partner's basis in its partnership interest, and the latter amount is the basis to be allocated among the distributed properties. For example, assume that a partnership with two assets, C and D, distributes them both in liquidation to a partner whose basis in its partnership interest is 20. Neither asset consists of inventory or unrealized receivables. Asset C has a basis to the partnership of 15 and a fair market value of 15, and asset D has a basis to the partnership of 15 and a fair market value of 5.

Under the provision, basis is first allocated to the extent of the partnership's basis in each distributed property, or 15 to each distributed property, for a total of 30. Because the partner's basis in its interest is only 20, a downward adjustment of 10 (30 minus 20) is required. The entire amount of the 10 downward adjustment is allocated to property D, reducing its basis to 5. Thus, the basis of property C is 15 in the hands of the distributee partner, and the basis of property D is 5 in the hands of the distributee partner.

Current California Law (R&T Sec. 17851)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to partnership distributions.

Effective Date

The provision applies to partnership distributions after August 5, 1997.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Impact on California Revenue

Revenue gains for this provision are estimated as follows:

Act Section 1061 Effective for Distributions (in millions)		
1997-8	1998-9	1999-0
$1	$2	$2

The estimate is based on a proration of federal estimates.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1062	Repeal of Requirement Inventory be Substantially Appreciated with Respect to Disposition of Partnership Interest

Background

Under prior law, upon the sale or exchange of a partnership interest, any amount received that was attributable to unrealized receivables, or to inventory that had substantially appreciated, was treated as an amount realized from the sale or exchange of property that was not a capital asset.

Present and prior law provides a similar rule to the extent that a distribution is treated as a sale or exchange of a partnership interest. A distribution by a partnership in which a partner receives substantially appreciated inventory or unrealized receivables in exchange for its interest in certain other partnership property (or receives certain other property in exchange for its interest in substantially appreciated inventory or unrealized receivables) is treated as a taxable sale or exchange of property, rather than as a nontaxable distribution.

For purposes of these rules, inventory of a partnership generally is treated as substantially appreciated if the fair market value of the inventory exceeds 120% of the adjusted basis of the inventory to the partnership. In applying this rule, inventory property is excluded from the calculation if a principal purpose for acquiring the inventory property was to avoid the rules relating to inventory.

New Federal Law (Secs. 724, 725, 731, 732, 735 and 751)

The Act repeals the requirement that inventory be substantially appreciated only with respect to sales or exchanges of partnership interests under section 751(a) of the Code, but not with respect to distributions under section 751(b) of the Code. Thus, present law is retained with respect to distributions governed by section 751(b).

IRC Section 751(a) relates to sale or exchanges of partnership interest. Section 751(b) relates to “certain distributions treated as sales or exchanges” (e.g., disproportionate distributions).

Current California Law (R&T Sec. 17851)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to partnership distributions of substantially appreciated inventory.

Effective Date

The provision is effective for sales, exchanges, and distributions after August 5, 1997, except that the provision does not apply to any sale or exchange pursuant to a written binding contract in effect on June 8, 1997, and at all times thereafter before such sale or exchange.

Impact on California Revenue

This revenue estimate covers Act sections 1062 and 1063.

The revenue gain from this proposal would be minor (less than $500,000 annually).

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

Federal estimates reflect the change from being taxed as capital gains to ordinary income. California does not have any difference in the rates for taxing capital gains and ordinary income. Therefore, the negligible revenue gain above reflects only capital losses that would not be permitted to be taken against ordinary income.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1063	Extension of Time for Taxing Pre-Contribution Gain

Background

Under present law, if a partner contributes appreciated property to a partnership, no gain is recognized to the contributing partner at the time of the contribution. The contributing partner's basis in its partnership interest is increased by the basis of the contributed property at the time of the contribution. The pre-contribution gain is reflected in the difference between the partner's capital account and its basis in its partnership interest (book/tax differential). Income, gain, loss, and deduction with respect to the contributed property must be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution. If the property is subsequently distributed to another partner within five years of the contribution, the contributing partner generally recognizes gain as if the property had been sold for its fair market value at the time of the distribution. Similarly, the contributing partner generally includes pre-contribution gain in income to the extent that the value of other property distributed by the partnership to that partner exceeds its adjusted basis in its partnership interest, if the distribution by the partnership is made within five years after the contribution of the appreciated property.

New Federal Law (Sec. 737(b))

The Act extends to seven years the period during which a partner recognizes pre-contribution gain with respect to property contributed to a partnership. Thus, under the provision, a partner that contributes appreciated property to a partnership generally recognizes pre-contribution gain in the event that the partnership distributes the contributed property to another partner, or distributes to the contributing partner other property whose value exceeds that partner's basis in its partnership interest, if the distribution occurs within seven years after the contribution to the partnership.

Current California Law (R&T Sec.17851)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to contributions of appreciated property to partnerships.

Effective Date

The provision is effective for property contributed to a partnership after June 8, 1997, except that the provision does not apply to any property contributed to a partnership pursuant to a written binding contract in effect on June 8, 1997, and at all times thereafter before such contribution, if the contract provides for the contribution of a fixed amount of property.

Impact on California Revenue

Revenue estimate is included with the estimate for Act section 1062.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1071	Cashout of Certain Accrued Benefits

Background

Under present law, in the case of an employee whose retirement plan participation terminates, a qualified plan may involuntarily “cash out” the benefit (i.e., pay out the balance to the credit of a plan participant without the participant's consent, and, if applicable, the consent of the participant's spouse) if the present value of the benefit does not exceed $3,500. If a benefit is cashed out under this rule and the participant subsequently returns to employment covered by the plan, then service taken into account in computing benefits payable under the plan after the return need not include service with respect to which benefits were cashed out unless the employee “buys back” the benefit.

Generally, a cash-out distribution from a qualified plan to a plan participant can be rolled over, tax free, to an IRA or to another qualified plan.

New Federal Law (Secs. 411(a), 417(e) and 457(e))

The Act increases the limit on involuntary cash outs from $3,500 to $5,000. The $5,000 amount is adjusted for inflation beginning after 1998 in $50 increments.

Current California Law (R&T Sec.17501)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to distributions from pension plans.

Effective Date

The provision is effective for plan years beginning after August 5, 1997.

Impact on California Revenue

The baseline revenue impact of this provision would be determined by the amount of additional accrued pension benefits that are distributed without consent and not rolled into another qualified plan and the marginal tax rates of recipients.

Based on the very low level of federal estimates, this provision would result in minor revenue gains of less than $500,000 annually beginning in 1997-98. This gain would occur automatically for state tax purposes. It is assumed the provision would be effective for plan years beginning after the federal date of enactment.

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

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1072	Taxable Cash Compensation in lieu of Nontaxable Parking Benefits

Background

Under present law, up to $170 per month of employer-provided parking is excludable from gross income. Under prior law, in order for the exclusion to apply, the parking must be provided in addition to and not in lieu of any compensation that is otherwise payable to the employee. Employer-provided parking cannot be provided as part of a cafeteria plan.

New Federal Law (Sec. 132(f))

Under the Act, no amount is includible in the income of an employee merely because the employer offers the employee a choice between cash and employer-provided parking. The amount of cash offered is includible in income only if the employee chooses the cash instead of parking.

Current California Law (R&T Secs. 17131, 17154)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to employer-provided parking benefits.

Effective Date

The provision is effective with respect to taxable years beginning after December 31, 1997.

Impact on California Revenue

Baseline revenue gains are projected to be negligible in 1997-8 and $500,000 annually thereafter.

Revenue gains would depend on the amount of qualified parking benefits received in cash and participating employees' average marginal tax rates in any given tax year. The revenue impact was based on federal projections and is a baseline reporting issue for state tax purposes.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1073	Repeal of Excess Distribution and Excess Retirement Accumulation Tax

Background

Under prior law, a 15% excise tax is imposed on excess distributions from qualified retirement plans, tax-sheltered annuities, and individual retirement arrangements. Excess distributions are generally the aggregate amount of retirement distributions from such plans during any calendar year in excess of $160,000 (for 1997) or five times that amount in the case of a lump-sum distribution. The 15% excise tax does not apply to distributions received in 1997, 1998, and 1999.

An additional 15% excise tax is imposed on an individual's excess retirement accumulations. Excess retirement accumulations are generally the balance in retirement plans in excess of the present value of a benefit that would not be subject to the 15% tax on excess distributions.

New Federal Law (Secs. 691(c), 2013(g), 2053(c) and 4980A)

The Act repeals both the 15% excise tax on excess distributions and the 15% estate tax on excess retirement accumulations.

Current California Law

California law does not contain an excise tax or penalty on excess distributions or excess retirement accumulations.

Effective Date

The provision repealing the excess distribution tax is effective with respect to excess distributions received after December 31, 1996. The repeal of the excess accumulation tax is effective with respect to decedents dying after December 31, 1996.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1074	Increase in Tax on Prohibited Transactions for Certain Pensions

Background

Present law prohibits certain transactions ("prohibited transactions") between a qualified plan and a disqualified person in order to prevent persons with a close relationship to the qualified plan from using that relationship to the detriment of plan participants and beneficiaries. A two-tier excise tax is imposed on prohibited transactions. Under prior law, the initial level tax was equal to 10% of the amount involved with respect to the transaction. If the transaction is not corrected within a certain period, a tax equal to 100% of the amount involved may be imposed.

New Federal Law (Sec. 4975(a))

The Act increases the initial-level prohibited transaction tax from 10% to 15%.

Current California Law

California law does not have an excise tax or penalty on prohibited transactions conducted by a qualified plan.

Effective Date

The provision is effective with respect to prohibited transactions occurring after August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1075	Basis Recovery Rules for Annuities Over More Than One Life

Background

Under present law, amounts received as an annuity under a tax-qualified pension plan generally are includible in income in the year received, except to the extent the amount received represents return of the recipient's investment in the contract (i.e., basis). The portion of each annuity payment that represents a return of basis generally is determined by a simplified method. Under this method, the portion of each annuity payment that is a return of basis is equal to the employee's total basis as of the annuity starting date, divided by the number of anticipated payments under a “specified table.” The number of anticipated payments listed in the table is based on the age of the primary annuitant on the annuity starting date.

New Federal Law (Sec. 72(d))

Under the Act, the present-law table applies to benefits based on the life of one annuitant. A separate table applies to benefits based on the life of more than one annuitant.

Combined age of annuitants	Number of payments
Not more than 110	410
More than 110 but not more than 120	360
More than 120 but not more than 130	310
More than 130 but not more than 140	260
More than 140	210

The Act clarifies that the new table applies to benefits based on the life of more than one annuitant, even if the amount of the annuity varies by annuitant. Thus, for example, the new table applies to a 50% joint and survivor annuity. The new table does not apply to an annuity paid on a single life merely because it has additional features, e.g., a term certain.

Current California Law (R&T Sec. 17081)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to the taxable portion of an annuity. Due to past differences in amounts excluded or deducted from income, state and federal amount differences may exist.

Effective Date

The provision is effective with respect to annuity starting dates after December 31, 1997.

Impact on California Revenue

Estimated revenue gains are projected to be negligible in 1997-8 and on the order of $500,000 annually thereafter.

Revenue gains would result due to the change in basis recovery rules in cases of multiple annuitants. The revenue impact depends on the marginal tax rates of affected individuals and was based on federal projections.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1081	Termination of Suspense Accounts for Family Corporations

Background

A corporation (or a partnership with a corporate partner) engaged in the trade or business of farming must use an accrual method of accounting for such activities unless such corporation (or partnership), for each prior taxable year beginning after December 31, 1975, did not have gross receipts exceeding $1 million. If a farm corporation is required to change its method of accounting, the section 481 adjustment resulting from such change is included in gross income ratably over a 10-year period, beginning with the year of change. This rule does not apply to a family farm corporation.

A provision of the Revenue Act of 1987 (1987 Act) requires a family corporation (or a partnership with a family corporation as a partner) to use an accrual method of accounting for its farming business, unless for each prior taxable year beginning after December 31, 1985, such corporation (and any predecessor corporation) did not have gross receipts exceeding $25 million. A family corporation is one where at least 50% of the stock of the corporation is held by one, or in some limited cases, two or three, families.

A family farm corporation that must change to an accrual method of accounting as a result of the 1987 Act provision is required to establish a suspense account in lieu of including the entire amount of the section 481 adjustment in gross income. The initial balance of the suspense account equals the lesser of (1) the section 481 adjustment otherwise required for the year of change, or (2) the section 481 adjustment computed as if the change in method of accounting had occurred as of the beginning of the taxable year preceding the year of change.

The amount of the suspense account is required to be included in gross income if the corporation ceases to be a family corporation. In addition, if the gross receipts of the corporation attributable to farming for any taxable year decline to an amount below the lesser of (1) the gross receipts attributable to farming for the last taxable year for which an accrual method of accounting was not required, or (2) the gross receipts attributable to farming for the most recent taxable year for which a portion of the suspense account was required to be included in income, a portion of the suspense account is required to be included in gross income.

New Federal Law (Sec. 447(i))

The Act repeals the requirement that a family farm corporation to establish a suspense account when it is required to change to an accrual method of accounting. Thus, under the provision, any family farm corporation required to change to an accrual method of accounting will restore the section 481 adjustment applicable to the change in gross income ratably over a 10-year period beginning with the year of change.

In addition, any taxpayer with an existing suspense account is required to restore the account into income ratably over a 20-year period beginning in the first taxable year beginning after June 8, 1997, subject to the present-law requirements to restore such accounts more rapidly. The amount required to be restored to income for a taxable year pursuant to the 20-year spread period shall not exceed the net operating loss of the corporation for the year (in the case of a corporation with a net operating loss) or 50% of the net income of the taxpayer for the year (for corporations with taxable income). For this purpose, a net operating loss or taxable income is determined without regard to the amount restored to income under the provision. Any reduction in the amount required to be restored to income is taken into account ratably over the remaining years in the 20-year period or, if applicable, after the end of the 20-year period. Amounts that extend beyond the 20-year period remain subject to the net operating loss and 50%-of-taxable income rules. The net operating loss and 50%-of-taxable income rules do not apply to restorations of suspense accounts pursuant to present law.

The Act also repeals the present-law requirement to accelerate the recovery of suspense accounts when the gross receipts of the taxpayer decreases.

The Act also clarifies that in the case of a family farm corporation that elects to be an S corporation for a taxable year, the net operating loss and 50% of taxable income limitations shall be determined by taking into account all the items of income, gain, deduction and loss of the corporation, regardless of whether such items are separately stated under section 1366.

Current California Law (R&T Secs. 17551, 24652)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to family farm corporations being required to use the accrual method of accounting and suspense accounts.

Effective Date

The provision is effective for taxable years ending after June 8, 1997.

Impact on California Revenue

Revenue gains from this provision are estimated as follows:

Estimated Revenue Impact Taxable Years Beginning After 6/8/97 (In Millions)		
1997-8	1998-9	1999-2000
$1	$1	$1

Based on the revenue projected for the federal law change, conforming to this change would be a gain of $1 million annually.

Revenue from this provision would depend on the number of family farm corporations required to change their accounting method from cash to an accrual method and the revenue difference attributable to disallowance of a suspense account. For pre-existing suspense accounts revenue would depend on the amount of the suspense account restored annually to income.

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

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1082	Modification of Net Operating Loss Carryback & Carryforward Periods

Background

The net operating loss (NOL) of a taxpayer (generally, the amount by which the business deductions of a taxpayer exceeds its gross income) may be carried back three years and carried forward 15 years to offset taxable income in such years. A taxpayer may elect to forgo the carryback of an NOL. Special rules apply to real estate investment trusts (REITs) (no carrybacks), specified liability losses (10-year carryback), and excess interest losses (no carrybacks).

New Federal Law (Sec. 172(b))

The Act limits the NOL carryback period to two years and extends the NOL carryforward period to 20 years. The Act does not apply to the carryback rules relating to REITs, specified liability losses, excess interest losses, and corporate capital losses. In addition, the Act does not apply to NOLs arising from casualty losses of individual taxpayers.

The Act preserves the three-year carryback for NOLs of farmers and small businesses attributable to losses incurred in Presidentially-declared disaster areas.

Current California Law (R&T Secs. 17276, 24416)

California law conforms to the computation of the federal NOL. California does not allow NOL carrybacks. On the type of taxpayer and how the NOL is generated determine the amount of the NOL that is eligible to be carried forward and the number of years it can be carried forward.

Existing state law provides for seven different types of NOLs:

Type of NOL	NOL % Allowed to be Carried Over	Carryover Period
General NOL	50%	5 Years
New Business Year 1	100%	8 Years
Year 2	100%	7 Years
Year 3	100%	6 Years
Eligible Small Business	100%	5 Years
Specified Disaster Loss	100%	5 Years
	50%	10 Years
LARZ, LAMBRA & EZ	100%	15 Years

Generally, for most taxpayers, 50% of the computed NOL may be carried forward for five years. Special NOL treatment as stated in the above chart is provided for the following taxpayers:

- "New Business" is defined as a trade or business activity that first commenced in California after January 1, 1994, and for taxpayers engaged in certain biopharmaceutical activities for taxable or income years beginning on or after January 1, 1997, who have not received approval for any product from the U.S. Food and Drug Administration.

- "Eligible Small Business" is defined as a trade or business with gross receipts, less returns and allowances, of less than $1 million during the taxable or income year.

- Taxpayers who suffer a casualty loss in an area declared as a disaster by the Legislature may carry over 100% of an NOL for five years and 50% of any NOL remaining after the first five years for an additional 10 years.

- Taxpayers who operate a business in the Los Angeles Revitalization Zone (LARZ), a Local Agency Military Base Recovery Area (LAMBRA), or Enterprise Zone (EZ). However, NOLs generated in these incentive areas may only offset income generated in the incentive areas, and only one such NOL may be claimed in any year.

Special rules apply for taxpayers who have different types of NOLs generated in the same year. Generally, taxpayers operating in various tax incentive zones, or within and outside tax incentive zones, must allocate their overall loss between their various zone and non-zone activities and either take just one particular zone loss, to the exclusion of all other losses, or carry forward the entire loss under the general NOL rules.

Effective Date

The provision is effective for NOLs arising in taxable years beginning after the date of enactment.

Impact on California Revenue

Not applicable. Unlike the federal law, California makes no provision for loss carrybacks and provides that only 50% (instead of 100%) of the net operating loss for any taxable year is eligible for carryover to subsequent taxable years.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1083	Modification to Which Taxable Years Unused Credits May be Carried

Background

A qualified taxpayer is allowed to claim the rehabilitation credit, the energy credit, the reforestation credit, the work opportunity credit, the alcohol fuels credit, the research credit, the low-income housing credit, the enhanced oil recovery credit, the disabled access credit, the renewable electricity production credit, the empowerment zone employment credit, the Indian employment credit, the employer social security credit, and the orphan drug credit (collectively, known as the general business credit) subject to certain limitations based on tax liability for the year. Generally, all of the aforementioned credits are added together and treated thereafter as the general business credit. Unused general business credits generally may be carried back three years and carried forward 15 years to offset tax liability of such years, subject to the same limitations.

New Federal Law (Sec. 39)

For credits arising in taxable years beginning after December 31, 1997, the Act limits the carryback period for the general business credit to one year and extends the carryforward period to 20 years.

Current California Law

California law does not have a “general business credit.” The various California tax credits are not added together to create a generic type credit. Each California tax credit has a specified carryover period.

Effective Date

The provision is effective for credits arising in taxable years beginning after December 31, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1084	Denial of Certain Amounts Paid in Connection with Insurance

Background

Federal income tax generally is not imposed on a policyholder with respect to the earnings under a life insurance contract (inside buildup). This favorable tax treatment is available only if the policyholder has an insurable interest in the insured when the contract is issued and if the life insurance contract meets certain requirements designed to limit the investment character of the contract. Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income. In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10% tax is imposed on the income portion of distributions made before age 59½ and in certain other circumstances.

A modified endowment contract is a life insurance contract that does not meet a statutory “seven-pay” test, i.e., generally is funded more rapidly than seven annual level premiums. An exclusion from federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured. Further, certain amounts received under a life insurance contract on the life of a terminally or chronically ill individual, and certain amounts paid by a viatical settlement provider or the sale or assignment of a life insurance contract on the life of a terminally ill or chronically ill individual, are generally not excluded from income.

No deduction is permitted for premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

Present law provides generally that no deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance contracts or annuity or endowment contracts owned by the taxpayer covering any individual who is or was (1) an officer or employee of, or (2) financially interested in, any trade or business currently or formerly carried on by the taxpayer (the “COLI” rules). This interest deduction disallowance rule generally does not apply to interest on debt with respect to contracts purchased on or before June 20, 1986; rather, an interest deduction limit based on Moody's Corporate Bond Yield Average-Monthly Average Corporates applies in the case of such contracts. Phase-in rules apply generally with respect to otherwise deductible interest paid or accrued after December 31, 1995, and before January 1, 1999, in the case of debt incurred before January 1, 1996. In addition, transition rules apply. An exception to this interest

disallowance rule is provided for interest on indebtedness with respect to life insurance policies covering up to 20 key persons. A key person is an individual who is either an officer or a 20% owner of the taxpayer. The number of individuals who can be treated as key persons may not exceed the greater of (1) five individuals, or (2) the lesser of 5% of the total number of officers and employees of the taxpayer, or 20 individuals. For determining who is a 20% owner, all members of a controlled group are treated as one taxpayer. Interest paid or accrued on debt with respect to a contract covering a key person is deductible only to the extent the rate of interest does not exceed Moody's Corporate Bond Yield Average-Monthly Average Corporates for each month beginning after December 31, 1995, that interest is paid or accrued. The foregoing interest deduction limitation was added in 1996 to existing interest deduction limitations with respect to life insurance and similar contracts.

Present law provides that no deduction is allowed for interest on debt incurred or continued to purchase or carry obligations the interest on which is wholly exempt from federal income tax. In addition, in the case of a financial institution, a proration rule provides that no deduction is allowed for that portion of the taxpayer's interest that is allocable to tax-exempt interest. The portion of the interest deduction that is disallowed under this rule generally is the portion determined by the ratio of the taxpayer's (1) average adjusted bases of tax-exempt obligations acquired after August 7, 1986, to (2) the average adjusted bases for all of the taxpayer's assets. Special rules apply for certain tax-exempt obligations of small issuers.

New Federal Law (Sec. 264)

Under the Act, the present-law premium deduction limitation is modified to provide that no deduction is permitted for premiums paid on any life insurance, annuity or endowment contract, if the taxpayer is directly or indirectly a beneficiary under the contract.

The premium deduction limitation does not apply to premiums with respect to any annuity contract described in section 72(s)(5) (relating to certain qualified pension plans, certain retirement annuities, individual retirement annuities, and qualified funding assets), or to premiums with respect to any annuity to which section 72(u) applies (relating to current taxation of income on the contract in the case of an annuity contract held by a person who is not a natural person).

Under this provision, no deduction is allowed for interest paid or accrued on any indebtedness with respect to a life insurance policy, or endowment or annuity contract, covering the life of any individual. Thus, the provision limits interest deductibility in the case of such a contract covering any individual in whom the taxpayer has an insurable interest when the contract is first issued under applicable state law, except as otherwise provided under present law with respect to key persons and pre-1986 contracts.

The Act specifies the treatment of certain interest to which the provision providing for expansion of interest disallowance to individuals in whom

taxpayer has an insurable interest otherwise would apply. The conference agreement provides that in the case of a transfer for valuable consideration of a life insurance contract or any interest therein described in section 101(a)(2), the amount of the death benefit excluded from gross income under section 101(a) may not exceed an amount equal to the sum of the actual value of the consideration, premiums, interest disallowed as a deduction under new section 264(a)(4), and other amounts subsequently paid by the transferee. Thus, under the provision, in the case of the transfer for value of a life insurance contract, the interest with respect to the contract that otherwise would be disallowed under new section 264(a)(4) is capitalized, reducing the amount included in income by the transferee upon receipt by the transferee of the amounts paid by reason of the death of the insured.

In the case of a taxpayer other than a natural person, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash surrender values with respect to any life insurance policy or annuity or endowment contract issued after June 8, 1997. Interest expense is so allocable based on the ratio of (1) the taxpayer's average unborrowed policy cash values of life insurance policies, and annuity and endowment contracts, issued after June 8, 1997, to (2) the sum of (a) in the case of assets that are life insurance policies or annuity or endowment contracts, the average unborrowed policy cash values, and (b) in the case of other assets, the average adjusted bases for all such other assets of the taxpayer.

This rule does not apply to any policy or contract owned by an entity engaged in a trade or business covering an individual who is an employee, officer or director of the trade or business at the time first covered. Under the conference agreement, the exception applies to any policy or contract owned by an entity engaged in a trade or business which covers one individual who (at the time first insured under the policy or contract) is (1) a 20% owner of the entity, or (2) an individual (who is not a 20% owner) who is an officer, director or employee of the trade or business. The exception also applies in the case of a joint-life policy or contract under which the sole insureds are a 20% owner and the spouse of the 20% owner.

A joint-life contract under which the sole insureds are a 20% owner and his or her spouse is the only type of policy or contract with more than one insured that comes within the exception. Thus, for example, if the insureds under a contract include an individual described in the exception (e.g., an employee, officer, director, or 20% owner) and any individual who is not described in the exception (e.g., a debtor of the entity), then the exception does not apply to the policy or contract. For purposes of this exception, a 20% owner has the same meaning as under present-law section 264(d)(4). In addition, the conference agreement provides that the pro rata interest disallowance rule does not apply to any annuity contract to which section 72(u) applies (relating to current taxation of income on the contract in the case of an annuity contract held by a person who is not a natural person). The conference agreement provides that any policy or contract that is not subject to the pro rata interest disallowance rule by reason of this exception (for 20% owners, their

spouses, employees, officers and directors, and in the case of an annuity contract to which section 72(u) applies) is not taken into account in applying the ratio to determine the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash values.

The unborrowed policy cash values means the cash surrender value of the policy or contract determined without regard to any surrender charge, reduced by the amount of any loan with respect to the policy or contract. The cash surrender value is to be determined without regard to any other contractual or noncontractual arrangement that artificially depresses the cash value of a contract.

If a trade or business (other than a sole proprietorship or a trade or business of performing services as an employee) is directly or indirectly the beneficiary under any policy or contract, then the policy or contract is treated as held by the trade or business. For this purpose, the amount of the unborrowed cash value is treated as not exceeding the amount of the benefit payable to the trade or business. In the case of a partnership or S corporation, the provision applies at the partnership or corporate level. The amount of the benefit is intended to take into account the amount payable to the business under the contract (e.g., as a death benefit) or pursuant to another agreement (e.g., under a split dollar agreement). The amount of the benefit is intended also to include any amount by which liabilities of the business would be reduced by payments under the policy or contract (e.g., when payments under the policy reduce the principal or interest on a liability owed to or by the business).

As provided in regulations, the issuer or policyholder of the life insurance policy or endowment or annuity contract is required to report the amount of the amount of the unborrowed cash value in order to carry out this rule.

If interest expense is disallowed under other provisions of section 264 (limiting interest deductions with respect to life insurance policies or endowment or annuity contracts) or under section 265 (relating to tax-exempt interest), then the disallowed interest expense is not taken into account under this provision, and the average adjusted bases of assets is reduced by the amount of debt, interest on which is so disallowed. The provision is applied before present-law rules relating to capitalization of certain expenses where the taxpayer produces property.

An aggregation rule is provided treating related persons as one for purposes of the provision. The aggregation rule is intended to prevent taxpayers from avoiding the pro rata interest limitation by owning life insurance, endowment or annuity contracts, while incurring interest expense through an related person.

The provision does not apply to any insurance company subject to tax under subchapter L of the Code. Rather, the rules reducing certain deductions for losses incurred in the case of property and casualty companies, and reducing reserve deductions or dividends-received deductions of life insurance

companies, are modified to take into account the increase in cash values of life insurance policies or annuity or endowment contracts held by insurance companies. For purposes of those rules, an increase in the policy cash value for any policy or contract is (1) the amount of the increase in the adjusted cash value, reduced by (2) the gross premiums received with respect to the policy or contract during the taxable year, and increased by (3) distributions under the policy or contract to which section 72(e) apply (other than amounts includable in the policyholder's gross income). For this purpose, the adjusted cash value means the cash surrender value of the policy or contract, increased by (1) commissions payable with respect to the policy or contract for the taxable year, and (2) asset management fees, surrender and mortality charges, and any other fees or charges, specified in regulations, which are imposed (or would be imposed if the policy or contract were surrendered or canceled) with respect to the policy or contract for the taxable year.

Current California Law (R&T Secs. 17201, 17279.5, 24424)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to interest expense relating to insurance contracts.

Effective Date

The provisions apply with respect to contracts issued after June 8, 1997. For this purpose, a material increase in the death benefit or other material change in the contract causes the contract to be treated as a new contract. To the extent of additional covered lives under a contract after June 8, 1997, the contract is treated as a new contract. It is intended that this rule apply with respect to a master or group policy or contract, not with respect to a joint-life policy or contract (i.e., a policy or contract that insures more than one individual).

In the case of an increase in the death benefit of a contract that is converted to extended term insurance pursuant to nonforfeiture provisions, in a transaction to which section 501(d)(2) of the Health Insurance Portability and Accountability Act of 1996 applies, the contract is not treated as a new contract.

Impact on California Revenue

Revenue gains from this proposal are estimated as follows:

Act Section 1084 Applies to Contracts Issued After June 8, 1997 (in millions)		
1997-8	1998-9	1999-0
$1	$2	$4

Revenue gains from this provision depend on the total amount of corporate deductions that are no longer allowed, resulting in tax increases. The estimated impact above is based on federal estimates.

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

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1085	Earned Income Credit Compliance Provisions

Background

Certain eligible low-income workers are entitled to claim a refundable earned income credit on their income tax return. A refundable credit is a credit that not only reduces an individual's tax liability but allows refunds to the individual in excess of their income tax liability. The amount of the credit an eligible individual may claim depends upon whether the individual has one, more than one, or no qualifying children, and is determined by multiplying the credit rate by the individual's earned income up to an earned income amount.

The maximum amount of the credit is the product of the credit rate and the earned income amount. The credit is reduced by the amount of the alternative minimum tax (AMT) the taxpayer owes for the year.

The credit is phased out above certain income levels. For individuals with earned income (or AGI, if greater) in excess of the beginning of the phase-out range, the maximum credit amount is reduced by the phase-out rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phase-out range. For individuals with earned income (or AGI, if greater) in excess of the end of the phase-out range, no credit is allowed.

The definition of AGI used for phasing out the earned income credit disregards certain losses. The losses disregarded are: (1) net capital losses (if greater than zero); (2) net losses from trusts and estates; (3) net losses from nonbusiness rents and royalties; and (4) 50% of the net losses from business, computed separately with respect to sole proprietorships (other than in farming), sole proprietorships in farming, and other businesses. Also, an individual is not eligible for the earned income credit if the aggregate amount of “disqualified income” of the taxpayer for the taxable year exceeds $2,250.

Disqualified income is the sum of: (1) interest (taxable and tax-exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gain net income; and (5) net passive income (if greater than zero) that is not self-employment income. The earned income amount, the phase-out amount and the disqualified income amount are indexed for inflation. The parameters for the credit depend upon the number of qualifying children the individual claims. For 1997, the parameters are given in the following table:

Qualifying Children	Two or more	One	None
Credit rate (percent)	40.00	34.00	7.65
Earned income amount	$ 9,140	$ 6,500	$4,340
Maximum credit	$ 3,656	$ 2,210	$ 332
Phase-out begins	$11,930	$11,930	$5,430
Phase-out rate (percent)	21.06	15.98	7.65
Phase-out ends	$29,290	$25,760	$9,770

In order to claim the credit, an individual must either have a qualifying child or meet other requirements. A qualifying child must meet a relationship test, an age test, an identification test, and a residence test. In order to claim the credit without a qualifying child, an individual must not be a dependent and must be over age 24 and under age 65.

New Federal Law (Sec. 32)

(a) Deny EIC Eligibility for Prior Acts of Recklessness or Fraud.

The accuracy-related penalty, which is imposed at a rate of 20%, applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation overstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. Negligence includes any careless, reckless, or intentional disregard of rules or regulations, as well as any failure to make a reasonable attempt to comply with the provisions of the Code. The fraud penalty, which is imposed at a rate of 75%, applies to the portion of any underpayment that is attributable to fraud. Neither the accuracy-related penalty nor the fraud penalty is imposed with respect to any portion of an underpayment if it is shown that there was reasonable cause for that portion and that the taxpayer acted in good faith with respect to that portion.

Under the Act, a taxpayer who fraudulently claims the earned income credit (EIC) is ineligible to claim the EIC for a subsequent period of 10 years. In addition, a taxpayer who erroneously claims the EIC due to reckless or intentional disregard of rules or regulations is ineligible to claim the EIC for a subsequent period of two years. These sanctions are in addition to any other penalty imposed under present law. The determination of fraud or of reckless or intentional disregard of rules or regulations are made in a deficiency proceeding (which provides for judicial review).

(b) Recertification Required When Taxpayer Found to be Ineligible for EIC in the Past.

If an individual fails to provide a correct TIN and claims the EIC, such omission is treated as a mathematical or clerical error. Also, if an individual who claims the EIC with respect to net earnings from self employment fails to pay the proper amount of self-employment tax on such net earnings, the failure is treated as a mathematical or clerical error for purposes of the amount of EIC claimed. Generally, taxpayers have 60 days in which they can either provide a correct TIN or request that the IRS follow the current-law deficiency procedures. If a taxpayer fails to respond within this period, he or she must file an amended return with a correct TIN or clarify that any self-employment tax has been paid in order to obtain the EIC originally claimed.

The IRS must follow deficiency procedures when investigating other types of questionable EIC claims. Under these procedures, contact letters are first sent to the taxpayer. If the necessary information is not provided by the

taxpayer, a statutory notice of deficiency is sent by certified mail, notifying the taxpayer that the adjustment will be assessed unless the taxpayer files a petition in Tax Court within 90 days. If a petition is not filed within that time and there is no other response to the statutory notice, the assessment is made and the EIC is denied.

Under the Act, a taxpayer who has been denied the EIC as a result of deficiency procedures is ineligible to claim the EIC in subsequent years unless evidence of eligibility for the credit is provided by the taxpayer. To demonstrate current eligibility, the taxpayer is required to meet evidentiary requirements established by the Secretary of the Treasury. Failure to provide this information when claiming the EIC is treated as a mathematical or clerical error. If a taxpayer is recertified as eligible for the credit, the taxpayer is not required to provide this information in the future unless the IRS again denies the EIC as a result of a deficiency procedure. Ineligibility for the EIC under the provision is subject to review by the courts.

(c) Due Diligence Requirements for Paid Preparers.

Several penalties apply in the case of an understatement of tax that is caused by an income tax return preparer. First, if any part of an understatement of tax on a return or claim for refund is attributable to a position for which there was not a realistic possibility of being sustained on its merits and if any person who is an income tax return preparer with respect to such return or claim for refund knew (or reasonably should have known) of such position and such position was not disclosed or was frivolous, then that return preparer is subject to a penalty of $250 with respect to that return or claim. The penalty is not imposed if there is reasonable cause for the understatement and the return preparer acted in good faith. In addition, if any part of an understatement of tax on a return or claim for refund is attributable to a willful attempt by an income tax return preparer to understate the tax liability of another person or to any reckless or intentional disregard of rules or regulations by an income tax return preparer, then the income tax return preparer is subject to a penalty of $1,000 with respect to that return or claim. Also, a penalty for aiding and abetting the understatement of tax liability is imposed in cases where any person aids, assists in, procures, or advises with respect to the preparation or presentation of any portion of a return or other document if (1) the person knows or has reason to believe that the return or other document will be used in connection with any material matter arising under the tax laws, and (2) the person knows that if the portion of the return or other document were so used, an understatement of the tax liability of another person would result. Additional penalties are imposed on return preparers with respect to each failure to (1) furnish a copy of a return or claim for refund to the taxpayer, (2) sign the return or claim for refund, (3) furnish his or her identifying number, (4) retain a copy or list of the returns prepared, and (5) file a correct information return. The penalty is $50 for each failure and the total penalties imposed for any single type of failure for any calendar year are limited to $25,000.

Under the Act, return preparers are required to fulfill certain due diligence

requirements with respect to returns they prepare claiming the EIC. The penalty for failure to meet these requirements is $100. This penalty is in addition to any other penalty imposed under present law.

(d) Modify the Definition of AGI Used to Phaseout the EIC.

The Act modifies the definition of AGI used for phasing out the credit by adding two items of nontaxable income and changing the percentage of certain losses disregarded. The two items added are: (1) tax-exempt interest, and (2) nontaxable distributions from pensions, annuities, and individual retirement arrangements (but only if not rolled over into similar vehicles during the applicable rollover period). The conference agreement also increases the amount of net losses from businesses, computed separately with respect to sole proprietorships (other than farming), sole proprietorships in farming, and other businesses disregarded from 50% to 75%.

(e) Treatment of amounts received under the work requirements of the Personal Responsibility and Work Opportunity Act (PRWOA) of 1996.

The Act provides that workfare payments are not wages for purposes of the EIC. The committee reports indicate that there is no inference intended with respect to whether workfare payments otherwise qualify as wages for purposes of income and employment taxes or as wages for purposes of an employer’s eligibility for the work opportunity tax credit and welfare to work credit.

Current California Law

California does not have a comparable credit.

Effective Date

The provisions affecting denying the EIC, recertification and due diligence (items (a), (b) and (c)) are effective for taxable years beginning after December 31, 1996. The provision affecting the AGI phase out (item (d))is effective for taxable years beginning after December 31, 1997. The provision affecting payments received under the work requirements of the PRWOA (item (e)) is effective August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1086	Limitation on Property for which Income Forecast Method May be Used

Background

A taxpayer generally recovers the cost of property used in a trade or business through depreciation or amortization deductions over time. Tangible property generally is depreciated under the modified Accelerated Cost Recovery System (MACRS) of section 168, which applies specific recovery periods and depreciation methods to the cost of various types of depreciable property. MACRS does not apply to certain property, including any motion picture film, video tape, or sound recording or to any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer applies a unit-of-production method or other method of depreciation not expressed in a term of years. The cost of such property may be depreciated under the "income forecast" method.

The income forecast method is considered to be a method of depreciation not expressed in a term of years. 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 is available to any property if (1) the taxpayer elects to exclude such property from MACRS and (2) for the first taxable year for which depreciation is allowable, the property is properly depreciated under such method. 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. Most recently, the income forecast method has been held applicable to consumer durable property subject to short-term "rent-to-own" leases.

New Federal Law (Secs. 167(g) and 168)

The Act clarifies the types of property to which the income forecast method may be applied. The income forecast method is available to motion picture films, television films and taped shows, books, patents, master sound recordings, copyrights, and other such property as designated by the Secretary of the Treasury. The mere fact that the property is subject to a lease should not make the property eligible for the income forecast method. The income forecast method is not to be applicable to property to which section 197 applies.

In addition, consumer durables subject to rent-to-own contracts are provided a three-year recovery period and a four-year class life for MACRS purposes (and are not eligible for the income forecast method). Such property generally is described in Rev. Proc. 95-38. In addition, the special three-year recovery period may apply to any property generally used in the home for personal, but not business, use. The committee reports indicate that Congress understands

that certain rent-to-own property, including computer and peripheral equipment, may be used in the home for either personal or business purposes, and the taxpayer may not be aware of how its customers may use the property. So as not to increase the administrative burdens of taxpayers, the conferees intend that if such dual-use property does not represent a significant portion of a taxpayer's leasing property and if such other leasing property predominantly is qualified rent-to-own property, then such dual-use property generally also would be qualified rent-to-own property. However, if such dual-use property represents a significant portion of the taxpayer's leasing property, the burden of proof is placed on the taxpayer to show that such property is qualified rent-to-own property. In addition, the Act modifies the definition of "rent-to-own contract" to include leases that provide for decreasing regular periodic payments.

Finally, the Act clarifies that the three-year recovery period provided under the provision only applies to property subject to leases, and the committee reports indicate that no inference is intended as to whether any arrangement constitutes a lease for tax purposes.

Current California Law (R&T Secs. 17201, 17250, 17250.5, 24249(f))

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to the income forecast method of depreciation.

California has not conformed to MACRS depreciation under the B&CTL.

Effective Date

The provision is effective for property placed in service after August 5, 1997.

Impact on California Revenue

State revenue gains for this provision under the PITL will result from federal law changes. These baseline gains are projected at less than $500,000 annually. Any additional effects from a matching state law change would be negligible.

Revenue gains are considered to be baseline since federal law now clarifies treatment of this property. Most taxpayers will report the same depreciation deduction for both federal and state purposes. This makes for simplicity and enables the taxpayer to maintain one set of records for depreciation.

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

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1087	Involuntarily Converted Property Acquired from an Unrelated Person

Background

Under section 1033, 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 or use to the converted property within a specified replacement period of time. Subchapter C corporations (and certain partnerships with corporate partners) are not entitled to defer gain under section 1033 if the replacement property or stock is purchased from a related person. A person is treated as related to another person if the person bears a relationship to the other person described in section 267(b) or 707(b)(1). An exception to this related party rule provides that a taxpayer could purchase replacement property or stock from a related person and defer gain under section 1033 to the extent the related person acquired the replacement property or stock from an unrelated person within the replacement period.

New Federal Law (Sec. 1033(i))

The Act expands the present-law denial of the application of section 1033 to any other taxpayer (including an individual) that acquires replacement property from a related party (as defined by secs. 267(b) and 707(b)(1)) unless the taxpayer has aggregate realized gain of $100,000 or less for the taxable year with respect to converted property with aggregate realized gains. In the case of a partnership (or S corporation), the annual $100,000 limitation applies to both the partnership (or S corporation) and each partner (or shareholder).

Current California Law (R&T Secs. 18031, 24943, 24944, 24947)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to qualified replacement property for involuntary converted property.

Effective Date

The provision applies to involuntary conversions occurring after June 8, 1997.

Impact on California Revenue

Based on the minor impact projected for the federal law change, conforming to this change would be a gain for 1997-8 of less than $250,000 and gains of less than $500,000, thereafter.

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

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1088	Exception from Installment Sales Rules for Sales by a Manufacturer

Background

In general, the installment sales method of accounting may not be used by dealers in personal property. Present law provides an exception which permits the use of the installment method for installment obligations arising from the sale of tangible personal property by a manufacturer of the property (or an affiliate of the manufacturer) to a dealer (i.e., the sale of the property must be intended to be for resale or leasing by the dealer), but only if the dealer is obligated to make payments of principal only when the dealer resells (or rents) the property, the manufacturer has the right to repurchase the property at a fixed (or ascertainable) price after no longer than a nine-month period following the sale to the dealer, and certain other conditions are met. In order to meet the other conditions, the aggregate face amount of the installment obligations that otherwise qualify for the exception must equal at least 50% of the total sales to dealers that gave rise to such receivables (the "50% test") in both the taxable year and the preceding taxable year, except that, if the taxpayer met all of the requirements for the exception in the preceding taxable year, the taxpayer would not be treated as failing to meet the 50% test before the second consecutive year in which the taxpayer did not actually meet the test. In addition, these requirements must be met by the taxpayer in its first taxable year beginning after October 22, 1986, except that obligations issued before that date are treated as meeting the applicable requirements if such obligations were conformed to the requirements of the provision within 60 days of that date.

New Federal Law (Sec. 811(c) of the Tax Reform Act of 1986)

The Act repeals the exception that permits the use of the installment method of accounting for certain sales by manufacturers to dealers.

Current California Law (R&T Secs. 17551, 24667)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to installment sales.

Effective Date

The provision is effective for taxable years beginning one year after August 5, 1997. Any resulting adjustment from a required change in accounting will be includible ratably over the four taxable years beginning after that date.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Impact on California Revenue

Revenue gains from this provision primarily under the Bank & Corporation Tax Law are estimated as follows:

Estimated Revenue Impact		
Effective After August 5, 1998		
(in millions)		
1998-9	1999-0	2000-0
$4	$4	$4

The impact above is based on federal estimates.

Revenue gains from this provision would depend on the additional amount of sales to dealers reported in any given year due to the installment repeal. This change would be considered a change in accounting method and adjustments would be required ratably over a four-year period.

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

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1089	Limitations on Charitable Remainder Trust Eligibility

Background

Sections 170(f), 2055(e)(2) and 2522(c)(2) disallow a charitable deduction for income, estate or gift tax purposes, respectively, where the donor transfers an interest in property to a charity (e.g., a remainder interest) while also either retaining an interest in that property (e.g., an income interest) or transferring an interest in that property to a noncharity for less than full and adequate consideration. Exceptions to this general rule are provided for: (1) remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, pooled income funds, farms, and personal residences; (2) present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property; (3) an undivided portion of the donor's entire interest in the property; and (4) a qualified conservation easement.

A charitable remainder annuity trust is a trust which is required to pay a fixed dollar amount, not less often than annually, of at least 5% of the initial value of the trust to a non-charity for the life of an individual or a period of years not to exceed 20 years, with the remainder passing to charity. A charitable remainder unitrust is a trust which generally is required to pay, at least annually, a fixed percentage of the fair market value of the trust's assets determined at least annually to a noncharity for the life of an individual or a period of years not to exceed 20 years, with the remainder passing to charity. Distributions from a charitable remainder annuity trust or charitable remainder unitrust are treated first as ordinary income to the extent of the trust's current and previously undistributed ordinary income for the trust's year in which the distribution occurred; second, as capital gains to the extent of the trust's current capital gain and previously undistributed capital gain for the trust's year in which the distribution occurred; third, as other income (e.g., tax-exempt income) to the extent of the trust's current and previously undistributed other income for the trust's year in which the distribution occurred; and, fourth, as corpus. Distributions are includible in the income of the beneficiary for the year that the annuity or unitrust amount is required to be distributed even though the annuity or unitrust amount is not distributed until after the close of the trust's taxable year.

On April 18, 1997, the Treasury Department proposed regulations providing additional rules under sections 664 and 2702 to address perceived abuses involving distributions from charitable remainder trusts. One of those proposed rules would require that payment of any required annuity or unitrust amount by a charitable remainder trust (other than an “income only” unitrust) be made by the close of the trust's taxable year in which such payments are due. See Prop. Treas. reg. secs. 1.664-(a)(1)(i) and 1.664-(a)(1)(i).

New Federal Law (Secs. 664 and 2055(e))

Under the Act, a trust cannot be a charitable remainder annuity trust if the annuity for any year is greater than 50% of the initial fair market value of the trust's assets or be a charitable remainder unitrust if the percentage of assets that are required to be distributed at least annually is greater than 50%. Any trust that fails this 50% rule will not be a charitable remainder trust whose taxation is governed under section 664, but will be treated as a complex trust and, accordingly, all its income will be taxed to its beneficiaries or to the trust.

In addition, the Act requires that the value of the charitable remainder with respect to any transfer to a qualified charitable remainder annuity trust or charitable remainder unitrust be at least 10% of the net fair market value of such property transferred in trust on the date of the contribution to the trust. The 10% test is measured on each transfer to the charitable remainder trust and, consequently, a charitable remainder trust which meets the 10% test on the date of transfer will not subsequently fail to meet that test if interest rates have declined between the trust's creation and the death of a measuring life. Similarly, where a charitable remainder trust is created for the joint lives of two individuals with a remainder to charity, the trust will not cease to qualify as a charitable remainder trust because the value of the charitable remainder was less than 10% of the trust's assets at the first death of those two individuals.

The Act provides several additional rules in order to provide relief for trusts that do not meet the 10% rule. First, where a transfer is made after July 28, 1997, to a charitable remainder trust that fails the 10% test, the trust is treated as meeting the 10% requirement if the governing instrument of the trust is changed by reformation, amendment, construction, or otherwise to meet such requirement by reducing the payout rate or duration (or both) of any noncharitable beneficiary's interest to the extent necessary to satisfy such requirement so long as the reformation is commenced within the period permitted for reformations of charitable remainder trusts under section 2055(e)(3). The statute of limitations applicable to a deficiency of any tax resulting from reformation of the trust shall not expire before the date one year after the Treasury Department is notified that the trust has been reformed. In substance, this rule relaxes the requirements of section 2055(e)(3)(B) to the extent necessary for the reformation for the trust to meet the 10% requirement.

Second, a transfer to a trust will be treated as if the transfer never had been made where a court having jurisdiction over the trust subsequently declares the trust void (because, e.g., the application of the 10% rule frustrates the purposes for which the trust was created) and judicial proceedings to revoke the trust are commenced within the period permitted for reformations of charitable remainder trusts under section 2055(e)(3). Under this provision, the effect of “unwinding” the trust is that any transactions made by the trust with respect to the property transferred (e.g., income earned on the assets transferred to the trust and capital gains generated by the sales of the property transferred) would be income and capital gain of the donor (or the

donor's estate if the trust was testamentary), and the donor (or the donor's estate if the trust was testamentary) would not be permitted a charitable deduction with respect to the transfer. The statute of limitations applicable to a deficiency of any tax resulting from "unwinding" the trust shall not expire before the date one year after the Treasury Department is notified that the trust has been revoked.

Third, where an additional contribution is made after July 28, 1997, to a charitable remainder unitrust created before July 29, 1997, and that unitrust would not meet the 10% requirement with respect to the additional contribution, the conference agreement provides that such additional contribution will be treated, under regulations to be issued by the Secretary of the Treasury, as if it had been made to a new trust that does not meet the 10% requirement, but which does not affect the status of the original unitrust as a charitable remainder trust.

The committee reports indicate that Congress intends that this provision not limit or alter the validity of regulations proposed by the Treasury Department on April 18, 1997, or the Treasury Department's authority to address abuses of the rules governing the taxation of charitable remainder trusts or their beneficiaries.

Current California Law (R&T Sec. 17731)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to charitable remainder trusts.

Effective Date

The requirement that the payout rate not exceed 50% applies to transfers to a trust made after June 18, 1997. The requirement that the value of the charitable remainder with respect to any transfer to a qualified remainder trust be at least 10% of the fair market value of the assets transferred in trust applies to transfers to a trust made after July 28, 1997. However, the 10% requirement does not apply to a charitable remainder trust created by a testamentary instrument (e.g., a will or revocable trust) executed before July 29, 1997, if the instrument is not modified after that date and the settlor dies before January 1, 1999, or could not be modified after July 28, 1997, because the settlor was under a mental disability on that date (i.e., July 28, 1997) and all times thereafter.

Impact on California Revenue

The vast majority of trusts, if not all, will make necessary changes to meet the new federal requirements and preserve charitable deductions for donors. California has consistently followed federal law in this subject area. Any revenue implications attributed to conformity would be insignificant.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1090(a)	Using Federal Case Registry of Child Support Orders for Tax Enforcement Purposes

Background

The Personal Responsibility and Work Opportunity Reconciliation Act of 1996 mandated the creation of a Federal Case Registry of Child Support Orders (the FCR) by October 1, 1998. Although Health & Human Services (HHS) has not yet issued final regulations, the FCR is required to include the names, and the state case identification numbers, of individuals who are owed or who owe child support or for whom paternity is being established. It may also include the social security numbers (SSNs) of these individuals.

New Federal Law

Not later than October 1, 1999, the Secretary of the Treasury will have access to the Federal Case Registry of Child Support Orders. Also, by October 1, 1999, the data elements on the State Case Registry will include the SSNs of children covered by cases in the Registry, and the states will provide the SSNs of these children to the FCR.

Current California Law

California's agency that is responsible for child support enforcement and creation and maintenance of the State Case Registry is the Department of Social Services (DSS). The district attorneys, and FTB on their behalf, are responsible for child support collections. The California Parent Locator Service has access to the federal registry for any child support collection purpose, including FTB's child support collection program.

Effective Date

The provision is effective on October 1, 1999.

Impact on California Revenue

Defer to DSS.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1090(b)	Expanded SSA Records for Tax Enforcement

Background

Under the Family Support Act of 1988, states must require each parent to furnish their social security number (SSN) for birth records. Parents can apply directly to the Social Security Administration (SSA) for an SSN for their child; or, in most states, they may apply for the child's SSN when obtaining a birth certificate. On an individual's SSN application, the SSA currently requires the mother's maiden name but not her SSN.

New Federal Law

SSA is required to obtain social security numbers (SSNs) of both parents on minor children's applications for SSNs. The SSA will provide this information to the IRS as part of the Data Master File (DM-1 file). The Act anticipates that the IRS will use the information to identify questionable claims for the earned income credit, the dependent exemption, and other tax benefits, before tax refunds are paid out.

Current California Law

Not applicable.

Effective Date

The provision is effective on August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1091	Estimated Tax Requirements of Individuals

Background

Under prior federal law, an individual taxpayer generally was subject to an addition to tax for any underpayment of estimated tax. An individual generally did not have an underpayment of estimated tax if he or she made timely estimated tax payments at least equal to: (1) 100% of the tax shown on the return of the individual for the preceding year (the 100% of last year's liability safe harbor), or (2) 90% of the tax shown on the return for the current year. The 100% of last year's liability safe harbor was modified to be a 110% of last year's liability safe harbor for any individual with an AGI of more than $150,000 as shown on the return for the preceding taxable year.

New Federal Law (Sec. 6654(d))

For individual taxpayers with AGI greater than $150,000 ($75,000 if married filing a separate return), the Act changes the 110% of last year's liability safe harbor to be a 100% of last year's liability safe harbor for taxable years beginning in 1998, a 105% of last year's liability safe harbor for taxable years beginning in 1999, 2000, and 2001, and a 112% of last year's liability safe harbor for taxable years beginning in 2002.

In addition, no estimated tax penalties will be imposed under sections 6654 or 6655 for any period before January 1, 1998, for any payment the due date of which is before January 16, 1998, with respect to any underpayment to the extent such underpayment is created or increased by a provision of the Act.

Current California Law (R&T Secs. 19136, 19136.2)

Current California law conforms, in general, with federal rules relating to the payment of estimated tax by individuals. However, there are several significant differences:

- The "required payment" is based upon 80% of the current year tax instead of 90%.
- The "required payment" does not include alternative minimum tax.
- Estimated payments are required, unless the tax due for the year is less than $100.
- No penalty will be assessed if 80% of the current or prior year tax is subject to withholding.
- No penalty will be assessed if 80% of the adjusted gross income consists of wages subject to withholding.
- California requires taxpayers with AGI greater than $150,000 ($75,000 if married filing a separate return) to pay 110% of the preceding year’s tax liability for 1997, 100% for 1998 and 110% thereafter to qualify under the preceding tax year exception to the underpayment of estimated tax

penalty. This provision was enacted by SB 455 (Stat. 1997, Ch. 611). SB 455 also contain a waiver of estimated tax penalty provision if the estimated tax payment was due to a provision in SB 455. Thus, effectively, only 100% of the prior year's liability for the 1997 tax year needed to be paid to qualify for the exception.

Effective Date

The provision is effective on August 5, 1997.

Impact on California Revenue

Reduced estimated tax payments under the Personal Income Tax Law from this provision are projected as follows:

Act Section 1091 Effective Tax Years After December 31, 1997 (in millions)		
1998-9	1999-0	2000-1
($4)	($1)	($1)

Reduced estimated tax payments from this provision would depend on the prior year tax liabilities of taxpayers with adjusted gross incomes exceeding $150,000 relative to current year projected liabilities.

The above estimates were based on a previous study of high income taxpayers that would be subject to the current state requirement of 110% of prior year for safe-harbor purposes. The 1998-9 impact reflects the first two estimate payments for 1999 that are reduced. Larger final payments for 1999 will occur in the 1999-0 fiscal year.

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

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1101	Simplify Foreign Tax Credit Limitation for Individuals

Background

In order to compute the foreign tax credit, a taxpayer computes foreign source taxable income and foreign taxes paid in each of the applicable separate foreign tax credit limitation categories. In the case of an individual, this requires the filing of IRS Form 1116. In many cases, individual taxpayers who are eligible to credit foreign taxes may have only a modest amount of foreign source gross income, all of which is income from investments. Taxable income of this type ordinarily is includable in the single foreign tax credit limitation category for passive income. However, under certain circumstances, the Code treats investment-type income (e.g., dividends and interest) as income in one of several other separate limitation categories (e.g., high withholding tax interest income or general limitation income). For this reason, any taxpayer with foreign source gross income is required to provide sufficient detail on Form 1116 to ensure that foreign source taxable income from investments, as well as all other foreign source taxable income, is allocated to the correct limitation category.

New Federal Law (Sec. 904(j) & (k))

The Act allows individuals with no more than $300 ($600 in the case of married persons filing jointly) of creditable foreign taxes, and no foreign source income other than passive income, an exemption from the foreign tax credit limitation rules. (It is intended that an individual electing this exemption will not be required to file Form 1116 in order to obtain the benefit of the foreign tax credit.) An individual making this election is not entitled to any carryover of excess foreign taxes to or from a taxable year to which the election applies.

For purposes of this election, passive income generally is defined to include all types of income that is foreign personal holding company income under the subpart F rules, plus income inclusions from foreign personal holding companies and passive foreign investment companies, provided that the income is shown on a payee statement furnished to the individual. For purposes of this election, creditable foreign taxes include only foreign taxes that are shown on a payee statement furnished to the individual.

Current California Law

California does not have a comparable credit.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Effective Date

The provision applies to taxable years beginning after December 31, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1102	Simplify Translation of Foreign Taxes

Background

Foreign income taxes paid in foreign currencies are required to be translated into U.S. dollar amounts using the exchange rate as of the time such taxes are paid to the foreign country or U.S. possession. This rule applies to foreign taxes paid directly by U.S. taxpayers, which taxes are creditable in the year paid or accrued. It also applies to foreign taxes paid by foreign corporations that are deemed paid by a U.S. corporation that is a shareholder of the foreign corporation, and hence creditable, in the year that the U.S. corporation receives a dividend or has an income inclusion from the foreign corporation.

For taxpayers that utilize the accrual basis of accounting for determining creditable foreign taxes, accrued and unpaid foreign tax liabilities denominated in foreign currencies are translated at the exchange rate as of the last day of the taxable year of accrual. If a difference exists between the dollar value of accrued foreign taxes and the dollar value of those taxes when paid, a redetermination of foreign taxes arises.

A foreign tax redetermination may occur in the case of a refund of foreign taxes. A foreign tax redetermination also may arise because the amount of foreign currency units actually paid differs from the amount of foreign currency units accrued. In addition, a redetermination may arise due to fluctuations in the value of the foreign currency relative to the dollar between the date of accrual and the date of payment.

As a general matter, a redetermination of foreign tax paid or accrued directly by a U.S. person requires notification of the Internal Revenue Service and a redetermination of U.S. tax liability for the taxable year for which the foreign tax was claimed as a credit. The Treasury regulations provide exceptions to this rule for de minimis cases. In the case of a redetermination of foreign taxes that qualify for the indirect (or “deemed-paid”) foreign tax credit under sections 902 and 960, the Treasury regulations generally require taxpayers to make appropriate adjustments to the payor foreign corporation's pools of earnings and profits and foreign taxes.

New Federal Law (Secs. 905(c), 986(a), 989(b) &(c)

Translation of Certain Accrued Foreign Taxes.

With respect to taxpayers that take foreign income taxes into account when accrued, the Act generally provides for foreign taxes to be translated at the average exchange rate for the taxable year to which such taxes relate. This rule does not apply (1) to any foreign income tax paid after the date two years after the close of the taxable year to which such taxes relate; (2) with respect to taxes of an accrual-basis taxpayer that are actually paid in a

taxable year prior to the year to which they relate; or (3) to tax payments that are denominated in an inflationary currency (as defined by regulations).

Translation of All Other Foreign Taxes.

Under the Act, foreign taxes not eligible for application of the preceding rule generally are translated into U.S. dollars using the exchange rates as of the time such taxes are paid. The Act provides the Secretary of the Treasury with authority to issue regulations that would allow foreign tax payments to be translated into U.S. dollar amounts using an average exchange rate for a specified period.

Under the Act, a redetermination is required if (1) accrued taxes when paid differ from the amounts claimed as credits by the taxpayer; (2) accrued taxes are not paid before the date two years after the close of the taxable year to which such taxes relate; or (3) any tax paid is refunded in whole or in part. Thus, for example, the Act provides that if at the close of the second taxable year after the taxable year to which an accrued tax relates, any portion of the tax so accrued has not yet been paid, a foreign tax redetermination under section 905(c) is required for the amount representing the unpaid portion of that accrued tax. In other words, the previous accrual of any tax that is unpaid as of that date is denied. In cases where a redetermination is required, as under present law, the bill specifies that the taxpayer must notify the Secretary, who will redetermine the amount of the tax for the year or years affected. Regulatory authority is granted to prescribe appropriate adjustments to the foreign tax credit pools in lieu of such a redetermination.

In the case of accrued taxes not paid within the date two years after the close of the taxable year to which such taxes relate, any such taxes if subsequently paid are taken into account for the taxable year to which such taxes relate. These taxes are translated into U.S. dollar amounts using the exchange rates in effect as of the time such taxes are paid. In the case of the indirect foreign tax credit, any such taxes are taken into account for the taxable year in which paid, and are translated into U.S. dollar amounts using the exchange rates as of the time such taxes are paid. In the case of the direct foreign tax credit, any such taxes are taken into account for the taxable year to which such taxes relate, but are translated into U.S. dollar amounts using the exchange rates in effect as of the time such taxes are paid.

For example, assume that in year 1 a taxpayer accrues 1,000 units of foreign tax that relate to year 1 and that the currency involved is not inflationary. Further assume that as of the end of year 1 the tax is unpaid. The taxpayer translates 1,000 units of accrued foreign tax into U.S. dollars at the average exchange rate for year 1. If the 1,000 units of tax are paid by the taxpayer in either year 2 or year 3, no redetermination of foreign tax is required. If any portion of the tax so accrued remains unpaid as of the end of year 3, however, the taxpayer is required to redetermine its foreign tax accrued in year 1 to eliminate the accrued but unpaid tax, thereby reducing its foreign tax credit for such year. If the taxpayer pays the disallowed taxes in year 4, the taxpayer again redetermines its foreign taxes (and foreign tax

credit) for year 1, but the taxes paid in year 4 are translated into U.S. dollars at the exchange rate for year 4.

Current California Law

California law does not allow a deduction for federal income taxes. Therefore, any redetermination of federal income tax expense would not require a redetermination for California tax purposes.

Effective Date

The provision generally is effective for foreign taxes paid (in the case of taxpayers using the cash basis for determining the foreign tax credit) or accrued (in the case of taxpayers using the accrual basis for determining the foreign tax credit) in taxable years beginning after December 31, 1997. The provision's changes to the foreign tax redetermination rules apply to foreign taxes which relate to taxable years beginning after December 31, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1103	Simplified AMT Foreign Tax Credit Limitation

Background

Computing foreign tax credit limitations requires the allocation and apportionment of deductions between items of foreign source income and items of U.S. source income. Foreign tax credit limitations must be computed both for regular tax purposes and for purposes of the alternative minimum tax (AMT). Consequently, the allocation and apportionment of deductions must be done separately for regular tax foreign tax credit limitation purposes and AMT foreign tax credit limitation purposes.

New Federal Law (Sec. 59(a)(3))

The Act permits taxpayers to elect to use as their AMT foreign tax credit limitation fraction the ratio of foreign source regular taxable income to entire alternative minimum taxable income, rather than the ratio of foreign source alternative minimum taxable income to entire alternative minimum taxable income. Under this election, foreign source regular taxable income is used, however, only to the extent it does not exceed entire alternative minimum taxable income. In the event that foreign source regular taxable income does exceed entire alternative minimum taxable income, and the taxpayer has income in more than one foreign tax credit limitation category, the committee reports indicate that it is intended that the foreign source taxable income in each such category generally would be reduced by a pro rata portion of that excess. The election is available only in the first taxable year beginning after December 31, 1997, for which the taxpayer claims an AMT foreign tax credit.

The committee reports indicate that it is further intended that a taxpayer will be treated, for this purpose, as claiming an AMT foreign tax credit for any taxable year for which the taxpayer chooses to have the benefits of the foreign tax credit and in which the taxpayer is subject to the alternative minimum tax or would be subject to the alternative minimum tax but for the availability of the AMT foreign tax credit. The election, once made, will apply to all subsequent taxable years, and may be revoked only with the consent of the Secretary of the Treasury.

Current California Law

California does not have a comparable credit.

Effective Date

The provision applies to taxable years beginning after December 31, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1104	Simplify Treatment of Personal Transactions in Foreign Currency

Background

When a U.S. taxpayer makes a payment in a foreign currency, gain or loss (referred to as "exchange gain or loss") generally arises from any change in the value of the foreign currency relative to the U.S. dollar between the time the currency was acquired (or the obligation to pay was incurred) and the time that the payment is made. Gain or loss results because foreign currency, unlike the U.S. dollar, is treated as property for Federal income tax purposes. Exchange gain or loss can arise in the course of a trade or business or in connection with an investment transaction. Exchange gain or loss also can arise where foreign currency was acquired for personal use.

New Federal Law (Sec. 988(e)

If an individual acquires foreign currency and disposes of it in a personal transaction, and the exchange rate changes between the acquisition and disposition of such currency, the Act applies nonrecognition treatment to any resulting exchange gain, provided that such gain does not exceed $200. The provision does not change the treatment of resulting exchange losses.

Transactions entered into in connection with a business trip constitute personal transactions for purposes of this provision. Exchange gain resulting from such transactions is eligible for nonrecognition treatment under this provision.

Current California Law (R&T Secs. 17078 and 24905)

California generally conforms to the federal treatment of certain foreign currency transactions, except as modified. However, California does not apply the source rules provided in IRC Section 988(a).

Effective Date

The provision applies to taxable years beginning after December 31, 1997.

Impact on California Revenue

Revenue losses under the Personal Income Tax Law would be negligible for the de-minimis floor.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1105	Simplify Foreign Tax Credit Limitation for Dividends

Background

U.S. persons may credit foreign taxes against U.S. tax on foreign source income. The amount of foreign tax credits that can be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. Separate limitations are applied to specific categories of income.

Special foreign tax credit limitation rules apply in the case of dividends received from a foreign corporation in which the taxpayer owns at least 10% of the stock by vote and which is not a controlled foreign corporation (a so-called ``10/50 company''). Dividends received by the taxpayer from each 10/50 company are subject to a separate foreign tax credit limitation.

New Federal Law (Sec. 904(d))

The Act generally provides for look-through treatment to apply in characterizing dividends from 10/50 companies for foreign tax credit limitation purposes. Under the conference agreement, any dividend from a 10/50 company paid out of earnings and profits accumulated in a taxable year beginning after December 31, 2002, is treated as income in a foreign tax credit limitation category in proportion to the ratio of the earnings and profits attributable to income in such foreign tax credit limitation category to the total earnings and profits. Regulatory authority is granted to provide rules regarding the treatment of distributions out of earnings and profits for periods prior to the taxpayer's acquisition of such stock.

In the case of dividends from a 10/50 company paid out of earnings and profits accumulated in a taxable year beginning before January 1, 2003, the conference agreement provides that a single foreign tax credit limitation generally applies to all such dividends from all 10/50 companies. However, separate foreign tax credit limitations continue to apply to any such dividends received by the taxpayer from each 10/50 company that qualifies as a passive foreign investment company. Regulatory authority is granted to provide rules regarding the treatment of distributions out of earnings and profits for periods prior to the taxpayer's acquisition of such stock.

Current California Law

California does not have a comparable credit.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Effective Date

The provision is effective for taxable years beginning after December 31, 2002.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1111	Provisions Affecting Treatment of Controlled Foreign Corporations

Background

If an upper-tier controlled foreign corporation (CFC) sells stock of a lower-tier CFC, the gain generally is included in the income of U.S. 10% shareholders as subpart F income and such U.S. shareholder's basis in the stock of the first-tier CFC is increased to account for the inclusion. The inclusion is not characterized for foreign tax credit limitation purposes by reference to the nature of the income of the lower-tier CFC; instead, it generally is characterized as passive income. For purposes of the foreign tax credit limitations applicable to so-called 10/50 companies, a CFC is not treated as a 10/50 company with respect to any distribution out of its earnings and profits for periods during which it was a CFC and, except as provided in regulations, the recipient of the distribution was a U.S. 10% shareholder in such corporation.

If subpart F income of a lower-tier CFC is included in the gross income of a U.S. 10% shareholder, no provision of present law allows adjustment of the basis of the upper-tier CFC's stock in the lower-tier CFC. The subpart F income earned by a foreign corporation during its taxable year is taxed to the persons who are U.S. 10% shareholders of the corporation on the last day, in that year, on which the corporation is a CFC. In the case of a U.S. 10% shareholder who acquired stock in a CFC during the year, such inclusions are reduced by all or a portion of the amount of dividends paid in that year by the foreign corporation to any person other than the acquirer with respect to that stock.

As a general rule, subpart F income does not include income earned from sources within the United States if the income is effectively connected with the conduct of a U.S. trade or business by the CFC. This general rule does not apply, however, if the income is exempt from, or subject to a reduced rate of, U.S. tax pursuant to a provision of a U.S. treaty. A U.S. corporation that owns at least 10% of the voting stock of a foreign corporation is treated as if it had paid a share of the foreign income taxes paid by the foreign corporation in the year in which the foreign corporation's earnings and profits become subject to U.S. tax as dividend income of the U.S. shareholder. A U.S. corporation also may be deemed to have paid taxes paid by a second- or third-tier foreign corporation if certain conditions are satisfied.

New Federal Law (Secs. 904(d) and 964(e))

Characterization of Gain on Stock Disposition.

Under the Act, if a CFC is treated as having gain from the sale or exchange of stock in a foreign corporation, the gain is treated as a dividend to the same extent that it would have been so treated under section 1248 if the CFC were a U.S. person. This provision, however, does not affect the determination of

whether the corporation whose stock is sold or exchanged is a CFC. Thus, for example, if a U.S. corporation owns 100% of the stock of a foreign corporation, which owns 100% of the stock of a second foreign corporation, then under the Act, any gain of the first corporation upon a sale or exchange of stock of the second corporation is treated as a dividend for purposes of subpart F income inclusions to the U.S. shareholder, to the extent of earnings and profits of the second corporation attributable to periods in which the first foreign corporation owned the stock of the second foreign corporation while the latter was a CFC with respect to the U.S. shareholder.

Gain on the disposition of stock in a related corporation created or organized under the laws of, and having a substantial part of its assets in a trade or business in, the same foreign country as the gain recipient, even if recharacterized as a dividend under the Act, is not excluded from foreign personal holding company income under the same-country exception that applies to actual dividends. Under the Act, for purposes of this rule, a CFC is treated as having sold or exchanged stock if, under any provision of subtitle A of the Code, the CFC is treated as having gain from the sale or exchange of such stock. Thus, for example, if a CFC distributes to its shareholder stock in a foreign corporation, and the distribution results in gain being recognized by the CFC under section 311(b) as if the stock were sold to the shareholder for fair market value, the Act makes clear that, for purposes of this rule, the CFC is treated as having sold or exchanged the stock.

The Act also repeals a provision added to the Code by the Technical and Miscellaneous Revenue Act of 1988 that, except as provided by regulations, requires a recipient of a distribution from a CFC to have been a U.S. 10% shareholder of that CFC for the period during which the earnings and profits which gave rise to the distribution were generated in order to avoid treating the distribution as one coming from a 10/50 company. Thus, under the Act, a CFC is not treated as a 10/50 company with respect to any distribution out of its earnings and profits for periods during which it was a CFC, whether or not the recipient of the distribution was a U.S. 10% shareholder of the corporation when the earnings and profits giving rise to the distribution were generated.

Current California Law (R&T Sec. 25110)

In general, California does not conform to the federal rules relating to controlled foreign corporations. However, for California water’s-edge purposes, a controlled foreign corporation (CFC) is required to be included in the water’s-edge combined report if the CFC has Subpart F income defined in IRC section 952. “Earnings and profits,” as defined in IRC section 964 is used solely for water’s-edge purposes to compute the denominator of the inclusion ratio.

California does not have a credit comparable to the foreign tax credit.

Effective Date

The gain inclusion provision applies to gain recognized on transactions occurring after August 5, 1997.

The repeal of the 10% shareholder requirement for foreign tax credit limitation purposes is effective for distributions after August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1112	Miscellaneous Modifications of Subpart F

Background

Federal law did not allow a basis adjustment of the upper-tier CFC's stock in a lower-tier CFC where subpart F income of a lower-tier controlled foreign corporation (CFC) was included in the gross income of a U.S. 10% shareholder. In the case of a U.S.10% shareholder who acquired stock in a CFC during the year, the inclusions were reduced by all or a portion of the amount of dividends paid in that year by the foreign corporation to any person other than the acquiror with respect to that stock. For income that is effectively connected with the conduct of a U.S. trade or business by the CFC, this general rule did not apply if the income was exempt from, or subject to a reduced rate of, U.S. tax pursuant to a provision of a U.S. treaty.

New Federal Law (Secs. 951(a), 952, 961 and 958(a))

Basis Adjustment.

For purposes of determining the amount included under Section 951 of the Internal Revenue Code, stock held in a controlled foreign corporation by a 10% U.S. shareholder shall be subject to adjustments similar to those made to the basis of stock in a first-tier CFC for income inclusions.

Inclusion in year of Acquisition.

If a U.S. 10% shareholder acquires the stock of a CFC from another U.S. 10% shareholder during a tax year of the CFC in which it earns subpart F income, the acquiror's subpart F income inclusion that year is reduced by a portion of the amount of the dividend deemed to be received by the transferor under Code Section 1248. The reduction may not exceed the lesser of the amount of dividends with respect to the stock deemed received by other persons during the year by the proportion of the year during which the acquiring shareholder did not own the stock.

U.S. Income Earned by CFC.

A reduction or elimination by treaty in the tax that would be imposed under Code Section 884 on a CFC does not affect the statutory exemption from Subpart F income so long as it is not exempt from U.S. taxation under any other treaty provision.

Current California Law (R&T Sec. 25110)

California does not generally conform to the U.S. income sourcing rules for foreign corporations. However, for California purposes, those California corporations which have a water's-edge election in force are required to use federal rules to determine U.S. source income, including rules for foreign corporations.

Effective Date

The basis adjustment provision applies to taxable years beginning after August 5, 1997.

The provision that permits dispositions of stock to be taken into consideration in determining a U.S. shareholder's subpart F inclusion for a tax year is effective for dispositions occurring after August 5, 1997.

The provision regarding treaty exemptions and/or reductions is effective for tax years beginning after December 31, 1986.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1113	Indirect Foreign Tax Credit for Certain Lower Tier Corporations

Background

A U.S. corporation that owns 10% or more of the voting stock of a foreign corporation is treated as if it had paid a share of the foreign corporation's foreign income taxes in the year in which the foreign corporation's earnings and profits become subject to U.S. tax as dividend income of the U.S. shareholder. Under certain circumstances, a U.S. corporation was deemed to have paid taxes paid by a second- or third-tier foreign corporation.

New Federal Law (Secs. 902 and 960(a))

For controlled foreign corporations (CFC) meeting certain requirements, the indirect foreign tax credit has been extended to taxes paid or accrued by fourth-, fifth-, and sixth-tier corporations. The percentage ownership of voting stock at each level must equal at least five percent.

Current California law

California does not have a comparable credit.

Effective Date

The provision applies to tax years beginning after August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1122-24	Modification of Passive Foreign Investment Porivisions

Background

U.S. citizens and residents and U.S. corporations (collectively, “U.S. persons”) are taxed currently by the United States on their worldwide income, subject to a credit against U.S. tax on foreign income based on foreign income taxes paid with respect to such income. A foreign corporation generally is not subject to U.S. tax on its income from operations outside the United States. Income of a foreign corporation generally is taxed by the United States when it is repatriated to the United States through payment to the corporation's U.S. shareholders, subject to a foreign tax credit. However, a variety of regimes imposing current U.S. tax on income earned through a foreign corporation have been reflected in the Code. Today the principal anti-deferral regimes set forth in the Code are the controlled foreign corporation rules of subpart F (secs. 951-964) and the passive foreign investment company rules (secs. 1291-1297).

Additional anti-deferral regimes set forth in the Code are the foreign personal holding company rules (secs. 551 558); the personal holding company rules (secs. 541-547); the accumulated earnings tax (secs. 531-537); and the foreign investment company and electing foreign investment company rules (secs. 1246-1247). The anti-deferral regimes included in the Code overlap such that a given taxpayer may be subject to multiple sets of anti-deferral rules.

Controlled Foreign Corporations.

A controlled foreign corporation (CFC) is defined generally as any foreign corporation if U.S. persons own more than 50% of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10% of the stock (measured by vote only) sec. 957). Stock ownership includes not only stock owned directly, but also stock owned indirectly or constructively (sec. 958). Certain income of a CFC (referred to as “subpart F income”) is subject to current U.S. tax. The United States generally taxes the U.S. 10% shareholders of a CFC currently on their pro rata shares of the subpart F income of the CFC. In effect, the Code treats those U.S. shareholders as having received a current distribution out of the CFC's subpart F income. Such shareholders also are subject to current U.S. tax on their pro rata shares of the CFC's earnings invested in U.S. property. The foreign tax credit may reduce the U.S. tax on these amounts.

The Tax Reform Act of 1986 established an anti-deferral regime for passive foreign investment companies (PFICs). A PFIC is any foreign corporation if (1) 75% or more of its gross income for the taxable year consists of passive income, or (2) 50% or more of the average fair market value of its assets consists of assets that produce, or are held for the production of, passive income. For purposes of applying the PFIC asset test, the assets of a CFC are required to be measured using adjusted basis; the assets of a foreign

corporation that is not a CFC are measured using fair market value unless the corporation elects to use adjusted basis.

Two alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a PFIC. One set of rules applies to PFICs that are "qualified electing funds," under which electing U.S. shareholders include currently in gross income their respective shares of the PFIC's total earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received. The second set of rules applies to PFICs that are not qualified electing funds (nonqualified funds), under which the U.S. shareholders pay tax on income realized from the PFIC and an interest charge that is attributable to the value of deferral.

A foreign corporation that is a CFC is also a PFIC if it meets the passive income test or the passive asset test described above. In such a case, the 10% U.S. shareholders are subject both to the subpart F provisions (which require current inclusion of certain earnings of the corporation) and to the PFIC provisions (which impose an interest charge on amounts distributed from the corporation and gains recognized upon the disposition of the corporation's stock, unless an election is made to include currently all of the corporation's earnings).

New Federal Law (Secs. 532(b),542(c), 551(f), 852(b)&(c), 1291(a)&(d), 1293(a), 1296, 1297(b), 1298, 4982(e))

Act Section 1121.

In the case of a PFIC that is also a CFC, the Act generally treats the corporation as not a PFIC with respect to certain 10% shareholders. This rule applies if the corporation is a CFC (within the meaning of section 957(a)) and the shareholder is a U.S. shareholder (within the meaning of section 951(b)) of the corporation (i.e., if the shareholder is subject to the current inclusion rules of subpart F with respect to such corporation). Moreover, the rule applies for that portion of the shareholder's holding period with respect to the corporation's stock which is after December 31, 1997, and during which the corporation is a CFC and the shareholder is a U.S. shareholder. Accordingly, a shareholder that is subject to current inclusion under the subpart F rules with respect to stock of a PFIC that is also a CFC generally is not subject also to the PFIC provisions with respect to the same stock.

The PFIC provisions continue to apply in the case of a PFIC that is also a CFC to shareholders that are not subject to subpart F (i.e., to shareholders that are U.S. persons and that own (directly, indirectly, or constructively) less than 10% of the corporation's stock by vote). If a shareholder of a PFIC is subject to the rules applicable to nonqualified funds before becoming eligible for the special rules provided under the Act for shareholders that are subject to subpart F, the stock held by such shareholder continues to be treated as PFIC stock, unless the shareholder makes an election to pay tax and an interest charge with respect to the unrealized appreciation in the stock or the accumulated earnings of the corporation.

Act Section 1122.

If, under the Act, a shareholder is not subject to the PFIC provisions because the shareholder is subject to subpart F and the shareholder subsequently ceases to be subject to subpart F with respect to the corporation, for purposes of the PFIC provisions, the shareholder's holding period for such stock is treated as beginning immediately after such cessation. Accordingly, in applying the rules applicable to PFICs that are not qualified electing funds, the earnings of the corporation are not attributed to the period during which the shareholder was subject to subpart F with respect to the corporation and was not subject to the PFIC provisions.

The Act allows a shareholder of a PFIC to make a mark-to-market election with respect to the stock of the PFIC, provided that such stock is marketable (as defined below). Under such an election, the shareholder includes in income each year an amount equal to the excess, if any, of the fair market value of the PFIC stock as of the close of the taxable year over the shareholder's adjusted basis in such stock. The shareholder is allowed a deduction for the excess, if any, of the adjusted basis of the PFIC stock over its fair market value as of the close of the taxable year. However, deductions are allowable under this rule only to the extent of any net mark-to-market gains with respect to the stock included by the shareholder for prior taxable years.

Under the Act, this mark-to-market election is available only for PFIC stock that is “marketable.” For this purpose, PFIC stock is considered marketable if it is regularly traded on a national securities exchange that is registered with the Securities and Exchange Commission or on the national market system established pursuant to section 11A of the Securities and Exchange Act of 1934. In addition, PFIC stock is considered marketable if it is regularly traded on any exchange or market that the Secretary of the Treasury determines has rules sufficient to ensure that the market price represents a legitimate and sound fair market value. Any option on stock that is considered marketable under the foregoing rules is treated as marketable to the extent provided in regulations. PFIC stock also is treated as marketable, to the extent provided in regulations, if the PFIC offers for sale (or has outstanding) stock of which it is the issuer and which is redeemable at its net asset value in a manner comparable to a U.S. regulated investment company (RIC).

In addition, the Act treats as marketable any PFIC stock owned by a RIC that offers for sale (or has outstanding) any stock of which it is the issuer and which is redeemable at its net asset value. The Act treats as marketable any PFIC stock held by any other RIC that otherwise publishes net asset valuations at least annually, except to the extent provided in regulations. The committee reports indicate that it is believed that even for RICs that do not make a market in their own stock, but that do regularly report their net asset values in compliance with the securities laws, inaccurate valuation may bring exposure to legal liabilities, and this exposure may ensure the reliability of the values such RICs assign to the PFIC stock they hold.

The shareholder's adjusted basis in the PFIC stock is adjusted to reflect the amounts included or deducted under this election. In the case of stock owned indirectly by a U.S. person through a foreign entity (as discussed below), the basis adjustments for mark-to-market gains and losses apply to the basis of the PFIC in the hands of the intermediary owner, but only for purposes of the subsequent application of the PFIC rules to the tax treatment of the indirect U.S. owner. In addition, similar basis adjustments are made to the adjusted basis of the property actually held by the U.S. person by reason of which the U.S. person is treated as owning PFIC stock. Amounts included in income pursuant to a mark-to-market election, as well as gain on the actual sale or other disposition of the PFIC stock, is treated as ordinary income. Ordinary loss treatment also applies to the deductible portion of any mark-to-market loss on PFIC stock, as well as to any loss realized on the actual sale or other disposition of PFIC stock to the extent that the amount of such loss does not exceed the net mark-to-market gains previously included with respect to such stock. The source of amounts with respect to a mark-to-market election generally is determined in the same manner as if such amounts were gain or loss from the sale of stock in the PFIC.

An election to mark-to-market applies to the taxable year for which made and all subsequent taxable years, unless the PFIC stock ceases to be marketable or the Secretary of the Treasury consents to the revocation of such election. Under constructive ownership rules, U.S. persons that own PFIC stock through certain foreign entities may make this election with respect to the PFIC. These constructive ownership rules apply to treat PFIC stock owned directly or indirectly by or for a foreign partnership, trust, or estate as owned proportionately by the partners or beneficiaries, except as provided in regulations. Stock in a PFIC that is thus treated as owned by a person is treated as actually owned by that person for purposes of again applying the constructive ownership rules. In the case of a U.S. person that is treated as owning PFIC stock by application of this constructive ownership rule, any disposition by the U.S. person or by any other person that results in the U.S. person being treated as no longer owning the PFIC stock, as well as any disposition by the person actually owning the PFIC stock, is treated as a disposition by the U.S. person of the PFIC stock.

In addition, a CFC that owns stock in a PFIC is treated as a U.S. person that may make the election with respect to such PFIC stock. Any amount includible (or deductible) in the CFC's gross income pursuant to this mark-to-market election is treated as foreign personal holding company income (or a deduction allocable to foreign personal holding company income). The source of such amounts, however, is determined by reference to the actual residence of the CFC. In the case of a taxpayer that makes the mark-to-market election with respect to stock in a PFIC that is a nonqualified fund after the beginning of the taxpayer's holding period with respect to such stock, a coordination rule applies to ensure that the taxpayer does not avoid the interest charge with respect to amounts attributable to periods before such election. A similar rule applies to RICs that make the mark-to-market election under the Act after the beginning of their holding period with respect to PFIC stock (to the extent that the RIC had not previously marked to market the stock of the PFIC).

Except as provided in the coordination rules described above, the rules of section 1291 (with respect to nonqualified funds) do not apply to a shareholder of a PFIC if a mark-to-market election is in effect for the shareholder's taxable year. Moreover, in applying section 1291 in a case where a mark-to-market election was in effect for any prior taxable year, the shareholder's holding period for the PFIC stock is treated as beginning immediately after the last taxable year for which such election applied.

A special rule is applicable in the case of a PFIC shareholder that becomes a U.S. person. The special rule treats the adjusted basis of any PFIC stock held by such person on the first day of the year in which such shareholder becomes a U.S. person as equal to the greater of its fair market value on such date or its adjusted basis on such date. Such rule applies only for purposes of the mark-to-market election.

Act Section 1123.

The Act also provides rules regarding the measurement of assets for purposes of applying the PFIC asset test. Under the Act, if the stock of a foreign corporation is publicly traded for the taxable year, the PFIC asset test is applied using fair market value (rather than the adjusted basis) for purposes of measuring the PFIC's assets. For this purpose, the stock of a foreign corporation is treated as publicly traded if such stock is readily tradeable on a national securities exchange that is registered with the Securities and Exchange Commission, the national market system established pursuant to section 11A of the Securities and Exchange Act of 1934, or any other exchange or market that the Secretary of the Treasury determines has rules sufficient to ensure that the market price represents a sound fair market value. Because the PFIC asset test is applied based on quarterly measurements of the corporation's assets, the committee reports indicate that it is intended that a corporation the stock of which is publicly traded on each such quarterly measurement date during the taxable year will be eligible for this asset measurement rule for such taxable year. In applying the PFIC asset test, it is intended that the total value of a publicly-traded foreign corporation's assets generally will be treated as equal to the sum of the aggregate value of its outstanding stock plus its liabilities.

The Act does not change the rules applicable to non-publicly-traded foreign corporations for purposes of the measurement of assets in applying the PFIC asset test. Accordingly, CFCs that are not publicly traded continue to be required to measure their assets using adjusted basis, and any other foreign corporations that are not publicly traded continue to measure their assets using fair market value unless they elect to use adjusted basis.

Current California Law (R&T Sec. 25110)

In general, California does not conform to the federal rules relating to controlled foreign corporations. However, for California water’s-edge purposes, a controlled foreign corporation (CFC) is required to be included in

the water's-edge combined report if the CFC has Subpart F income defined in Section 952 of the Internal Revenue Code.

With respect to a "water's-edge election," the income subject to California apportionment is generally the income for federal purposes of the corporations within the electing group, including the income under the federal rules for Subpart F income. However, California does not follow the PFIC rules.

Effective Date

The provision is effective for taxable years of U.S. persons beginning after December 31, 1997, and taxable years of foreign corporations ending with or within such taxable years of U.S. persons.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1131-45	Simplify Formation and Operation of International Joint Ventures

Background

Under section 1491, an excise tax generally is imposed on transfers of property by a U.S. person to a foreign corporation as paid-in surplus or as a contribution to capital or to a foreign partnership, estate or trust. The tax is 35% of the amount of gain inherent in the property transferred but not recognized for income tax purposes at the time of the transfer. However, several exceptions to the section 1491 excise tax are available. Under section 1494(c), a substantial penalty applies in the case of a failure to report a transfer described in section 1491. Certain transfers were excluded from the excise tax by Section 1492.

Section 367 applies to require gain recognition upon certain transfers by U.S. persons to foreign corporations. Under section 367(d), a U.S. person that contributes intangible property to a foreign corporation is treated as having sold the property to the corporation and is treated as receiving deemed royalty payments from the corporation. These deemed royalty payments are treated as U.S. source income. A U.S. person may elect to apply similar rules to a transfer of intangible property to a foreign partnership that otherwise would be subject to the section 1491 excise tax.

A foreign partnership may be required to file a partnership return. If a foreign partnership fails to file a required return, losses and credits with respect to the partnership may be disallowed to the partnership. A U.S. person that acquires or disposes of an interest in a foreign partnership, or whose proportional interest in the partnership changes substantially, may be required to file an information return with respect to such event.

New Federal Law (Secs. 318(b), 367(d) & (f), 684, 721(c) & (d), 814(h), 901(k), 1035(c)-(d), 1057, 1491, 1492, 1494, and 6031(e), 6038, 6038B, 6046A, 6231(f), 6422, 6501(c) and 6679(a))

Act Section 1131.

The Act repeals the sections 1491 and 1494 excise tax and information reporting rules that apply to certain transfers of appreciated property by a U.S. person to a foreign entity. Instead of the excise tax that applies under present law to transfers to a foreign estate or trust, gain recognition is required upon a transfer of appreciated property by a U.S. person to a foreign estate or trust. Instead of the excise tax that applies under present law to certain transfers to foreign corporations, regulatory authority is granted under section 367 to deny nonrecognition treatment to such a transfer in a transaction that is not otherwise described in section 367. In the case of a transfer by a U.S. person to a foreign corporation as paid-in surplus or as a contribution to capital in a transaction not otherwise described in section 367 (e.g., a capital contribution by a non-shareholder), regulatory authority is granted under

section 367 to treat such transfer as a sale at fair market value and to require gain recognition thereon.

Instead of the excise tax that applies under present law to transfers to foreign partnerships, regulatory authority is granted to provide for gain recognition on a transfer of appreciated property to a partnership in cases where such gain otherwise would be transferred to a foreign partner. In addition, regulatory authority is granted to deny the nonrecognition treatment that is provided under section 1035 to certain exchanges of insurance policies, where the transfer is to a foreign person.

Gain recognition is required upon a transfer of appreciated property by a U.S. person to a foreign estate or trust, except as provided in regulations. This rule does not apply to a transfer to a trust to the extent that any person is treated as the owner of the trust under section 679.

The Act clarifies that, for purposes of the requirement of gain recognition upon a transfer of appreciated property by a U.S. person to a foreign estate or trust, a U.S. trust that becomes a foreign trust is treated as having transferred all of its assets to a foreign trust.

The Act repeals the rule that treats as U.S. source income any deemed royalty arising under section 367(d). Under the Act, in the case of a transfer of intangible property to a foreign corporation, the deemed royalty payments under section 367(d) are treated as foreign source income to the same extent that an actual royalty payment would be considered to be foreign source income. Regulatory authority is granted to provide similar treatment in the case of a transfer of intangible property to a foreign partnership.

Act Section 1141.

The Act provides detailed information reporting rules in the case of foreign partnerships. A foreign partnership generally is required to file a partnership return for a taxable year if the partnership has U.S. source income or is engaged in a U.S. trade or business, except to the extent provided in regulations. Failure to properly file a return will result in partners being denied their share of partnership deductions, losses, and credits.

Act Section 1142.

Under the Act, reporting rules similar to those applicable under present law in the case of controlled foreign corporations apply in the case of foreign partnerships. A U.S. partner that controls a foreign partnership is required to file an annual information return with respect to such partnership. For this purpose, a U.S. partner is considered to control a foreign partnership if the partner holds a more than 50% interest in the capital, profits, or, to the extent provided in regulations, losses, of the partnership.

Similar information reporting also will be required from a U.S. 10% partner of a foreign partnership that is controlled by U.S. 10% partners. A $10,000

penalty applies to a failure to comply with these reporting requirements; additional penalties of up to $50,000 apply in the case of continued noncompliance after notification by the Secretary of the Treasury.

The penalties for failure to report information with respect to a controlled foreign corporation are conformed with these penalties. Under the Act, reporting by a U.S. person of an acquisition or disposition of an interest in a foreign partnership, or a change in the person's proportional interest in the partnership, is required only in the case of acquisitions, dispositions, or changes involving at least a 10% interest. A $10,000 penalty applies to a failure to comply with these reporting requirements; additional penalties of up to $50,000 apply in the case of continued noncompliance after notification by the Secretary. The penalties for failure to report information with respect to a foreign corporation are conformed with these penalties.

For purposes of the information reporting rules applicable to a U.S. partner that controls a foreign partnership, the Act clarifies that a partner's interest in a partnership is determined with application of constructive ownership rules similar to those provided in section 267(c) (other than paragraph (3)).

Act Section 1143.

The requirement that a U.S. person report the acquisition or disposition of an interest in a foreign partnership, or change in his proportional interest in the partnership, is modified to apply only to 10% partners. For sales or acquisitions, the reporting requirement applies only if the U.S. partner owns at least a 10% interest in the partnership either immediately prior to or after the transaction. For proportional increases or decreases in the partner’s interest in the partnership, the change in ownership percentage must be reported only if the change involved a 10% or greater interest.

The term “10%” refers to a direct or indirect ownership interest of at least 10% in the partnership’s capital or profits (or, to the extent provided by regulations, an allocation of at least 10% of the partnerships deductions or losses).

Failure to file information returns attributable to changes in ownership in a foreign partnership or in the stock of a foreign corporation is subject to an increased penalty of $10,000. An additional penalty of $10,000 applies for each 30-day period of continued noncompliance after expiration of the 90-day notification period. The increased penalty under this provision is capped at $50,000 where the failure continues after the 90-day period.

Act Section 1144.

Under the Act, reporting rules similar to those applicable under present law in the case of transfers by U.S. persons to foreign corporations apply in the case of transfers to foreign partnerships. These reporting rules apply in the case of a transfer to a foreign partnership only if the U.S. person holds at least a

10% interest in the partnership or the value of the property transferred by such person to the partnership during a 12-month period exceeded $100,000.

A penalty equal to 10% of the value of the property transferred applies to a failure to comply with these reporting requirements. The penalty under present law for failure to report transfers to a foreign corporation is conformed with this penalty. In the case of a transfer to a foreign partnership, failure to comply also results in gain recognition with respect to the property transferred. The penalty may not exceed $100,000, except in cases of intentional disregard for such reporting requirements.

Act Section 1145.

In the case of a failure to report required information with respect to a foreign corporation, partnership, or trust, the statute of limitations with respect to any event or period to which such information relates does not expire before the date that is three years after the date on which such information is provided.

Current California Law (R&T Sec. 25110)

California law conforms to IRC section 367, Foreign Corporations, as the IRC read on January 1, 1997 without exception. California is not in conformity with IRC sections 1491 through 1494, Tax on Transfers to Avoid Income Tax.

California does not generally conform to the federal rules for foreign corporations, except for certain foreign corporations doing business in California that make a water’s-edge election. Water’s-edge electors are required to use federal rules to determine United States source income, including the rules for foreign corporations. In general, for water’s-edge electors, California applies federal rules for transactions with affiliated entities that are not in the water’s-edge group. Thus, California generally accepts the federal section 482 allocation for transfers between the water’s-edge-group and affiliates (inbound/outbound transfers).

With respect to banks and corporations, other than water’s-edge corporations, California uses the world wide combined reporting (WWCR) method of determining the income subject to California tax.

California law does not conform to the excise tax provision in Internal Revenue Code Section 1491 or the related reporting requirements and penalty provisions.

California conforms with certain modifications to the federal requirements to furnish information about foreign-owned corporations and the related penalties (R&TC Section 19141.5). In addition, California recently conformed to federal foreign reporting requirements (Form 5471) by adding Section 19141.2 to the R&TC (Ch. 611, 1997).

Under California law insurance companies are not subject to the California franchise or income tax. However, life insurance companies are subject to the gross premiums tax, which is administered by the Board of Equalization.

Effective Date

The provisions with respect to the repeal of sections 1491 and 1494 are effective upon date of enactment.

The provisions with respect to the source of a deemed royalty under section 367(d) also are effective for transfers made and royalties deemed received after date of enactment.

The provisions regarding information reporting with respect to foreign partnerships generally are effective for partnership taxable years beginning after date of enactment. The provisions regarding information reporting with respect to interests in, and transfers to, foreign partnerships are effective for transfers to, and changes in interest in, foreign partnerships after date of enactment.

Taxpayers may elect to apply these rules to transfers made after August 20, 1996 (and thereby avoid a penalty under section 1494(c)) and the Secretary may prescribe simplified reporting requirements for these cases. The provision with respect to the statute of limitations in the case of noncompliance with reporting requirements is effective for information returns due after August 5, 1997. The provision granting regulatory authority with respect to the treatment of partnerships as foreign or domestic is effective for partnership taxable years beginning after August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1146	Reporting Threshold for Stock Ownership of a Foreign Corporation

Background

Several provisions of the Code require U.S. persons to report information with respect to a foreign corporation in which they are shareholders or officers or directors. Sections 6038 and 6035 generally require every U.S. citizen or resident who is an officer, or director, or who owns at least 10% of the stock, of a foreign corporation that is a controlled foreign corporation or a foreign personal holding company to file Form 5471 annually. Section 6046 mandates the filing of information returns by certain U.S. persons with respect to a foreign corporation upon the occurrence of certain events. U.S. persons required to file these information returns are those who acquire 5% or more of the value of the stock of a foreign corporation, others who become U.S. persons while owning that percentage of the stock of a foreign corporation, and U.S. citizens and residents who are officers or directors of foreign corporations with such U.S. ownership.

A failure to file the required information return under section 6038 may result in monetary penalties or reduction of foreign tax credit benefits. A failure to file the required information returns under sections 6035 or 6046 may result in monetary penalties.

New Federal Law (Sec. 6046(a))

The Act increases the threshold for stock ownership of a foreign corporation that results in information reporting obligations under section 6046 from 5% (based on value) to 10% (based on vote or value).

Current California Law (R&T Sec. 19141.2)

California law conforms to certain federal foreign information reporting requirements, such as providing a copy of the federal form 5471. However, California does not conform to the federal fling thresholds and information reporting requirement in IRC Section 6046.

Effective Date

The provision is effective for reportable transactions occurring after December 31, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1151	Residence of Partnership

Background

A partnership generally is considered to be a domestic partnership if it is created or organized in the United States or under the laws of the United States or any state. A foreign partnership generally is any partnership that is not a domestic partnership.

New Federal Law (Sec. 7701(a)(4))

Under the Act, regulatory authority is granted to provide rules treating a partnership as a foreign partnership where such treatment is more appropriate. It is expected that a recharacterization of a partnership as foreign rather than domestic under such regulations will be based only on material factors such as the residence of the partners and the extent to which the partnership is engaged in business in the United States or earns U.S. source income. It also is expected that such regulations will provide guidance regarding the determination of whether an entity that is a partnership for Federal income tax purposes is to be considered to be created or organized in the United States or under the law of the United States or any state.

Current California Law (R&T Sec. 19141.2)

California law applies the federal definition of “domestic” for purposes of the California R&T Code Section (19141.2) which conforms to the federal foreign information reporting requirement (Form 5471). California law modifies the federal foreign reporting requirement to provide that only those United States domestic corporations that are doing business in California or deriving income from California are required to file.

Effective Date

The Conference Committee Report indicates that regulations issued under this grant of regulatory authority will apply only to partnerships created or organized after the date such regulations are filed with the Federal Register (or, if earlier, the date of a public notice substantially describing the expected contents of the regulations). Accordingly, regulations issued under this grant of regulatory authority will not be applied to reclassify pre-existing partnerships. In connection with this regulatory authority, the Conference Committee Report indicates that the general rule for classifying a partnership as domestic or foreign will continue to be the place where the partnership is created or organized (or the laws under which it is created or organized), and that the regulations are expected to provide a different classification result only in unusual cases. The regulations are to avoid period-by-period reclassifications of partnerships.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Impact on California Revenue

Regulations that are to be issued are not expected to have a material impact on changes to partnership classifications and tax revenue.

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

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1161	Foreign Provision - Transition Rule for Certain Trusts

Background

Under rules enacted with the Small Business Job Protection Act (SBJPA) of 1996, a trust is considered to be a U.S. trust if two criteria are met. First, a court within the United States must be able to exercise primary supervision over the administration of the trust. Second, U.S. fiduciaries of the trust must have the authority to control all substantial decisions of the trust. A trust that does not satisfy both of these criteria is considered to be a foreign trust. These rules for defining a U.S. trust generally are effective for taxable years of a trust that begin after December 31, 1996. A trust that qualified as a U.S. trust under prior law could fail to qualify as a U.S. trust under these new criteria.

New Federal Law (Sec. 1907 of SBJPA of 1996)

Under the Act, the Secretary of the Treasury is granted authority to allow nongrantor trusts that had been treated as U.S. trusts under prior law to elect to continue to be treated as U.S. trusts, notwithstanding the new criteria for qualification as a U.S. trust.

Current California Law

California does not make a determination of whether a trust is a U.S. trust.

Effective Date

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

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1162	Stock and Securities Trading Safe Harbor

Background

A nonresident alien individual or foreign corporation that is engaged in a trade or business within the United States is subject to U.S. taxation on its net income that is effectively connected with the trade or business at graduated rates of tax. Under a “safe harbor” rule, foreign persons that trade in stocks or securities for their own accounts are not treated as engaged in a U.S. trade or business for this purpose.

For a foreign corporation to qualify for the safe harbor, it must not be a dealer in stock or securities. In addition, if the principal business of the foreign corporation is trading in stock or securities for its own account, the safe harbor generally does not apply if the principal office of the corporation is in the United States.

For foreign persons who invest in securities trading partnerships, the safe harbor applies only if the partnership is not a dealer in stock and securities. In addition, if the principal business of the partnership is trading stock or securities for its own account, the safe harbor generally does not apply if the principal office of the partnership is in the United States.

Under Treasury regulations that apply to both corporations and partnerships, the determination of the location of the entity's principal office turns on the location of various functions relating to operation of the entity, including communication with investors and the general public, solicitation and acceptance of sales of interests, and maintenance and audits of its books of account (Treas. reg. sec. 1.864-2(c)(2) (ii) and (iii)). Under the regulations, the location of the entity's principal office does not depend on the location of the entity's management or where investment decisions are made.

New Federal Law (Sec. 864(b)(2)(A)(ii))

The Act modifies the stock and securities trading safe harbor by eliminating the requirement for both partnerships and foreign corporations that trade stock or securities for their own accounts that the entity's principal office not be within the United States.

Current California Law (R&T Secs. 17951, 17954 and 25110)

In general, California law taxes California residents on income from all sources. Nonresidents of California are subject to tax on all income derived from sources within this state. The state does not conform to any federal nonresident alien rules, since it has unique rules relating to nonresidents of California.

California does not generally conform to the U.S. income sourcing rules for foreign corporations. However, for California purposes, those California corporations which have a water's-edge election in forces, are required to use federal rules to determine U.S. source income, including rules for foreign corporations.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1163	Clarification of Foreign Tax Credit Provision

Background

Under section 902, a domestic corporation that receives a dividend from a foreign corporation in which it owns 10% or more of the voting stock is deemed to have paid a portion of the foreign taxes paid by such foreign corporation. The domestic corporation that receives a dividend is deemed to have paid a portion of the foreign corporation's post-1986 foreign income taxes based on the ratio of the amount of such dividend to the foreign corporation's post-1986 undistributed earnings. The foreign corporation's post-1986 foreign income taxes is the sum of the foreign income taxes with respect to the taxable year in which the dividend is distributed plus certain foreign income taxes with respect to prior taxable years (beginning after December 31, 1986).

Under section 904, separate foreign tax credit limitations apply to various categories of income. Two of these separate limitation categories are passive income and financial services income. For purposes of the separate foreign tax credit limitation applicable to passive income, certain income that is treated as high-taxed income is excluded from the definition of passive income. For purposes of the separate foreign tax credit limitation applicable to financial services income, the definition of financial services income generally incorporates passive income as defined for purposes of the separate limitation applicable to passive income.

New Federal Law (Secs. 902(c) and 904(d))

The Act clarifies that, for purposes of the deemed paid credit under section 902 for a taxable year, a foreign corporation's post-1986 foreign income taxes includes foreign income taxes with respect to prior taxable years (beginning after December 31, 1986) only to the extent such taxes are not attributable to dividends distributed by the foreign corporation in prior taxable years. No inference is intended regarding the determination of foreign taxes deemed paid under present law.

The Act clarifies that the exclusion of income that is treated as high-taxed income does not apply for purposes of the separate foreign tax credit limitation applicable to financial services income. The committee reports indicate that no inference is intended regarding the treatment of high-taxed income for purposes of the separate foreign tax credit limitation applicable to financial services income under present law.

Current California Law

California does not have a comparable credit.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Effective Date

The provision is effective on August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1171	Computer Software Qualifying as FSC Export Property

Background

Under special tax provisions that provide an export benefit, a portion of the foreign trade income of an eligible foreign sales corporation (FSC) is exempt from Federal income tax. Foreign trade income is defined as the gross income of a FSC that is attributable to foreign trading gross receipts. The term "foreign trading gross receipts" includes the gross receipts of a FSC from the sale, lease, or rental of export property and from services related and subsidiary to such sales, leases, or rentals.

For purposes of the FSC rules, export property is defined as property (1) which is manufactured, produced, grown, or extracted in the United States by a person other than a FSC; (2) which is held primarily for sale, lease, or rental in the ordinary conduct of a trade or business by or to a FSC for direct use, consumption, or disposition outside the United States; and (3) not more than 50% of the fair market value of which is attributable to articles imported into the United States. Intangible property generally is excluded from the definition of export property for purposes of the FSC rules; this exclusion applies to copyrights other than films, tapes, records, or similar reproductions for commercial or home use.

The temporary Treasury regulations provide that a license of a master recording tape for reproduction outside the United States is not excluded from the definition of export property (Treas. Reg. sec. 1.927(a)-1T(f)(3)). The statutory exclusion for intangible property does not contain any specific reference to computer software. However, the temporary Treasury regulations provide that a copyright on computer software does not constitute export property, and that standardized, mass-marketed computer software constitutes export property if such software is not accompanied by a right to reproduce for external use (Treas. Reg. sec. 1.927(a)-1T(f)(3)).

New Federal Law (Sec. 927(a))

The Act provides that computer software licensed for reproduction abroad is not excluded from the definition of export property for purposes of the FSC provisions. Accordingly, computer software that is exported with a right to reproduce is eligible for the benefits of the FSC provisions. In light of the rapid innovations in the computer and software industries, the committee reports indicate that Congress intends that the term "computer software" be construed broadly to accommodate technological changes in the products produced by both industries. The committee reports indicate that no inference is intended regarding the qualification as export property of computer software licensed for reproduction abroad under present law.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Current California Law (R&T Sec. 25110)

In general, California does not conform to the federal rules relating to FSC.

With respect to a “water’s-edge election” the income subject to California apportionment is generally the income for federal purposes of the corporations of the electing group, including the income under the federal rules for subpart F income. However, California does not follow the FSC and DISC exemption/deferral of income provisions. All of the income and factors of FSCs and DISCs are required to be included in the water’s-edge combined report.

Effective Date

The provision generally applies to gross receipts from computer software licenses attributable to periods after December 31, 1997. Accordingly, in the case of a multi-year license, the provision applies to gross receipts attributable to the period of such license that is after December 31, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1172	Increase Dollar Limitation on IRC Section 911 Exclusion

Background

U.S. citizens generally are subject to U.S. income tax on all their income, whether derived in the United States or elsewhere. A U.S. citizen who earns income in a foreign country also may be taxed on such income by that foreign country. A credit against the U.S. income tax imposed on foreign source income is allowed for foreign taxes paid on such income. U.S. citizens living abroad may be eligible to exclude from their income for U.S. tax purposes certain foreign earned income and foreign housing costs.

In order to qualify for these exclusions, a U.S. citizen must be either (1) a bona fide resident of a foreign country for an uninterrupted period that includes an entire taxable year, or (2) present overseas for 330 days out of any 12 consecutive month period. In addition, the taxpayer must have his or her tax home in a foreign country.

The exclusion for foreign earned income generally applies to income earned from sources outside the United States as compensation for personal services actually rendered by the taxpayer. The maximum exclusion for foreign earned income for a taxable year is $70,000.

The exclusion for housing costs applies to reasonable expenses, other than deductible interest and taxes, paid or incurred by or on behalf of the taxpayer for housing for the taxpayer and his or her spouse and dependents in a foreign country. The exclusion amount for housing costs for a taxable year is equal to the excess of such housing costs for the taxable year over an amount computed pursuant to a specified formula.

The combined earned income exclusion and housing cost exclusion may not exceed the taxpayer's total foreign earned income. The taxpayer's foreign tax credit is reduced by the amount of the credit that is attributable to excluded income.

New Federal Law (Sec. 911(b))

Under the Act, the $70,000 limitation on the exclusion for foreign earned income is increased to $80,000, in increments of $2,000 each year beginning in 1998. The $80,000 limitation on the exclusion for foreign earned income is indexed for inflation beginning in 2008 (for inflation occurring after 2006).

Current California Law

California does not have a comparable exclusion.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1173	Treatment for Certain Securities Under Subpart F Rules

Background

Under the rules of subpart F (secs. 951-964), the U.S. 10% 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 distributed currently to the shareholders. The U.S. 10% 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 U.S. 10% shareholders also are subject to current U.S. tax on their shares of the CFC's earnings to the extent invested by the CFC in certain U.S. property. A shareholder's current income inclusion with respect to a CFC's investment in U.S. property for a taxable year is based on the CFC's average investment in U.S. property for such year. For this purpose, the U.S. property held by the CFC must be measured as of the close of each quarter in the taxable year. U.S. property generally is defined to include tangible property located in the United States, stock of a U.S. corporation, obligations of a U.S. person, and the right to use certain intellectual property in the United States. Exceptions are provided for, among other things, obligations of the United States, U.S. bank deposits, certain trade or business obligations, and stock or debts of certain unrelated U.S. corporations.

New Federal Law (Sec. 956(c))

The Act provides two additional exceptions from the definition of U.S. property for purposes of the subpart F rules. Both exceptions relate to transactions entered into by a securities or commodities dealer in the ordinary course of its business as a securities or commodities dealer.

The first exception covers the deposit of collateral or margin by a securities or commodities dealer, or the receipt of such a deposit by a securities or commodities dealer, if such deposit is made or received on commercial terms in the ordinary course of the dealer's business as a securities or commodities dealer. This exception applies to deposits of margin or collateral for securities loans, notional principal contracts, options contracts, forward contracts, futures contracts, and any other financial transaction with respect to which the Secretary of the Treasury determines that the posting of collateral or margin is customary.

The second exception covers repurchase agreement transactions and reverse repurchase agreement transactions entered into by or with a securities or commodities dealer in the ordinary course of its business as a securities or commodities dealer. The exception applies only to the extent that the obligation under the transaction does not exceed the fair market value of readily marketable securities transferred or otherwise posted as collateral for the obligation.

For purposes of these two additional exceptions under section 956, the term "dealer in commodities" means futures commission merchants and dealers in commodities within the meaning of the new definition that is added to section 475 by the conference agreement. In addition, the committee reports indicate that Congress intent to clarify that the addition of these two exceptions under section 956 is not intended to create any inference regarding the treatment of an obligation of a U.S. person to return stock that is borrowed pursuant to a securities loan.

Current California Law (R&T Sec. 25110)

In general, California law does not conform to the rules relating to controlled foreign corporations (CFC). However, for California water's-edge purposes, a CFC is required to be included in the water's-edge combined report if the CFC has subpart F income defined in Section 952 of the Internal Revenue Code.

With respect to a water's-edge election, the income subject to California apportionment is generally the income for federal purposes of the corporations within the electing group, including the income under federal rules for Subpart F income. However, California regulations [25110(d)(2)(F)(i)] specifically exclude IRC section 956 Subpart F income.

Effective Date

The provision applies only to taxable years of foreign corporations beginning after December 31, 1997, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1174	Treatment of Service Income of Nonresident Alien Individuals

Background

Nonresident alien individuals generally are subject to U.S. taxation and withholding on their U.S. source income. Compensation for labor and personal services performed within the United States is considered U.S. source unless such income qualifies for a de minimis exception. To qualify for the exception, the compensation paid to a nonresident alien individual must not exceed $3,000, the compensation must reflect services performed on behalf of a foreign employer, and the individual must be present in the United Sates for not more than 90 days during the taxable year. Special rules apply to exclude certain items from the gross income of a nonresident alien. An exclusion applies to gross income derived by a nonresident alien individual from the international operation of a ship if the country in which such individual is resident provides a reciprocal exemption for U.S. residents. However, this exclusion does not apply to income from personal services performed by an individual crew member on board a ship. Consequently, wages exceeding $3,000 in a taxable year that are earned by nonresident alien individual crew members of a foreign ship while the vessel is within U.S. territory are subject to income taxation by the United States.

U.S. residents are subject to U.S. tax on their worldwide income. In general, a non-U.S. citizen is considered to be a resident of the United States if the individual (1) has entered the United States as a lawful permanent U.S. resident or (2) is present in the United States for 31 or more days during the current calendar year and has been present in the United States for a substantial period of time--183 or more days--during a three-year period computed by weighting toward the present year (the “substantial presence test”). An individual generally is treated as present in the United States on any day if such individual is physically present in the United States at any time during the day. Certain categories of individuals (e.g., foreign government employees and certain students) are not treated as U.S. residents even if they are present in the United States for the requisite period of time. Crew members of a foreign vessel who are on board the vessel while it is stationed within U.S. territorial waters are treated as present in the United States.

New Federal Law (Secs. 861(a), 863(c), 7701(a))

The Act treats as income from foreign sources the gross income of a nonresident alien individual who is present in the United States as a member of the regular crew of a foreign vessel from the performance of personal services in connection with the international operation of a ship. Thus, such income is exempt from U.S. income and withholding tax. However, such income is not treated as foreign source income for purposes of applying the group-term life insurance rules, accident and health rules and pension plan rules. Such persons are not excluded for purposes of applying the minimum participation

standards of section 410 to a plan of the employer. In addition, for purposes of determining whether an individual is a U.S. resident under the substantial presence test, the Act provides that the days that such individual is present as a member of the regular crew of a foreign vessel are disregarded, unless the individual engages in trade or business within the United States on such day.

Current California Law (R&T Secs. 17014, 17015, 17041, 17951 and 17954)

In general, California law taxes California residents on income from all sources. Nonresidents of California are subject to tax on all income derived from sources within this state. The state does not conform to any federal nonresident alien rules, since it has unique rules relating to nonresidents of California.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1201	Increase Standard Deduction and AMT Exemption Amount for Kiddie Tax

Background

Standard deduction of dependents -- Under present law, the standard deduction of a taxpayer for whom a dependency exemption is allowed on another taxpayer's return can not exceed the lesser of (1) the standard deduction for an individual taxpayer (projected to be $4,250 for 1998) or (2) the greater of $500 (indexed, projected to be $700 for 1998) or the dependent's earned income

Taxation of unearned income of children under age 14 -- The tax on a portion of the unearned income (e.g., interest and dividends) of a child under age 14 is the additional tax that the child's custodial parent would pay if the child's unearned income were included in that parent's income. The portion of the child's unearned income which is taxed at the parent's top marginal rate is the amount by which the child's unearned income is more than the sum of (1) $500 (indexed) plus (2) the greater of (a) $500 (indexed) or (b) the child's itemized deductions directly connected with the production of the unearned income (sec. 1(g)).

Alternative minimum tax (AMT) exemption for children under age 14 -- Single taxpayers are entitled to an exemption from the AMT of $33,750. However, in the case of a child under age 14, his exemption from the AMT, in substance, is the unused AMT exemption of the child's custodial parent, limited to the sum of earned income and $1,000 (indexed, projected to be $1,400 for 1998).

New Federal Law (Sec. 59(j) and 63(c))

Standard deduction of dependents -- The standard deduction of a taxpayer for whom a dependency exemption is allowed on another taxpayer's return cannot exceed the lesser of (1) the standard deduction for individual taxpayers or (2) the greater of: (a) $500 (indexed for inflation from calendar year 1987, which is the same as prior law), or (b) the individual's earned income plus $250 (indexed for inflation after calendar year 1998).

The AMT exemption for children under age 14 -- The AMT exemption for a child under age 14 in substance, is the lesser of (1) $33,750 or (2) the sum of the child's earned income plus $5,000 (indexed for inflation after calendar year 1998).

Current California Law (R&T Secs. 17062, 17073.5(c))

With respect to both of the above provisions, California conforms to federal law prior to the TRA 97, including the federal inflation adjustment:

- The standard deduction of a taxpayer for whom a dependency exemption is allowed on another taxpayer's return cannot exceed the lesser of (1) the standard deduction for individual taxpayers or (2) the greater of: (a) $500

(indexed for inflation from calendar year 1987), or (b) the individual's earned income.

- The AMT exemption for children under age 14, in substance, is the unused AMT exemption of the child's custodial parent, limited to sum of earned income and $1,000 (indexed for inflation.)

Effective Date

Both the above federal provisions are effective for taxable years beginning after December 31, 1997.

Impact on California Revenue

Revenue losses from conformity to this provision are estimated as follows:

Estimated Revenue Impact		
For Taxable Years After 12/31/1997		
Enactment After June 30, 1998		
(In Millions)		
1998-9	1999-0	2000-01
($2)	($2)	($2)

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

This proposal would increase the maximum standard deduction for certain qualifying dependents by $250 as indexed for 1998 and thereafter.

Revenue losses from this proposal would depend on the number of dependents filing returns, their income characteristics for determining the new standard deduction limitations, and their marginal tax rates.

Based on the impact projected for the federal law change, conforming to this change would be losses of $2 million annually.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1202	Increase Amount of Tax Exempt from Estimated Tax Requirements

Background

An individual taxpayer generally is subject to an addition to tax for any underpayment of estimated tax. An individual generally does not have an underpayment of estimated tax if he or she makes certain timely estimated tax payments based on the tax shown on the return for the preceding or the current year. Income tax withholding from wages is considered to be a payment of estimated taxes.

New Federal Law (Sec. 6654 (e)(1))

The addition to tax is not imposed where the total tax liability for the year, reduced by any withheld tax, is less than $1,000, rather than the pre-TRA 97 amount of $500.

Current California Law (R&T Sec. 19136(d)(2)(A))

California requires estimated tax payments and imposes an addition to tax for certain underpayments of estimated tax by individual taxpayers comparable to the federal law relating to estimated tax payments. However, the amount that constitutes an underpayment for California differs from the federal law. Additionally, the circumstances under which an addition to tax would not be imposed for an underpayment of estimated tax differ. For California purposes, the addition to tax is not imposed for individual taxpayers, generally, where withholding is equal to 80% of the tax liability or the tax liability for the year reduced by all credits (estimated tax and withholding credits) is $100 or less ($50 for married persons filing separate returns).

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

Impact on California Revenue

The fiscal year, cash flow impact of conforming to the concept of this provision but at a $200 rather than $1,000 new threshold is as follows:

Estimated Revenue Impact		
For Taxable Years After 12/31/97		
Enactment After June 30, 1998		
(In Millions)		
1998-9	1999-0	2000-01
($1.0)	* Minor Loss	* Minor Loss

* Less than $100 thousand

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

If California conforms in concept to the federal provision, the amount of tax exempt from estimated tax requirements would double (from $100 to $200 and from $50 to $100).

Based on the impact projected for the federal law change, conforming to this change would be minor cash flow losses with exception of the first year impact where the loss is estimated to be $1 million. This revenue loss is strictly a timing issue and would not alter tax liabilities, but could, to some extent, result in the delay of small tax payments.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1203	Treatment of Certain Reimbursed Expenses of Rural Mail Carriers

New Federal Law (Sec. 162(o))

For employees using their automobile in performing services involving the collection and delivery of mail on a rural route and reimbursed by the U.S. Postal Service at a rate contained in their 1991 collective bargaining agreement, their business expense deduction is equal to the reimbursement, which may be increased by no more than the rate of inflation. Under this treatment, income and expenses would be equal, so that neither will have to be reported on the taxpayer’s tax return.

Current California Law (R&T Secs. 17201, 17072)

California conforms to the federal law prior to the TRA 97 amendment as it conforms to the underlying federal law relating to itemized deductions and adjusted gross income for individuals. Postal Service employees who are paid an equipment maintenance allowance (EMA) for using their automobile for the collection and delivery of mail on a rural route may compute their deduction for business by using, for all business-use mileage, 150% of the standard mileage rate for the first 15,000 miles of business use of an automobile that is not fully depreciated. Using this method, the tax is determined by comparing the EMA to the automobile expense deductions that each carrier is allowed to claim (using either the Actual expenses method or the 150% of the standard mileage rate). If the EMA exceeds the allowable automobile expense deductions, the excess generally is subject to tax. If the EMA falls short of the allowable automobile expense deductions, a deduction is allowed only to the extent that the sum of this shortfall and all other miscellaneous itemized deductions exceeds 2% of the taxpayer's adjusted gross income.

Effective Date

The federal provision is effective for taxable years beginning after December 31, 1997.

Impact on California Revenue

Based on the minor impact projected for the federal law change, conforming to this change would produce negligible revenue losses (less than $50,000 annually beginning in 1997-8).

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1204	Travel Expenses for Certain Federal Employees

New Federal Law (Sec. 162(a))

The one-year limitation with respect to deductibility of an employee’s expenses while temporarily away from home does not include any period during which a federal employee is certified by the Attorney General (or the Attorney General's designee) as traveling on behalf of the federal government in a temporary duty status to investigate or provide support services to the investigation of a federal crime. Therefore, expenses for these individuals during these periods are deductible, regardless of the length of the period for which certification is given (provided that the other requirements for deductibility are satisfied).

Current California Law (R&T Sec. 17201)

California conforms to the federal law prior to the TRA 97 amendment as it conforms to the underlying law relating to itemized deductions for individuals. Unreimbursed ordinary and necessary travel expenses paid or incurred by an individual in connection with temporary employment away from home (e.g., transportation costs and the cost of meals and lodging) are generally deductible, subject to the 2% floor on miscellaneous itemized deductions. Travel expenses paid or incurred in connection with indefinite employment away from home, however, are not deductible. A taxpayer's employment away from home in a single location is indefinite rather than temporary if it lasts for one year or more; thus, no deduction is permitted for travel expenses paid or incurred in connection with such employment. If a taxpayer's employment away from home in a single location lasts for less than one year, whether such employment is temporary or indefinite is determined on the basis of the facts and circumstances.

Effective Date

The federal provision is effective for amounts paid or incurred with respect to taxable years ending after August 5, 1997.

Impact on California Revenue

Based on the impact projected for the federal law change, conforming to this change would be negligible, losses less than $250,000 annually.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1205	Payment of Tax by Commercial Acceptable Means

New Federal Law (Secs. 6103, 6317, 7431)

The Act gives the IRS the authority to accept payment by any commercially acceptable means including credit or debit cards. The IRS is required to prescribe regulations as necessary. Federal law clarifies that errors relating to the credit or debit card account would be subject to the Truth in Lending Act, but not the underlying tax debt. Additionally, provisions expressly control disclosure of confidential information relative to the credit or debit card transactions. The IRS is expressly authorized to enter into contracts to obtain services, but is precluded from paying any fee or providing any other consideration for the services.

Current California Law (R&T Sec. 19005(b))

The FTB currently has the authority to accept credit cards for payment of taxes. Additionally, AB 1374 (Stats. 1995, Ch. 926)requires all state agencies to accept credit card payments effective January 1, 1997, unless the Department of General Services (DGS) grants an exemption. Due to the cost attributable to the absorption of the credit card discount fee, the FTB has received an exemption from the DGS not to implement the requirements of AB 1374. The current authority requires the FTB to charge the taxpayer the discount fee associated with the credit card payment. Between 1991 and April 30, 1994, the FTB accepted 4,400 credit cards payments totaling $3.2 million. Credit card payments were discontinued April 30, 1994, because the major credit card companies would not allow the FTB to pass to the taxpayer the discount fee associated with the credit card payment. Representatives of the companies claimed that the FTB's passing of the discount fee to the taxpayer violated the companies' policy, which is based on their counsel's opinion that for FTB to pass the discount fee to the taxpayer violates section 1666(f)(a)(2) of the federal Truth in Lending Act. FTB counsel disagrees with that opinion as this particular section of the Truth in Lending Act pertains to "sales transactions" which are distinguishable from a tax debt. FTB staff continues to explore other options as a means of reinstating the acceptance of credit cards. It is anticipated that it could use a third-party processing vendor that would charge a user fee equal to the discount fee. Additionally, FTB staff has explored the use of debit cards as a means for making payment; however, a significant need or benefit for the taxpayer or the state could not be identified, while there would be significant processing complications.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Effective Date

The federal provision is effective after May 5, 1998. The IRS may, in this interim period, conduct internal tests and negotiate with card issuers, but may not accept credit or debit cards for payment of tax liability.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1211	Modifications to Look-Back Method for Long-Term Contracts

Background

Taxpayers engaged in the production of property under a long-term contract generally compute income from the contract under the percentage of completion method. Under this method, the taxpayer includes in gross income for any taxable year an amount that is based on the product of (1) the gross contract price and (2) the percentage of the contract completed as of the end of the year. The percentage of the contract completed as of the end of the year is determined by comparing costs incurred with respect to the contract as of the end of the year with estimated total contract costs. Because the percentage of completion method relies upon estimated, rather than Actual, contract price and costs to determine gross income for any taxable year, a “look-back” method is applied in the year a contract is completed in order to compensate the taxpayer (or the Internal Revenue Service) for the acceleration (or deferral) of taxes paid over the contract term. The first step of the look-back method is to reapply the percentage of completion method using Actual contract price and costs rather than estimated contract price and costs. For the second step, the taxpayer recomputes the tax liability for each year of the contract using gross income as reallocated under the “look-back” method. If there is any difference between the recomputed tax liability and the tax liability as previously determined for a year, the difference is treated as a hypothetical underpayment or overpayment of tax to which the taxpayer applies a rate of interest equal to the overpayment rate, compounded daily. The taxpayer receives (or pays) interest if the net amount of interest applicable to hypothetical overpayments exceeds (or is less than) the amount of interest applicable to hypothetical underpayments. The overpayment rate equals the applicable Federal short-term rate plus two percentage points. This rate is adjusted quarterly by the IRS, therefore, in applying the “look-back” method for a contract year, a taxpayer may be required to use five different interest rates.

New Federal Law (Sec. 460(b))

A taxpayer may elect not to apply the “look-back” method with respect to a long-term contract, if for each prior contract year, the cumulative taxable income (or loss) under the contract as determined using estimated contract price and costs is within 10% of the cumulative taxable income (or loss) as determined using Actual contract price and costs.

A taxpayer may elect not to reapply the “look-back” method with respect to costs incurred after completion of the long-term contract, if as of the close of any taxable year after the year the contract is completed, the cumulative taxable income (or loss) under the contract is within 10% of the cumulative look-back income (or loss) as of the close of the most recent year in which the look-back method was applied (or would have applied but for the other de minimis exception described above).

Additionally, for purposes of the “look-back” method, the applicable rate of interest is the overpayment rate in effect for the calendar quarter in which the accrual period begins, which is the day after the return due date (determined without regard to extensions) for the taxable year, and ends on such return due date for the following taxable year.

Current California Law (R&T Secs. 17564, 24673.2, 17551)

California conforms to the federal “look-back” method without the alternative treatment allowed by TRA 97 since it conforms to the underlying federal law relating to the accounting periods and methods of accounting.

Effective Date

The federal provision applies to contracts completed in taxable years ending after August 5, 1997 and as it relates to the income forecast method of depreciation, applies to property placed in service after September 13, 1995.

Impact on California Revenue

Based on the minor impact projected for the federal law change, revenue losses would be negligible (less than $250,000 annually).

The revenue impact for this provision would depend on the amount of costs of contracts for taxpayers that elect to forego the look-back method and avoid the interest calculation.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1212	AMT Treatment of Certain Property and Casualty Insurance Companies

New Federal Law (Sec. 56(g))

A property and casualty insurance company that elects for regular tax purposes to be taxed only on taxable investment income determines its adjusted current earnings under the alternative minimum tax (AMT) without regard to deductions not taken into account in determining its gross investment income. Thus, adjusted current earnings of an electing company is determined without regard to underwriting income (or underwriting expense).

Current California Law

Not applicable. For California purposes, property and casualty insurance companies are not subject to the corporate franchise or income tax laws, including AMT.

Effective Date

The federal provision is effective for taxable years beginning after December 31, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1213	Treatment of Construction Allowance Provided to Lessee

Background

Issues have arisen as to the proper treatment of amounts provided to a lessee by a lessor for property to be constructed and used by the lessee pursuant to the lease ("construction allowances"). In general, incentive payments are includible in income as accessions to wealth. A coordinated issue paper issued by the Internal Revenue Service (IRS) on October 7, 1996, states the IRS position that construction allowances should generally be included in income in the year received. However, the paper does recognize that amounts received by a lessee from a lessor and expended by the lessee on assets owned by the lessor were not includible in the lessee's income. The issue paper provides that tax ownership is determined by applying a "benefits and burdens of ownership" test that includes an examination of several factors.

New Federal Law (Sec. 110, 168(i)(8))

The TRA 97 codifies the treatment recognized in the federal coordinated issue paper. Additionally, however, it provides a safe harbor by providing that (1) a lessee's gross income would not include amounts received in cash (or treated as a rent reduction) from a lessor under a short-term lease of retail space for the purpose of the lessee's construction or improvement of qualified long-term real property for use in the lessee's trade or business at such retail space; and (2) the lessor must treat the amounts expended on the construction allowance as nonresidential real property owned by the lessor for depreciation.

The exclusion only applies to the extent the allowance does not exceed the amount expended by the lessee on the construction or improvement of qualified long-term real property. Reporting requirements are provided to ensure that both the lessor and lessee treat such amounts in accordance with the provision. Under regulations, the lessor and the lessee shall, at such times and in such manner as provided by the regulations, furnish to the Secretary of the Treasury information concerning the amounts received (or treated as a rent reduction), the amounts expended on qualified long-term real property, and such other information as the Secretary deems necessary to carry out the provision.

Current California Law (R&T Sec. 17131)

California conforms to the federal treatment described in the federal issue paper by virtue of conforming to the underlying federal law relating to items specifically excluded from gross income.

Effective Date

The federal provision applies to leases entered into after August 5, 1997. No inference is intended as to the treatment of amounts that are not subject to the provision.

Impact on California Revenue

Based on the impact projected for the federal law change, conforming to this change would be negligible, losses less than $250,000 annually.

Revenue losses would depend on the amount of qualified allowances received in any given tax year by the lessees and their marginal tax rates. The revenue impact is based on federal projections.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1221	Simplified Flow-Through for Electing Large Partnerships.

Background

A partnership generally is treated as a conduit for federal income tax purposes. Each partner takes into account separately his distributive share of the partnership's items of income, gain, loss, deduction or credit. The character of an item is the same as if it had been directly realized or incurred by the partner. Limitations affecting the computation of taxable income generally apply at the partner level. The taxable income of a partnership is computed in the same manner as that of an individual, except that no deduction is permitted for personal exemptions, foreign taxes, charitable contributions, net operating losses, certain itemized deductions, or depletion. Elections affecting the computation of taxable income derived from a partnership are made by the partnership, except for certain elections such as those relating to discharge of indebtedness income and the foreign tax credit.

Capital Gain.

Net capital gain is the excess of net long-term capital gain over net short-term capital loss. Individuals with a net capital loss generally may deduct up to $3,000 of the loss each year against ordinary income. Net capital losses in excess of the $3,000 limit may be carried forward indefinitely. A special rule applies to gains and losses on the sale, exchange or involuntary conversion of certain trade or business assets (sec. 1231). In general, net gains from such assets are treated as long-term capital gains, but net losses are treated as ordinary losses. A partner's share of a partnership's net short-term capital gain or loss and net long-term capital gain or loss from portfolio investments is separately reported to the partner. A partner's share of a partnership's net gain or loss under section 1231 generally is also separately reported.

Deduction and credits.

Miscellaneous itemized deductions (e.g., certain investment expenses) are deductible only to the extent that, in the aggregate, they exceed 2% of the individual's adjusted gross income.

In general, taxpayers are allowed a deduction for charitable contributions, subject to certain limitations. The deduction allowed an individual generally cannot exceed 50% of the individual's adjusted gross income for the taxable year. The deduction allowed a corporation generally cannot exceed 10% of the corporation's taxable income. Excess contributions are carried forward for five years. A partner's distributive share of a partnership's miscellaneous itemized deductions and charitable contributions is separately reported to the partner. Each partner is allowed his distributive share of credits against his taxable income.

Foreign Taxes.

The foreign tax credit generally allows U.S. taxpayers to reduce U.S. income tax on foreign source income by the amount of foreign income taxes paid or accrued with respect to that income. In lieu of electing the foreign tax credit, a taxpayer may deduct foreign taxes. The total amount of the credit may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign source taxable income bears to the taxpayer's worldwide taxable income for the taxable year.

Unrelated Business Taxable Income.

Tax-exempt organizations are subject to tax on income from unrelated businesses. Certain types of income (such as dividends, interest and certain rental income) are not treated as unrelated business taxable income. Thus, for a partner that is an exempt organization, whether partnership income is unrelated business taxable income depends on the character of the underlying income. Income from a publicly traded partnership, however, is treated as unrelated business taxable income regardless of the character of the underlying income.

Special Rules Relating to Oil and Gas Activities.

Taxpayers involved in the search for and extraction of crude oil and natural gas are subject to certain special tax rules. As a result, in the case of partnerships engaged in such activities, certain specific information is separately reported to partners. A taxpayer who owns an economic interest in a producing deposit of natural resources (including crude oil and natural gas) is permitted to claim a deduction for depletion of the deposit as the minerals are extracted.

In the case of oil and gas produced in the United States, a taxpayer generally is permitted to claim the greater of a deduction for cost depletion or percentage depletion. Cost depletion is computed by multiplying a taxpayer's adjusted basis in the depletable property by a fraction, the numerator of which is the amount of current year production from the property and the denominator of which is the property's estimated reserves as of the beginning of that year. Percentage depletion is equal to a specified percentage (generally, 15% in the case of oil and gas) of gross income from production. Cost depletion is limited to the taxpayer's basis in the depletable property; percentage depletion is not so limited.

Once a taxpayer has exhausted its basis in the depletable property, it may continue to claim percentage depletion deductions (generally referred to as “excess percentage depletion”). Certain limitations apply to the deduction for oil and gas percentage depletion. First, percentage depletion is not available to oil and gas producers who also engage (directly or indirectly) in significant levels of oil and gas retailing or refining activities (so-called “integrated producers” of oil and gas). Second, the deduction for percentage depletion may be claimed by a taxpayer only with respect to up to 1,000

barrels-per-day of production. Third, the percentage depletion deduction may not exceed 100% of the taxpayer's net income for the taxable year from the depletable oil and gas property. Fourth, a percentage depletion deduction may not be claimed to the extent that it exceeds 65% of the taxpayer's pre-percentage depletion taxable income.

In the case of a partnership that owns depletable oil and gas properties, the depletion allowance is computed separately by the partners and not by the partnership. In computing a partner's basis in his partnership interest, basis is increased by the partner's share of any partnership-related excess percentage depletion deductions and is decreased (but not below zero) by the partner's total amount of depletion deductions attributable to partnership property.

Intangible drilling and development costs (IDCs) incurred with respect to domestic oil and gas wells generally may be deducted at the election of the taxpayer. In the case of integrated producers, no more than 70% of IDCs incurred during a taxable year may be deducted. IDCs not deducted are capitalized and generally are either added to the property's basis and recovered through depletion deductions or amortized on a straight-line basis over a 60-month period. The special treatment granted to IDCs incurred in the pursuit of oil and gas may give rise to an item of tax preference or (in the case of corporate taxpayers) an adjusted current earnings (ACE) adjustment for the alternative minimum tax. The tax preference item is based on a concept of “excess IDCs.” In general, excess IDCs are the excess of IDCs deducted for the taxable year over the amount of those IDCs that would have been deducted had they been capitalized and amortized on a straight-line basis over 120 months commencing with the month production begins from the related well. The amount of tax preference is then computed as the difference between the excess IDC amount and 65% of the taxpayer's net income from oil and gas (computed without a deduction for excess IDCs).

For IDCs incurred in taxable years beginning after 1992, the ACE adjustment related to IDCs is repealed for taxpayers other than integrated producers. Moreover, beginning in 1993, the IDC tax preference generally is repealed for taxpayers other than integrated producers. In this case, however, the repeal of the excess IDC preference may not result in more than a 40% reduction (30% for taxable years beginning in 1993) in the amount of the taxpayer's alternative minimum taxable income computed as if that preference had not been repealed.

Passive Losses.

The passive loss rules generally disallow deductions and credits from passive activities to the extent they exceed income from passive activities. Losses not allowed in a taxable year are suspended and treated as current deductions from passive activities in the next taxable year. These losses are allowed in full when a taxpayer disposes of the entire interest in the passive Activity to

an unrelated person in a taxable transaction. Passive activities include trade or business activities in which the taxpayer does not materially participate. (Limited partners generally do not materially participate in the activities of a partnership.)

An individual who Actively participates in a rental real estate Activity and holds at least a 10% interest may deduct up to $25,000 of passive losses. The $25,000 amount phases out as the individual's income increases from $100,000 to $150,000. The $25,000 allowance also applies to low-income housing and rehabilitation credits (on a deduction equivalent basis), regardless of whether the taxpayer claiming the credit Actively participates in the rental real estate Activity generating the credit. In addition, the income phaseout range for the $25,000 allowance for rehabilitation credits is $200,000 to $250,000 (rather than $100,000 to $150,000).

For interests acquired after December 31, 1989, in partnerships holding property placed in service after that date, the $25,000 deduction-equivalent allowance is permitted for the low-income housing credit without regard to the taxpayer's income. A partnership's operations may be treated as multiple activities for purposes of the passive loss rules. In such case, the partnership must separately report items of income and deductions from each of its activities. Income, loss and other items from a publicly-traded-partnership are treated as separate from income and loss from any other publicly-traded-partnership and also as separate from any income or loss from passive activities. The Omnibus Budget Reconciliation Act of 1993 added a rule, effective for taxable years beginning after December 31, 1993, treating a taxpayer's rental real estate activities in which he materially participates as not subject to limitation under the passive loss rules if the taxpayer meets eligibility requirements relating to real property trades or businesses in which he performs services. Real property trade or business means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. An individual taxpayer generally meets the eligibility requirements if (1) more than half of the personal services the taxpayer performs in trades or businesses during the taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and (2) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.

Portfolio income (such as interest and dividends) and expenses allocable to such income are not treated as income or loss from a passive Activity.

REMICs.

A tax is imposed on partnerships holding a residual interest in a real estate mortgage investment conduit (REMIC). The amount of the tax is the amount of excess inclusions allocable to partnership interests owned by certain tax-exempt organizations (disqualified organizations) multiplied by the highest corporate tax rate.

Contribution of Property to a Partnership.

In general, a partner recognizes no gain or loss upon the contribution of property to a partnership. However, income, gain, loss and deduction with respect to property contributed to a partnership by a partner must be allocated among the partners so as to take into account the difference between the partnership’s basis of the property and the property’s fair market value at the time of contribution. In addition, the contributing partner must recognize gain or loss equal to such difference if the property is distributed to another partner within five years of its contribution (sec. 704(c)), or if other property is distributed to the contributor within the five year period (sec. 737).

Election of Optional Basis Adjustment.

In general, the transfer of a partnership interest or a distribution of partnership property does not affect the basis of partnership assets. A partnership, however, may elect to make certain adjustments in the basis of partnership property (sec. 754). Under a section 754 election, the transfer of a partnership interest generally results in an adjustment in the partnership's basis in its property for the benefit of the transferee partner only, to reflect the difference between that partner's basis for his interest and his proportionate share of the adjusted basis of partnership property . Also under the election, a distribution of property to a partner in certain cases results in an adjustment in the basis of other partnership property.

Terminations.

A partnership terminates if either (1) all partners cease carrying on the business, financial operation or venture of the partnership, or (2) within a 12-month period 50% or more of the total partnership interests is sold or exchanged.

New Federal Law (Added Sections 771-777)

The Act modifies the tax treatment of an electing large partnership (generally, any partnership that elects under the provision, if the number of partners in the preceding taxable year is 100 or more) and its partners. The provision provides that each partner takes into account separately the partner's distributive share of the following items, which are determined at the partnership level: (1) taxable income or loss from passive loss limitation activities; (2) taxable income or loss from other activities (e.g., portfolio income or loss); (3) net capital gain or loss to the extent allocable to passive loss limitation activities and other activities; (4) tax-exempt interest; (5) net alternative minimum tax adjustment separately computed for passive loss limitation activities and other activities; (6) general credits; (7) low-income housing credit; (8) rehabilitation credit; (9) credit for producing fuel from a nonconventional source; (10) creditable foreign taxes and foreign source items; and (11) any other items to the extent that the Secretary determines that separate treatment of such items is appropriate.

Under the Act, the taxable income of an electing large partnership is computed in the same manner as that of an individual, except that the items described above are separately stated and certain modifications are made. These modifications include disallowing the deduction for personal exemptions, the net operating loss deduction and certain itemized deductions. All limitations and other provisions affecting the computation of taxable income or any credit (except for the at risk, passive loss and itemized deduction limitations, and any other provision specified in regulations) are applied at the partnership (and not the partner) level.

Capital Gains.

The netting of capital gains and losses occurs at the partnership level. A partner in a large partnership takes into account separately his distributive share of the partnership's net capital gain or net capital loss. Such net capital gain or loss is treated as long-term capital gain or loss. The term “net capital gain” has the same meaning as in section 1222(11). The term “net capital loss” means the excess of the losses from sales or exchanges of capital assets over the gains from sales or exchanges of capital assets. Thus, the partnership cannot offset any portion of capital losses against ordinary income.

Any excess of net short-term capital gain over net long-term capital loss is consolidated with the partnership's other taxable income and is not separately reported.

A partner's distributive share of the partnership's net capital gain is allocated between passive loss limitation activities and other activities. The net capital gain is allocated to passive loss limitation activities to the extent of net capital gain from sales and exchanges of property used in connection with such activities, and any excess is allocated to other activities. A similar rule applies for purposes of allocating any net capital loss. Any gains and losses of the partnership under section 1231 are netted at the partnership level. Net gain is treated as long-term capital gain and is subject to the rules described above. Net loss is treated as ordinary loss and consolidated with the partnership's other taxable income.

Deductions.

The Act contains two special rules for deductions. First, miscellaneous itemized deductions are not separately reported to partners. Instead, 70% of the amount of such deductions is disallowed at the partnership level. The remaining 30% is allowed at the partnership level in determining taxable income and is not subject to the 2% floor at the partner level. The 70% figure is intended to approximate the amount of such deductions that would be denied at the partner level as a result of the 2% floor. Second, charitable contributions are not separately reported to partners. Instead, the charitable contribution deduction is allowed at the partnership level in determining taxable income, subject to the limitations that apply to corporate donors.

Credits.

Under the Act, general credits are separately reported to partners as a single item. General credits are any credits other than the low-income housing credit, the rehabilitation credit and the credit for producing fuel from a nonconventional source. A partner's distributive share of general credits is taken into account as a current year general business credit. Thus, for example, the credit for clinical testing expenses is subject to the present law limitations on the general business credit. The refundable credit for gasoline used for exempt purposes and the refund or credit for undistributed capital gains of a regulated investment company are allowed to the partnership, and thus are not separately reported to partners. In recognition of their special treatment under the passive loss rules, the low-income housing and rehabilitation credits are separately reported. In addition, the credit for producing fuel from a nonconventional source is separately reported.

The Act imposes credit recapture at the partnership level and determines the amount of recapture by assuming that the credit fully reduced taxes. Such recapture is applied first to reduce the partnership's current year credit, if any; the partnership is liable for any excess over that amount. The transfer of an interest in an electing large partnership does not trigger recapture.

Foreign Taxes.

The Act retains present-law treatment of foreign taxes. The partnership reports to the partner creditable foreign taxes and the source of any income, gain, loss or deduction taken into account by the partnership. Elections, computations and limitations are made by the partner.

Tax-Exempt Interest.

The Act retains present-law treatment of tax-exempt interest. Interest on a State or local bond is separately reported to each partner.

Unrelated Business Taxable Income.

The Act retains present-law treatment of unrelated business taxable income. Thus, a tax-exempt partner's distributive share of partnership items is taken into account separately to the extent necessary to comply with the rules governing such income.

Passive Losses.

Under the Act, a partner in an electing large partnership takes into account separately his distributive share of the partnership's taxable income or loss from passive loss limitation activities. The term “passive loss limitation Activity” means any Activity involving the conduct of a trade or business (including any Activity treated as a trade or business under sec. 469(c) (5) or (6)) and any rental Activity. A partner's share of an electing large

partnership's taxable income or loss from passive loss limitation activities is treated as an item of income or loss from the conduct of a trade or business which is a single passive Activity, as defined in the passive loss rules. Thus, an electing large partnership generally is not required to separately report items from multiple activities.

A partner in an electing large partnership also takes into account separately his distributive share of the partnership's taxable income or loss from activities other than passive loss limitation activities. Such distributive share is treated as an item of income or expense with respect to property held for investment. Thus, portfolio income (e.g., interest and dividends) is reported separately and is reduced by portfolio deductions and allocable investment interest expense. In the case of a partner holding an interest in an electing large partnership which is not a limited partnership interest, such partner's distributive share of any items are taken into account separately to the extent necessary to comply with the passive loss rules. Thus, for example, income of an electing large partnership is not treated as passive income with respect to the general partnership interest of a partner who materially participates in the partnership's trade or business. The requirement that the passive loss rule be separately applied to each publicly traded partnership (sec. 469(k) of the Code) continues to apply.

Alternative Minimum Tax.

Under the Act, alternative minimum tax (AMT) adjustments and preferences are combined at the partnership level. An electing large partnership would report to partners a net AMT adjustment separately computed for passive loss limitation activities and other activities. In determining a partner's alternative minimum taxable income, a partner's distributive share of any net AMT adjustment is taken into account instead of making separate AMT adjustments with respect to partnership items. The net AMT adjustment is determined by using the adjustments applicable to individuals (in the case of partners other than corporations), and by using the adjustments applicable to corporations (in the case of corporate partners). Except as provided in regulations, the net AMT adjustment is treated as a deferral preference for purposes of the section 53 minimum tax credit.

Discharge of Indebtedness.

If an electing large partnership has income from the discharge of any indebtedness, such income is separately reported to each partner. In addition, the rules governing such income (sec. 108) are applied without regard to the large partnership rules. Partner-level elections under section 108 are made by each partner separately. Thus, for example, the large partnership provisions do not affect section 108(d)(6), which provides that certain section 108 rules apply at the partner level, or section 108(b)(5), which provides for an election to reduce the basis of depreciable property. The large partnership provisions also do not affect the election under section 108(c) (added by the Omnibus Budget Reconciliation Act of 1993) to exclude discharge of indebtedness income with respect to qualified real property business indebtedness.

REMICs.

For purposes of the tax on partnerships holding residual interests in REMICs, all interests in an electing large partnership are treated as held by disqualified organizations. Thus, an electing large partnership holding a residual interest in a REMIC is subject to a tax equal to the excess inclusions multiplied by the highest corporate rate. The amount subject to tax is excluded from partnership income.

Election of Optional Basis Adjustment.

Under the Act, an electing large partnership may still elect to adjust the basis of partnership assets with respect to transferee partners. The computation of an electing large partnership's taxable income is made without regard to the section 743(b) adjustment. As under present law, the section 743(b) adjustment is made only with respect to the transferee partner. In addition, an electing large partnership is permitted to adjust the basis of partnership property under section 734(b) if property is distributed to a partner, as under present law.

Terminations.

The Act provides that an electing large partnership does not terminate for tax purposes solely because 50% of its interests is sold or exchanged within a 12-month period.

Definition of Electing Large Partnership.

An “electing large partnership” is any partnership that elects under the provision, if the number of partners in the preceding taxable year is 100 or more. The number of partners is determined by counting only persons directly holding partnership interests in the taxable year, including persons holding through nominees. Persons holding indirectly (e.g., through another partnership) are not counted. Regulations may provide, however, that if the number of partners in any taxable year falls below 100, the partnership may not be treated as an electing large partnership. The election applies to the year for which made and all subsequent years and cannot be revoked without the Secretary's consent.

Special Rules for Certain Service Partnerships.

An election under this provision is not effective for any partnership if substantially all the partners are: (1) individuals performing substantial services in connection with the partnership's activities, or personal service corporations the owner-employees of which perform such services; (2) retired partners who had performed such services; or (3) spouses of partners who had performed such services. In addition, the term “partner” does not include any

individual performing substantial services in connection with the partnership's activities and holding a partnership interest, or an individual who formerly performed such services and who held a partnership interest at the time the individual performed such services.

Exclusion for Commodity Partnerships.

An election under this provision is not effective for any partnership the principal Activity of which is the buying and selling of commodities (not described in sec. 1221(1)), or options, futures or forwards with respect to commodities.

Special Rules for Partnerships Holding Oil and Gas Properties.

The Act provides special rules for electing large partnerships with oil and gas activities that operate under the simplified reporting regime. These partnerships are collectively referred to herein as “oil and gas large partnerships.” Generally, an oil and gas large partnership reports information to its partners under the general simplified large partnership reporting regime described above. However, to prevent the extension of percentage depletion deductions to persons excluded therefrom under present law, certain partners are treated as disqualified persons under the Act. The treatment of a disqualified person's distributive share of any item of income, gain, loss, deduction, or credit attributable to any partnership oil or gas property is determined without regard to the special rules applicable to large partnerships. Thus, an oil and gas large partnership reports information related to oil and gas activities to a partner who is a disqualified person in the same manner and to the same extent that it reports such information to that partner under law prior to this Act. The simplified reporting rules of the Act, however, apply with respect to reporting such a partner's share of items not related to oil and gas activities.

The Act defines two categories of taxpayers as disqualified persons. The first category encompasses taxpayers who do not qualify for the deduction for percentage depletion under section 613A (i.e., integrated producers of oil and gas). The second category includes any person whose average daily production of oil and gas (for purposes of determining the depletable oil and natural gas quantity under section 613A(c)(2)) is at least 500 barrels for its taxable year in which (or with which) the partnership's taxable year ends. In making this computation, all production of domestic crude oil and natural gas attributable to the partner is taken into account, including such partner's proportionate share of any production of the large partnership.

A taxpayer that falls within a category of disqualified person has the responsibility of notifying any large partnership in which it holds a direct or indirect interest (e.g., through a pass-through entity) of its status as such. Thus, for example, if an integrated producer owns an interest in a partnership which in turn owns an interest in an oil and gas large partnership, it is

responsible for providing the management of the electing large partnership information regarding its status as a disqualified person and details regarding its indirect interest in the electing large partnership.

Under the Act, an oil and gas large partnership computes its deduction for oil and gas depletion under the general statutory rules (subject to certain exceptions described below) under the assumptions that the partnership is the taxpayer and that it qualifies for the percentage depletion deduction. The amount of the depletion deduction, as well as other oil and gas related items, generally are reported to each partner (other than to partners who are disqualified persons) as components of that partner's distributive share of taxable income or loss from passive loss limitation activities. In computing the partnership's oil and gas percentage depletion deduction, the 1,000-barrel-per-day limitation does not apply. In addition, an oil and gas large partnership is allowed to compute percentage depletion under the Act without applying the 65% of taxable income limitation under section 613A(d)(1).

As under the law prior to the passage of the Act, an election to deduct IDCs under section 263(c) is made at the partnership level. Since the Act treats those taxpayers required by the Internal Revenue Code (sec. 291) to capitalize 30% of IDCs as disqualified persons, an oil and gas large partnership may pass through a full deduction of IDCs to its partners who are not disqualified persons. In contrast to the law prior to this Act, an oil and gas large partnership also has the responsibility with respect to its partners who are not disqualified persons for making an election under section 59(e) to capitalize and amortize certain specified IDCs. Partners who are disqualified persons are permitted to make their own separate section 59(e) elections under the Act.

Consistent with the general reporting regime for electing large partnerships, the Act provides that a single AMT adjustment (under either corporate or non-corporate principles, as the case may be) is made and reported to the partners (other than disqualified persons) of an oil and gas large partnership as a separate item. This separately-reported item is affected by the limitation on the repeal of the tax preference for excess IDCs. For purposes of computing this limitation, the Act treats an oil and gas large partnership as the taxpayer. Thus, the limitation on repeal of the IDC preference is applied at the partnership level and is based on the cumulative reduction in the partnership's alternative minimum taxable income resulting from repeal of that preference. The Act provides that in making partnership-level computations, any item of income, gain, loss, deduction, or credit attributable to a partner who is a disqualified person is disregarded. For example, in computing the partnership's net income from oil and gas for purposes of determining the IDC preference (if any) to be reported to partners who are not disqualified persons as part of the AMT adjustment, disqualified persons' distributive shares of the partnership's net income from oil and gas are not to be taken into account.

Regulatory Authority.

The Secretary of the Treasury is granted authority to prescribe such regulations as may be appropriate to carry out the purposes of this Act Section's provisions.

Current California Law (R&T Sec. None)

Prior to the passage of the TRA of 1997, California was in conformity with the partnership reporting requirements of a partner's pro-rata share of partnership income, loss and/or deduction. There are usually minor differences in amounts reported under state and federal law due to other state and federal differences (e.g., depreciation). Except for passive Activity limitations on real estate activities, generally California is in conformity with federal law as it relates to the areas of tax law (discussed above) that now have different reporting requirements for large partnerships under federal law.

Effective Date

The provisions generally apply to partnership taxable years beginning after December 31, 1997.

Impact on California Revenue

Due to the interaction of other partnership provision contained in the TRA, the revenue effect of this provision and other partnership provisions are provided in an aggregate estimate. Act Sections 1221-1226, 1231-1243 and 1246 are included in this revenue analysis.

Based on the low level of federal estimates for these provisions in H.R. 2014, conforming to these provisions would, on balance, have negligible revenue effects. It is assumed these provisions would be effective with partnership taxable years beginning after December 31, 1997.

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

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1222	Simplified Audit Procedures for Electing Large Partnerships

Background

Prior to 1982, regardless of the size of a partnership, adjustments to a partnership's items of income, gain, loss, deduction, or credit had to be made in separate proceedings with respect to each partner individually. Because a large partnership sometimes had many partners located in different audit districts, adjustments to items of income, gains, losses, deductions, or credits of the partnership had to be made in numerous actions in several jurisdictions, sometimes with conflicting outcomes.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) established unified audit rules applicable to all but certain small (10 or fewer partners) partnerships. These rules require the tax treatment of all “partnership items” to be determined at the partnership, rather than the partner, level. Partnership items are those items that are more appropriately determined at the partnership level than at the partner level, as provided by regulations.

Administrative Proceedings.

Under the TEFRA rules, a partner must report all partnership items consistently with the partnership return or must notify the Internal Revenue Service (IRS) of any inconsistency. If a partner fails to report any partnership item consistently with the partnership return, the IRS may make a computational adjustment and immediately assess any additional tax that results.

The IRS may challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners. However, the IRS still must assess any resulting deficiency against each taxpayer who was a partner in the year in which the understatement of tax liability arose.

Any partner of a partnership can request an administrative adjustment or a refund for his own separate tax liability. Any partner also has the right to participate in partnership-level administrative proceedings. A settlement agreement with respect to partnership items binds all parties to the settlement.

Tax Matters Partner.

The TEFRA rules established the “Tax Matters Partner” as the primary representative of a partnership in dealings with the IRS. The Tax Matters Partner is a general partner designated by the partnership or, in the absence of designation, the general partner with the largest profits interest at the close of the taxable year. If no Tax Matters Partner is designated, and it is impractical to apply the largest profits interest rule, the IRS may select any partner as the Tax Matters Partner.

Notice Requirements.

The IRS generally is required to give notice of the beginning of partnership-level administrative proceedings and any resulting administrative adjustment to all partners whose names and addresses are furnished to the IRS. For partnerships with more than 100 partners, however, the IRS generally is not required to give notice to any partner whose profits interest is less than 1%.

Adjudication of Disputes Concerning Partnership Items.

After the IRS makes an administrative adjustment, the Tax Matters Partner (and, in limited circumstances, certain other partners) may file a petition for readjustment of partnership items in the Tax Court, the district court in which the partnership's principal place of business is located, or the Claims Court.

Statute of Limitations.

The IRS generally cannot adjust a partnership item for a partnership taxable year if more than three years have elapsed since the later of the filing of the partnership return or the last day for the filing of the partnership return.

New Federal Law (Sec. 6240-6252)

The Act creates a new audit system for electing large partnerships. The provision defines “electing large partnership” the same way for audit and reporting purposes (generally, any partnership that elects under the reporting provisions, if the number of partners in the preceding taxable year is 100 or more).

As prior to this Act, electing large partnerships and their partners are subject to unified audit rules. Thus, the tax treatment of “partnership items” is determined at the partnership, rather than the partner level. The term “partnership items” is defined as under prior law.

Unlike prior law, however, partnership adjustments generally will flow through to the partners for the year in which the adjustment takes effect. Thus, the current-year partners' share of current-year partnership items of income, gains, losses, deductions, or credits will be adjusted to reflect partnership adjustments that take effect in that year. The adjustments generally will not affect prior-year returns of any partners (except in the case of changes to any partner's distributive shares).

In lieu of flowing an adjustment through to its partners, the partnership may elect to pay an imputed underpayment. The imputed underpayment generally is calculated by netting the adjustments to the income and loss items of the partnership and multiplying that amount by the highest tax rate (whether individual or corporate). A partner may not file a claim for credit or refund of his allocable share of the payment. A partnership may make this election

only if it meets requirements set forth in Treasury regulations designed to ensure payment (for example, in the case of a foreign partnership).

Regardless of whether a partnership adjustment flows through to the partners, an adjustment must be offset if it requires another adjustment in a year after the adjusted year and before the year the offset adjustment takes effect. For example, if a partnership expensed a $1,000 item in year 1, and it was determined in year 4 that the item should have been capitalized and amortized ratably over 10 years, the adjustment in year 4 would be $700, apart from any interest or penalty. (The $900 adjustment for the improper deduction would be offset by $200 of adjustments for amortization deductions.) The year 4 partners would be required to include an additional $700 in income for that year. The partnership may ratably amortize the remaining $700 of expenses in years four through ten.

In addition, the partnership, rather than the partners individually, generally is liable for any interest and penalties that result from a partnership adjustment. Interest is computed for the period beginning on the return due date for the adjusted year and ending on the earlier of the return due date for the partnership taxable year in which the adjustment takes effect or the date the partnership pays the imputed underpayment. Thus, in the above example, the partnership would be liable for 4 years' worth of interest (on a declining principal amount). Penalties (such as the accuracy and fraud penalties) are determined on a year-by-year basis (without offsets) based on an imputed underpayment. All accuracy penalty criteria and waiver criteria (such as reasonable cause, substantial authority, etc.) are determined as if the partnership were a taxable individual. Accuracy and fraud penalties are assessed and accrue interest in the same manner as if asserted against a taxable individual. Any payment (for federal income taxes, interest, or penalties) that an electing large partnership is required to make is non-deductible. If a partnership ceases to exist before a partnership adjustment takes effect, the former partners are required to take the adjustment into account, as provided by regulations. Regulations are also authorized to prevent abuse and to enforce efficiently the audit rules in circumstances that present special enforcement considerations (such as partnership bankruptcy).

Administrative Proceedings.

Under the electing large partnership audit rules, a partner is not permitted to report any partnership items inconsistently with the partnership return, even if the partner notifies the IRS of the inconsistency. The IRS may treat a partnership item that was reported inconsistently by a partner as a mathematical or clerical error and immediately assess any additional tax against that partner. As under prior law, the IRS may challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners. Unlike under prior law, however, partners will have no right individually to participate in settlement conferences or to request a refund.

Partnership Representatives.

The Act requires each electing large partnership to designate a partner or other person to Act on its behalf. If an electing large partnership fails to designate such a person, the IRS is permitted to designate any one of the partners as the person authorized to Act on the partnership's behalf. After the IRS's designation, an electing large partnership could designate a replacement for the IRS-designated partner.

Notice Requirements.

Unlike under prior law, the IRS is not required to give notice to individual partners of the commencement of an administrative proceeding or of a final adjustment. Instead, the IRS is authorized to send notice of a partnership adjustment to the partnership itself by certified or registered mail. The IRS could give proper notice by mailing the notice to the last known address of the partnership, even if the partnership had terminated its existence.

Adjudication of Disputes Concerning Partnership Items.

As under prior law, an administrative adjustment could be challenged in the Tax Court, the district court in which the partnership's principal place of business is located, or the Claims Court. However, only the partnership, and not partners individually, can petition for a readjustment of partnership items. If a petition for readjustment of partnership items is filed by the partnership, the court with which the petition is filed will have jurisdiction to determine the tax treatment of all partnership items of the partnership for the partnership taxable year to which the notice of partnership adjustment relates, and the proper allocation of such items among the partners. Thus, the court's jurisdiction is not limited to the items adjusted in the notice.

Statute of Limitations.

Absent an agreement to extend the statute of limitations, the IRS generally could not adjust a partnership item of an electing large partnership more than three years after the later of the filing of the partnership return or the last day for the filing of the partnership return. Special rules apply to false or fraudulent returns, a substantial omission of income, or the failure to file a return. The IRS would assess and collect any deficiency of a partner that arises from any adjustment to a partnership item subject to the limitations period on assessments and collection applicable to the year the adjustment takes effect.

Regulatory Authority.

The Secretary of the Treasury is granted authority to prescribe regulations as may be necessary to carry out the simplified audit procedure provisions, including regulations to prevent abuse of the provisions through manipulation. The regulations may include rules that address transfers of partnership interests, in anticipation of a partnership adjustment, to persons who are tax-

favored (e.g., corporations with net operating losses, tax-exempt organizations, and foreign partners) or persons who are expected to be unable to pay tax (e.g., shell corporations). For example, if prior to the time a partnership adjustment takes effect, a taxable partner transfers a partnership interest to a nonresident alien to avoid the tax effect of the partnership adjustment, the rules may provide, among other things, that income related to the partnership adjustment is treated as effectively connected taxable income, that the partnership adjustment is treated as taking effect before the

partnership interest was transferred, or that the former partner is treated as a current partner to whom the partnership adjustment is allocated.

Current California Law (R&T Sec. None)

California has not conformed to the 1982 TEFRA unified audit provisions. As it relates to partnership adjustments, California law conforms to pre-1982 federal law. Adjustments to partnership items are made in separate proceedings with respect to each partner. Additionally, California does not have a consistency requirement between the partnership's return and the partner's tax return.

Effective Date

The provision applies to partnership taxable years beginning after December 31, 1997.

Impact on California Revenue

The revenue impact is included in the revenue analysis for Act Section 1221.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1223	Due Date for Furnishing Information to Partners.

Background

A partnership required to file an income tax return with the IRS must also furnish an information return to each of its partners on or before the day on which the income tax return for the year is required to be filed, including extensions. Under regulations, a partnership must file its income tax return on or before the 15th day of the fourth month following the end of the partnership's taxable year (on or before April 15, for calendar year partnerships). This is the same deadline by which most individual partners must file their tax returns.

New Federal Law (Sec. 6031)

The Act provides that an electing large partnership must furnish information returns to partners by the first March 15 following the close of the partnership's taxable year. Electing large partnerships are those partnerships subject to the simplified reporting and audit rules (generally, any partnership that elects under the reporting provision, if the number of partners in the preceding taxable year is 100 or more).

The Act also provides that, if the partnership is required to provide copies of the information returns to the IRS on magnetic media, each schedule (such as each Schedule K-1) with respect to each partner is treated as a separate information return with respect to the corrective periods and penalties that are generally applicable to all information returns. Prior to the passage of this Act, partnerships were not required to file information returns on magnetic media.

Current California Law (R&T Sec. 18633, 19172

California law provides that partnerships file a return within three months and 15 days after the close of its taxable year (March 15th, for calendar year partnerships.) California law also requires a Schedule K-1 be furnished to partners by the required due date of the partnership return. California does not require partnership information returns to be filed on magnetic media. California law does contain a penalty for failure to file an information return or filing a return which fails to disclosed required information. The penalty is computed in the same manner as under federal law except that the federal penalty is $50 for each partner for each month or fraction thereof up to five months the failure continues; the California penalty is computed by substituting “$10” for “$50”.

Effective Date

The provision is effective for partnership taxable years beginning after December 31, 1997.

Impact on California Revenue

The revenue impact is included in the revenue analysis for Act Section 1221.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1224	Partnership Returns Required On Magnetic Media.

Background

Partnerships are permitted, but not required, to provide the tax return of the partnership (Form 1065), as well as copies of the schedules sent to each partner (Form K-1), to the IRS on magnetic media.

New Federal Law (Sec. 6011)

The Act provides generally that any partnership is required to provide the tax return of the partnership (Form 1065), as well as copies of the schedule sent to each partner (Form K-1), to the IRS on magnetic media. An exception is provided for partnerships with 100 or fewer partners.

Current California Law (R&T Sec. 19524)

California does not have a requirement that partnerships of any size file on magnetic media. However, the Franchise Tax Board does allow a partnership to file its tax return on magnetic media. For the 1996 processing year, approximately 250 partnerships (encompassing almost 1 million K-1s) filed on magnetic media.

Effective Date

The provision is effective for partnership taxable years beginning after December 31, 1997.

Impact on California Revenue

The revenue impact is included in the revenue analysis for Act Section 1221.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1225	Treatment of Partnership Items of IRAs.

Background

Return Filing Requirements.

An individual retirement account (IRA) is a trust which generally is exempt from taxation except for the taxes imposed on income from an unrelated trade or business. A fiduciary of a trust that is exempt from taxation (but subject to the taxes imposed on income from an unrelated trade or business) generally is required to file a return on behalf of the trust for a taxable year if the trust has gross income of $1,000 or more included in computing unrelated business taxable income for that year. Unrelated business taxable income is the gross income (including gross income from a partnership) derived by an exempt organization from an unrelated trade or business, less certain deductions which are directly connected with the carrying on of such trade or business. In calculating unrelated business taxable income, exempt organizations (including IRAs) generally also are permitted a specific deduction of $1,000 (§512(b)(12)).

Unified Audits of Partnerships.

All but certain small partnerships are subject to unified audit rules established by TEFRA. These rules require the tax treatment of all “partnership items” to be determined at the partnership, rather than the partner, level. Partnership items are those items that are more appropriately determined at the partnership level than at the partner level, including such items as gross income and deductions of the partnership.

New Federal Law (Sec. 6012)

The Act modifies the filing threshold for an IRA with an interest in a partnership that is subject to the partnership-level audit rules. A fiduciary of such an IRA could treat the trust's share of partnership taxable income as gross income, for purposes of determining whether the trust meets the $1,000 gross income filing threshold. A fiduciary of an IRA that receives taxable income from a partnership that is subject to partnership-level audit rules of less than $1,000 (before the $1,000 specific deduction) is not required to file an income tax return if the IRA does not have any other income from an unrelated trade or business.

Current California Law (R&T Sec. 18505)

California law conforms to federal law as it read prior to the passage of the TRA of 1997 with respect to return filing requirements of an IRA. A return for an IRA is required if the gross income of the IRA used to compute unrelated business taxable income exceeds $1,000. California, however, has not conformed to the TEFRA unified partnership audit rules.

Effective Date

The provision applies to taxable years beginning after December 31, 1997.

Impact on California Revenue

The revenue impact is included in the revenue analysis for Act Section 1221.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1231	Treatment of Partnership Items in Deficiency Proceedings.

Background

Partnership proceedings under rules enActed in TEFRA must be kept separate from deficiency proceedings involving the partners in their individual capacities. One item that must be kept separate for TEFRA partnerships is the statute of limitations. A TEFRA partnership's statute of limitation for deficiency or refund purposes is separate from that of its partners. Prior to the Tax Court's opinion in Munro v. Commissioner, 92 T.C. 71 (1989), the IRS computed deficiencies by assuming that all items that were subject to the TEFRA partnership procedures were correctly reported on the taxpayer's return. However, where the losses claimed from TEFRA partnerships were so large that they offset any proposed adjustments to nonpartnership items, no deficiency could arise from a non-TEFRA proceeding, and if the partnership losses were subsequently disallowed in a partnership proceeding, the non-TEFRA adjustments might be uncollectible because of the expiration of the statute of limitations with respect to nonpartnership items.

Faced with this situation in Munro, the IRS issued a notice of deficiency to the taxpayer that presumptively disallowed the taxpayer's TEFRA partnership losses for computational purposes only. Although the Tax Court ruled that a deficiency existed and that the court had jurisdiction to hear the case, the court disapproved of the methodology used by the IRS to compute the deficiency. Specifically, the court held that partnership items (whether income, loss, deduction, or credit) included on a taxpayer's return must be completely ignored in determining whether a deficiency exists that is attributable to nonpartnership items.

New Federal Law (Sec. 6211, 6234)

The Act overrules Munro and allows the IRS to return to its prior practice of computing deficiencies by assuming that all TEFRA items whose treatment has not been finally determined had been correctly reported on the taxpayer's return. This eliminates the need to do special computations that involve the removal of TEFRA items from a taxpayer's return, and will restore to taxpayers a prepayment forum with respect to the TEFRA items.

In addition, the provision provides a special rule to address the factual situation presented in Munro. Specifically, the Act provides a declaratory judgment procedure in the Tax Court for adjustments to an oversheltered return. An oversheltered return is a return that shows no taxable income and a net loss from TEFRA partnerships. In such a case, the IRS is authorized to issue a notice of adjustment with respect to non-TEFRA items, notwithstanding that no deficiency would result from the adjustment. However, the IRS could only issue such a notice if a deficiency would have arisen in the absence of the net loss from TEFRA partnerships. The Tax Court is granted jurisdiction to determine the correctness of such an adjustment as well as to make a declaration with

respect to any other item for the taxable year to which the notice of adjustment relates, except for partnership items and affected items which require partner-level determinations. No tax is due upon such a determination, but a decision of the Tax Court is treated as a final decision, permitting an appeal of the decision by either the taxpayer or the IRS.

An adjustment determined to be correct would thus have the effect of increasing the taxable income that is deemed to have been reported on the taxpayer's return. If the taxpayer's partnership items were then adjusted in a subsequent proceeding, the IRS has preserved its ability to collect tax on any increased deficiency attributable to the nonpartnership items. Alternatively, if the taxpayer chooses not to contest the notice of adjustment within the 90-day period, the Act provides that when the taxpayer's partnership items are finally determined, the taxpayer has the right to file a refund claim for tax attributable to the items adjusted by the earlier notice of adjustment for the taxable year. Although a refund claim is not generally permitted with respect to a deficiency arising from a TEFRA proceeding, such a rule is appropriate with respect to a defaulted notice of adjustment because taxpayers may not challenge such a notice when issued since it does not require the payment of additional tax.

In addition, the Act incorporates a number of provisions intended to clarify the coordination between TEFRA audit proceedings and individual deficiency proceedings. Under these provisions, any adjustment with respect to a non-partnership item that caused an increase in tax liability with respect to a partnership item would be treated as a computational adjustment and assessed after the conclusion of the TEFRA proceeding. Accordingly, deficiency procedures do not apply with respect to this increase in tax liability, and the statute of limitations applicable to TEFRA proceedings are controlling.

Current California Law (R&T Sec. None)

California has never conformed to the 1982 TEFRA unified partnership audit provisions. The determinative “statute of limitations” for making an adjustment from a “partnership item” is the partner’s personal statute of limitation, not the partnership’s.

Effective Date

The provision is effective for partnership taxable years ending after August 5, 1997.

Impact on California Revenue

The revenue impact is included in the revenue analysis for Act Section 1221.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1232	Partnership Return to be Determinative of Audit Procedures.

Background

TEFRA established unified audit rules applicable to all partnerships, except for partnerships with 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, and for which each partner's share of each partnership item is the same as that partner's share of every other partnership item. Partners in the exempted partnerships are subject to regular deficiency procedures.

New Federal Law (Sec. 6231)

The Act permits the IRS to apply the TEFRA audit procedures if, based on the partnership's return for the year, the IRS reasonably determines that those procedures should apply. Similarly, the provision permits the IRS to apply the normal deficiency procedures if, based on the partnership's return for the year, the IRS reasonably determines that those procedures should apply.

Current California Law

California law has not conformed to the unified partnership audit provisions contained in TEFRA. Therefore, this section is not applicable.

Effective Date

The provision is effective for partnership taxable years ending after August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1233	Provisions Relating to Partnership Statute of Limitations

Section 1233(a)-Suspend statute when an untimely petition is filed.

Background

In a deficiency case, section 6503(a) provides that if a proceeding in respect of the deficiency is placed on the docket of the Tax Court, the period of limitations on assessment and collection is suspended until 60 days after the decision of the Tax Court becomes final. The counterpart to this provision with respect to TEFRA cases is contained in section 6229(d). That section provides that the period of limitations is suspended for the period during which an action may be brought under section 6226 and, if an action is brought during such period, until one year after the decision of the court becomes final. As a result of this difference in language, the running of the statute of limitations in a TEFRA case will only be tolled by the filing of a timely petition, whereas in a deficiency case, the statute of limitations is tolled by the filing of any petition, regardless of whether the petition is timely.

New Federal Law (Secs. 6211, 6234)

The Act conforms the suspension rule for the filing of petitions in TEFRA cases with the rule under section 6503(a) pertaining to deficiency cases. Under the provision, the statute of limitations in TEFRA cases is suspended by the filing of any petition under section 6226, regardless of whether the petition is timely or valid, and the suspension will remain in effect until one year after the decision of the court becomes final. Hence, if the statute of limitations is open at the time that an untimely petition is filed, the limitations period would no longer continue to run and possibly expire while the action is pending before the court.

Section 1233(b)-Suspend statute of limitations during bankruptcy proceedings.

Background

The period for assessing tax with respect to partnership items generally is the longer of the periods provided by section 6229 or section 6501. For partnership items that convert to nonpartnership items, section 6229(f) provides that the period for assessing tax shall not expire before the date which is one year after the date that the items become nonpartnership items. Section 6503(h) provides for the suspension of the limitations period during the pendency of a bankruptcy proceeding. However, this provision only applies to the limitations periods provided in sections 6501 and 6502. Under present law, because the suspension provision in section 6503(h) applies only to the limitations periods provided in section 6501 and 6502, some uncertainty exists as to whether section 6503(h) applies to suspend the limitations period pertaining to converted items provided in section 6229(f) when a petition naming a partner as a debtor in a bankruptcy proceeding is filed. As a result,

the limitations period provided in section 6229(f) may continue to run during the pendency of the bankruptcy proceeding, notwithstanding that the IRS is prohibited from making an assessment against the debtor because of the automatic stay provisions of the Bankruptcy Code.

New Federal Law (Secs. 6211, 6234)

The Act clarifies that the statute of limitations is suspended for a partner who is named in a bankruptcy petition. The suspension period is for the entire period during which the IRS is prohibited by reason of the bankruptcy proceeding from making an assessment and for 60 days thereafter. The provision does not purport to create any inference as to the proper interpretation of prior law.

Section 1233(c)-Extend statute of limitations for bankrupt TMPs.

Background

Section 6229(b)(1)(B) provides that the statute of limitations is extended with respect to all partners in the partnership by an agreement entered into between the tax matters partner (TMP) and the IRS. However, Temporary Treasury Regulation sections 301.6231(a)(7)-1T(1)(4) and 301.6231(c)-7T(a) provide that upon the filing of a petition naming a partner as a debtor in a bankruptcy proceeding, that partner's partnership items convert to nonpartnership items, and if the debtor was the tax matters partner, such status terminates. These rules are necessary because of the automatic stay provision contained in the Bankruptcy Code. As a result, if a consent to extend the statute of limitations is signed by a person who would be the TMP but for the fact that at the time that the agreement is executed the person was a debtor in a bankruptcy proceeding, the consent would not be binding on the other partners because the person signing the agreement was no longer the TMP when that the agreement was executed.

New Federal Law (Secs. 6211, 6234)

The Act provides that unless the IRS is notified of a bankruptcy proceeding in accordance with regulations, the IRS can rely on a statute extension signed by a person who is the tax matters partner but for the fact that said person was in bankruptcy at the time that the person signed the agreement. Statute extensions granted by a bankrupt TMP in these cases are binding on all partners in the partnership. The provision is not intended to create any inference as to the proper interpretation of prior law.

Current California Law

California law has not conformed to the unified partnership audit provisions contained in TEFRA. Therefore, this section is not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Effective Date

The provisions under Act Sections 1233 (a) and (b) are effective with respect to all cases in which the period of limitations has not expired under present law as of August 5, 1997. The provision under Act Section 1233(c) is effective for extension agreements entered into after August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1234	Expansion of small partnership exception.

Background

TEFRA established unified audit rules applicable to all partnerships, except for partnerships with 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, and for which each partner's share of each partnership item is the same as that partner's share of every other partnership item. Partners in the exempted partnerships are subject to regular deficiency procedures.

New Federal Law (Sec. 6231)

The Act permits a small partnership to have a C corporation as a partner or to specially allocate items without jeopardizing its exception from the TEFRA rules. However, the provision retains the prohibition of present law against having a flow-through entity (other than an estate of a deceased partner) as a partner for purposes of qualifying for the small partnership exception.

Current California Law

California law has not conformed to the unified partnership audit provisions contained in TEFRA. Therefore, this section is not applicable.

Effective Date

The provision is effective for partnership taxable years ending after August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1235	Exclusion of Partial Settlements from 1-Year Assessment Limitation

Background

The period for assessing tax with respect to partnership items generally is the longer of the periods provided by section 6229 or section 6501. For partnership items that convert to nonpartnership items, section 6229(f) provides that the period for assessing tax shall not expire before the date which is one year after the date that the items become nonpartnership items. Section 6231(b)(1)(C) provides that the partnership items of a partner for a partnership taxable year become nonpartnership items as of the date the partner enters into a settlement agreement with the IRS with respect to such items.

New Federal Law (Sec. 6229)

The Act provides that if a partner and the IRS enter into a settlement agreement with respect to some but not all of the partnership items in dispute for a partnership taxable year and other partnership items remain in dispute, the period for assessing any tax attributable to the settled items is determined as if such agreement had not been entered into. Consequently, the limitations period that is applicable to the last item to be resolved for the partnership taxable year is controlling with respect to all disputed partnership items for the partnership taxable year. The provision does not purport to create any inference as to the proper interpretation of prior law.

Current California Law

California law has not conformed to the unified partnership audit provisions contained in TEFRA. Therefore, this section is not applicable.

Effective Date

The provision is effective for settlements entered into after the date of enactment.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1236	Extension of Time for Filing a Request for Administrative Adjust.

Background

If an agreement extending the statute is entered into with respect to a non-TEFRA statute of limitations, that agreement also extends the statute of limitations for filing refund claims. There is no comparable provision for extending the time for filing refund claims with respect to partnership items subject to the TEFRA partnership rules.

New Federal Law (Sec. 6227)

The Act provides that if a TEFRA statute extension agreement is entered into, that agreement also extends the statute of limitations for filing refund claims attributable to partnership items or affected items until six months after the expiration of the limitations period for assessments.

Current California Law

California law has not conformed to the unified partnership audit provisions contained in TEFRA. Therefore, this section is not applicable.

Effective Date

The provision is effective as if included in the amendments made by section 402 of TEFRA.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1237	Innocent Spouse Relief in Context of Partnership Proceedings

Background

In general, an innocent spouse may be relieved of liability for tax, penalties and interest if certain conditions are met (§6013(e)). However, existing law does not provide the spouse of a partner in a TEFRA partnership with a judicial forum to raise the innocent spouse defense with respect to any tax or interest that relates to an investment in a TEFRA partnership.

New Federal Law (Sec. 6230)

The Act provides both a prepayment forum and a refund forum for raising the innocent spouse defense in TEFRA cases. With respect to a prepayment forum, the provision provides that within 60 days of the date that a notice of computational adjustment relating to partnership items is mailed to the spouse of a partner, the spouse can request that the assessment be abated. Upon receipt of such a request, the assessment is abated and any reassessment will be subject to the deficiency procedures. If an abatement is requested, the statute of limitations does not expire before 60 days after the date of the abatement. If the spouse files a petition with the Tax Court, the Tax Court only has jurisdiction to determine whether the requirements of section 6013(e) have been satisfied. In making this determination, the treatment of the partnership items that gave rise to the liability in question is conclusive.

Alternatively, the Act provides that the spouse of a partner may file a claim for refund to raise the innocent spouse defense. The claim has to be filed within six months from the date that the notice of computational adjustment is mailed to the spouse. If the claim is not allowed, the spouse may file a refund action. For purposes of any claim or suit under this provision, the treatment of the partnership items that gave rise to the liability in question is conclusive.

Current California Law (R&T Sec. 18533)

Although California has not conformed to the unified partnership audit rules of TEFRA, California does have stand alone language regarding innocent spouse relief. Under California law, a spouse may file for relief from a deficiency resulting from a partnership pass-through adjustment.

Effective Date

The provision is effective as if included in the amendments made by section 402 of the TEFRA.

Impact on California Revenue

The revenue impact is included in the revenue analysis for Act Section 1221.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1238	Determination of Penalties at Partnership Level

Background

Partnership items include only items that are required to be taken into account under the income tax subtitle. Penalties are not partnership items since they are contained in the procedure and administration subtitle. As a result, penalties may only be asserted against a partner through the application of the deficiency procedures following completion of the partnership-level proceeding.

New Federal Law (Secs. 6221, 6230)

The Act provides that the partnership-level proceeding is to include a determination of the applicability of penalties at the partnership level. However, the provision allows partners to raise any partner-level defenses in a refund forum.

Current California Law (R&T Sec. None)

California has not conformed to the unified partnership audit rules of TEFRA. Under California law, a penalty may be assessed on a partnership pass-through adjustment.

Effective Date

The provision is effective for partnership taxable years ending after August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1239	Provisions Relating to Tax Court Jurisdiction

Background

Improper assessment and collection activities by the IRS during the 150-day period for filing a petition or during the pendency of any Tax Court proceeding "may be enjoined in the proper court." Prior law may be unclear as to whether this includes the Tax Court. For a partner other than the tax matters partner to be eligible to file a petition for redetermination of partnership items in any court or to participate in an existing case, the period for assessing any tax attributable to the partnership items of that partner must not have expired. Since such partners would only be treated as a party to the action if the statute of limitations with respect to them was still open, the law is unclear whether partners would have standing to assert that the statute of limitations had expired with respect to them.

New Federal Law (Secs. 6225, 6226)

The Act clarifies that an action to enjoin premature assessments of deficiencies attributable to partnership items may be brought in the Tax Court. The provision also permits a partner to participate in an action or file a petition for the sole purpose of asserting that the period of limitations for assessing any tax attributable to partnership items has expired for that person. Additionally, the provision clarifies that the Tax Court has overpayment jurisdiction with respect to affected items.

Current California Law

California law has not conformed to the unified partnership audit provisions contained in TEFRA. Therefore, this section is not applicable.

Effective Date

The provision is effective for partnership taxable years ending after August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1240	Premature Petitions Filed by Notice Partners or 5% Groups

Background

The tax matters partner (TMP) is given the exclusive right to file a petition for a readjustment of partnership items within the 90-day period after the issuance of the notice of a final partnership administrative adjustment (FPAA). If the TMP does not file a petition within the 90-day period, certain other partners are permitted to file a petition within the next 60 days. Ordering rules determine which action goes forward and which actions are dismissed.

New Federal Law (Sec. 6226)

The Act treats premature petitions filed by certain partners within the 90-day period as being filed on the last day of the following 60-day period under specified circumstances, thus affording the partnership with an opportunity for judicial review not available under prior law.

Current California Law

California law has not conformed to the unified partnership audit provisions contained in TEFRA. Therefore, this section is not applicable.

Effective Date

The provision is effective with respect to petitions filed after the August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1241	Bonds in Case of Appeals from Certain Proceedings

Background

A bond must be filed to stay the collection of deficiencies pending the appeal of the Tax Court's decision in a TEFRA proceeding. The amount of the bond must be based on the court's estimate of the aggregate deficiencies of the partners.

New Federal Law (Sec. 7485)

The Act clarifies that the amount of the bond should be based on the Tax Court's estimate of the aggregate liability of the parties to the action (and not all of the partners in the partnership). For purposes of this provision, the amount of the bond could be estimated by applying the highest individual rate to the total adjustments determined by the Tax Court and doubling that amount to take into account interest and penalties.

Current California Law

California law has not conformed to the unified partnership audit provisions contained in TEFRA. Therefore, this section is not applicable.

Effective Date

The provision is effective as if included in the amendments made by section 402 of TEFRA.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1242	Suspension of Interest When Delay in Computational Adjustment

Background

Interest on a deficiency generally is suspended when a taxpayer executes a settlement agreement with the IRS and waives the restrictions on assessments and collections, and the IRS does not issue a notice and demand for payment of such deficiency within 30 days. However, interest on a deficiency that results from an adjustment of partnership items in TEFRA proceedings is not suspended.

New Federal Law (Sec. 6601)

The Act suspends interest where there is a delay in making a computational adjustment relating to a TEFRA settlement.

Current California Law

California law has not conformed to the unified partnership audit provisions contained in TEFRA. Therefore, this section is not applicable. California law does permit the abatement of interest due to a delay caused by a ministerial Act.

Effective Date

The provision is effective with respect to adjustments relating to taxable years beginning after August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1243	Special TEFRA Rules for Bad Debts or Worthless Securities

Background

The non-TEFRA statute of limitations for filing a claim for credit or refund generally is the later of (1) three years from the date the return in question was filed or (2) three years from the date the claimed tax was paid, whichever is later (§6511(b)). However, an extended period, seven years from the date the return was due, is provided for filing a claim for refund of an overpayment resulting from a deduction for a worthless security or bad debt (§6511(d)). Under the TEFRA partnership rules, a request for administrative adjustment (RAA) must be filed within three years after the later of (1) the date the partnership return was filed or (2) the due date of the partnership return (determined without regard to extensions) (§6227(a)(1)). In addition, the request must be filed before a final partnership administrative adjustment (FPAA) is mailed for the taxable year (§6227(a)(2)). no special provision extends the time for filing an RAA that relates to a deduction for a worthless security or an entirely worthless bad debt.

New Federal Law (Sec. 6601)

The Act extends the time for the filing of an RAA relating to the deduction by a partnership for a worthless security or bad debt. In these circumstances, in lieu of the three-year period provided in section 6227(a)(1), the period for filing an RAA is seven years from the date the partnership return was due with respect to which the request is made (determined without regard to extensions). The RAA is still required to be filed before the FPAA is mailed for the taxable year.

Current California Law (R&T Sec. 19312)

California has not conformed to the unified partnership audit rules of TEFRA. California law does contain a special provision allowing claims for refund due to a bad debt or a worthless security to be filed up to seven years from the date the taxpayers return was filed. For example, if a bad debt was incurred by a partnership in 1995, and all items of income, loss and gain, except the bad debt, were passed-through to and reported by the partner, the partner would normally have until April 15, 2003, to file a claim for refund due to the bad debt.

Effective Date

The provision is effective as if included in the amendments made by section 402 of TEFRA.

Impact on California Revenue

The revenue impact is included in the revenue analysis for Act Section 1221.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1246	Closing of Partnership Year with Respect to Deceased Partner

Background

The partnership taxable year closes with respect to a partner whose entire interest is sold, exchanged, or liquidated. Prior to the passage of the TRA, such year generally did not close upon the death of a partner. Thus, under prior law, a decedent's entire share of items of income, gain, loss, deduction and credit for the partnership year in which death occurs was taxed to the estate or successor in interest rather than to the decedent on his or her final income tax return.

New Federal Law (Sec. 706(c))

The Act provides that the taxable year of a partnership closes with respect to a partner whose entire interest in the partnership terminates, whether by death, liquidation or otherwise. The provision does not change present law with respect to the effect upon the partnership taxable year of a transfer of a partnership interest by a debtor to the debtor's estate (under Chapters 7 or 11 of Title 11, relating to bankruptcy).

Current California Law (R&T Sec. 17851)

California law conforms to federal law as it read on January 1, 1997, which did not provide for the close of the partnership taxable year due to the death of a partner as it relates to the decedent.

Effective Date

Partnership taxable years beginning after December 31, 1997.

Impact on California Revenue

The revenue impact is included in the revenue analysis for Act Section 1221.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1251-62	Modifications of Rules for Real Estate Investment Trusts

Background

In general, a real estate investment trust (REIT) is an entity that receives most of its income from passive real estate related investments and that receives conduit treatment for income tax purposes with respect to amounts that are distributed to shareholders. If an entity meets the qualifications for REIT status, the portion of its income that is distributed to the investors each year generally is taxed to the investors without being subjected to a tax at the REIT level; the REIT generally is subject to a corporate tax only on the income that it retains and on certain income from property that qualifies as foreclosure property.

Election to be treated as a REIT.

To qualify as a REIT and thereby receive conduit treatment, an entity must elect REIT status. A newly-electing entity generally cannot have earnings and profits accumulated from any year in which the entity was in existence and not treated as a REIT. To satisfy this requirement, the entity must distribute, during its first REIT taxable year, any earnings and profits that were accumulated in non-REIT years. For this purpose, distributions by the entity generally are treated as being made from the most recently accumulated earnings and profits.

Taxation of REITS.

In general, if an entity qualifies as a REIT by satisfying the various requirements described below, the entity is taxable as a corporation on its “real estate investment trust taxable income” (REITTI) and also is taxable on certain other amounts. REITTI is the taxable income of the REIT with certain adjustments. The most significant adjustment is a deduction for dividends paid. The allowance of this deduction is the mechanism by which the REIT becomes a conduit for income tax purposes.

Capital Gains.

A REIT that has a net capital gain for a taxable year generally is subject to tax on such capital gain under the capital gains tax regime generally applicable to corporations. However, a REIT may diminish or eliminate its tax liability attributable to such capital gain by paying a “capital gain dividend” to its shareholders. A capital gain dividend is any dividend or part of a dividend that is designated by the payor REIT as a capital gain dividend in a written notice mailed to shareholders. Shareholders who receive capital gain dividends treat the amount of such dividends as long-term capital gain regardless of the holding period of their stock.

A regulated investment company (RIC), but not a REIT, may elect to retain and pay income tax on net long-term capital gains it received during the tax year. If a RIC makes this election, the RIC shareholders must include in their income as long-term capital gains their proportionate share of these undistributed long-term capital gains as designated by the RIC. The shareholder is deemed to have paid the shareholder's share of the tax, which can be credited or refunded to the shareholder. Also, the basis of the shareholder's shares is increased by the amount of the undistributed long-term capital gains (less the amount of capital gains tax paid by the RIC) included in the shareholder's long-term capital gains.

Income from Foreclosure Property.

In addition to tax on its REITTI, a REIT is subject to tax at the highest rate of tax paid by corporations on its net income from foreclosure property. Net income from foreclosure property is the excess of the sum of gains from foreclosure property that is held for sale to customers in the ordinary course of a trade or business and gross income from foreclosure property (other than income that otherwise would qualify under the 75% income test described below) over all allowable deductions directly connected with the production of such income.

Foreclosure property is any real property or personal property incident to such real property that is acquired by a REIT as a result of default or imminent default on a lease of such property or indebtedness secured by such property, provided that (unless acquired as foreclosure property) such property was not held by the REIT for sale to customers. A property generally may be treated as foreclosure property for a period of two years after the date the property is acquired by the REIT. The IRS may grant extensions of the period for treating the property as foreclosure property if the REIT establishes that an extension of the grace period is necessary for the orderly liquidation of the REIT's interest in the property. The grace period cannot be extended beyond six years from the date the property is acquired by the REIT.

Property will cease to be treated as foreclosure property if, after 90 days after the date of acquisition, the REIT operates the foreclosure property in a trade or business other than through an independent contractor from whom the REIT does not derive or receive any income (§856(e)(4)(C)).

Income or Loss from Prohibited Transactions.

In general, a REIT must derive its income from passive sources and not engage in any Active trade or business. Accordingly, in addition to the tax on its REITTI and on its net income from foreclosure property, a 100% tax is imposed on the net income of a REIT from “prohibited transactions” (§857(b)(6)). A prohibited transaction is the sale or other disposition of property described in section 1221(1) of the code (property held for sale in the ordinary course of a trade or business) other than foreclosure property. Thus, the 100% tax on prohibited transactions helps to ensure that the REIT is a passive entity and may not engage in ordinary retailing activities such as sales to customers of

condominium units or subdivided lots in a development project. A safe harbor is provided for certain sales that otherwise might be considered prohibited transactions (§857(b)(6)(C)). The safe harbor is limited to seven or fewer sales a year or, alternatively, any number of sales provided that the aggregate adjusted basis of the property sold does not exceed 10% of the aggregate basis of all the REIT's assets at the beginning of the REIT's taxable year.

Requirements for REIT status.

A REIT must satisfy four tests on a year-by-year basis: organizational structure, source of income, nature of assets, and distribution of income. These tests are intended to allow conduit treatment in circumstances in which a corporate tax otherwise would be imposed, only if there really is a pooling of investment arrangement that is evidenced by its organizational structure, if its investments are basically in real estate assets, and if its income is passive income from real estate investment, as contrasted with income from the operation of business involving real estate. In addition, substantially all of the entity's income must be passed through to its shareholders on a current basis.

Organizational Structure.

To qualify as a REIT, an entity must be for its entire taxable year a corporation or an unincorporated trust or association that would be taxable as a domestic corporation but for the REIT provisions, and must be managed by one or more trustees (§856(a)). The beneficial ownership of the entity must be evidenced by transferable shares or certificates of ownership. Except for the first taxable year for which an entity elects to be a REIT, the beneficial ownership of the entity must be held by 100 or more persons, and the entity may not be so closely held by individuals that it would be treated as a personal holding company if all its adjusted gross income constituted personal holding company income. A REIT is disqualified for any year in which it does not comply with regulations to ascertain the Actual ownership of the REIT's outstanding shares. Treasury regulations require that the entity request information from certain shareholders regarding shares directly or indirectly owned by them.

Income Requirements.

In order for an entity to qualify as a REIT, at least 95% of its gross income generally must be derived from certain passive sources (the “95% test”). In addition, at least 75% of its income generally must be from certain real estate sources (the “75% test”), including rents from real property.

In addition, less than 30% of the entity's gross income may be derived from gain from the sale or other disposition of stock or securities held for less than one year, real property held less than four years (other than foreclosure property, or property subject to an involuntary conversion within the meaning of §1033), and property that is sold or disposed of in a prohibited transaction (§856(c)(4)).

Definition of Rents from Real Property.

For purposes of the income requirements, rents from real property generally include: (1) rents from interests in real property; (2) charges for services customarily rendered or furnished in connection with the rental of real property, whether or not such charges are separately stated; and (3) rent attributable to personal property that is leased under or in connection with a lease of real property, but only if the rent attributable to such personal property does not exceed 15% of the total rent for the year under the lease. Services provided to tenants are regarded as customary if, in the geographic market within which the building is located, tenants in buildings of a similar class (for example, luxury apartment buildings) are customarily provided with the service. The furnishing of water, heat, light, and air conditioning; the cleaning of windows, public entrances, exits, and lobbies; the performance of general maintenance and of janitorial and cleaning services; the collection of trash; the furnishing of elevator services, telephone answering services, incidental storage space, laundry equipment, watchman or guard service, parking facilities and swimming pool facilities are examples of services customarily furnished to tenants of a particular class of buildings in many geographical marketing areas (Treas. Reg. §1.856-4(b)).

Exclusion of Rents from Related Tenants.

Amounts are not treated as qualified rent if they are received from corporate or noncorporate tenants in which the REIT, directly or indirectly, has an ownership interest of 10% or more.

Exclusion of Rents Where Services to Tenants Are Performed by Related Contractors.

Where a REIT furnishes or renders services to the tenants, amounts received or accrued with respect to such property generally are not treated as qualifying rents unless the services are furnished through an independent contractor. A REIT may furnish or render a service directly, however, if the service would not generate unrelated business taxable income under section 512(b)(3) if provided by an organization described in section 511(a)(2). In general, an independent contractor is a person: (1) who does not own more than a 35% interest in the REIT, (2)who is not owned 35% or greater by the REIT or, (3) who is not owned 35% or greater by persons who own 35% of the REIT.

Constructive Ownership Rules Involving Corporations.

For purposes of determining the REIT's ownership interest in a tenant and whether a contractor is independent, the attribution rules of section 318 apply, except that 10% is substituted for 50% where it appears in subparagraph (C) of section 318(a)(2) and 318(a)(3). Thus, under section 318(a)(2)(C) (as so modified), if 10 or more percent of a REIT or other corporation is owned,

directly or indirectly, by or for a person, that person is treated as owning that person's proportionate share of any stock owned directly or indirectly by that corporation.

Constructive Ownership Rules Involving Partnerships.

Under section 318, stock owned, directly or indirectly, by or for a partnership is considered owned proportionately by its partners (§318(a)(2)(A)). In addition, stock owned, directly or indirectly, by or for a partner is considered owned by the partnership (§318(a)(3)(A)). However, stock constructively owned by a partnership is not considered as owned for purposes of being constructively owned by partners (§318(a)(5)(C)).

The following examples illustrate the application of these provisions for purposes of the related tenant and independent contractor rules.

Constructive Ownership of Tenant.

If a REIT owns a 10% or greater interest in a entity that is a tenant of the REIT, rents paid by that person to the REIT are not qualifying rents to the REIT.

Example #1. --If 10% or more of a REIT's shares are owned by a partnership and a partner owning a 1% interest in that partnership also owns a 10% or greater interest in a person that is a tenant of the REIT, rents paid by the tenant to the REIT are not qualifying rents to the REIT; the 10% or greater interest in the tenant is considered owned by the partnership (§318(a)(3)(A)) and in turn by the REIT.

Example #2. --If a REIT owns a 30% interest in a partnership that in turn owns a 40% interest in a person that is a tenant of the REIT, rents paid by that person to the REIT are not qualifying rents to the REIT because the REIT is considered to own more than 10% of the tenant

Example #3. --If 10% or more of a REIT's shares are owned by persons who are 50% partners in a partnership whose other partners own the entirety of the interests in a tenant of the REIT, none of the interests in the tenant are considered owned by the partners who own interests in the REIT.

Constructive Ownership of Contractor.

If a person providing services to tenants of the REIT owns a greater-than-35% interest in the REIT, or if another person owns a greater-than-35% interest in both the REIT and a person providing services, amounts received or accrued by the REIT with respect to the property are not qualifying rents because the service provider does not qualify as an independent contractor (§856(d)(3)).

Example #4. --If more than 35% of a REIT's shares are owned by a partnership and a partner owning a 1% interest in that partnership also owns a greater-than-35% interest in a contractor, that person will not be considered an

independent contractor because the partnership owns more than 35% of the REIT's shares and will also be considered to own a greater-than-35% interest in the contractor (§318(a)(3)A)).

Example #5. --If more than 35% of a REIT's shares are owned by a person who owns a 1% interest in a partnership and another one-percent partner in that partnership owns more than 35% of the interests in a contractor, the independent contractor definition will not be met because the partnership will be considered to own more than 35% interests in both the REIT and the contractor (§318 (a)(3)(A)).

Hedging Instruments.

Interest rate swaps or cap agreements that protect a REIT from interest rate fluctuations on variable rate debt incurred to acquire or carry real property are treated as securities under the 30% test, and payments under these agreements are treated as qualifying under the 95% test (§856(c)(6)(G)).

Treatment of Shared Appreciation Mortgages.

For purposes of the income requirements for qualification as a REIT, and for purposes of the prohibited transaction provisions, any income derived from a “shared appreciation provision” is treated as gain recognized on the sale of the “secured property.” For these purposes, a shared appreciation provision is any provision that is in connection with an obligation held by the REIT and secured by an interest in real property, which provision entitles the REIT to receive a specified portion of any gain realized on the sale or exchange of such real property (or of any gain that would be realized if the property were sold on a specified date). Secured property for these purposes means the real property that secures the obligation that has the shared appreciation provision.

In addition, for purposes of the income requirements for qualification as a REIT, and for purposes of the prohibited transaction provisions, the REIT is treated as holding the secured property for the period during which it held the shared appreciation provision (or, if shorter, the period during which the secured property was held by the person holding such property), and the secured property is treated as inventory property held for sale if it is such property in the hands of the obligor on the obligation to which the shared appreciation provision relates (or if it would be such property if held by the REIT).

For purposes of the prohibited transaction safe harbor, the REIT is treated as having sold the secured property at the time that it recognizes income on account of the shared appreciation provision, and any expenditures made by the holder of the secured property are treated as made by the REIT.

Asset Requirements.

To satisfy the asset requirements to qualify for treatment as a REIT, at the close of each quarter of its taxable year, an entity must have at least 75% of

the value of its assets invested in real estate assets, cash and cash items, and government securities. Moreover, not more than 25% of the value of the entity's assets can be invested in securities of any one issuer (other than government securities and other securities described in the preceding sentence). Further, these securities may not comprise more than 5% of the entity's assets or more than 10% of the outstanding voting securities of such issuer. The term real estate assets is defined to mean real property (including interests in real property and mortgages on real property) and interests in REITs.

REIT Subsidiaries.

Prior to the passage of this Act, all the assets, liabilities, and items of income, deduction, and credit of a “qualified REIT subsidiary” are treated as the assets, liabilities, and respective items of the REIT that owns the stock of the qualified REIT subsidiary. A subsidiary of a REIT is a qualified REIT subsidiary if and only if 100% of the subsidiary's stock is owned by the REIT at all times that the subsidiary is in existence. If at any time the REIT ceases to own 100% of the stock of the subsidiary, or if the REIT ceases to qualify for (or revokes an election of) REIT status, such subsidiary is treated as a new corporation that acquired all of its assets in exchange for its stock (and assumption of liabilities) immediately before the time that the REIT ceased to own 100% of the subsidiary's stock, or ceased to be a REIT as the case may be.

Distribution Requirements.

To satisfy the distribution requirement, a REIT must distribute as dividends to its shareholders during the taxable year an amount equal to or exceeding (i) the sum of 95% of its REITTI other than net capital gain income and 95% of the excess of its net income from foreclosure property over the tax imposed on that income minus (ii) certain excess noncash income. Excess noncash items include (1) the excess of the amounts that the REIT is required to include in income under section 467 with respect to certain rental agreements involving deferred rents, over the amounts that the REIT otherwise would recognize under its regular method of accounting, (2) in the case of a REIT using the cash method of accounting, the excess of the amount of original issue discount and coupon interest that the REIT is required to take into account with respect to a loan to which section 1274 applies, over the amount of money and fair market value of other property received with respect to the loan, and (3) income arising from the disposition of a real estate asset in certain transactions that failed to qualify as like-kind exchanges under section 1031.

New Federal Law

The Act makes modifications relating to the general requirements for qualification as a REIT, the taxation of a REIT, the income requirements for qualification as a REIT, and certain other provisions.

Act Section 1251 – Clarification of Limitation on Maximum Number of Shareholders and Penalties for Failure to Determine Ownership (IRC Sec. 857).

The Act replaces the rule that disqualifies a REIT, for any year in which the REIT failed to comply with Treasury regulations to ascertain its ownership, with an intermediate penalty for failing to do so. The penalty is $25,000 ($50,000 for intentional violations) for any year in which the REIT did not comply with the ownership regulations. The REIT also is required, when requested by the IRS, to send curative demand letters.

In addition, a REIT that complied with the Treasury regulations for ascertaining its ownership, and which did not know, or have reason to know, that it was so closely held as to be classified as a personal holding company, is treated as meeting the requirement that it not be a personal holding company.

Act Section 1252 – De Minimis Rule for Tenant Services Income (IRC Sec. 856).

The Act permits a REIT to render a de minimis amount of impermissible services to tenants, or in connection with the management of property, and still treat amounts received with respect to that property as rent. The value of the impermissible services may not exceed 1% of the gross income from the property. For these purposes, the services may not be valued at less than 150% of the REIT's direct cost of the services.

Act Section 1253 – 25% Attribution for Partners (IRC Sec. 856).

The Act modifies the application of the rule attributing ownership from partners to partnerships for purposes of defining non-qualifying rent from related persons, so that attribution occurs only when a partner owns directly or indirectly a 25% or greater interest in the partnership. Thus, a REIT and a tenant will not be treated as related (and, therefore, rents paid by the tenant to the REIT will not be treated as non-qualifying rents) if the REIT's shares are owned by a partnership and a partner owning directly and indirectly a less-than-25% interest in that partnership also owns an interest in the tenant. The related tenant rule also will not be violated where owners of the REIT and owners of the tenant are partners in a partnership and either the owners of the REIT or the owners of the tenant are directly and indirectly less-than-25% partners in the partnership.

In addition, the Act extends, to the definition of an independent contractor under section 856(d)(3), the modification to the attribution to partnerships of section 318(a)(3)(A) so that attribution occurs only when a partner owns a 25% or greater interest in the partnership. Thus, a person providing services will not fail to be an independent contractor (and, therefore, amounts received or accrued by the REIT with respect to the property will not be treated as non-qualifying rents) where the REIT's shares are owned by a partnership and a partner owning directly and indirectly a less-than-25% interest in the partnership also owns an interest in a contractor. Similarly, a contractor will not fail to be an independent contractor where owners of the REIT and

owners of the contractor are partners in a partnership and either the owners of the REIT or owners of the tenant are directly and indirectly less-than-25% partners in the partnership.

Act Section 1254 - Credit Retained Capital Gains Tax Paid (IRC Sec. 857).

The Act permits a REIT to elect to retain and pay income tax on net long-term capital gains it received during the tax year, just as a RIC is permitted. Thus, if a REIT made this election, the REIT shareholders would include in their income as long-term capital gains their proportionate share of the undistributed long-term capital gains as designated by the REIT. The shareholder would be deemed to have paid the shareholder's share of the tax, which would be credited or refunded to the shareholder. Also, the basis of the shareholder's shares would be increased by the amount of the undistributed long-term capital gains (less the amount of capital gains tax paid by the REIT) included in the shareholder's long-term capital gains.

Act Section 1255 – 30% Gross Test Repealed (IRC Sec. 856).

The Act repeals the rule that requires less than 30% of a REIT's gross income be derived from gain from the sale or other disposition of stock or securities held for less than one year, certain real property held less than four years, and property that is sold or disposed of in a prohibited transaction.

Act Section 1256 – Ordering Rules for Earnings and Profits Distribution (IRC Sec. 857(d)).

The Act changes the ordering rule for purposes of the requirement that newly-electing REITs distribute earnings and profits that were accumulated in non-REIT years. Distributions of accumulated earnings and profits generally are treated as made from the entity's earliest accumulated earnings and profits, rather than the most recently accumulated earnings and profits. These distributions are not treated as distributions for purposes of calculating the dividends paid deduction.

Act Section 1257 – Grace Period for Foreclosure Property Extended (IRC Sec. 856(e)).

The Act lengthens the original grace period for foreclosure property until the last day of the third full taxable year following the election. The grace period also could be extended for an additional three years by filing a request with the IRS. A REIT could revoke an election to treat property as foreclosure property for any taxable year by filing a revocation on or before its due date for filing its tax return.

In addition, the Act conformed the definition of independent contractor for purposes of the foreclosure property rule (§856(e)(4)(C)) to the definition of independent contractor for purposes of the general rules (§856(d)(2)(C)).

Act Section 1258 – Payments for Hedging Treated as Qualifying Income (IRC Sec. 856(c)).

The Act provides that income from all hedges that reduce the interest rate risk of REIT liabilities, not just from interest rate swaps and caps, is treated as qualifying income under the 95% test. Thus, payments to a REIT under an interest rate swap, cap agreement, option, futures contract, forward rate agreement or any similar financial instrument entered into by the REIT to hedge its indebtedness incurred or to be incurred (and any gain from the sale or other disposition of these instruments) are treated as qualifying income for purposes of the 95% test.

Act Section 1259 – Definition of Excess Noncash Income Expanded (IRC Sec. 857).

The Act: (1) expands the class of excess noncash items that are not subject to the distribution requirement to include income from the cancellation of indebtedness and (2) extends the treatment of original issue discount and coupon interest as excess noncash items to REITs that use an accrual method of taxation.

Act Section 1260 – Involuntary Conversions Ignored for Prohibited Sales (IRC Sec. 857(b)).

The Act excludes from the prohibited sales rules property that was involuntarily converted.

Act Section 1261 – Shared Appreciation Clarified, Bankruptcy Safe Harbor Added (IRC Sec. 856(j)).

The Act provides that interest received on a shared appreciation mortgage is not subject to the tax on prohibited transactions where the property subject to the mortgage is sold within four years of the REIT's acquisition of the mortgage pursuant to a bankruptcy plan of the mortgagor unless, when the REIT acquired the mortgage, and the REIT knew, or had reason to know, that the property subject to the mortgage would be sold in a bankruptcy proceeding.

Act Section 1262 – Qualified REIT Subsidiary Definition Modified (IRC Sec. 856(i)).

The Act permits any corporation wholly-owned by a REIT to be treated as a qualified subsidiary, regardless of whether the corporation had always been owned by the REIT. Where the REIT acquired an existing corporation, any such corporation is treated as being liquidated as of the time of acquisition by the REIT and then reincorporated (thus, any of the subsidiary's pre-REIT built-in gain would be subject to tax under the normal rules of §337). In addition, any pre-REIT earnings and profits of the subsidiary must be distributed before the end of the REIT's taxable year.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Current California Law (R&T Sec. 17088, 24870, 24872-24874)

California conforms to the federal treatment of REITs prior to the passage of the TRA with the following modifications:

- REIT taxable income does
  - not include a deduction for dividends received,
  - not include a deduction for the tax imposed for not meeting the 95% or 75% income test,
  - include income from foreclosure property,
  - include income from prohibited transactions.

- Taxes on “income from foreclosed property, “income of a prohibitive transaction”, “alternative tax on capital gains” and failure to meet the 95% or 75% income test do not apply.

- A REIT is subject to the corporate minimum tax (currently $800).

Effective Date

The provisions are effective for taxable years beginning after August 5, 1997.

Impact on California Revenue

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

Based on the low level of federal estimates for these provisions in H.R. 2014 excluding any differences between federal and state, conforming to the provisions would result in minor revenue losses not exceeding $500,000 in any given year.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1271	Repeal of 30% Gross Income Test for Regulated Investment Companies

Background

To qualify as a regulated investment company (RIC), a company must derive less than 30% of its gross income from the sale or other disposition of stock or securities held for less than three months (the “30% test” or “short-short rule”).

New Federal Law (Sec. 851)

The 30% test (or short-short rule) is repealed.

Current California Law (R&T Sec. 24870)

California law conforms to the federal treatment of RICs with certain modifications. The 30% test or “short-short rule” applies to California law.

Effective Date

The provision is effective for taxable years ending after August 5, 1997.

Impact on California Revenue

The revenue impact in any given year cannot be quantified but would most likely be minor for reasons discussed below. It is assumed the provision would be effective with taxable years beginning after August 5, 1997.

Generally, a RIC does not pay federal income taxes if it distributes all of its income and gains to shareholders in a timely manner. Shareholders of a RIC are subject to federal taxation on the income and gains distributed from the RIC. RICs in California currently qualify for beneficial California tax treatment by satisfying the federal requirements to qualify as a RIC. California tax treatment of RICs follows the federal tax treatment by essentially eliminating tax at the entity level.

Before enactment of the Taxpayer Relief Act of 1997, RICs were subject to the “30%” rule under IRC Sec. 851(b)(3). This rule required a RIC to receive less than 30% of its gross income from the sale of securities and other specified assets held for less than three months. RIC investment advisors have used compliance staff and computer software to monitor compliance with this rule. In those few cases where a RIC failed the 30% rule, the advisor would generally negotiate a settlement with the IRS that would allow it to retain its RIC status in exchange for some payment of tax. Upon successful completion of this negotiation, a RIC in effect “perfected” its RIC status for federal tax purposes.

The low-level federal projections for this provision attempt to estimate negotiated settlement payments rather than the tax impact of outright disqualification of any RICs. Therefore, for California purposes, prorating federal estimates would not accurately reflect the potential impact of conforming to the newly enacted federal provision.

If California did not conform to this provision, some entities could be disqualified as RICs for state tax purposes by exceeding the less than 30% of gross income requirement for disposition of short period investments. To acknowledge a potential conformity impact requires assuming one or more RICs would be disqualified if California did not conform with the federal provision. Industry contacts have indicated disqualification of a California RIC would be unlikely because California RICs would continue to conduct their day-to-day operations to satisfy the 30% rule.

In the event a RIC were disqualified, an entity level tax would be imposed under the B&CTL at an 8.84% tax rate. Entity level taxes would reduce available income and gains distributed to shareholders, thus reducing taxes otherwise paid by shareholders with a filing requirement in California. Tax rates of individual shareholders could be greater or lesser than the franchise tax rate. Primarily the tax rate differential between the entity and the shareholders would determine the amount of revenue gain or loss, which would likely be minor in any given year.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1281	Provide Reasonable Cause for Additional Penalties

Background

Many penalties in the IRC may be waived if the taxpayer establishes reasonable cause. For example, the accuracy-related penalty may be waived with respect to any item if the taxpayer establishes reasonable cause for his treatment of the item and that he Acted in good faith.

New Federal Law (Secs. 6652, 6683, 7519)

Under the TRA 97, the following penalties may be waived if the failure is shown to be due to reasonable cause and not willful neglect:

(1) the penalty for failure to make a report in connection with deductible employee contributions to a retirement savings plan (sec. 6652(g));
(2) the penalty for failure to make a report as to certain small business stock (sec. 6652(k));
(3) the penalty for failure of a foreign corporation to file a return of personal holding company tax (sec. 6683); and
(4) the penalty for failure to make required payments for S corporations and partnerships electing not to have the required taxable year (sec. 7519).

Current California Law (Sec. 19133.5)

Many penalty laws administered by FTB are comparable to those administered by IRS, and many allow for a waiver of the penalty if the taxpayer can establish that the failure to comply was based on reasonable cause. Of the four penalties amended by the TRA 97 to provide for waiver of penalty based on reasonable cause, FTB administers only one comparable penalty, which is the failure to make a report as to certain small business. For this penalty, California conforms to the federal law prior to the TRA 97; therefore, the penalty cannot be waived based on reasonable cause. For the other three penalties, California does not have comparable provisions because California relies on the IRS/FTB exchange of information system and IRS penalty to encourage compliance (employee contributions to retirement plans and S corporations elections) or does not have a comparable underlying provision (foreign personal holding companies).

Effective Date

The provision is effective for taxable years beginning after August 5, 1997.

Impact on California Revenue

Federal estimates were cast as either negligible or no revenue effects. Therefore, conforming to the provisions with respect to the one relevant provision would have negligible, if any, revenue effects.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1282	Clarification for Period for Filing Claim For Refund

Background

The federal law contains a series of limitations on tax refunds. Refunds are limited based on both the time period in which a claim for refund can be made (section 6511(a)) and on the amount that can be allowed as a refund (section 6511(b)). The general rule is that a claim for refund must be filed within three years of the date of the return is filed or three years of the date of payment of the taxes at issue, whichever is later, or if no return is filed, two years from the date of payment. The refund amount that can be recovered is limited: if a return was filed, a taxpayer can recover amounts paid up to two years before the claim. Where taxpayers that challenge deficiency notices in Tax Court are found to be entitled to refunds, these rules are incorporated.

In Commissioner v. Lundy, 116 S. Ct. 647 (1996), the taxpayer had not filed a return, but received a notice of deficiency within three years after the date the return was due and challenged the proposed deficiency in Tax Court. The Supreme Court held that the taxpayer could not recover overpayments attributable to withholding during the tax year, because no return was filed and, therefore, the two-year “look back” rule applied. Since overwithheld amounts are deemed paid as of the date the taxpayer's return was first due (i.e., more than two years before the notice of deficiency was issued), such overpayments could not be recovered. By contrast, if the same taxpayer had filed a return on the date the notice of deficiency was issued and then claimed a refund, the three-year “look back” rule would apply, and the taxpayer could have obtained a refund of the overwithheld amounts.

New Federal Law (Sec. 6512(b))

For taxpayers who initially fail to file returns, but receive notices of deficiency that are contested in Tax Court during the third year after the return due date, amounts paid three years prior to the date of the deficiency notice, which typically could include withholding credits, may be refunded.

Current California Law (R&T Sec. 19306)

California’s laws differ from federal law with respect to most of the underlying law relevant to the issuance of deficiency assessments that result from the failure to file tax returns. Under federal law, a deficiency assessment imposed as a result of failure to file a tax return is considered a substitute tax return, which may be considered a claim for refund. Under California law, the authority to issue a substitute tax return does not exist. To receive a refund under California law, the taxpayer must file a tax return. Furthermore, for California purposes, the statute of limitations for filing a claim for refund is within four years from the due date of the return or one

year from the date of payment of the taxes at issue, whichever is later, and California does not further limit the amount of refund by applying "look back" rules based on whether a tax return was filed.

Under current practice, FTB commences the issuance of notices of proposed deficencies for the failure to file tax returns during the first year following the due date of the tax return. Therefore, in most cases, the results achieved under the new federal law are currently achieved by virtue of FTB's current practice and California law. With the later date for filing a claim for refund being four years after the due date of the return, and the issuance of the proposed deficiency occurring early during that four year period, taxpayers generally have three years after the issuance of a filing enforcement deficiency assessment to file a tax return to recover withholding that was paid three years earlier.

Effective Date

The federal provision applies to claims for refund with respect to tax years ending after August 5, 1997.

Impact on California Revenue

Not applicable. The specific change in the "look back" rules is not applicable for California purposes.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1283	Repeal Disclosure of Whether Prospective Juror Has Been Audited

New Federal Law (Sec. 6103(h))

In connection with a civil or criminal tax proceeding to which the United States is a party, the Secretary is no longer authorized to disclose, upon the written request of either party to the lawsuit, whether an individual who is a prospective juror has or has not been the subject of an audit or other tax investigation by the Internal Revenue Service.

Current California Law (R&T Sec. 19542, et seq.)

FTB is authorized to disclose information only as expressly provided by law and is not authorized to disclose whether an individual who is a prospective juror has or has not been the subject of an audit or other tax investigation by FTB.

Effective Date

The new federal provision is effective for judicial proceedings commenced after August 5, 1997.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1284	Clarification of Statute of Limitations for Pass Thru Entity Items

Background

Pass-through entities (such as S corporations, partnerships, and certain trusts) generally are not subject to income tax on their taxable income. Instead, these entities file information returns and the entities' shareholders (or beneficial owners) report their pro rata share of the gross income and are liable for any taxes due. Some believe that, prior to 1993, it may have been unclear as to whether the statute of limitations for adjustments that arise from distributions from pass-through entities should be applied at the entity or individual level (i.e., whether the three-year statute of limitations for assessments runs from the time that the entity files its information return or from the time that a shareholder timely files his or her income tax return). In 1993, the Supreme Court held that the limitations period for assessing the income tax liability of an S corporation shareholder runs from the date the shareholder's return is filed (Bufferd v. Commissioner., 113 S. Ct. 927 (1993)).

New Federal Law (Sec. 6501(a))

Federal law clarifies that the return that starts the running of the statute of limitations for a taxpayer is the return of the taxpayer and not the return of another person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit.

Current California Law (R&T Sec. 19063)

California has specific statutes of limitations for assessing deficiencies attributable to partnership items that differ from federal law. For California purposes, the statute of limitations starts running from the filing of the partnership return. As to the federal provision relating to S corporations, California law treats both the S corporation and shareholder as taxpayers and California conceptually conforms to federal law. The return due date that starts the running of the statute of limitations for a shareholder is the return of the shareholder and not the return of S corporation from whom the taxpayer has received an item of income, gain, loss, deduction, or credit.

Effective Date

The federal provision is effective for taxable years beginning after August 5, 1997.

Impact on California Revenue

Conforming to the federal provision is not applicable to California because California’s underlying law is significantly different.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1285	Awarding of Administrative Costs and Attorneys Fees

Background

Under federal law, any person who substantially prevails in any action brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative costs incurred before the IRS and reasonable litigation costs incurred in connection with any court proceeding.

New Federal Law (Sec. 7430)

A taxpayer who seeks an award of administrative costs must apply for such costs within 90 days of the date on which the taxpayer was determined to be a prevailing party. A taxpayer who seeks to appeal an IRS denial of an administrative cost award must petition the Tax Court within 90 days after the date that the IRS mails the denial notice. Additionally, federal law clarifies that dispositions by the Tax Court of petitions relating only to administrative costs are to be reviewed in the same manner as other decisions of the Tax Court.

Current California Law (R&T Secs. 19717, 21013)

California basically conforms to the federal law, however, California's proceedings comparable to the federal Tax Court proceeding is a civil proceeding generally brought as a suit for refund and the forum comparable to IRS' administrative proceeding is a Board of Equalization (BOE) hearing. No time limit is specified for the taxpayer to apply to the BOE for an award of reasonable fees and expenses under R&T section 21013. The time frame and procedural rules as they would relate to civil proceedings would not be relevant. In the case where the taxpayer did not prevail and BOE sustains FTB's actions and does not award reasonable fees and expenses, the usual time frame for bringing a civil suit for refund and the awarding of costs would apply.

Effective Date

The federal provision is effective with respect to costs incurred in civil actions or proceedings commenced after August 5, 1997.

Impact on California Revenue

Conforming to the 90 day time limit for filing a claim for fees and expenses relative to a BOE appeal would have negligible, if any, revenue effects.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1301-14	Estate Tax Provisions

Background

A gift tax generally is imposed on lifetime transfers of property by gift. In computing the amount of taxable gifts made during a calendar year, a taxpayer generally may deduct the amount of any gifts made to a charity. Generally, this charitable gift deduction is available for outright gifts to charity, as well as gifts of certain partial interests in property (such as a remainder interest). A gift of a partial interest in property must be in a prescribed form in order to qualify for the deduction. Individuals who make gifts in excess of $10,000 to any one donee during the calendar year generally are required to file a gift tax return. This filing requirement applies to all gifts, whether charitable or noncharitable, and regardless of whether the gift qualifies for a gift tax charitable deduction. Thus, under current law, a gift tax return is required to be filed for gifts to charity in excess of $10,000, even though no gift tax is payable on the transfer.

For estate and gift tax purposes, a marital deduction is allowed for qualified terminable interest property (QTIP). Such property generally is included in the surviving spouse's gross estate upon his or her death. The surviving spouse's estate is entitled to recover the portion of the estate tax attributable to inclusion of QTIP from the person receiving the property, unless the spouse directs otherwise by will. For this purpose, a will provision specifying that all taxes shall be paid by the estate is sufficient to waive the right of recovery. A decedent's gross estate includes the value of previously transferred property in which the decedent retains enjoyment or the right to income. The estate is entitled to recover from the person receiving the property a portion of the estate tax attributable to the inclusion. This right may be waived only by a provision in the will (or revocable trust) specifically referring to section 2207B.

A “marital deduction” generally is allowed for estate and gift tax purposes for the value of property passing to a spouse. The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) denied the marital deduction for property passing to an alien spouse outside a qualified domestic trust (QDT). An estate tax generally is imposed on corpus distributions from a QDT.

TAMRA defined a QDT as a trust that, among other things, required all trustees to be U.S. citizens or domestic corporations. This provision was modified in the Omnibus Budget Reconciliation Acts of 1989 and 1990 to require that at least one trustee be a U.S. citizen or domestic corporation and that no corpus distribution be made unless such trustee has the right to withhold any estate tax imposed on the distribution (the “withholding requirement”). Trusts are not permitted in some countries (e.g., many civil law countries). As a result, it is not possible to create a QDT in those countries.

In order for a trust to be a QDT, a U.S. trustee must have the power to approve all corpus distributions from the trust. In some countries, trusts cannot have any U.S. trustees. As a result, trusts established in those countries cannot qualify as a QDT.

The United States imposes estate tax on assets of noncitizen nondomiciliaries that were situated in the United States at the time of the individual's death. Debt obligations of a U.S. person, the United States, a political subdivision of a state, or the District of Columbia are considered property located within the United States if held by a nonresident not a citizen of the United States. Special rules apply to treat certain bank deposits and debt instruments, the income from which qualifies for the bank deposit interest exemption and the portfolio interest exemption, as property from without the United States despite the fact that such items are obligations of a U.S. person, the United States, a political subdivision of a state, or the District of Columbia. Income from such items is exempt from U.S. income tax in the hands of the nonresident recipient. The effect of these special rules is to exclude these items from the U.S. gross estate of a nonresident not a citizen of the United States. However, because of an amendment to section 871(h) made by the Tax Reform Act of 1986, these special rules no longer cover obligations that generate short-term OID income despite the fact that such income is exempt from U.S. income tax in the hands of the nonresident recipient.

Both estates and revocable inter vivos trusts can function to settle the affairs of a decedent and distribute assets to heirs. In the case of revocable inter vivos trusts, the grantor transfers property into a trust which is revocable during his or her lifetime. Upon the grantor's death, the power to revoke ceases and the trustee then performs the settlement functions typically performed by the executor of an estate. While both estates and revocable trusts perform essentially the same function after the testator or grantor's death, there are a number of ways in which an estate and a revocable trust operate differently. First, there can be only one estate per decedent while there can be more than one revocable trust. Second, estates are in existence only for a reasonable period of administration; revocable trusts can perform the same settlement functions as an estate, but may continue in existence thereafter as testamentary trusts. Numerous differences presently exist between the income tax treatment of estates and revocable trusts, including: (1) estates are allowed a charitable deduction for amounts permanently set aside for charitable purposes while post-death revocable trusts are allowed a charitable deduction only for amounts paid to charities; (2) the active participation requirement contained in the passive loss rules under section 469 is waived in the case of estates (but not revocable trusts) for two years after the owner's death; and (3) estates (but not revocable trusts) can qualify for section 194 amortization of reforestation expenditures.

In general, trusts and estates are treated as conduits for federal income tax purposes. Income received by a trust or estate which is distributed to a beneficiary in the trust or estate's taxable year “ending with or within” the taxable year of the beneficiary is taxable to the beneficiary in that year; income that is retained by the trust or estate is initially taxable to the

trust or estate. In the case of distributions of previously accumulated income by trusts (but not estates), there may be additional tax under the so-called "throwback" rules if the beneficiary to whom the distributions were made has marginal rates higher than those of the trust. Under the "65-day rule," a trust may elect to treat distributions paid within 65 days after the close of its taxable year as paid on the last day of its taxable year. The 65-day rule is not applicable to estates.

Trusts with more than one beneficiary must use the "separate share" rule in order to provide different tax treatment of distributions to different beneficiaries to reflect the income earned by different shares of the trust's corpus. Treasury regulations provide that the application of the separate share rule will generally depend upon whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created. Separate share treatment will not be applied to a trust or portion of a trust subject to a power to distribute, apportion, or accumulate income or distribute corpus to or for the use of one or more beneficiaries within a group or class of beneficiaries, unless the payment of income, accumulated income, or corpus of a share of one beneficiary cannot affect the proportionate share of income, accumulated income, or corpus of any shares of the other beneficiaries, or unless substantially proper adjustment must thereafter be made under the governing instrument so that substantially separate and independent shares exist. The separate share rule presently does not apply to estates. Application of the separate share rule is not elective; it is mandatory if there are separate shares in the trust.

Section 267 disallows a deduction for any loss on the sale of an asset to a person related to the taxpayer. For purposes of section 267, the following parties are related persons: (1) a trust and the trust's grantor, (2) two trusts with the same grantor, (3) a trust and a beneficiary of the trust, (4) a trust and a beneficiary of another trust, if both trusts have the same grantor, and (5) a trust and a corporation the stock of which is more than 50% owned by the trust or the trust's grantor. Section 1239 disallows capital gain treatment on the sale of depreciable property to a related person. For purposes of section 1239, a trust and any beneficiary of the trust are treated as related persons, unless the beneficiary's interest is a remote contingent interest. Neither section 267 nor section 1239 presently treat an estate and a beneficiary of the estate as related persons.

A pre-need funeral trust is an arrangement where an individual purchases funeral services or merchandise from a funeral home for the benefit of a specified person in advance of that person's death. (The beneficiary may be either the purchaser or another person.) The purchaser enters into a contract with the provider of such services or merchandise whereby the purchaser selects the services or merchandise to be provided upon the death of the beneficiary and agrees to pay for them in advance of the beneficiary's death. Such amounts (or a portion thereof) are held in trust during the beneficiary's lifetime and are paid to the seller upon the beneficiary's death. Under present law, pre-need funeral trusts generally are treated as grantor trusts, and the annual income earned by such trusts is taxed to the purchaser/grantor of the trust.

Any amount received from the trust by the seller (as payment for services or merchandise) is includible in the gross income of the seller.

The first $10,000 of gifts of present interests to each donee during any one calendar year are excluded from federal gift tax. The value of the gross estate includes the value of any previously transferred property if the decedent retained the power to revoke the transfer. The gross estate also includes the value of any property with respect to which such power is relinquished during the three years before death. There has been significant litigation as to whether these rules require that certain transfers made from a revocable trust within three years of death be includible in the gross estate.

Under state community property laws, each spouse owns an undivided one-half interest in each community property asset. In community property jurisdictions, a nonparticipant spouse may be treated as having a vested community property interest in the participating spouse's qualified plan, IRA, or simplified employee pension (SEP) plan.

In the Retirement Equity Act of 1984 (REA), qualified retirement plans were required to provide automatic survivor benefits (1) in the case of a participant who retires under the plan, in the form of a qualified joint and survivor annuity, and (2) in the case of a vested participant who dies before the annuity starting date and who has a surviving spouse, in the form of a preretirement survivor annuity. A participant generally is permitted to waive such annuities, provided he or she obtains the written consent of his or her spouse. The Tax Reform Act of 1986 repealed the estate tax exclusion, formerly contained in sections 2039(c) and 2039(d), for certain interests in qualified plans owned by a nonparticipant spouse attributable to community property laws and made certain other changes to conform the transfer tax treatment of qualified and nonqualified plans.

As a result of these changes made by REA and the Tax Reform Act of 1986, the transfer tax treatment of married couples residing in a community property state is unclear where either spouse is covered by a qualified plan.

For estate tax purposes, an executor may elect to value certain real property used in farming or other closely-held business operations at its current use value rather than its highest and best use. A written agreement signed by each person with an interest in the property must be filed with the election. In 1984, section 2032A was amended to provide that if an executor makes a timely election that substantially complies with Treasury regulations, but fails to provide all required information or the signatures of all persons required to enter into the agreement, the executor may supply the missing information within a reasonable period of time (not exceeding 90 days) after notification by the Treasury Department. Treasury regulations require that a notice of election and certain information be filed with the Federal estate tax return. The administrative policy of the Treasury Department is to disallow current use valuation elections unless the required information is supplied.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

New Federal Law (Secs. 267, 646, 663(b), 663(c), 685, 1239(b), 2035, 2032A, 2056(b), 2056A, 2105, 2207A, 2652(b) and 6019)

Act Section 1301 Eliminate Gift Tax Filing Requirements for Gifts To Charities.

The Act provides that gifts to charity are not subject to the gift tax filing requirements of section 6019, as long as the entire value of the transferred property qualifies for the gift tax charitable deduction under section 2522. The filing requirements for gifts of partial interests in property remain unchanged. The Conference Committee Report clarifies that the property given to charity must be the donor's entire interest in the property.

Act Section 1302 Clarification of Waiver of Certain Rights of Recovery.

The Act provides that the right of recovery with respect to a QTIP is waived only to the extent that language in the decedent's will or revocable trust specifically so indicates (e.g., by a specific reference to a QTIP, the QTIP trust, section 2044, or section 2207A). Thus, a general provision specifying that all taxes be paid by the estate is no longer sufficient to waive the right of recovery. The Act also provides that the right of contribution for property over which the decedent retained enjoyment or the right to income is waived by a specific indication in the decedent's will or revocable trust, but specific reference to section 2207B is no longer required.

Act Section 1303 Transitional Rule Under Section 2056A.

The Act provides that certain trusts created before the enactment of the Omnibus Budget Reconciliation Act of 1990 are treated as satisfying the withholding requirement if the governing instruments require that all trustees be U.S. citizens or domestic corporations.

Act Section 1304 Treatment for Estate Tax Purposes of Short-Term Obligations Held By Nonresident Aliens.

The Act provides that any debt obligation, the income from which would be eligible for the exemption for short-term OID under section 871(g)(1)(B)(i) if such income were received by the decedent on the date of his death, is treated as property located outside of the United States in determining the U.S. estate tax liability of a nonresident not a U.S. citizen. The committee reports indicate that no inference is intended with respect to the estate tax treatment of such obligations under present law.

Act Section 1305 Certain Revocable Trusts as Part of Estate.

The Act provides an irrevocable election to treat a qualified revocable trust as part of the decedent's estate for federal income tax purposes. This elective treatment is effective from the date of the decedent's death until two years after his or her death (if no estate tax return is required) or, if later, six months after the final determination of estate tax liability (if an estate tax return is required). The election must be made by both the executor

of the decedent's estate (if any) and the trustee of the revocable trust no later than the time required for filing the income tax return of the estate for its first taxable year, taking into account any extensions. A conforming change is made to section 2652(b) for generation-skipping transfer tax purposes. For this purpose, a qualified revocable trust is any trust (or portion thereof) which was treated under section 676 as owned by the decedent with respect to whom the election is being made, by reason of a power in the grantor (i.e., trusts that are treated as owned by the decedent solely by reason of a power in a nonadverse party would not qualify). The separate share rule (described below) generally will apply when a qualified revocable trust is treated as part of the decedent's estate.

Act Section 1306 Distributions During First 65 Days of Taxable Year of Estate.

The Act extends application of the 65-day rule to distributions by estates. Thus, an executor can elect to treat distributions paid by the estate within 65 days after the close of the estate's taxable year as having been paid on the last day of such taxable year.

Act Section 1307 Separate Share Rules Available To Estate.

The Act extends the application of the separate share rule to estates. There are separate shares in an estate when the governing instrument of the estate (e.g., the will and applicable local law) creates separate economic interests in one beneficiary or class of beneficiaries such that the economic interests of those beneficiaries (e.g., rights to income or gains from specified items of property) are not affected by economic interests accruing to another separate beneficiary or class of beneficiaries. For example, a separate share in an estate would exist where the decedent's will provides that all shares of a closely-held corporation are devised to one beneficiary and that any dividends paid to the estate by that corporation should be paid only to that beneficiary and any such dividends would not affect any other amounts which that beneficiary would receive under the will. As in the case of trusts, the application of the separate share rule is mandatory where separate shares exist.

Act Section 1308 Executor of Estate and Beneficiaries Treated as Related Persons for Disallowance of Losses.

Under the Act, an estate and a beneficiary of that estate are treated as related persons for purposes of sections 267 and 1239, except in the case of a sale or exchange in satisfaction of a pecuniary bequest.

Act Section 1309 Simplified Taxation of Earnings of Pre-Need Funeral Trusts.

The Act allows the trustee of a pre-need funeral trust to elect special tax treatment for such a trust to the extent the trust would otherwise be treated as a grantor trust. A qualified funeral trust is defined as one which meets the following requirements: (1) the trust arises as the result of a contract between a person engaged in the trade or business of providing funeral or

burial services or merchandise and one or more individuals to have such services or property provided upon such individuals' death; (2) the only beneficiaries of the trust are individuals who have entered into contracts to have such services or merchandise provided upon their death; (3) the only contributions to the trust are contributions by or for the benefit of the trust beneficiaries; (4) the trust's only purpose is to hold and invest funds that will be used to make payments for funeral or burial services or merchandise for the trust beneficiaries; and (5) the trust has not accepted contributions totaling more than $7,000 by or for the benefit of any individual. For this purpose, “contributions” include all amounts transferred to the trust, regardless of how denominated in the contract. Contributions do not, however, include income or gain earned with respect to property in the trust. For purposes of applying the $7,000 limit, if a purchaser has more than one contract with a single trustee (or related trustees), all such trusts are treated as one trust.

Similarly, if the Secretary of Treasury determines that a purchaser has entered into separate contracts with unrelated trustees to avoid the $7,000 limit described above, the Secretary may require that such trusts be treated as one trust. For contracts entered into after 1998, the $7,000 limit is indexed annually for inflation.

The trustee's election to have this provision apply to a qualified funeral trust is to be made separately with respect to each purchaser's trust. It is anticipated that the Secretary of Treasury will issue prompt guidance with respect to the simplified reporting requirements so that if the election is made, a single annual trust return may be filed by the trustee, separately listing the amount of income earned with respect to each purchaser. If the election is made, the trust is not treated as a grantor trust and the amount of tax paid with respect to each purchaser's trust is determined in accordance with the income tax rate schedule generally applicable to estates and trusts, but no deduction is allowed under section 642(b). The tax on the annual earnings of the trust is payable by the trustee.

As under present law, amounts received from the trust by the seller are treated as payments for services and merchandise and are includible in the gross income of the seller. No gain or loss is recognized to the beneficiary of the trust for payments from the trust to the beneficiary upon cancellation of the contract, and the beneficiary takes a carryover basis in any assets received from the trust upon cancellation.

The Conference Committee Report indicates that the provision would be applied to contracts purchased by one individual to have funeral or burial services or merchandise provided for another individual upon that individual's death (to the extent that such arrangements would otherwise be treated as grantor trusts).

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section 1310 Adjustments for Gifts Within Three Years of Decent's Death.

The Act codifies the rule set forth in the McNeely and Kisling cases to provide that a transfer from a revocable trust (i.e., a trust described under section 676) is treated as if made directly by the grantor. Thus, an annual exclusion gift from such a trust is not included in the gross estate. The Act also revises section 2035 to improve its clarity. The provision is not intended to modify the result reached in the Kisling case.

Act Section 1311 Clarify Relationship Between Community Property Rights and Retirement Benefits.

The Act clarifies that the marital deduction is available with respect to a nonparticipant spouse's interest in an annuity attributable to community property laws where he or she predeceases the participant spouse. Under the Act, the nonparticipant spouse's interest in an annuity arising under the community property laws of a state that passes to the surviving participant spouse may qualify for treatment as QTIP under section 2056(b)(7). The provision is not intended to create an inference regarding the treatment under present law of a transfer to a surviving spouse of the decedent spouse's interest in an annuity arising under community property laws. The committee reports indicate that the provision is not intended to modify the result of the Supreme Court's decision in Boggs v. Boggs, 117 S.Ct. 1754 (1997).

Act Section 1312 Treatment Under Qualified Domestic Trust Rules of Forms of Ownership Which Are Not Trusts.

The Act provides the Treasury Department with regulatory authority to treat as trusts legal arrangements that have substantially the same effect as a trust. It is anticipated that such regulations, if any, would only permit a marital deduction with respect to non-trust arrangements under which the U.S. would retain jurisdiction and adequate security to impose U.S. transfer tax on transfers by the surviving spouse of the property transferred by the decedent. Possible arrangements could include the adoption of a bilateral treaty that provides for the collection of U.S. transfer tax from the noncitizen surviving spouse or a closing agreement process under which the surviving spouse waives treaty benefits, allows the U.S. to retain taxing jurisdiction, and provides adequate security with respect to such transfer taxes.

Act Section 1313 Opportunity to Correct Certain Failures Under Section 2032A.

The Act extends the procedures allowing subsequent submission of information to any executor who makes the election and submits the recapture agreement, without regard to compliance with the Treasury regulations. Thus, the Act allows the current use valuation election if the executor supplies the required information within a reasonable period of time (not exceeding 90 days) after notification by the IRS. During that time period, the Act also allows the addition of signatures to a previously filed agreement. The Conference Committee Report indicates that Congress believes that the Treasury Department has taken an unnecessarily restrictive view of the 1984 amendment to section

2032A and intends no inference that the Treasury Department lacks the power, under the law in effect prior to the date of enactment, to correct the situation addressed by this provision. The Act intends that, with respect to technically defective section 2032A elections made prior to the date of enactment, prior law should be applied in a manner consistent with the provision.

Act Section 1314 Authority to Waive Requirement of U.S. Trustee for Qualified Domestic Trusts.

In order to permit the establishment of a QDT in those situations where a country prohibits a trust from having a U.S. trustee, the Act provides the Treasury Department with regulatory authority to waive the requirement that a QDT have a U.S. trustee. It is anticipated that such regulations, if any, would provide an alternative mechanism under which the U.S. would retain jurisdiction and adequate security to impose U.S. transfer tax on transfers by the surviving spouse of the property transferred by the decedent.

Current California Law (R&T Secs. 17731-17737 and 17742-17745.1)

California does not impose a gift tax, and the California estate tax is a "pick-up" tax, that is, the state tax is equal to the maximum credit for a state tax on the federal estate tax return for that particular decedent's estate. This "pick-up" tax is administered by the State Controller's Office.

In general, except for those provisions not applicable because they relate directly to either the federal estate or gift tax (as distinguished from income tax provisions affecting estates, trusts, beneficiaries and decedents), California law conforms to federal law relating to estates, trusts, beneficiaries, and decedents as it read January 1, 1997. In particular, California conforms to federal law regarding funeral trusts. Consequently, owners of pre-need funeral trusts pay tax on the earnings of the trusts. California has additional rules relating to the apportionment of taxable income of estates and trusts based on the respective residence of fiduciaries and beneficiaries.

Effective Date

In general, the provisions apply to gifts, decedents dying, waivers, transfers and disclaimers made after August 5, 1997.

The pre-need funeral trust provision is effective for tax years beginning after the date of enactment.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Impact on California Revenue

Except for the pre-need funeral trusts, the above provisions are not applicable.

Based on the negligible revenue gains projected for the federal law change, conforming to the pre-need funeral trusts change would be negligible.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1401-36	Excise Tax Simplification Provisions

Federal law contains various excise taxes on heavy trucks and vehicles, luxury automobiles, alcoholic beverages, aviation flights and fuels, bows and arrows and various other items. The Act modifies several provisions contain in the Internal Revenue Code relating to excise taxes.

New Federal Law

Act Section 1401 (Code sec. 4001, 4051) Increase De Minimis Limit for After-Market Alterations Subject to Heavy Truck and Luxury Automobile Excise Taxes

An excise tax is imposed on retail sales of truck chassis and truck bodies suitable for use in a vehicle with a gross vehicle weight of over 33,000 pounds. The tax is equal to 12% of the retail sales price. An excise tax also is imposed on retail sales of luxury automobiles. The tax currently is equal to 8% of the amount by which the retail sales price exceeds an inflation-adjusted $30,000 base. (The rate is reduced by one percentage point per year through 2002, and the tax is not imposed after 2002.). Anti-abuse rules prevent the avoidance of these taxes through separate purchases of major component parts. With certain exceptions, tax at the rate applicable to the vehicle is imposed on the subsequent installation of parts and accessories within six months after purchase of a taxable vehicle. The exceptions include a de minimis exception for parts and accessories with an aggregate price that does not exceed $200.

The excise tax on subsequent installation of parts and accessories installed after August 5, 1997, does not apply to parts and accessories with an aggregate price that does not exceed $1,000.

Act Section 1402 (Code sec. 4052) Modify Treatment of Tires under the Heavy Highway Vehicle Retail Excise Tax

A 12% retail excise tax is imposed on certain heavy highway trucks and trailers, and on highway tractors. A separate manufacturers' excise tax is imposed on tires weighing more than 40 pounds. This tire tax is imposed as a fixed dollar amount which varies based on the weight of the tire. Because tires are taxed separately, the value of tires installed on a highway vehicle was excluded from the 12% excise tax on heavy highway vehicles under prior law. The determination of value was factual and gave rise to numerous tax audit challenges.

The prior-law exclusion of the value of tires installed on a taxable highway vehicle is repealed. Instead, a credit for the amount of manufacturers' excise tax actually paid on the tires is allowed. The provision is effective for sales after December 31, 1997.

Act Section 1411-1422 (Code secs. 5008, 5053, 5055, 5115, 5175, 5207, 5222, 5418) Simplification of Excise Taxes on Distilled Spirits, Wine, and Beer.

Imported distilled spirits returned to plant.-- Excise tax that has been paid on domestic distilled spirits is credited or refunded if the spirits are later returned to bonded premises. Under prior law, tax was imposed on imported bottled spirits when they were withdrawn from customs custody, but the tax was not refunded or credited if the spirits were later returned to bonded premises. Under the Act, refunds or credits of the tax are available for imported bottled spirits that are returned to distilled spirits plants.

Cancellation of export bonds.-- An exporter that withdraws distilled spirits from bonded warehouses for export or transportation to a customs bonded warehouse without the payment of tax must furnish a bond to cover the withdrawal. Under prior law, the required bonds were canceled "on the submission of such evidence, records, and certification indicating exportation as the Secretary may by regulations prescribe." Under the Act, the certification requirements are relaxed to allow the bonds to be canceled if there is such proof of exportation as the Secretary may require.

Location of records of distilled spirits plant.-- Proprietors of distilled spirits plants were required to maintain records and reports relating to their production, storage, denaturation, and processing activities on the premises where the operations covered by the record are carried on. Under the Act, records and reports are permitted to be maintained elsewhere other than on the plant premises.

Transfers from brewery to distilled spirits plant.-- A distilled spirits plant could receive on its bonded premises beer to be used in the production of distilled spirits only if the beer was produced on contiguous brewery premises. Under the Act, beer may be brought from any brewery for use in the production of spirits. Such beer is exempt from excise tax, subject to Treasury Department regulations.

Sign not required for wholesale dealers.-- Wholesale liquor dealers were required to post a sign identifying the firm as such. Failure to do so was subject to a penalty. Under the Act, the requirement that a sign be posted is repealed.

Refund on returns of merchantable wine.-- Excise tax paid on domestic wine that was returned to bond as unmerchantable was refunded or credited, and the wine was once again treated as wine in bond on the premises of a bonded wine cellar. Under the Act, a refund or credit is available in the case of all domestic wine returned to bond, regardless whether of its unmerchantable.

Increased sugar limits for certain wine.-- Natural wines could be sweetened to correct high acid content. For most wines, however, sugar could not constitute more than 35% (by volume) of the combined sugar and juice used to produce the wine. Up to 60% sugar could be used in wine made from loganberries, currants, and gooseberries. If the amount of sugar used exceeded the applicable limitation, the wine was required to be labeled "substandard." Under the Act, up to 60% sugar is permitted in any wine made from juice, such as cranberry or

plum juice, with an acid content of 20 or more parts per thousand.

Beer withdrawn for embassy use.-- Imported beer to be used for the family and official use of representatives of foreign governments or public international organizations may be withdrawn from customs bonded warehouses without payment of excise tax. Under prior law, no similar exemption applied to domestic beer withdrawn from a brewery or entered into a bonded customs warehouse for the same authorized use. Under the Act, subject to the Treasury Department's regulatory authority, an exemption similar to that currently available for imported beer is provided for domestic beer.

Beer withdrawn for destruction.-- Removals of beer from a brewery are exempt from tax if the removal is for export, because the beer is unfit for beverage use, for laboratory analysis, research, development and testing, for the brewer's personal or family use, or as supplies for certain vessels and aircraft. Under the Act, an exemption from tax is added for removals for destruction, subject to Treasury regulations.

Drawback on exported beer.-- Under prior law, a domestic producer that exports beer could recover the tax (receive a “drawback”) found to have been paid on the exported beer upon the “submission of such evidence, records and certificates indicating exportation” required by regulations. Under the Act, the certification requirement is relaxed to allow a drawback of tax paid if there is such proof of exportation as the Secretary may by regulations require.

Imported beer transferred in bulk to brewery and imported wine transferred in bulk to wineries.-- Imported beer and wine were subject to tax when removed from customs custody. Under the Act, subject to Treasury Department regulations, beer and wine imported in bulk may be withdrawn from customs custody and transferred in bulk to a brewery (beer) or a winery (wine) without payment of tax. The proprietor of the brewery to which the beer is transferred or of the winery to which the wine is transferred is liable for the tax imposed on beer or wine withdrawn from customs custody and the importer is relieved of liability.

Effective Date for Act Sections 1411-1422.-- The provision to repeal the requirement that wholesale liquor dealers post a sign outside their place of business takes effect on the date of enactment. The other provisions take effect on the first day of the calendar quarter that begins at least 180 days after the date of enactment.

Act Section 1431 (Code sec. 4222) Authority for Internal Revenue Service to Grant Exemptions from Excise Tax Registration Requirements.

The Internal Revenue Code exempts certain types of sales (e.g., sales for use in further manufacture, sales for export, and sales for use by a state or local government or a nonprofit educational organization) from certain excise taxes imposed on manufacturers and retailers. These exemptions generally apply only if the seller, the purchaser, and any person to whom the article is resold by the purchaser (the second purchaser) are registered with the Internal Revenue

Service (IRS). Under prior law, the IRS could waive the registration requirement for the purchaser and second purchaser in some but not all cases.

Under the Act, the IRS is authorized to waive the registration requirement for purchasers and second purchasers in all cases. The provision applies to sales made pursuant to waivers issued after the date of enactment.

Act Section 1432 (Code secs. 4051, 4495-4498, and 4681-4682) Repeal of Expired Excise Tax Provisions.

The Internal Revenue Code included a provision relating to a temporary reduction in the tax on piggyback trailers sold before July 18, 1985, and provisions relating to the tax on the removal of hard minerals from the deep seabed before June 28, 1990.

An excise tax is imposed on the sale or use by the manufacturer or importer of certain ozone-depleting chemicals. The amount of the tax generally is determined by multiplying the base tax amount applicable for the calendar year by an ozone-depleting factor assigned to each taxable chemical. The base tax amount was $5.80 per pound in 1996 and will increase by 45 cents per pound per year thereafter. The Code contains provisions for special rates of tax applicable to years before 1996.

These provisions are repealed as obsolete effective on August 5, 1997.

Act Section 1433 (Code sec. 4161) Modifications to Excise Tax on Certain Arrows.

An 11% manufacturer's excise tax is imposed on bows having a draw weight of 10 pounds or more, and under prior law on arrows that either were 18 inches or more in length or were suitable for use with a taxable bow. The prior-law tax was imposed on the manufacturer's sales price of the completed arrow.

Under the Act, the prior-law excise tax on arrows is replaced with a manufacturers' excise tax on the four component parts of the arrow: shafts, points, nocks, and vanes. The tax rate is increased to 12.4% of the sale price of each of these four components to offset the reduction in aggregate value subjected to tax compared to present-law valuation of the completed arrow. The provision was effective for arrow components sold after September 30, 1997.

Act Section 1434 (Code sec. 4051) Modifications to Heavy Highway Vehicle Retail Excise Tax.

A 12% retail excise tax is imposed on certain heavy highway trucks and trailers, and on highway tractors. Small trucks (those with a gross vehicle weight not over 33,000 pounds) and lighter trailers (those with a gross vehicle weight not over 26,000 pounds) are exempt from the tax. The tax applies to the first retail sale of a new or remanufactured vehicle. The determination under present law of whether a particular modification to an existing vehicle constitutes remanufacture (taxable) or a repair (nontaxable) is factual and

generally is based on whether the transportation function of the vehicle is changed, the vehicle was wrecked or, in the case of worn vehicles, whether the cost of the modification exceeds 75% of the value of the modified vehicle.

No tax is imposed on trucks, tractors, and trailers when they are sold for resale or long-term lease, if the purchaser is registered with the Treasury Department. In such cases, purchasers are liable for the tax when the vehicle is sold or leased. The tax is based on the sales price in the transaction to which it applies.

The Act makes two changes effective after December 31, 1997, to the heavy vehicle excise tax:

(1) The 75%-of-value threshold applies in determining whether repairs to a wrecked vehicle constitute remanufacture; and

(2) The registration requirement currently applicable to certain sales of trucks, tractors, and trailers for resale is replaced with a certification requirement.

Act Section 1435 (Code secs. 4081 and 4261) Treatment of Skydiving Flights as Noncommercial Aviation.

Under prior law, commercial passenger aviation, or air transportation for which a fare was charged, was subject to a 10% ad valorem excise tax for the Airport and Airway Trust Fund. Noncommercial aviation, or air transportation which is not “for hire”, is subject to a fuels tax for the Trust Fund. In the case of skydiving flights, questions arose under prior law as to when the flight was commercial aviation subject to the ticket tax and when it was noncommercial aviation subject to the fuels tax. In general, if instruction was offered, the flight was noncommercial aviation. Otherwise, the flight was treated as commercial aviation. Many skydiving flights carry both persons receiving instruction and others not receiving instruction.

The Act specifies that flights which are exclusively dedicated to skydiving are taxed as noncommercial aviation flights, regardless of whether instruction is offered to any of the passengers. The provision was effective for flights beginning after September 30, 1997.

Act Section 1436 (Code sec. 4091) Eliminate Double Taxation of Certain Aviation Fuels Sold to Producers by Fixed Base Operators.

Internal Revenue Code section 4091 imposes a tax on the sale of aviation fuel by any producer (defined to include a wholesale distributor). Fuel sold at many rural airports is sold by retail dealers who do not qualify as wholesale distributors. This fuel is purchased by the retailers tax-paid. In certain instances, fuel which has been purchased tax-paid by a retailer will be resold to a producer, e.g., to enable the producer to serve one of its customers at

the airport. When this fuel is resold at retail by the producer, a second tax may be imposed. Under prior law, the Code contained no provision allowing a refund of the first tax in such cases.

The Act permits a producer to obtain a refund of tax previously paid on aviation fuel that the producer buys. The provision was effective for fuel acquired by a producer after September 30, 1997.

Current California Law

The Franchise Tax Board does not administer excise taxes. Where applicable, excise taxes are normally administered by the State Board of Equalization.

Impact on California Revenue

Defer to the Board of Equalization.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1441-44	Tax-Exempt Bond Provisions

Background

Interest on state and local government bonds generally is excluded from gross income for purposes of the regular individual and corporate income taxes if the proceeds of the bonds are used to finance direct activities of these governmental units.

Unlike the interest on governmental bonds, described above, interest on private activity bonds generally is taxable. A private activity bond is a bond issued by a state or local governmental unit acting as a conduit to provide financing for private parties in a manner violating either (1) a private business use and payment test or (2) a private loan restriction. However, interest on private activity bonds is not taxable if (1) the financed activity is specified in the Internal Revenue Code and (2) at least 95% of the net proceeds of the bond issue is used to finance the specified activity.

Issuers of state and local government bonds must satisfy numerous other requirements, including arbitrage restrictions (for all such bonds) and annual state volume limitations (for most private activity bonds), for the interest on these bonds to be excluded from gross income.

New Federal Law

Act Section 1441 (Code sec. 148) Repeal of $100,000 Limitation on Unspent Proceeds Under 1-Year Exception from Rebate.

Subject to limited exceptions, arbitrage profits from investing bond proceeds in investments unrelated to the governmental purpose of the borrowing must be rebated to the federal government. No rebate is required if the gross proceeds of an issue are spent for the governmental purpose of the borrowing within six months after issuance.

Under prior law, this six-month exception is deemed to be satisfied by issuers of governmental bonds and qualified 501(c)(3) bonds if (1) all proceeds other than an amount not exceeding the lesser of 5% or $100,000 are so spent within six months and (2) the remaining proceeds are spent within one year after the bonds are issued.

Under the Act, the $100,000 limit on proceeds that may remain unspent after six months for certain governmental and qualified 501(c)(3) bonds otherwise exempt from the rebate requirement is deleted. Thus, if at least 95% of the proceeds of these bonds are spent within six months after their issuance, and the remainder is spent within one year, the six-month exception is deemed to be satisfied. The provision applies to bonds issued August 5, 1997.

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Act Section 1442 (Code sec. 148) Exception from Rebate for Earnings on Bona Fide Debt Service Fund Under Construction Bond Rules.

In general, arbitrage profits from investing bond proceeds in investments unrelated to the governmental purpose of the borrowing must be rebated to the federal government. An exception is provided for certain construction bond issues if the bonds are governmental bonds, qualified 501(c)(3) bonds, or exempt-facility private activity bonds for governmentally-owned property.

This exception is satisfied only if the available construction proceeds of the issue are spent at minimum specified rates during the 24-month period after the bonds are issued. The exception does not apply to bond proceeds invested after the 24-month expenditure period as part of a reasonably required reserve or replacement fund, a bona fide debt service fund under prior law, or to certain other investments (e.g., sinking funds). Issuers of these construction bonds also may elect to comply with a penalty regime in lieu of rebating arbitrage profits if they fail to satisfy the exception's spending requirements.

The Act exempts earnings on bond proceeds invested in bona fide debt service funds from the arbitrage rebate requirement and the penalty requirement of the 24-month exception if the spending requirements of that exception are otherwise satisfied. The provision applies to bonds issued after August 5, 1997.

Act Section 1443 (Code sec. 148) Repeal of Debt Service-Based Limitation on Investment in Certain Nonpurpose Investments.

Issuers of all tax-exempt bonds generally are subject to two sets of restrictions on investment of their bond proceeds to limit arbitrage profits. The first set requires that tax-exempt bond proceeds be invested at a yield that is not materially higher (generally defined as 0.125 percentage points) than the bond yield (“yield restrictions”). Exceptions are provided to this restriction for investments during any of several “temporary periods” pending use of the proceeds and, throughout the term of the issue, for proceeds invested as part of a reasonably required reserve or replacement fund or a “minor” portion of the issue proceeds.

Except for temporary periods and amounts held pending use to pay current debt service, prior law also limited the amount of the proceeds of private activity bonds (other than qualified 501(c)(3) bonds) that may be invested at materially higher yields at any time during a bond year to 150% of the debt service for that bond year. This restriction affected primarily investments in reasonably required reserve or replacement funds. Present law and prior law further restricts the amount of proceeds from the sale of bonds that may be invested in these reserve funds to 10% of such proceeds.

The second set of restrictions requires generally that all arbitrage profits earned on investments unrelated to the governmental purpose of the borrowing be rebated to the federal government (“arbitrage rebate”). Arbitrage profits include all earnings (in excess of bond yield) derived from the investment of bond proceeds (and subsequent earnings on any such earnings).

Effective for bonds issued after August 5, 1997, the Act repeals the 150% of debt service yield restriction.

Act Section 1444 (Code sec. 148) Repeal of Expired Provisions Relating to Student Loan Bonds.

Prior law included two special exceptions to the arbitrage rebate and pooled financing temporary period rules for certain qualified student loan bonds. These exceptions applied only to bonds issued before January 1, 1989.

These special exceptions are deleted as “obselete.” The provision applies to bonds issued after August 5, 1997.

Current California Law (R&T Secs. 17133, 24272)

The Personal Income Tax Law specifically does not conform to federal law regarding private activity bonds and arbitrage profit from issuance of exempt bonds. The California Constitution provides an exemption from income taxation for all interest from bonds issued by this state or a local government of this state. Federal law, other than the Internal Revenue Code, prohibits state taxation of interest on federal bonds, if the interest on state obligations is exempt from tax. Taxpayers subject to the corporate franchise tax must include in the base upon which the franchise tax is imposed all interest received (including interest on exempt obligations). Interest received from federal obligations and California obligations or obligations of its political subdivisions generally is excluded from income subject to the corporation and personal income tax.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1451-54	Tax Court Procedures

New Federal Law

Act Section 1451 (Code sec. 6512) Overpayment Determinations of Tax Court.

The Tax Court may order the refund of an overpayment determined by the Court, plus interest, if the IRS fails to refund such overpayment and interest within 120 days after the court's decision becomes final. Whether such an order is appealable is uncertain.

In addition, it is unclear whether the Tax Court has jurisdiction over the validity or merits of certain credits or offsets (e.g., providing for collection of student loans, child support, etc.) made by the IRS that reduce or eliminate the refund to which the taxpayer was otherwise entitled.

The Act clarifies that an order to refund an overpayment is appealable in the same manner as a decision of the Tax Court. The Act also clarifies that the Tax Court does not have jurisdiction over the validity or merits of the credits or offsets that reduce or eliminate the refund to which the taxpayer was otherwise entitled. The provision was effective on August 5, 1997.

Act Section 1452 (Code sec. 7481) Redetermination of Interest Pursuant to Motion.

A taxpayer may seek a redetermination of interest after certain decisions of the Tax Court have become final by filing a petition with the Tax Court.

The Act provides that a taxpayer must file a “motion” (rather than a “petition”) to seek a redetermination of interest in the Tax Court. The Act also clarifies that the Tax Court's jurisdiction to redetermine the amount of interest under section 7481(c) does not depend on whether the interest is underpayment or overpayment interest. In clarifying the Tax Court's jurisdiction over interest determinations, the committee report indicates that Congress did not intend to limit any other remedies that taxpayers may currently have with respect to such determinations, including in particular refund proceedings relating solely to the amount of interest due. The provision was effective August 5, 1997.

Act Section 1453 (Code sec. 7430) Application of Net Worth Requirement for Awards of Litigation Costs.

Any person who substantially prevails in any action brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative costs incurred before the IRS and reasonable litigation costs incurred in connection with any court proceeding. A person who substantially prevails must meet certain net worth requirements to be eligible for an award of administrative or

litigation costs. In general, only an individual whose net worth does not exceed $2 million is eligible for an award, and only a corporation or partnership whose net worth does not exceed $7 million is eligible for an award. (The net worth determination with respect to a partnership or S corporation applies to all actions that are in substance partnership actions or S corporation actions, including unified entity-level proceedings under sections 6226 or 6228, that are nominally brought in the name of a partner or a shareholder.)

The Act provides that the net worth limitations currently applicable to individuals also apply to estates and trusts. The Act also provides that individuals who file a joint tax return shall be treated as separate individuals for purposes of computing the net worth limitations (resulting in a net worth limitation of $4 million for individuals who file a joint return). The provision applies to proceedings commenced after August 5, 1997.

Act Section 1454 (Code sec. 7436) Tax Court Jurisdiction for Determination of Employment Status.

The Tax Court is a court of limited jurisdiction, established under Article I of the United States Constitution. The Tax Court only has the jurisdiction that is expressly conferred on it by statute.

The Act provides that, in connection with the audit of any person, if there is an actual controversy involving a determination by the IRS as part of an examination that (1) one or more individuals performing services for that person are employees of that person or (2) that person is not entitled to relief under section 530 of the Revenue Act of 1978, the Tax Court has jurisdiction to determine whether the IRS is correct. For example, one way the IRS could make the required determination is through a mechanism similar to the employment tax early referral procedures. A failure to agree would also be considered a determination for this purpose, to the extent permitted under Tax Court rules.

The Act provides for de novo review (rather than review of the administrative record). Assessment and collection of the tax attributable to those issues would be suspended while the matter is pending in the Tax Court. Any determination by the Tax Court would have the force and effect of a decision of the Tax Court and would be reviewable as such; accordingly, it would be binding on the parties. Awards of costs and certain fees (pursuant to section 7430) would be available to eligible taxpayers with respect to Tax Court determinations pursuant to this proposal. The Act also provides a number of procedural rules to incorporate this new jurisdiction within the existing procedures applicable in the Tax Court. The provision was effective on August 5, 1997.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Current California Law

California does not have a Tax Court. Instead, disagreements between the Franchise Tax Board and taxpayers are heard by the State Board of Equalization.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1461	Due Date for First Quarter Estimated Tax Payments by Private Foundations.

Background

Under section 4940, tax-exempt private foundations generally are required to pay an excise tax equal to 2% of their net investment income for the taxable year. Under section 6655(g)(3), private foundations are required to pay estimated tax with respect to their excise tax liability under section 4940 (as well as any unrelated business income tax (UBIT) liability under section 511). Generally, the amount of the first quarter payment must be at least 25% of the lesser of (1) the preceding year's tax liability, as shown on the foundation's Form 990-PF, or (2) 95% of the foundation's current-year tax liability.

Section 6655(c) provides that this estimated tax is payable in quarterly installments and that, for calendar-year foundations, the first quarterly installment is due on April 15th. Under section 6655(i), foundations with taxable years other than the calendar year must make their quarterly estimated tax payments no later than the dates in their fiscal years that correspond to the dates applicable to calendar-year foundations.

New Federal Law (Sec. 6655(g))

The Act amends section 6655(g)(3) to provide that a calendar-year foundation's first-quarter estimated tax payment is due on May 15th (which is the same day that its annual return, Form 990-PF, for the preceding year is due). As a result of the operation of present-law section 6655(i), fiscal-year foundations will be required to make their first-quarter estimated tax payment no later than the 15th day of the fifth month of their taxable year.

Current California Law (R&T Sec. 19023)

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to UBIT of tax-exempt private foundations and the payment of estimated tax. California law does not contain an excise tax equal to 2% of a tax-exempt private foundation’s net investment income for the taxable year.

Effective Date

The provision applies to taxable years beginning after August 5, 1997, the date of enactment.

Impact on California Revenue

Based on the minor impact projected for the federal change, delayed estimated tax payments would be negligible (less than $250,000) on a fiscal year basis beginning in 1998-9.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1462	Withholding of Commonwealth Income Taxes from Wages of Federal Employees.

Background

If state law provides generally for the withholding of state income taxes from the wages of employees in a state, the Secretary of the Treasury shall (upon the request of the state) enter into an agreement with the state providing for the withholding of state income taxes from the wages of federal employees in the state. For this purpose, a state is a state, territory, or possession of the United States.

New Federal Law

The Act makes any Commonwealth eligible to enter into an agreement with the Secretary of the Treasury that would provide for income tax withholding from the wages of federal employees.

Current California Law

California through the Employment Development Department presently has an agreement with the federal government to withhold state income taxes from the wages of federal employees. Moreover, California is not a “commonwealth”; therefore, the provision would not apply.

Effective Date

The provision is effective on January 1, 1998.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1463	Certain Notices Disregarded Under Provision Increasing Interest Rate on Large Corporate Underpayments.

Background

The interest rate on a large corporate underpayment of tax is the federal short-term rate plus five percentage points. A large corporate underpayment is any underpayment by a subchapter C corporation of any tax imposed for any taxable period, if the amount of such underpayment for such period exceeds $100,000. The large corporate underpayment rate generally applies to periods beginning 30 days after the earlier of the date on which the first letter of proposed deficiency, a statutory notice of deficiency, or a nondeficiency letter or notice of assessment or proposed assessment is sent. For this purpose, a letter or notice is disregarded if the taxpayer makes a payment equal to the amount shown on the letter or notice within that 30 day period.

New Federal Law (Sec. 6621(c))

For purposes of determining the period to which the large corporate underpayment rate applies, any letter or notice is disregarded if the amount of the deficiency, proposed deficiency, assessment, or proposed assessment set forth in the letter or notice is not greater than $100,000 (determined by not taking into account any interest, penalties, or additions to tax).

Current California Law (R&T Sec. 19521(c))

Except for the inherent difference in the definition of deficiency, California law is in conformity with federal law as it read on January 1, 1997, as it relates to an increased interest rate for underpayments of large corporations.

Effective Date

The provision is effective for purposes of determining interest for periods after December 31, 1997.

Impact on California Revenue

On a preliminary basis it is projected that California would receive reduced interest payments on the order of $300,000 annually.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1501-10	Pension Simplification Provisions.

New Federal Law

Act Section 1501 (Code sec. 402(g)) Matching Contributions of Self-Employed Individuals Not Treated as Elective Deferrals.

Under present and prior law, a qualified cash or deferred arrangement (a "section 401(k) plan") is a type of tax-qualified pension plan under which employees can elect to make pre-tax deferrals. An employee's annual elective deferrals are subject to a dollar limit ($9,500 for 1997). Employers may make matching contributions based on employees' elective deferrals. In the case of employees, such matching contributions are not subject to the $9,500 limit on elective deferrals. Elective deferrals are subject to a special nondiscrimination test, called the average deferral percentage (ADP) test. Under the ADP test, the maximum amount of elective deferrals that can be made by highly compensated employees is based on the amount of elective deferrals made by nonhighly compensated employees. Matching contributions are subject to a similar nondiscrimination test, called the average contribution percentage (ACP) test. An employer may treat certain qualified matching contributions as elective deferrals for purposes of satisfying the ADP test.

Under present and prior law, a SIMPLE retirement plan is either an individual retirement arrangement (IRA) or part of a 401(k) plan that meets certain requirements. Under a SIMPLE retirement plan, employees can elect to make pre-tax deferrals of up to $6,000 per year. Employers are required to make either a matching contribution of up to 3% of the employee's compensation or, alternatively, the employer can elect to make a lower percentage contribution on behalf of all eligible employees. Contributions to a SIMPLE retirement plan are not subject to the ADP or ACP tests.

Under prior law, matching contributions made for a self-employed individual were generally treated as additional elective deferrals by the self-employed individual who received the matching contribution. Accordingly, elective deferrals and matching contributions for self-employed individuals were subject to the dollar limits on elective deferrals and, in the case of a 401(k) plan, treated as elective deferrals for purposes of the ADP test.

The Act provides that matching contributions for self-employed individuals are treated the same as matching contributions for employees, i.e., they are not subject to the elective deferral limits and are not treated as elective deferrals for purposes of the ADP test (unless the employer elects to treat qualified matching contributions as elective deferrals under the ADP test). The provision does not apply to qualified matching contributions that are treated as elective deferrals for purposes of satisfying the ADP test. The provision is effective for years beginning after December 31, 1997. In the case of SIMPLE retirement plans (including SIMPLE IRAs and SIMPLE 401(k)s), the provision is effective for years beginning after December 31, 1996.

Act Section 1502 (Code sec. 402) Modification of Prohibition on Assignment or Alienation.

Under present and prior law, amounts held in a qualified retirement plan for the benefit of a participant are not, except in very limited circumstances, assignable or available to personal creditors of the participant. A plan may permit a participant, at such time as benefits under the plan are in pay status, to make a voluntary revocable assignment of an amount not in excess of 10% of any benefit payment, provided the purpose is not to defray plan administration costs. In addition, a plan may comply with a qualified domestic relations order issued by a state court requiring benefit payments to former spouses or other “alternate payees” even if the participant is not in pay status.

Under prior law, no specific exception under the Employee Retirement Income Security Act of 1974, as amended (ERISA), or the Internal Revenue Code would permit the offset of a participant's benefit against the amount owed to a plan by the participant as a result of a breach of fiduciary duty to the plan or criminality involving the plan. Courts were divided in their interpretation of the prohibition on assignment or alienation in these cases. Some courts ruled that there is no exception in ERISA for the offset of a participant's benefit to make a plan whole in the case of a fiduciary breach. Other courts reached a different result and permitted an offset of a participant's benefit for breach of fiduciary duties.

The Act permits a participant's benefit in a qualified plan to be reduced to satisfy liabilities of the participant to the plan due to (1) the participant being convicted of committing a crime involving the plan, (2) a civil judgment (or consent order or decree) entered by a court in an action brought in connection with a violation of the fiduciary provisions of ERISA, or (3) a settlement agreement between the Secretary of Labor or the Pension Benefit Guaranty Corporation and the participant in connection with a violation of the fiduciary provisions of ERISA. The court order establishing such liability must require that the participant's benefit in the plan be applied to satisfy the liability. If the participant is married at the time his or her benefit under the plan is offset to satisfy the liability, spousal consent to such offset is required unless the spouse is also required to pay an amount to the plan in the judgment, order, decree or settlement or the judgment, order, decree or settlement provides a 50% survivor annuity for the spouse. An offset is includible in income on the date of the offset (except to the extent attributable to the employee's basis). The provision is effective for judgments, orders, and degrees issued, and settlement agreements entered into, on or after August 5, 1997.

Act Section 1503 (ERISA sec. 101) Elimination of Paperwork Burdens on Plans.

Under present and prior law, employers are required to prepare summary plan descriptions of employee benefit plans (SPDs) and summaries of material modifications to such plans (SMMs). The SPDs and SMMs generally provide information concerning the benefits provided by the plan and the participants'

rights and obligations under the plan. The SPDs and SMMs must be furnished to plan participants and beneficiaries. Under prior law, SPDs and SMMs had to be filed with the Secretary of Labor.

The Act eliminates the requirement that SPDs and SMMs automatically be filed with the Secretary of Labor. Employers are required to furnish these documents to the Secretary of Labor upon request. A civil penalty may be imposed by the Secretary of Labor on the plan administrator for failure to comply with such requests. The penalty is up to $100 per day of failure, up to a maximum of $1,000 per request. No penalty is imposed if the failure was due to matters reasonably outside the control of the plan administrator. The provision was effective on August 5, 1997.

Act Section 1504 (Code sec. 403(b)) Modification of Section 403(b) Exclusion Allowance to Conform to Section 415 Modifications.

Under present and prior law, annual contributions to a section 403(b) annuity cannot exceed the exclusion allowance. In general, the exclusion allowance for a taxable year is the excess, if any, of (1) 20% of the employee's includible compensation multiplied by his or her years of service, over (2) the aggregate employer contributions for an annuity excludable for any prior taxable years.

Alternatively, an employee may elect to have the exclusion allowance determined under the rules relating to a tax-qualified defined contribution plan. Tax-qualified defined contribution plans are subject to limitations on annual additions. In addition, for years beginning before January 1, 2000, an overall limit applies if an employee is a participant in both a defined contribution plan and defined benefit plan of the same employer.

The Act conforms the section 403(b) exclusion allowance to the section 415 limits by providing that includible compensation includes elective deferrals (and similar pre-tax contributions) of the employee.

The Secretary of the Treasury is directed to revise the regulations regarding the election to have the exclusion allowance determined under section 415 to reflect the fact that the overall limit on benefits and contributions is repealed. The revised regulations are to be effective for years beginning after December 31, 1999.

The modification to the definition of includible compensation is effective for years beginning after December 31, 1997. The direction to the Secretary of the Treasury is effective on August 5, 1997.

Act Section 1505 (Code secs. 401, 403(b)) Permanent Moratorium on Application of Nondiscrimination Rules to state and Local Governmental Plans.

Under present and prior law, the rules applicable to governmental plans require that such plans satisfy certain nondiscrimination and minimum participation rules. In general, the rules require that a plan not discriminate in favor of highly compensated employees with regard to the contribution and benefits

provided under the plan, participation in the plan, coverage under the plan, and compensation taken into account under the plan. The nondiscrimination rules apply to all governmental plans, qualified retirement plans (including cash or deferred arrangements (sec. 401(k) plans) in effect before May 6, 1986) and annuity plans (sec. 403(b) plans). Elective deferrals under section 401(k) plans are required to satisfy the ADP test. Employer matching and after-tax employee contributions are subject to the ACP test.

For purposes of satisfying the nondiscrimination rules, the Internal Revenue Service has issued several notices which extended the effective date for compliance for governmental plans. Under the notices, governmental plans will be required to comply with the nondiscrimination rules beginning with plan years beginning on or after the later of January 1, 1999, or 90 days after the opening of the first legislative session beginning on or after January 1, 1999, of the governing body with authority to amend the plan, if that body does not meet continuously. For plan years beginning before the extended effective date, governmental plans are deemed to satisfy the nondiscrimination requirements.

The Act provides that state and local governmental plans are permanentlyexempt from the nondiscrimination and minimum participation rules. The exemption from the nondiscrimination and participation rules includes exemption from the ADP and ACP tests. A cash or deferred arrangement under a governmental plan is treated as a qualified cash or deferred arrangement even though the ADP test is not in fact satisfied. Thus, for example, elective contributions made by a governmental employer on behalf of an employee are not treated as distributed or made available to the employee (in accordance with section 402(e)(3)).

The provision is effective for taxable years beginning on and after August 5, 1997. A governmental plan is treated as satisfying the coverage and nondiscrimination tests for taxable years beginning before August 5, 1997.

Act Section 1506 (Code Sec. 409) Clarification of Certain Rules Relating to ESOPs of S Corporations.

Under present and prior law, an S corporation can have no more than 75 shareholders. For taxable years beginning after December 31, 1997, certain tax-exempt organizations, including employee stock ownership plans (ESOPs), can be a shareholder of an S corporation.

ESOPs are generally required to make distributions in the form of employer securities. If the employer securities are not readily tradable, the employee has a right to require the employer to buy the securities. In the case of an employer whose bylaws or charter restricts ownership of substantially all employer securities to employees or a pension plan, the plan may provide that benefits are distributed in the form of cash. Such a plan may distribute employer securities, if the employee has a right to require the employer to purchase the securities. Under prior law, similar rules did not apply in the case of an ESOP maintained by an S corporation.

ESOPs are subject to certain prohibited transaction rules under the Internal Revenue Code and title I of ERISA which are designed to prohibit certain transactions between the plan and certain persons close to the plan. A number of statutory exceptions are provided to the prohibited transaction rules. Under prior law, these statutory exceptions did not apply to any transaction in which a plan (directly or indirectly) (1) lends any part of the assets of the plan to, (2) pays any compensation for personal services rendered to the plan to, or (3) acquires for the plan any property from or sells any property to a shareholder employee of an S corporation, a member of the family of such a shareholder employee, or a corporation controlled by the shareholder employee. An administrative exception from the prohibited transactions rules may be obtained from the Secretary of Labor, even if a statutory exception does not apply.

The Act provides that ESOPs of S corporations may distribute cash to plan participants. Such a plan may distribute employer securities as long as the employee has a right to require the employer to purchase the securities (as under the rules applicable to ESOPs generally). In addition, the Act provides that the statutory exceptions to the prohibited transaction rules do not fail to apply merely because a transaction involves the sale of employer securities to an ESOP maintained by an S corporation by a shareholder employee, a family member of the shareholder employee, or a corporation controlled by the shareholder employee. Thus, the statutory exemptions for such a transaction (including the exemption for a loan to the ESOP to acquire employer securities in connection with such a sale or a guarantee of such a loan) apply. The provision is effective for taxable years beginning after December 31, 1997.

Act Section 1507 (Code sec. 4972) Modification of 10% Tax on Nondeductible Contributions.

Under present and prior law, contributions to qualified pension plans are deductible within certain limits. In the case of a single-employer defined benefit plan which has more than 100 participants during the year, the maximum amount deductible is not less than the plan's unfunded current liability as determined under the minimum funding rules. Limits are also imposed on the amount of annual deductible contributions if an employer sponsors both a defined benefit plan and a defined contribution plan that covers some of the same employees. Under the combined plan limitation, the total deduction for all plans for a plan year is generally limited to the greater of (1) 25% of compensation or (2) the contribution necessary to meet the minimum funding requirements of the defined benefit plan for the year.

A 10% nondeductible excise tax is imposed on contributions that are not deductible. This excise tax does not apply to contributions to one or more defined contribution plans that are nondeductible because they exceed the combined plan deduction limit to the extent such contributions do not exceed 6% of compensation in the year for which the contribution is made.

The Act adds an additional exception to the 10% excise tax on nondeductible contributions. Under the provision, the excise tax does not apply to

contributions to one or more defined contribution plans that are not deductible because they exceed the combined plan deduction limit to the extent such contributions do not exceed the amount of the employer's matching contributions plus the elective deferral contributions to a section 401(k) plan for the taxable year for which the contributions are made. The provision is effective with respect to taxable years beginning after December 31, 1997.

Act Section 1508 (Code sec. 412) Modify Funding Requirements for Certain Plans.

Under present and prior law, defined benefit pension plans are required to meet certain minimum funding rules. Underfunded plans are required to satisfy certain faster funding requirements. In general, these additional requirements do not apply in the case of plans with a funded current liability percentage of at least 90%.

The Pension Benefit Guaranty Corporation (PBGC) insures benefits under most defined benefit pension plans in the event the plan is terminated with insufficient assets to pay for plan benefits. The PBGC is funded in part by a flat-rate premium per plan participant, and a variable rate premium based on plan underfunding.

The Act modifies the minimum funding requirements in the case of certain plans. The Act applies in the case of plans that (1) were not required to pay a variable rate PBGC premium for the plan year beginning in 1996, (2) do not, in plan years beginning after 1995 and before 2009, merge with another plan (other than a plan sponsored by an employer that was a member of the controlled group of the employer in 1996), and (3) are sponsored by a company that is engaged primarily in the interurban or interstate passenger bus service.

The provision treats a plan to which it applies as having a funded current liability percentage of at least 90% for plan years beginning after 1996 and before 2005. For plan years beginning after 2004, the funded current liability percentage will be deemed to be at least 90% if the actual funded current liability percentage is at least at certain specified levels.

The relief from the minimum funding requirements applies for plan years beginning in 2005, 2006, 2007, and 2008 only if contributions to the plan equal at least the expected increase in current liability due to benefits accruing during the plan year. The provision is effective with respect to plan years beginning after December 31, 1996.

Act Section 1509 (Code sec. 401(a)) Plans Not Disqualified Merely by Accepting Rollover Contributions

Under present and prior law, Treasury regulations provide that a qualified retirement plan that accepts rollover contributions from other plans will not be disqualified because the plan making the distribution is, in fact, not qualified at the time of the distribution if, prior to accepting the rollover, the receiving plan reasonably concluded that the distributing plan was

qualified. The receiving plan can reasonably conclude that the distributing plan was qualified if, for example, prior to accepting the rollover, the distributing plan provided a statement that the distributing plan had a favorable determination letter issued by the Internal Revenue Service. The receiving plan is not required to verify this information.

The Act directs the Secretary of the Treasury to clarify that, under its regulations protecting plans from disqualification because they receive invalid rollover contributions, it is not necessary for a distributing plan to have a determination letter in order for the administrator of the receiving plan to reasonably conclude that a contribution is a valid rollover. The provision was effective on August 5, 1997.

Act Section 1510 New technologies in Retirement Plans.

Under prior law, it was not clear if sponsors of employee benefit plans could use new technologies (telephonic response systems, computers, email) to satisfy the various ERISA requirements for notice, election, consent, record keeping, and participant disclosure.

The Act directs the Secretaries of the Treasury and Labor to issue guidance facilitating the use of new technology for plan purposes. The guidance must be designed to (1) interpret the notice, election, consent, disclosure, and time requirements (and related recordkeeping requirements) under the IRC and ERISA relating to retirement plans as applied to the use of new technologies by plan sponsors and administrators while maintaining the protection of the rights of participants and beneficiaries, and (2) clarify the extent to which written requirements under the IRC will be interpreted to permit paperless transactions. The provision was effective on August 5, 1997, and requires that the guidance be issued not later than December 31, 1998.

Current California Law (R&T Sec. 17501)

Except for tax rates and the imposition of excise taxes, California is in full conformity to the various pension provisions as of January 1, 1997. California does not have a separate program dedicated to monitoring and enforcing pension plan rules. By being fully conformed to the federal provisions, California benefits from the federal government’s monitoring and enforcement of pension plans.

California law does not contain the 10% tax on nondeductible contributions (Act section 1507). Additionally, California law does not require plans to provide “summary plan descriptions” or “summaries of material modifications” or satisfy various ERISA notice, election, consent and disclosure requirements (Act sections 1503 and 1510).

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Impact on California Revenue

Based on a minor impacts projected for the federal law changes, conforming to these changes would produce revenue losses of less than $250,000 annually beginning in 1997-8.

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

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1521-30	Miscellaneous Provisions Relating to Pensions and Other Benefits

New Federal Law

Act Section 1521 (Code sec. 412) Increase in Full Funding Limit.

Under present and prior law, defined benefit pension plans are subject to minimum funding requirements. In addition, there is a maximum limit on contributions that can be made to a plan, called the full funding limit. Under prior law, the full funding limit was generally the lesser of a plan's accrued liability and 150% of current liability. In general, current liability includes all liabilities to plan participants and beneficiaries. Current liability represents benefits accrued to date, whereas the accrued liability full funding limit is based on projected benefits. Under IRS rules, amounts that cannot be contributed because of the current liability full funding limit are amortized over 10 years.

The Act increases the 150% of current liability full funding limit as follows: 155% for plan years beginning in 1999 or 2000, 160% for plan years beginning in 2001 or 2002, 165% for plan years beginning in 2003 and 2004, and 170% for plan years beginning in 2005 and thereafter. In addition, amounts that cannot be contributed due to the current liability full funding limit are amortized over 20 years. Amounts that could not be contributed because of the prior-law current liability full funding limit and that have not been amortized as of the last day of the last plan year beginning in 1998 are amortized over this 20-year period. With respect to amortization bases remaining at the end of the 1998 plan year, the 20-year amortization period is reduced by the number of years since the amortization base had been established. No amortization is required with respect to funding methods that do not provide for amortization bases. The provision is effective for plan years beginning after December 31, 1998.

Act Section 1522(a)(2) (Code sec. 414(e) Contributions on Behalf of a Minister to a Church Plan.

Under present and prior law, contributions made to retirement plans by ministers who are self-employed are deductible to the extent such contributions do not exceed certain limitations applicable to retirement plans. These limitations include the limit on elective deferrals, the exclusion allowance, and the limit on annual additions to a retirement plan.

The Act provides that in the case of a contribution made to a church plan on behalf of a minister who is self-employed, the contribution is excludable from the income of the minister to the extent that the contribution would be excludable if the minister were an employee of a church. The provision does not alter present law under which amounts contributed for a minister in connection with section 403(b), either by the minister's actual employer or by any church or convention or association of churches that is treated as the

minister's employer under section 414(e), are excluded from the minister's income, and amounts contributed in accordance with section 403(b) by the minister (whether the minister is an employee or is self-employed) are deductible by the minister as provided in section 404 taking into account the other special rules of section 414(e). A minister will not be entitled to both an exclusion and deduction for the same contribution. The provision is effective for years beginning after December 31, 1997.

Act Section 1522(a)(3) (Code sec. 414(e)) Exclusion of Ministers from Discrimination Testing of Certain Non-Church Retirement Plans.

Under present and prior law ministers who are employed by an organization other than a church are treated as if employed by the church and may participate in the retirement plan sponsored by the church. Under prior law, if the organization also sponsored a retirement plan, such plan did not have to include the ministers as employees for purposes of satisfying the nondiscrimination rules applicable to qualified plans provided the organization was not eligible to participate in the church plan.

The Act provides that if a minister is employed by an organization other than a church and the organization is not otherwise participating in the church plan, then the minister does not have to be included as an employee under the retirement plan of the organization for purposes of the nondiscrimination rules. The provision is effective for years beginning after December 31, 1997.

Act Section 1523 (Code sec. 512) Repeal Application of UBIT to ESOPs of S Corporations.

Under present and prior law, for taxable years beginning after December 31, 1997, certain tax-exempt organizations, including ESOPs, can be a shareholder of an S corporation. Under prior law, items of income or loss of the S corporation flowed through to all qualified tax-exempt shareholders as unrelated business taxable income (UBTI), regardless of the source of the income.

The Act repeals the provision treating items of income or loss of an S corporation as unrelated business taxable income in the case of an employee stock ownership plan that is an S corporation shareholder. The repeal of such provision applies only with respect to employer securities held by an employee stock ownership plan (as defined in section 4975(e)(7) of the Code) maintained by an S corporation. The provision is effective for taxable years beginning after December 31, 1997.

Act Section 1524 (Code sec. 407(b)) Diversification in IRC Section 401(k) Plan Investments.

ERISA prohibits certain employee benefit plans from acquiring securities or real property of the employer who sponsors the plan if, after the acquisition, the fair market value of such securities and property exceeds 10% of the fair market value of plan assets. Under prior law, the 10% limitation did not apply

to any “eligible individual account plans” that specifically authorized such investments. Generally, eligible individual account plans were defined contribution plans, including plans containing a cash or deferred arrangement (401(k) plans). Under prior law, the assets of such plans could be invested in employer securities and real property without regard to the 10% limitation.

The Act provides that the term “eligible individual account plan” does not include the portion of a plan that consists of elective deferrals (and earnings on the elective deferrals) made under section 401(k) if elective deferrals equal to more than 1% of any employee's eligible compensation are required to be invested in employer securities and employer real property. Eligible compensation is compensation that is eligible to be deferred under the plan. The portion of the plan that consists of elective deferrals (and earnings thereon) is still treated as an individual account plan, and the 10% limitation does not apply, as long as elective deferrals (and earnings thereon) are not required to be invested in employer securities or employer real property.

The provision does not apply if individual account plans are a small part of the employer's retirement plans. In particular, the provision does not apply to an individual account plan for a plan year if the value of the assets of all individual account plans maintained by the employer do not exceed 10% of the value of the assets of all pension plans maintained by the employer (determined as of the last day of the preceding plan year). Multiemployer plans are not taken into account in determining whether the value of the assets of all individual account plans maintained by the employer exceed 10% of the value of the assets of all pension plans maintained by the employer. The provision does not apply to an employee stock ownership plan as defined in section 4975(e)(7).

In determining whether individual account plans are a small part of the employer's total pension plan assets, all assets of such plans (regardless of when acquired) are taken into account. Similarly, if the provision applies to the portion of a plan consisting of elective deferrals and earnings thereon (so that such portion of a plan is subject to the 10% limitation on employer securities and real property), all assets of such portion of the plan (regardless of when acquired) are taken into account in determining whether the 10% limitation is violated.

The effect of the provision is illustrated as follows. Assume the provision applies to the portion of a plan consisting of elective deferrals (and earnings thereon), so that such portion of a plan is treated as a separate plan subject to the 10% limitation on employer securities and real property, and that more than 10% of such separate plan's assets are invested in employer securities. The separate plan cannot acquire more employer securities or real property, unless the participants elect such investment.

The provision is effective with respect to elective deferrals for plan years beginning after December 31, 1998 (and earnings thereon). The provision does not apply with respect to earnings on elective deferrals for plan years beginning before January 1, 1999.

Act Section 1525 (Code sec. 401(k)) Cash or Deferred Arrangements for Irrigation and Drainage Entities.

Under present and prior law, taxable and tax-exempt employers may maintain qualified cash or deferred arrangements. Under prior law, all state and local government organizations generally were prohibited from maintaining qualified cash or deferred arrangements ("section 401(k) plans"), other than qualified cash or deferred arrangements adopted by a state or local government before May 6, 1986.

Mutual irrigation or ditch companies are exempt from tax if at least 85% of the income of the company consists of amounts collected from members for the sole purpose of meeting losses and expenses.

Under the Act, mutual irrigation or ditch companies and districts organized under the laws of a state as a municipal corporation for the purpose of irrigation, water conservation or drainage (or a national association of such organizations) are permitted to maintain qualified cash or deferred arrangements, even if the company or district is a state or local government organization. The provision is effective with respect to years beginning after December 31, 1997.

Act Section 1526 (Code sec. 415) Portability of Permissive Service Credit under Governmental Pension Plans.

Under present and prior law, limits are imposed on contributions and benefits under qualified pension plans.

In the case of a defined contribution plan, the limit on annual additions is the lesser of $30,000 or 25% of compensation. Annual additions include employer contributions, as well as after-tax employee contributions. In the case of a defined benefit pension plan, the limit on the annual retirement benefit is the lesser of (1) 100% of compensation or (2) $120,000 (indexed for inflation). The 100% of compensation limitation does not apply in the case of state and local governmental pension plans. Certain other special rules apply in the case of state and local governmental plans.

Amounts contributed by employees to a state or local governmental plan are treated as made by the employer if the employer "picks up" the contribution.

Under prior law, no special rules applied to make-up contributions by state and local government employees.

Under the Act, contributions by a participant in a state or local governmental plan to purchase permissive service credits are subject to one of two limits. Either (1) the accrued benefit derived from all contributions to purchase permissive service credit must be taken into account in determining whether the defined benefit pension plan limit is satisfied, or (2) all such contributions must be taken into account in determining whether the $30,000 limit on annual additions is met for the year (taking into account any other annual additions

of the participant). Under the first alternative, a plan will not fail to satisfy the reduced defined benefit pension plan limit that applies in the case of early retirement due to the accrued benefit derived from the purchase of permissive service credits. These limits may be applied on a participant-by-participant basis. That is, contributions to purchase permissive service credits by all participants in the same plan do not have to satisfy the same limit.

Under the Act, permissive service credit means credit for a period of service recognized by the governmental plan only if the employee voluntarily contributes to the plan an amount (as determined by the plan) which does not exceed the amount necessary to fund the benefit attributable to the period of service and which is in addition to the regular employee contributions, if any, under the plan. Section 415 is violated if more than 5 years of permissive service credit is purchased for “nonqualified service.” In addition, section 415 is violated if nonqualified service is taken into account for an employee who has less than five years of participation under the plan. Nonqualified service is service other than service (1) as a Federal, state, or local government employee, (2) as an employee of an association representing federal, state or local government employees, (3) as an employee of an educational institution which provides elementary or secondary education, or (4) for military service. Service under (1), (2) or (3) is not qualified if it enables a participant to receive a retirement benefit for the same service under more than one plan.

The Act provides that in the case of any repayment of contributions and earnings to a governmental plan with respect to an amount previously refunded upon a forfeiture of service credit under the plan (or another plan maintained by a state or local government employer within the same state), any such repayment shall not be taken into account for purposes of section 415 and service credit obtained as a result of the repayment shall not be considered permissive service credit.

The provision is not intended to affect the application of “pick up” contributions to purchase permissive service credit or the treatment of pick up contributions under section 415. The provision does not apply to purchases of service credit for qualified military service under the rules relating to veterans' reemployment rights.

The provision is effective with respect to contributions to purchase permissive service credits made in years beginning after December 31, 1997.

The Act provides a transition rule for plans that provided for the purchase of permissive service credit prior to enactment of the Act. Under this rule, the defined contribution limits will not reduce the amount of permissive service credit of an eligible participant allowed under the terms of the plan as in effect on the date of enactment. For this purpose an eligible participant is an individual who first became a participant in the plan before the first plan

year beginning after the last day of the calendar year in which the next regular session (following the date of the enactment of this Act) of the governing body with authority to amend the plan ends.

Act Section 1527 (Code sec. 415(b)) Removal of Dollar Limitation on Benefit Payments from a Defined Benefit Plan for Police and Fire Employees.

Under present and prior law, limits are imposed on the contributions and benefits under qualified pension plans. Certain special rules apply in the case of state and local governmental plans.

In the case of a defined benefit pension plan, the limit on the annual retirement benefit is the lesser of (1) 100% of compensation or (2) $125,000 (for 1997, indexed for inflation). The 100% of compensation limitation does not apply in the case of state and local governmental pension plans. In general, the dollar limit is reduced if benefits begin before social security retirement age and increased if benefits begin after social security retirement age. In the case of state and local government plans, the dollar limit is not reduced unless benefits begin before age 62 and in any case is not less than $75,000, and the dollar limit is increased if benefits begin after age 65. Under prior law, this rule applied to police and fire department employees, except that the dollar limit could not be reduced below $50,000 (indexed), regardless of the age at which benefits commenced. This special rule applied to participants (1) in a defined benefit plan of a state or local government plan, and (2) with respect to whom the period of service taken into account in determining the amount of the benefit under such plan includes at least 15 years of service of the participant as (a) a full-time employee of a police or fire department organized by a state or political subdivision to provide police protection, firefighting services, or emergency medical services or (b) as a member of the Armed Services of the United States.

Under the Act, the dollar limit on defined benefit plans does not apply to the reduction for early retirement benefits for individuals who received the special rule for certain police and fire department employees under prior law. Thus, the defined benefit plan dollar limit continues to apply, but is not reduced in the case of early retirement. As under present law, the dollar limit is increased for such employees if benefits begin after age 65. The provision is effective for years beginning after December 31, 1996.

Act Section 1528 (Code sec. 101) Survivor Benefits of Public Safety Officers Killed in the Line of Duty.

Under present and prior law, survivors of military service personnel (such as those killed in combat) are generally entitled to survivor benefits (38 U.S.C. sec. 1310). These survivor benefits are generally exempt from taxation (38 U.S.C. sec. 5301). “Survivor” means the surviving spouse or surviving dependent child of the military service personnel.

Under prior law, survivor annuity benefits paid under a governmental retirement plan to a survivor of a law enforcement officer killed in the line of duty were

generally includible in income except to the extent the benefits were a return of after-tax employee contributions. Under present and prior law, survivor benefits paid under a government plan only to survivors of officers who died as a result of injuries sustained in the line of duty are in the nature of workers' compensation and are generally excludable from income.

The Act generally provides that an amount paid as a survivor annuity on account of the death of a public safety officer who is killed in the line of duty is excludable from income to the extent the survivor annuity is attributable to the officer's service as a law enforcement officer. The survivor annuity must be provided under a governmental plan to the surviving spouse (or former spouse) of the public safety officer or to a child of the officer. Public safety officers include law enforcement officers, firefighters, rescue squad or ambulance crew. The provision does not apply with respect to the death of a public safety officer if it is determined by the appropriate supervising authority that (1) the death was caused by the intentional misconduct of the officer or by the officer's intention to bring about the death, (2) the officer was voluntarily intoxicated at the time of death, (3) the officer was performing his or her duties in a grossly negligent manner at the time of death, or (4) the actions of the individual to whom payment is to be made were a substantial contributing factor to the death of the officer.

The provision applies to amounts received in taxable years beginning after December 31, 1996, with respect to individuals dying after that date.

Act Section 1529 (Code sec. 104) Treatment of Certain Disability Payments to Public Safety Employees.

Under present and prior law, amounts received under a worker's compensation act as compensation for personal injuries or sickness incurred in the course of employment are excluded from gross income. Compensation received under a worker's compensation act by the survivors of a deceased employee also are excluded from gross income. Under prior law, no nonoccupational death and disability benefits were excludable from income as worker's compensation benefits.

Under the Act, certain payments made on behalf of full-time employees of any police or fire department organized and operated by a state (or any political subdivision, agency, or instrumentality thereof) are excludable from income. The provision applies to payments made on account of heart disease or hypertension of the employee and that were received in 1989, 1990, 1991 pursuant to a state law as amended on May 19, 1992, which irrebuttably presumed that heart disease and hypertension are work-related illnesses, but only for employees separating from service before July 1, 1992.

The Act provides that claims for refund or credit for overpayment of tax resulting from the provision could be filed up to one year after the date of enactment, without regard to the otherwise applicable statute of limitations.

The provision was effective on August 5, 1997.

Act Section 1530 (Code sec. 664) Gratuitous Transfers for the Benefit of Employees.

Under present and prior law, an ESOP is a qualified stock bonus plan or a combination stock bonus and money purchase pension plan under which employer securities are held for the benefit of employees.

Under present and prior law, a deduction is allowed for federal estate tax purposes for transfers by a decedent to charitable, religious, scientific, etc. organizations. In the case of a transfer of a remainder interest to a charity, the remainder interest must be in a charitable remainder trust. A charitable remainder trust generally is a trust that is required to pay, no less often than annually, a fixed dollar amount (charitable remainder annuity trust) or a fixed percentage of the fair market value of the trust's assets determined at least annually (charitable remainder unitrust) to noncharitable beneficiaries, and, under prior law, the remainder of the trust (i.e., after termination of the annuity or unitrust amounts) to a charitable, religious, scientific, etc. organization.

In General.

The Act permits certain limited transfers of qualified employer securities by charitable remainder trusts to ESOPs without adversely affecting the status of the charitable remainder trusts under section 664. As a result, the Act provides that a qualified gratuitous transfer of employer securities to an ESOP is deductible from the gross estate of a decedent under section 2055 to the extent of the present value of the remainder interest. In addition, an ESOP will not fail to be a qualified plan because it complies with the requirements with respect to a qualified gratuitous transfer.

Qualified Gratuitous Transfer.

In order for a transfer of securities to be a “qualified gratuitous transfer,” the following requirements must be satisfied, including the following: (1) the securities transferred to the ESOP must previously have passed from the decedent to a charitable remainder trust; (2) at the time of the transfer to the ESOP, family members of the decedent own (directly or indirectly) no more than 10% of the value of the outstanding stock of the company; (3) immediately after the transfer to the ESOP, the ESOP owns at least 60% of the value of outstanding stock of the company (the 60% requirement is determined assuming that outstanding options have been exercised); and (4) the plan meets certain requirements. In order to prevent erosion of the 60% ownership requirements, an excise tax is imposed on the employer maintaining the ESOP with respect to certain dispositions of the transferred stock within three years of the transfer.

The provision applies in cases in which the ESOP was in existence on August 1, 1996, and the decedent dies on or before December 31, 1998. The provision does not fail to apply merely because the ESOP is amended after August 1, 1996, for example, in order to conform to the requirements of the provision.

Plan Requirements.

In order for a transfer to qualify as a gratuitous transfer, the ESOP must contain certain provisions. First, the plan must provide that plan participants are entitled to direct the manner in which stock transferred are to be voted (with respect to all matters). Transferred securities that have not yet been allocated to participants must be voted by a trustee that is not a 5% owner of the company or a family member of the decedent.

Second, the plan must provide that participants have the right to receive distributions in the form of stock and that the participant can require the employer to repurchase any shares distributed under a fair valuation formula. For this purpose, a valuation formula is not considered fair if it takes into account a discount for minority interests.

Finally, the plan must provide that, if the plan is terminated before all the transferred stock has been allocated, the remaining stock is to be transferred to one or more charitable organizations. The employer is subject to an excise tax designed to recapture the estate taxes that would have been due had the transfer to the ESOP not occurred if the plan is terminated and any unallocated shares are not transferred to charitable organizations.

Treatment of Transferred Stock and Allocation Rules.

No deduction is permitted under section 404 with respect to securities transferred from the charitable remainder trust. The nondiscrimination requirements normally applicable to qualified plans must be satisfied with respect to the securities transferred. The ESOP is required to treat the securities transferred as employer securities, except for purposes of determining the amount of deductible contributions to the plan otherwise permitted by the employer. The ESOP is required to allocate the transferred securities up to the limit on contributions and benefits after allocating any other employer contributions for the year; any transferred securities that cannot be allocated because of the section 415 limits would be held in a suspense account and allocated in the same manner in subsequent years. Transferred securities are not taken into account in determining whether any other contributions satisfy the section 415 limit. Further, securities transferred to an ESOP by a charitable remainder trust cannot be allocated to the account of (1) any family member of the decedent, or (2) any employee owning more than 5% of any class of outstanding stock of the corporation issuing the securities (or a member of a controlled group of corporations) or the total value of any class of outstanding stock of any such corporation. The employer is subject to an excise tax if impermissible allocations are made.

Definition of Qualified Employer Securities.

Qualified employer securities include only employer securities (within the meaning of section 409(l), which are issued by a domestic corporation that has no outstanding stock that is readily tradable on an established securities market and that has only one class of stock.

The provision was effective with respect to transfers to an ESOP after August 5, 1997.

Current California Law (R&T Secs. 17131, 17501)

Except for tax rates and the imposition of some excise taxes California is in full conformity to the various pension provisions as of January 1, 1997.

California law is also conformed to the federal provisions as of January 1, 1997, relating to survivor benefits and disability payments

Impact on California Revenue

Based on the impact projected for the federal law changes, conforming to these changes would result in revenue losses of $3 million annually beginning with the 1998-9 fiscal year.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1531	Newborns' and Mothers' Health Protection; Mental Health Parity.

Background

The Newborns' and Mothers' Health Protection Act of 1996 amended the Employee Retirement Income Security Act (ERISA) and the Public Health Service Act to impose certain requirements on group health plans with respect to coverage of newborns and mothers, including a requirement that a group health plan cannot restrict benefits for a hospital stay in connection with childbirth for the mother or newborn to less than 48 hours following a normal vaginal delivery or less than 96 hours following a cesarean section. These provisions are effective with respect to plan years beginning on or after January 1, 1998.

The Mental Health Parity Act of 1996 amended ERISA and the Public Health Service Act to provide that group health plans that provide both medical and surgical benefits and mental health benefits cannot impose aggregate lifetime or annual dollar limits on mental health benefits that are not imposed on substantially all medical and surgical benefits. The provisions of the Mental Health Parity Act are effective with respect to plan years beginning on or after January 1, 1998, but do not apply to benefits for services furnished on or after September 30, 2001.

The Internal Revenue Code requires that group health plans meet certain requirements with respect to limitations on exclusions of preexisting conditions and that group health plans not discriminate against individuals based on health status. An excise tax of $100 per day during the period of noncompliance is imposed on the employer sponsoring the plan if the plan fails to meet these requirements. The maximum tax that can be imposed during a taxable year cannot exceed the lesser of 10% of the employer's group health plan expenses for the prior year or $500,000. No tax is imposed if the Secretary determines that the employer did not know, and exercising reasonable diligence would not have known, that the failure existed.

Under prior law, the provisions of the Newborns' and Mothers' Health Protection Act and the Mental Health Parity Act were not in the Internal Revenue Code.

New Federal Law

The Act incorporates into the Internal Revenue Code the provisions of the Newborns' and Mothers' Health Protection Act of 1996 and the Mental Health Parity Act of 1996 relating to group health plans. Failures to comply with such provisions are subject to the excise tax applicable to failures to comply with present-law group health plan requirements.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Current California Law

California law does not contain an excise tax imposed on health plans not meeting certain requirements.

Effective Date

The provisions are effective with respect to plan years beginning on or after January 1, 1998. However, the provisions relating to the Mental Health Parity Act do not apply to benefits for services furnished on or after September 30, 2001.

Impact on California Revenue

Not applicable.

TAXPAYER RELIEF ACT OF 1997
(P.L. 105-34)

Act Section	Section Title
1532	Church Plan Exception to Prohibition on Discrimination Against Individuals Based on Health Status.

Background

Under the Health Insurance Portability and Accountability Act (HIPAA), group health plans generally may not establish rules for eligibility based on any of the following factors relating to an individual or a dependent of the individual: (1) health status, (2) medical condition, (3) claims experience, (4) receipt of health care, (5) medical history, (6) genetic information, (7) evidence of insurability, or (8) disability. In addition, a group health plan may not charge an individual a greater premium based on any of such factors.

An excise tax is imposed on the failure of a group plan to satisfy the nondiscrimination rule. In general, the excise tax is imposed on the employer sponsoring the plan and is equal to $100 per day per individual as long as the plan is not in compliance. Under prior law, there were no exceptions to these rules for church plans.

New Federal Law

The Act provides that certain church plans are not treated as violating HIPAA's health plan eligibility requirements merely because the plan requires evidence of good health in order for an individual to enroll in the plan for (1) both any individual who is an employee of an employer with 10 or fewer employees and any self-employed individual or (2) any individual who enrolls after the first 90 days of eligibility under the plan. The provision applies to a church plan for a year if the plan included either of such provisions requiring evidence of good health on July 15, 1997, and at all times thereafter before the beginning of the year.

Current California Law

Except for tax rates and the imposition of excise taxes, California is in full conformity to the various pension provisions as of January 1, 1997. California does not have a separate program dedicated to monitoring and enforcing pension plan rules. By being fully conformed to the federal provisions, California benefits from the federal government’s monitoring and enforcement of pension plans. California law does not contain an excise tax imposed on health plans not meeting certain requirements.

Effective Date

The provision is effective as if included in HIPAA.

Impact on California Revenue

Not applicable.

TAXPAYER BROWSING PROTECTION ACT OF 1997
(P.L. 105-35)

Background

The Internal Revenue Code prohibits disclosure of tax returns and return information, except to the extent specifically authorized (sec. 6103). Unauthorized willful disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431).

The Internal Revenue Code does not contain explicit criminal penalty for unauthorized inspection (absent subsequent disclosure) of tax returns and return information. Such inspection is, however, explicitly prohibited by the IRS. In a recent case, an individual was convicted of violating the federal wire fraud statute (18 U.S.C. 1343 and 1346) and a Federal computer fraud statute (18 U.S.C. 1030) for unauthorized inspection. However, the U.S. First Circuit Court of Appeals overturned this conviction. (U.S. v. Czubinski, 106 F.3d 1069 (1st Cie. 1997). Unauthorized inspection of information of any department or agency of the United States (including the IRS) via computer was made a crime under 18 U.S.C. 1030 by the Economic Espionage Act of 1996. This provision does not apply to unauthorized inspection of paper documents.

New Federal Law

Act Section 2 (Code sec. 7213A) Criminal Penalties

The Act creates a new criminal penalty in the Internal Revenue Code. The penalty is imposed for willful inspection (except as authorized by the Code) of any tax return or return information by any Federal employee or IRS contractor. The penalty also applies to willful inspection (except as authorized) by any state employee or other person who acquired the tax return or return information under specific provisions of section 6103. Upon conviction, the penalty is a fine in any amount not exceeding $1,000, or imprisonment of not more than one year, or both, together with the costs of prosecution. In addition, upon conviction, an officer or employee of the United States would be dismissed from office or discharged from employment.

Act Section 3 (Code sec. 7431) Civil Damages.

The Act amends the provision providing for civil damages for unauthorized disclosure by also providing for civil damages for unauthorized inspection. Damages are available for unauthorized inspection that occurs either knowingly or by reason of negligence. Accidental or inadvertent inspection that may occur (such as, for example, by making an error in typing in a TIN) would not be subject to damages because it would not meet this standard. The Act also provides that no damages are available to a taxpayer if that taxpayer requested the inspection or disclosure.

The Act also requires that, if any person is criminally charged by indictment or information with inspection or disclosure of a taxpayer's return or return

information in violation of section 7213 (a) or (b), new section 7213A (as added by the Act), or 18 USC section 1030(a)(2)(B), the Secretary notify that taxpayer as soon as practicable of the inspection or disclosure.

Current California Law (R&T Sec. 19552)

California law makes it a misdemeanor for a member of the Franchise Tax Board, any employee of the state, or former officer or employee of the state to make an unwarranted disclosure of any information included in tax returns filed with the state. (California has no statute on unauthorized inspection of taxpayer information.)

State employees also are subject to federal misdemeanor and felony charges for unauthorized disclosures or browsing of federal information received by the Franchise Tax Board from the IRS through an exchange program.

Effective Date

The Act is effective for violations occurring on or after August 5, 1997.

Impact on California Revenue

Any collections for criminal penalties and civil damages that may result, under conformity, would be negligible based on federal projections.

SURFACE TRANSPORTATION EXTENSION ACT OF 1997
(P.L. 105-130)

Act Section	Section Title
9	Extension of Highway Trust Fund

Background

Under prior law, the Internal Revenue Code authorized expenditures (subject to appropriations) to be made from the Highway Trust Fund (HTF) through September 30, 1997, for purposes provided in specified authorizing legislation as in effect on the date of enactment of the most recent authorizing Act (the Intermodal Surface Transportation Efficiency Act of 1991).

Highway Trust Fund provisions also provided for transfer of 11.5 cents per gallon of the revenues from the excise tax imposed on motor fuels used in motorboats and off-highway recreational vehicles. Those revenues were transferred from the HTF to the Boat Safety Account of the Aquatic Resources Trust Fund (up to $70 million per year), the Land and Water Conservation Fund ($1 million per year), and the National Recreational Trails Trust Fund, respectively, through September 30, 1997. Revenues from the gasoline tax used in small engines were transferred to the Sport Fish Restoration Account of the Aquatic Resources Trust Fund through September 30, 1997. Expenditures were and are authorized from the Boat Safety Account of the Aquatic Resources Trust Fund through March 31, 1998. Expenditures were authorized from the National Recreational Trails Trust Fund through September 30, 1997.

New Federal Law (Sec. 9503, 9504(c) and 9511(c))

The Act extends the authority to make expenditures (subject to appropriations) from the HTF through September 30, 1998. The Act also updates the HTF cross reference to authorizing legislation to include expenditure purposes in this Act as in effect on the date of enactment.

In addition, the Act extends the deadline for the transfer from the HTF of revenues from the tax on gasoline and special motor fuels used in motorboats, gasoline used in small engines, and motor fuels used in off-highway recreational vehicles through September 30, 1998. Further, the Act extends the expenditure authority from the Boat Safety Account of the Aquatic Resources Trust Fund for 6 months, through September 30, 1998, and extends the expenditure authority from the National Recreational Trails Trust Fund through September 30, 1998.

Current California Law

Tax assessed on motor vehicle fuels (an excise tax) is administered by the State Board of Equalization (SBE).

SURFACE TRANSPORTATION EXTENSION ACT OF 1997 (P.L. 105-130)

Effective Date

The provision was effective on October 1, 1997.

Impact on California Revenue

Not applicable.

EXHIBIT A

EXPIRING TAX PROVISIONS

California Sunset *	Calif. Section	Federal Sunset*	Federal Section	Description and Comments
12/31/97	17053.5	N/A	N/A	Credit: Renters (no credit for 1997 but credit resumes in 1998 without any limitation based upon AGI)
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
12/31/98	19283	N/A	N/A	Collection of Amounts Due a Court
12/31/98	18152.5	Permanent	1202	Exclusion: Capital Gain on Sale of Small Business Stock
1/01/99	19290.1	N/A	N/A	Collections for the Department of Industrial Relations
1/01/99[1]	18785	N/A	N/A	Voluntary Contribution: D.A.R.E. California (Drug Abuse Resistance Education) Fund
1/01/99[1]	18804	N/A	N/A	Voluntary Contribution: California Firefighters' Memorial Fund
1/01/99[1]	18816	N/A	N/A	Voluntary Contribution: California Public School Library Protection Fund
12/31/99	25135	N/A	N/A	Apportionment Formula: Sales of Unprocessed Timber

EXHIBIT A

EXPIRING TAX PROVISIONS

California Sunset *	Calif. Section	Federal Sunset*	Federal Section	Description and Comments
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
1/01/00[2]	18715	N/A	N/A	Voluntary Contribution: Children's Trust Fund for the Prevention of Child Abuse
1/01/00[3]	18724	N/A	N/A	Voluntary Contribution: California Fund for Senior Citizens
1/01/00[3]	18766	N/A	N/A	Voluntary Contribution: Alzheimer's Disease and Related Disorders Fund
1/01/00[3]	18844	N/A	N/A	Voluntary Contribution: California Military Museum Fund
12/31/00[6]	17053.49 23649	N/A	N/A	Credit: Manufacturer’s Investment
1/01/01[3]	18796	N/A	N/A	Voluntary Contribution: California Breast Cancer Research Fund
1/01/01[5]	18824	N/A	N/A	Voluntary Contribution: Mexican American Veterans' Memorial Account
12/31/01	19568	N/A	N/A	Collection: Delinquent Student Loans
12/31/01	17053.57 23657	N/A	N/A	Credit: Community Development Financial Institution Deposits
12/31/01	17131	12/31/01	137	Deduction: Adoption Assistance
12/31/01	17502 24602	N/A	N/A	Exclusion: California Stock Options
1/01/02[1]	18744	N/A	N/A	Voluntary Contribution: Rare and Endangered Species Preservation Program
12/31/02	17053.45 23645	N/A	N/A	Credit: Sales and Use taxes paid in the LA Revitalization Zone
12/31/02	17053.46 23646	N/A	N/A	Credit: Hiring in the Local Agency Military Base Recovery Area

EXHIBIT A

EXPIRING TAX PROVISIONS

California Sunset *	Calif. Section	Federal Sunset*	Federal Section	Description and Comments
12/31/02	17268 24356.8	N/A	N/A	Deduction: Expensing business property in Local Agency Military Base Recovery Area
12/31/02	17276.2 24416.2	N/A	N/A	Deduction: Net operating losses in the Local Agency Military Base Recovery Area
12/31/07	17052.10 23610	N/A	N/A	Credit: Rice Straw

* 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 1998 return.

[2] The last return upon which this voluntary contribution will appear is the 1999 return.

[3] The last return upon which this voluntary contribution will appear is the 2000 return.

[4] The last return upon which this voluntary contribution will appear is the 2001 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.

[6] The actual date this provision expires is unknown at this time. The law provides that the credit will expire on January 1, 2001 or on January 1 of the earliest year thereafter, if the total employment in this state on the preceding January 1, does not exceed by 100,000 jobs the total employment in this state on January 1, 1994. EDD is to make this determination.