State of California
Franchise Tax Board

Summary of Federal Income Tax Changes 2008

Laws Affected

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

Revised April 24, 2009

Summary of Federal Income Tax Changes 2008

Prepared by the Staff of the

Franchise Tax Board

STATE OF CALIFORNIA

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

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TABLE OF CONTENTS

TABLE OF CONTENTS

TABLE OF CONTENTS

TABLE OF CONTENTS

TABLE OF CONTENTS

TABLE OF CONTENTS

TABLE OF CONTENTS

TABLE OF CONTENTS

EXECUTIVE SUMMARY

FEDERAL INCOME TAX CHANGES - 2008

Prepared by the Staff of the
Franchise Tax Board
State of California

During 2008, the Internal Revenue Code or its application by California was changed by:

PUBLIC LAW	TITLE
110-185	Economic Stimulus Act of 2008 (February 13, 2008)
110-246 (repealed Public Law 110-234)	Heartland, Habitat, Harvest and Horticulture Act of 2008 (TITLE XV – Trade and Tax Provisions PL 110-234, June 18, 2008)
110-245	Heroes Earnings Assistance and Relief Act of 2008 (June 17, 2008)
110-289	Housing and Economic Recovery Act of 2008 (July 30, 2008)
110-343	Emergency Economic Stabilization Act of 2008
110-458	Worker, Retiree, and Employer Recovery Act of 2008 (December 23, 2008)
110-181, 110-190, 110-233, 110-244, 110-252, 110-253, 110-287, 110-428	2008 Miscellaneous Federal Acts Impacting the Internal Revenue Code (IRC) Not Requiring a California Response

This report explains the new federal laws along with the effective dates, the 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 federal changes. This report also contains citations to the section numbers of federal Public Law (PL), the Internal Revenue Code (IRC), and the California Revenue and Taxation Code (R&TC) impacted by the federal changes.

Following is a list of California tax provisions that expire in 2008. See Exhibit B for a complete listing of expiring provisions in California law.

California Sunset*	California Section	Federal Section	Federal Sunset	Description and Comments
06/30/08	17053.30 23630	N/A	N/A	Credit: Natural Heritage Preservation
12/31/08	17255.5 24356.4	179B	Permanent	Deduction: Expensing of Capital Costs Incurred by Certain Refiners
12/31/08	17144.5	108	12/31/2012	Discharge of Indebtedness on Principal Residence
12/31/08	21028	Title 31	Permanent	Taxpayers' Bill of Rights: Confidentiality/Taxpayer Communications

*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 repeal date of the section is listed or the expiration applies to transactions occurring after this date.

This report contains the following exhibits:

Exhibit A 2008 Miscellaneous Federal Acts Impacting the IRC Not Requiring A California Response.
This exhibit contains a short explanation of the federal change where that change is either not administered by the Franchise Tax Board or not applicable to California.

Exhibit B Complete listing of expiring provisions in California law.

Exhibit C Revenue tables.

ECONOMIC STIMULUS ACT OF 2008 (ESA)(PL 110-185, FEBRUARY 13, 2008)

TITLE I – RECOVERY REBATES AND INCENTIVES FOR BUSINESS INVESTMENT

<u>Section</u>	<u>Section Title</u>
101	Recovery Rebates for Individual - 2008

<u>Background</u>

In general, under the federal individual income tax system, an individual who is a citizen or a resident of the United States generally is subject to tax on worldwide taxable income. Taxable income is total gross income less certain exclusions, exemptions, and deductions.

An individual may claim either a standard deduction or itemized deductions. An individual's income tax liability is determined by computing his or her regular income tax liability and, if applicable, alternative minimum tax liability.

Income tax liability

Regular income tax liability is determined by applying the regular income tax rate to the individual's taxable income. This tax liability is then reduced by any applicable tax credits. The regular income tax rate schedules are divided into several ranges of income, known as income brackets, and the marginal tax rate increases as the individual's income increases. The income bracket amounts are adjusted annually for inflation. Separate rate schedules apply based on filing status:

- Single individuals (other than heads of households and surviving spouses).
- Heads of households, married individuals filing joint returns (including surviving spouses).
- Married individuals filing separate returns, and estates and trusts.

Lower rates may apply to capital gains. A taxpayer may also be subject to an alternative minimum tax.

Child tax credit

An individual may claim a tax credit of $1,000 for each qualifying child under the age of 17. Generally, a qualifying child must have the same principal place of abode as the taxpayer for more than one-half the taxable year and satisfy a relationship test. To satisfy the relationship test, the child must be the taxpayer's son, daughter, stepson, stepdaughter, brother, sister, stepbrother, stepsister, or a descendant of any such individual. The credit is phased-out at higher income levels. A child who is not a citizen, national, or resident of the United States may not be a qualifying child. No credit is allowed unless the individual includes the name and taxpayer identification number of each qualifying child on the income tax return.

Earned income credit

Low and moderate-income workers may be eligible for the refundable earned income credit (EIC). Eligibility for the EIC is based on earned income, adjusted gross income, investment income, filing status, and immigration and work status in the United States. The amount of the EIC is based on the presence and number of qualifying children in the worker's family, as well as on adjusted gross income and earned income. Earned income is defined as (1) wages, salaries, tips, and other employee compensation, but only if such amounts are includible in gross income, plus (2) the amount of the individual's net self-employment earnings.

<u>New Federal Law (IRC sections 1, 6211, 6213, 6411, and 6428)</u>

In general

The provision includes a recovery rebate credit for 2008 that is refundable. The credit mechanism (and the issuance of checks described below) is intended to deliver an expedited fiscal stimulus to the economy. The credit is computed with two components in the following manner.

Basic credit

Eligible individuals receive a basic credit (for the first taxable year beginning) in 2008 equal to the greater of the following:

- Net income tax liability not to exceed $600 ($1,200 in the case of a joint return).
- $300 ($600 in the case of a joint return) if:
    1) the eligible individual has qualifying income of at least $3,000; or
    2) the eligible individual has a net income tax liability of at least $1 and gross income greater than the sum of the applicable basic standard deduction amount and one personal exemption (two personal exemptions for a joint return).

An eligible individual is any individual other than: (1) a nonresident alien; (2) an estate or trust; or (3) a dependent.

For these purposes, "net income tax liability" means the excess of the sum of the individual's regular tax liability and alternative minimum tax over the sum of all nonrefundable credits (other than the child credit). Net income tax liability as determined for these purposes is not reduced by the credit added by this provision or any credit that is refundable under present law.

Qualifying income is the sum of the eligible individual's: (a) earned income; (b) social security benefits (within the meaning of sec. 86(d)); and (c) veteran's payments (under Chapters 11, 13, or 15 of title 38 of the U. S. Code).

The definition of earned income has the same meaning as used in the earned income credit except that it includes certain combat pay and does not include net earnings from self-employment, which are not taken into account in computing taxable income.

Qualifying child credit

If an individual is eligible for any amount of the basic credit, the individual also may be eligible for a qualifying child credit. The qualifying child credit equals $300 for each qualifying child of such individual. For these purposes, the child credit definition of qualifying child applies.

Limitation based on adjusted gross income

The amount of the credit (i.e., the sum of the amounts of the basic credit and the qualifying child credit) is phased out at a rate of five percent of adjusted gross income above certain income levels. The beginning point of this phase-out range is $75,000 of adjusted gross income ($150,000 in the case of joint returns).

Valid identification numbers

No credit is allowed to an individual who does not include a valid identification number on the individual's income tax return. In the case of a joint return, which does not include valid identification numbers for both spouses, no credit is allowed. In addition, a child shall not be taken into account in determining the amount of the credit if a valid identification number for the child is not included on the return. For this purpose, a valid identification number means a social security number issued to an individual by the Social Security Administration. A taxpayer identification number issued by the Internal Revenue Service is not a valid identification number for purposes of this credit (e.g., an ITIN).

If an individual fails to provide a valid identification number, the omission is treated as a mathematical or clerical error. As under present law, the Internal Revenue Service (the "IRS") may summarily assess additional tax due as a result of a mathematical or clerical error without sending the taxpayer a notice of deficiency and giving the taxpayer an opportunity to petition the Tax Court. Where the IRS uses the summary assessment procedure for mathematical or clerical errors, the taxpayer must be given an explanation of the asserted error and given 60 days to request that the IRS abate its assessment.

ECONOMIC STIMULUS ACT OF 2008 (ESA)
(PL 110-185, FEBRUARY 13, 2008)

Rebate checks

Most taxpayers will receive this credit in the form of a check issued by the Department of the Treasury.[1] The amount of the payment will be computed in the same manner as the credit, except that it will be done on the basis of tax returns filed for 2007 (instead of 2008). It is anticipated that the Department of the Treasury will make every effort to issue all payments as rapidly as possible to taxpayers who timely file their 2007 tax returns. (Taxpayers who file late or pursuant to extensions will receive their payments later.)

Taxpayers will reconcile the amount of the credit with the payment they receive in the following manner. They will complete a worksheet calculating the amount of the credit based on their 2008 income tax return. They will then subtract from the credit the amount of the payment they received in 2008. For many taxpayers, these two amounts will be the same. If, however, the result is a positive number (because, for example, the taxpayer paid no tax in 2007 but is paying tax in 2008), the taxpayer may claim that amount as a refundable credit against 2008 tax liability. If, however, the result is negative (for example, the taxpayer paid tax in 2007 but owes no tax for 2008), the taxpayer is not required to repay that amount to the Treasury. Otherwise, the checks have no effect on tax returns filed for 2008; the amount is not includible in gross income, and it does not otherwise reduce the amount of withholding.

In no event may the Department of the Treasury issue checks after December 31, 2008. This is designed to prevent errors by taxpayers who might claim the full amount of the credit on their 2008 tax returns and file those returns early in 2009, at the same time the Treasury check might be mailed to them. Payment of the credit (or the check) is treated, for all purposes of the IRC, as a payment of tax. Any resulting overpayment under this provision is subject to the refund offset provisions, such as those applicable to past-due child support under section 6402 of the IRC.

Examples of rebate determination

The following examples show the rebate amounts as calculated from the taxpayer’s 2007 tax return:

Example 1.–A single taxpayer has $14,000 in Social Security income, no qualifying children, and no net tax liability prior to the application of refundable credits and the child credit. The taxpayer will receive a rebate of $300 for meeting the qualifying income test.

Example 2.–A head of household taxpayer has $4,000 in earned income, one qualifying child, and no net tax liability prior to the application of refundable credits and the child credit. The taxpayer will receive a rebate of $600, comprising $300 for meeting the qualifying income test, and $300 per child.

[1] To the extent practicable, the Department of the Treasury is expected to utilize individuals’ current direct deposit information in its possession to expedite delivery of these amounts rather than the mailing of rebate checks.

Example 3.–A married taxpayer filing jointly has $4,000 in earned income, one qualifying child, and no net tax liability prior to the application of refundable credits and the child credit. The taxpayer will receive a rebate of $900, comprising $600 for meeting the qualifying income test, and $300 per child.

Example 4.–A married taxpayer filing jointly has $2,000 in earned income, one qualifying child, and $1,100 in net tax liability (resulting from other unearned income) prior to the application of refundable credits and the child credit (the taxpayer's actual liability after the child credit is $100). The qualifying income test is not met, but the taxpayer has net tax liability for purposes of determining the rebate of $1,100. The taxpayer will receive a rebate of $1,400, comprising $1,100 of net tax liability, and $300 per child.

Example 5.–A married taxpayer filing jointly has $40,000 in earned income, two qualifying children, and a net tax liability of $1,573 prior to the application of refundable credits and child credits (the taxpayer's actual tax liability after the child credit is -$427). The taxpayer meets the qualifying income test and the net tax liability test. The taxpayer will receive a rebate of $1,800, comprising $1,200 (greater of $600 or net tax liability not to exceed $1,200), and $300 per child.

Example 6.–A married taxpayer filing jointly has $175,000 in earned income, two qualifying children, and a net tax liability of $31,189 (the taxpayer's actual liability after the child credit also is $31,189 as the joint income is too high to qualify). The taxpayer meets the qualifying income test and the net tax liability test. The taxpayer will, in the absence of the rebate phase-out provision, receive a rebate of $1,800, comprising $1,200 (greater of $600 or net tax liability not to exceed $1,200), and $300 per child. The phase-out provision reduces the total rebate amount by five percent of the amount by which the taxpayer's adjusted gross income exceeds $150,000. Five percent of $25,000 ($175,000 minus $150,000) equals $1,250. The taxpayer's rebate is thus $1,800 minus $1,250, or $550.

Treatment of the United State (U.S.) possessions

Mirror code possessions[2]

The U.S. Treasury will make a payment to each mirror code possession in an amount equal to the aggregate amount of the credits allowable by reason of the provision to that possession's residents against its income tax. This amount will be determined by the Treasury Secretary based on information provided by the government of the respective possession. For purposes of this payment, a possession is a mirror code possession if the income tax liability of residents of the possession under that possession's income tax system is determined by reference to the U.S. income tax laws as if the possession were the United States.

[2] Possessions with mirror code tax systems are the United States Virgin Islands, Guam, and the Commonwealth of the Northern Mariana Islands.

Non-mirror code possessions[3]

To each possession that does not have a mirror code tax system, the U.S. Treasury will make a payment in an amount estimated by the Secretary as being equal to the aggregate credits that would have been allowed to residents of that possession if a mirror code tax system had been in effect in that possession. Accordingly, the amount of each payment to a non-mirror IRC possession will be an estimate of the aggregate amount of the credits that would be allowed to the possession's residents if the credit provided by the provision to U.S. residents were provided by the possession to its residents. This payment will not be made to any U.S. possession unless that possession has a plan that has been approved by the Secretary under which the possession will promptly distribute the payment to its residents.

General rules

No credit against U.S. income taxes is permitted under the provision for any person to whom a credit is allowed against possession income taxes as a result of the provision (for example, under that possession's mirror income tax). Similarly, no credit against U.S. income taxes is permitted for any person who is eligible for a payment under a non-mirror code possession's plan for distributing to its residents the payment described above from the U.S. Treasury.

For purposes of the rebate credit payment, the Commonwealth of Puerto Rico and the Commonwealth of the Northern Mariana Islands are considered possessions of the United States.

For purposes of the rule permitting the Treasury Secretary to disburse appropriated amounts for refunds due from certain credit provisions of the Internal Revenue Code of 1986, the payments required to be made to possessions under the provision are treated in the same manner as a refund due from the recovery rebate credit.

Effective Date

The provision applies to taxable years beginning after December 31, 2007.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

[3] Possessions that do not have mirror code tax systems are Puerto Rico and American Samoa.

ECONOMIC STIMULUS ACT OF 2008 (ESA)
(PL 110-185, FEBRUARY 13, 2008)

Section	Section Title
102	Temporary Increase in Limitation on Expensing of Certain Depreciable Business Assets

Background

A taxpayer that satisfies limitations on annual investment may elect under IRC section 179 to deduct (or "expense") the cost of qualifying property, rather than to recover such costs through depreciation deductions.[4] For taxable years beginning in 2008, the maximum amount that a taxpayer may expense is $128,000 of the cost of qualifying property placed in service for the taxable year. The $128,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $510,000.[5] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Off-the-shelf computer software placed in service in taxable years beginning before 2011 is treated as qualifying property.

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under IRC section 38 is allowed with respect to any amount for which a deduction is allowed under IRC section 179. An expensing election is made under rules prescribed by the Secretary. An expensing election is made under rules prescribed by the Secretary. For taxable years beginning in 2011 and thereafter, other rules apply.[6]

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[4] Additional IRC section 179 incentives are provided with respect to qualified property meeting applicable requirements that is used by a business in an empowerment zone (IRC section 1397A), a renewal community (IRC section 1400J), or the Gulf Opportunity Zone (IRC section 1400N(e)).

[5] Amounts applicable for 2008 are set forth in Rev. Proc. 2007-66, 2007-45 I.R.B. 970. Present law provides that the maximum amount a taxpayer may expense, for taxable years beginning in 2007 through 2010, is $125,000 of the cost of qualifying property placed in service for the taxable year. The $125,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $500,000. The $125,000 and $500,000 amounts are indexed for inflation in taxable years beginning after 2007 and before 2011.

[6] Under the rules in effect for taxable years beginning in 2011 and thereafter, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. The $25,000 and $200,000 amounts are not indexed. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business (not including off-the-shelf computer software). An expensing election may be revoked only with consent of the Commissioner (IRC section 179(c)(2)).

ECONOMIC STIMULUS ACT OF 2008 (ESA)
(PL 110-185, FEBRUARY 13, 2008)

New Federal Law (IRC section 179)

The provision increases the $128,000 and $510,000 amounts under IRC section 179 for taxable years beginning in 2008 to $250,000 and $800,000, respectively. The $250,000 and $800,000 amounts are not indexed for inflation.

Effective Date

The provision is effective for taxable years beginning after December 31, 2007.

California Law (R&TC sections 17255 and 24356)

California law, as it relates to the IRC Section 179 deduction, conforms to federal law as of the "specified date" of January 1, 2005, with significant exceptions. California law does not conform to the increased expense amount and instead both corporate and non-corporate taxpayers with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision.) Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations.).

Impact on California Revenue

Not applicable.

Section	Section Title
103	Special Allowance for Certain Property Acquired During 2008

Background

A taxpayer is allowed to recover through annual depreciation deductions the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property range from 3 to 25 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the taxpayer's depreciation deduction would be maximized.

IRC section 280F limits the annual depreciation deductions with respect to certain passenger automobiles to specified dollar amounts, indexed for inflation.

IRC section 167(f)(1) provides that capitalized computer software costs, other than computer software to which IRC section 197 applies, are recovered ratably over 36 months.

A taxpayer that satisfies limitations on annual investment may elect under IRC section 179 to deduct (or "expense") the cost of qualifying property, rather than to recover such costs through depreciation deductions.[7]

For taxable years beginning in 2008, the maximum amount that a taxpayer may expense is $128,000 of the cost of qualifying property placed in service for the taxable year. The $128,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $510,000.[8]
In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Off-the-shelf computer software placed in service in taxable years beginning before 2011 is treated as qualifying property. For taxable years beginning in 2011 and thereafter, other rules apply.[9]

<u>New Federal Law (IRC sections 168(k), 1400L, and 1400N)</u>

The provision allows an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified property.[10] The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in

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[7] Additional IRC section 179 incentives are provided with respect to qualified property meeting applicable requirements that is used by a business in an empowerment zone (IRC section 1397A), a renewal community (IRC section 1400J), or the Gulf Opportunity Zone (IRC section 1400N(e)).

[8] Amounts applicable for 2008 are set forth in Rev. Proc. 2007-66, 2007-45 I.R.B. 970. Present law provides that the maximum amount a taxpayer may expense, for taxable years beginning in 2007 through 2010, is $125,000 of the cost of qualifying property placed in service for the taxable year. The $125,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $500,000. The $125,000 and $500,000 amounts are indexed for inflation in taxable years beginning after 2007 and before 2011.

[9] Under the rules in effect for taxable years beginning in 2011 and thereafter, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. The $25,000 and $200,000 amounts are not indexed. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business (not including off-the-shelf computer software). An expensing election may be revoked only with consent of the Commissioner (IRC section 179(c)(2)).

[10] IRC section 168(k) is amended. Additionally, the additional first-year depreciation deduction is subject to the general rules regarding whether an item is deductible under IRC section 162 or instead is subject to capitalization under IRC section 263 or IRC section 263A.

which the property is placed in service.[11] The basis of the property and the depreciation allowances in the year the property is placed in service and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there are no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. The amount of the additional first-year depreciation deduction is not affected by a short taxable year. The taxpayer may elect out of additional first-year depreciation for any class of property for any taxable year.

The interaction of the additional first-year depreciation allowance with the otherwise applicable depreciation allowance may be illustrated as follows. Assume that in 2008, a taxpayer purchases new depreciable property and places it in service.[12] The property's cost is $1,000, and it is five-year property subject to the half-year convention. The amount of additional first-year depreciation allowed under the provision is $500. The remaining $500 of the cost of the property is deductible under the rules applicable to five-year property. Thus, 20 percent, or $100, is also allowed as a depreciation deduction in 2008. The total depreciation deduction with respect to the property for 2008 is $600. The remaining $400 cost of the property is recovered under otherwise applicable rules for computing depreciation.

For property to qualify for the additional first-year depreciation deduction, it must meet all of the following requirements. First, the property must be (1) property to which MACRS applies with an applicable recovery period of 20 years or less, (2) water utility property (as defined in IRC section 168(e)(5)), (3) computer software other than computer software covered by IRC section 197, or (4) qualified leasehold improvement property (as defined in IRC section 168(k)(3)).[13] Second, the original use[14] of the property must commence with the taxpayer after December 31, 2007.[15] Third, the taxpayer must purchase the property within the applicable time period. Finally, the property must be placed in service after December 31, 2007, and before January 1, 2009. An extension of the placed in service date of one year (i.e., to January 1, 2010) is provided for certain property with a recovery period of 10 years or longer and certain transportation property.[16] Transportation property is defined as tangible personal property used in the trade or business of transporting persons or property. Special rules, including an extension of the placed-in-service date of one year (i.e., to January 1, 2010), also apply to certain aircraft.

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[11] However, the additional first-year depreciation deduction is not allowed for purposes of computing earnings and profits.

[12] Assume that the cost of the property is not eligible for expensing under IRC section 179.

[13] A special rule precludes the additional first-year depreciation deduction for any property that is required to be depreciated under the alternative depreciation system of MACRS.

[14] The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer.

[15] A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property would be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback.

[16] For property to qualify for the extended placed in service date, the property is required to have an estimated production period exceeding one year and a cost exceeding $1 million.

The applicable time period for acquired property is (1) after December 31, 2007, and before January 1, 2009, but only if no binding written contract for the acquisition is in effect before January 1, 2008, or (2) pursuant to a binding written contract which was entered into after December 31, 2007, and before January 1, 2009.[17] With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after December 31, 2007, and before January 1, 2009. Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer. For property eligible for the extended placed in service date, a special rule limits the amount of costs eligible for the additional first year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred before January 1, 2009, ("progress expenditures") is eligible for the additional first-year depreciation.[18] Property does not qualify for the additional first-year depreciation deduction when the user of such property (or a related party) would not have been eligible for the additional first year depreciation deduction if the user (or a related party) were treated as the owner. For example, if a taxpayer sells to a related party property that was under construction prior to January 1, 2008, the property does not qualify for the additional first-year depreciation deduction. Similarly, if a taxpayer sells to a related party property that was subject to a binding written contract prior to January 1, 2008, the property does not qualify for the additional first-year depreciation deduction. As a further example, if a taxpayer (the lessee) sells property in a sale-leaseback arrangement, and the property otherwise would not have qualified for the additional first-year depreciation deduction if it were owned by the taxpayer-lessee, then the lessor is not entitled to the additional first-year depreciation deduction.

The limitation on the amount of depreciation deductions allowed with respect to certain passenger automobiles (IRC section 280F) is increased in the first year by $8,000 for qualifying automobiles (and do not elect out of the increased first year deduction). The $8,000 increase is not indexed for inflation.

Effective Date

The provision is effective for property placed in service after December 31, 2007.

California Law (R&TC sections 17201, 17250 and 24349-24366)

Under the Personal Income Tax Law (PITL), California law conforms to IRC section 168, relating to MACRS, as of the "specified date" of January 1, 2005, with certain modifications. California specifically does not conform to IRC section 168(k), which allows 30% and 50% bonus depreciation for certain property. California did not conform to the American Jobs

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[17] Property does not fail to qualify for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to January 1, 2008.

[18] For purposes of determining the amount of eligible progress expenditures, it is intended that rules similar to IRC section 46(d)(3) as in effect prior to the Tax Reform Act of 1986 shall apply.

Creation Act (AJCA) of 2004 changes to IRC section 168 that specifically provided a statutory recovery period for depreciation of certain restaurant property and leasehold improvements.

Under the Corporation Tax Law (CTL), California does not conform to IRC section 168, relating to MACRS depreciation. Instead, the CTL is in substantial conformity to the pre-1981 federal asset depreciation range (ADR) deduction. The ADR is based on the "useful life" of depreciable property. The CTL has specified a useful life of seven years for certain motorsport entertainment complexes and natural gas pipelines located in Alaska. For California purposes, natural gas pipelines have a "useful life" of 22 years.

Prior to the adoption of the accelerated cost recovery system (ACRS) by the Economic Recovery Tax Act (ERTA) of 1981, taxpayers were allowed to depreciate (under the ADR) the various components of a building as separate assets with separate useful lives. The CTL has not conformed to the repeal of the use of component depreciation, as ACRS, originally enacted by ERTA, was never adopted in the CTL. Similarly, the CTL did not adopt the MACRS depreciation rules for corporations that were enacted in the Tax Reform Act of 1986, which also denied the use of component depreciation under MACRS. Thus, the CTL still allows the use of component depreciation.

Impact on California Revenue

Not applicable.

HEARTLAND, HABITAT, HARVEST, AND HORTICULTURE ACT OF 2008 (HHHHA)(PL 110-246, JUNE 18, 2008)

TITLE XV – TRADE AND TAX PROVISIONS
SUBTITLE B - REVENUE PROVISIONS FOR AGRICULTURE PROGRAMS

Section	Section Title
15202	Time for Payment of Corporate Estimated Taxes

Background

In general

In general, corporations are required to make quarterly estimated tax payments of their income tax liability. For a corporation whose taxable year is a calendar year, these estimated tax payments must be made by April 15, June 15, September 15, and December 15.

Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA")

The uncodified provision in the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA") provides that in case of a corporation with assets of at least $1 billion, payments due in July, August, and September, 2006, shall be increased to 105% of the payment otherwise due and the next required payment shall be reduced accordingly.

In the case of a corporation with assets of at least $1 billion, the payments due in July, August, and September, 2012, shall be increased to 106.25% of the payment otherwise due and the next required payment shall be reduced accordingly.

In the case of a corporation with assets of at least $1 billion, the payments due in July, August, and September, 2013, shall be increased to 100.75% of the payment otherwise due and the next required payment shall be reduced accordingly.

New Federal Law (IRC section 6655)

For corporation with assets of at least $1 billion, the payments due in July, August, and September, 2012, the applicable percentage is increased by 7.75%.

Effective Date

This provision is effective on June 18, 2008.

California Law (R&TC sections 19142 – 19150, inclusive)

The CTL does not conform to IRC section 6655 by reference, but instead has its own stand-alone rules for estimated tax payments that parallel federal law. In general, corporations are required to make quarterly estimated tax payments of their California tax liability. For a corporation whose taxable year is a calendar year, these estimated tax payments must be made by April 15, June 15, September 15, and December 15.

Impact on California Revenue

Not applicable.

SUBTITLE C – TAX PROVISIONS
PART I – CONSERVATION
SUBPART A – LAND AND SPECIES PRESERVATION PROVISIONS

Section	Section Title
15301	Exclusion of Conservation Reserve Program Payments from SECA Tax for Certain Individuals

Background

Generally, the Self-Employment Contributions Act (''SECA'') tax is imposed on an individual's net earnings from self-employment income within the social security wage base. Net earnings from self-employment generally mean gross income (including the individual's net distributive share of partnership income) derived by an individual from any trade or business carried on by the individual less applicable deductions.[19]

According to the Senate Report 110-206, the correct measurement of income for SECA purposes in the cases of retired or disabled individuals does not include conservation reserve program payments.

New Federal Law (IRC section 1402)

The provision excludes conservation reserve program payments from self-employment income for purpose of SECA tax in the case of individuals who are receiving social security retirement or disability benefits. The treatment of conservation reserve program payments received by other entities is not changed.

[19] IRC section 1402.

Effective Date

This provision shall apply to contributions made in taxable years beginning after December 31, 2007.

California Law

California employment taxes are administered by the Employment Development Department (EDD) and not the Franchise Tax Board.

Impact on California Revenue

Defer to EDD.

Section	Section Title
15302	Two-Year Extension of Special Rule Encouraging Contributions of Capital Gain Real Property for Conservation Purposes

Background

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. The amount of deduction generally equals the fair market value of the contributed property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes.[20]

In general, in any taxable year, charitable contributions by a corporation are not deductible to the extent the aggregate contributions exceed 10% of the corporation's taxable income, computed without regard to net operating or capital loss carrybacks. For individuals, the amount deductible is a percentage of the taxpayer's contribution base, which is the taxpayer's adjusted gross income computed without regard to any net operating loss carry-back. The applicable percentage of the contribution base varies depending on the type of donee organization and property contributed. Cash contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private non-operating foundations, may not exceed 50% of the taxpayer's contribution base. Cash contributions to private foundations and certain other organizations generally may be deducted up to 30% of the taxpayer's contribution base.

[20] IRC sections 170, 2055, and 2522, respectively.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity while also either retaining an interest in that property or transferring an interest in that property to a non-charity for less than full and adequate consideration. Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property, and qualified conservation contributions.

Capital gain property

Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property to a qualified charity are deductible at fair market value within certain limitations. Contributions of capital gain property to charitable organizations described in IRC section 170(b)(1)(A) (e.g., public charities, private foundations other than private non-operating foundations, and certain governmental units) generally are deductible up to 30% of the taxpayer's contribution base. An individual may elect, however, to bring all these contributions of capital gain property for a taxable year within the 50% limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of capital gain property to charitable organizations described in IRC section 170(b)(1)(B) (e.g., private non-operating foundations) are deductible up to 20% of the taxpayer's contribution base.

For purposes of determining whether a taxpayer's aggregate charitable contributions in a taxable year exceed the applicable percentage limitation, contributions of capital gain property are taken into account after other charitable contributions. Contributions of capital gain property that exceed the percentage limitation may be carried forward for five years.

Qualified conservation contributions

Qualified conservation contributions are not subject to the "partial interest" rule, which generally bars deductions for charitable contributions of partial interests in property. A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property. Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated

federal, state, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.
Qualified conservation contributions of capital gain property are subject to the same limitations and carryover rules of other charitable contributions of capital gain property.

Under the Pension Protection Act of 2006 (PPA), the 30% contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions. Instead, individuals may deduct the fair market value of any qualified conservation contribution to an organization described in IRC section 170(b)(1)(A) to the extent of the excess of 50% of the contribution base over the amount of all other allowable charitable contributions. These contributions are not taken into account in determining the amount of other allowable charitable contributions.

Individuals are allowed to carry over any qualified conservation contributions that exceed the 50% limitation for up to 15 years.

For example, assume an individual with a contribution base of $100 makes a qualified conservation contribution of property with a fair market value of $80 and makes other charitable contributions subject to the 50% limitation of $60. The individual is allowed a deduction of $50 in the current taxable year for the non-conservation contributions (50% of the $100 contribution base) and is allowed to carry over the excess $10 for up to 5 years. No current deduction is allowed for the qualified conservation contribution, but the entire $80 qualified conservation contribution may be carried forward for up to 15 years.

Farmers and ranchers

Individuals

In the case of an individual who is a qualified farmer or rancher for the taxable year in which the contribution is made, a qualified conservation contribution is allowable up to 100% of the excess of the taxpayer's contribution base over the amount of all other allowable charitable contributions.

In the above example, if the individual is a qualified farmer or rancher, in addition to the $50 deduction for non-conservation contributions, an additional $50 for the qualified contribution is subject to the 100% limitation.

Corporations

In the case of a corporation (other than a publicly traded corporation) that is a qualified farmer or rancher for the taxable year in which the contribution is made, any qualified conservation contribution is allowable up to 100% of the excess of the corporation's taxable income (as computed under IRC section 170(b)(2)) over the amount of all other allowable charitable contributions. Any excess may be carried forward for up to 15 years as a contribution subject to the 100% limitation.

Requirement that land be available for agriculture or livestock production

As an additional condition of eligibility for the 100% limitation, with respect to any contribution of property in agriculture or livestock production, or that is available for such production, by a qualified farmer or rancher, the qualified real property interest must include a restriction that the property remains generally available for such production. (There is no requirement as to any specific use in agriculture or farming, or necessarily that the property be used for such purposes, merely that the property remain available for such purposes). Such additional condition does not apply to contributions made after December 31, 2005, and on or before August 17, 2006.

Definition

A qualified farmer or rancher means a taxpayer whose gross income from the trade of business of farming (within the meaning of IRC section 2032A(e)(5)) is greater than 50% of the taxpayer's gross income for the taxable year.

<u>New Federal Law (IRC section 170)</u>

The provisions added by the PPA applying to real property contributions for conservation purposes by individuals, and also the provisions specifically targeted at conservation contributions made by qualified individual farmers and ranchers, are extended through December 31, 2009, (IRC section 170(b)(1)(E)(vi), and the Pension Protection provisions applying to conservation contributions by corporate farmers and ranchers are extended through December 31, 2009, (IRC section 170(b)(2)(B)(iii).

<u>Effective Date</u>

This provision is effective for contributions made in taxable years beginning after December 31, 2007.

California Law (R&TC sections 17024.5(b)(3), 17201, 17275.5, 23051.5(b)(3), and 24357 – 24357.9)

The PITL conforms by reference to IRC section 170, relating to charitable contributions, in R&TC section 17201, as of the “specified date” of January 1, 2005, with modifications in 17275.5. Under the CTL, California has stand alone law in R&TC sections 24357 – 24357.9 providing for charitable contributions for corporations, with two instances where specific rules contained in IRC section 170 are specifically made applicable as of the “specified date” of January 1, 2005. Under the CTL, R&TC sections 24357.2 and 24357.7 provide stand-alone law providing rules that parallel the federal rules for qualified conservation contributions.

California has not conformed to the charitable contribution provisions contained in the Katrina Emergency Tax Relief Act of 2005, TIPRA, or the PPA in either the PITL or the CTL.

Impact on California Revenue

Estimated Revenue Impact of Two-Year Extension of Special Rule Encouraging Contributions of Capital Gain Real Property for Conservation Purposes For Tax Years Beginning On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$1,300,000	No impact	No impact

Estimates are based on a proration of federal projections developed for the Heartland, Habitat, Harvest and Horticulture Act of 2008.

Section	Section Title
15303	Deduction for Endangered Species Recovery Expenditure

Background

Under present law, a taxpayer engaged in the business of farming may treat expenditures that are paid or incurred by him during the taxable year for the purpose of soil or water conservation in respect of land used in farming, or for the prevention or erosion of land used in farming, as expenses that are not chargeable to capital account. Such expenditures are allowed as a deduction, not to exceed 25 percent of the gross income derived from farming during the taxable year.[21] Any excess above such percentage is deductible for succeeding

[21] IRC section 175.

taxable years, not to exceed 25 percent of the gross income derived from farming during such succeeding taxable year.

New Federal Law (IRC section 175)

The provision provides that expenditures paid or incurred by a taxpayer engaged in the business of farming for the purpose of achieving site-specific management actions pursuant to the Endangered Species Act of 1973[22] to be treated the same as expenditures for the purpose of soil or water conservation in respect of land used in farming, or for the prevention or erosion of land used in farming, i.e., such expenditures are treated as not chargeable to capital account and are deductible subject to the limitation that the deduction may not exceed 25 percent of the farmer's gross income derived from farming during the taxable year.

Effective Date

The provision is effective for expenditures paid or incurred after December 31, 2008.

California Law (R&TC sections 17201 and 24369)

California conforms by reference as of a "specified date" of January 1, 2005, to IRC section 175 relating to deductions for soil and water conservation or conditioning expenditures in R&TC sections 17201 and 24369 with no modifications. Because this change was made after the "specified date," California is not conformed.

Impact on California Revenue

Estimated Revenue Impact of Deduction for Endangered Species Recovery Expenditures Effective for Expenditures Incurred on or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$100,000	-$700,000	-$900,000

Estimates are based on a proration of federal projections developed for the Heartland, Habitat, Harvest and Horticulture Act of 2008.

[22] 16 U.S.C. 1533(f)(B).

HEARTLAND, HABITAT, HARVEST, AND HORTICULTURE ACT OF 2008 (HHHHA)(PL 110-246, JUNE 18, 2008)

SUBPART B – TIMBER PROVISIONS

Sections	Section Title
15311 - 15315	Timber REIT Provisions

Background

Treatment of certain timber gain

Under present law, if a taxpayer cuts standing timber, the taxpayer may elect to treat the cutting as a sale or exchange eligible for capital gains treatment (IRC section 631(a)). For purposes of determining the gain attributable to such cutting and the cost of the cut timber for purposes of the taxpayer's income from later sales of the timber or timber products, the fair market value of the timber will be the first day of the taxable year in which the timber is used. Also, if a taxpayer disposes of the timber with a retained economic interest or makes an outright sale of the timber, the gain is eligible for capital gain treatment (IRC section 631(b)). This treatment under either IRC section 631(a) or (b) requires that the taxpayer has owned the timber or held the contract right for a period of more than one year.

Under present law, for taxable years beginning before January 1, 2011, the maximum rate of tax on long term capital gain (''net capital gain'') of an individual, estate, or trust is 15 percent. Any net capital gain that otherwise would be taxed at a 10- or 15-percent rate is taxed at a 5-percent rate (zero for taxable years beginning after 2007). These rates apply for purposes of both the regular tax and the alternative minimum tax.[23]

For taxable years beginning after December 31, 2010, the maximum rate of tax on the net capital gain of an individual is 20 percent. Any net capital gain that otherwise would be taxed at a 10- or 15-percent rate is taxed at a 10-percent rate. In addition, any gain from the sale or exchange of property held more than five years that would otherwise have been taxed at the 10-percent rate is taxed at an 8-percent rate. Any gain from the sale or exchange of property held more than five years and the holding period for which began after December 31, 2000, which would otherwise have been taxed at a 20-percent rate, is taxed at an 18-percent rate.

The net capital gain of a corporation is taxed at the same rates as ordinary income, up to a maximum rate of 35 percent.

[23] Because the entire amount of the capital gain is included in alternative minimum taxable income (''AMTI''), for taxpayers subject to the alternative minimum tax with AMTI in excess of $112,500 ($150,000 in the case of a joint return), the gain may cause a reduction in the minimum tax exemption amount and thus effectively tax the gain at rates of 21.5 or 22 percent. Also, the gain may cause the phase-out of certain benefits in computing the regular tax.

Real estate investment trusts (''REITs'') are subject to a special taxation regime. Under this regime, a REIT is allowed a deduction for dividends paid to its shareholders.[24] As a result, REITs generally do not pay tax on distributed income, but the income is taxed to the REIT shareholders. A REIT that has long term capital gain can declare a dividend that shareholders are entitled to treat as long term capital gain.

REITs generally are required to distribute 90 percent of their taxable income (other than net capital gain). A REIT generally must pay tax at regular corporate rates on any undistributed income. However, a REIT that has net capital gain can retain that gain without distributing it, and the shareholders can report the net capital gain as if it were distributed to them. In that case, the REIT pays a C corporation tax on the retained gain, but the shareholders who report the income are entitled to a credit or refund for the difference between the tax that would be due if the income had been distributed and the 35-percent rate paid by the REIT.[25] In effect, net capital gain of a REIT (including but not limited to timber gain) can be taxed as net capital gain of the shareholders, whether or not the gain is distributed.

Other REIT provisions

A REIT is also subject to a 4-percent excise tax to the extent it does not distribute specified percentages of its income within any calendar year. The required distributed percentage is 85 percent in the case of the REIT ordinary income, and 95 percent in the case of the REIT capital gain net income (as defined).[26] The amount of the excess of the required distribution over the actual distribution is subject to the 4-percent tax.

A REIT generally is restricted to earning certain types of passive income. Among other requirements, at least 75 percent of the gross income of a REIT in a taxable year must consist of certain types of real estate related income, including rents from real property, income from the sale or exchange of real property (including interests in real property) that is not stock in trade, inventory, or held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business, and interest on mortgages secured by real property or interests in real property.[27] Interests in real property are specifically defined to exclude

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[24] A distribution to a corporate shareholder out of current or accumulated earnings and profits of the corporation is a dividend, unless the distribution is a redemption that terminates the shareholder's stock interest or reduces the shareholder's interest in the distributing corporation to an extent considered to result in treatment as a sale or exchange of the shareholder's stock. IRC sections 301 and 302. A distribution in excess of corporate earnings and profits is treated by shareholders as first a recovery of their stock basis and then, to the extent the distribution exceeds a shareholder's stock basis, as a sale or exchange of the stock. IRC section 301. These rules generally apply to REITs.

[25] IRC section 857(b)(3)(D). The shareholders also obtain a basis increase in their REIT stock for the gross amount of the deemed distribution that is included in their income less the amount of corporate tax deemed paid by them that was paid by the REIT on the retained gain. IRC section 857(b)(3)(D)(iii).

[26] IRC section 4981. The definition is the excess of gains from sales or exchanges of capital assets over losses from such sales or exchanges for the calendar year, reduced by any net ordinary loss.

[27] IRC sections 856(c) and 1221(a). Income from sales that are not prohibited transactions solely by virtue of IRC section 857(b)(6) is also qualified REIT income.

mineral, oil, or gas royalty interests.[28] A REIT will not qualify as a REIT, and will be taxable as a C corporation, for any taxable year if it does not meet this income test.

Some REITs have been formed to hold land on which trees are grown. Upon maturity of the trees, the standing trees are sold by the REIT. The Internal Revenue Service has issued private letter rulings in particular instances stating that the income from the sale of the trees under IRC section 631(b) can qualify as REIT real property income because the uncut timber and the timberland on which the timber grew is considered real property and the sale of uncut trees can qualify as capital gain derived from the sale of real property.[29]

A REIT is subject to a 100-percent excise tax on gain from any sale that is a ''prohibited transaction,'' defined as a sale of property that is stock in trade, inventory, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.[30] This determination is based on facts and circumstances. However, a safe-harbor provides that no excise tax is imposed if certain requirements are met. In the case of timber property, the safe harbor is met, regardless of the number of sales that occur during the taxable year, if (i) the REIT has held the property for not less than 4 years in connection with the trade or business of producing timber; (ii) the aggregate adjusted bases of the property sold (other than foreclosure property) during the taxable year does not exceed 10 percent of the aggregate bases of all the assets of the REIT as of the beginning of the taxable year, and if certain other requirements are met. These include requirements that limit the amount of expenditures the REIT can make during the 4-year period prior to the sale that are includible in the adjusted basis of the property,[31] that require marketing to be done by an independent contractor, and that forbid a sales price that is based on the income or profits of any person.[32] There is a similar but separate safe harbor for sales of non-timber property, with similar rules, including a 4-year holding period requirement and a limit on the percentage of the aggregate adjusted basis of property that can be sold in one taxable year.[33]

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[28] IRC section 856(c)(5)(C).
[29] Timber income under section 631(b) has also been held to be qualified real estate income even if the one year holding period is not met. See, e.g., PLR 200052021, see also PLR 199945055, PLR 199927021, PLR 8838016. A private letter ruling may be relied upon only by the taxpayer to whom the ruling is issued. However, such rulings provide an indication of administrative practice.
[30] IRC sections 857(b)(6) and 1221(a)(1). There is an exception for certain foreclosure property.
[31] Aggregate expenditures (other than timberland acquisition expenditures) during such period made by the REIT or a partner of the REIT, which are includible in basis, may not exceed 30 percent of the net selling price in the case of expenditures that are directly related to operation of the property for the production of timber or the preservation of the property for use as timberland, and may not exceed 5 percent of the net selling price in the case of expenditures that are not directly related to those purposes.
[32] IRC section 857(b)(6)(D).
[33] IRC section 857(b)(6)(C).

A REIT is not generally permitted to hold securities representing more than 10 percent of the voting power or value of the securities of any one issuer; nor may more than 5 percent of the fair market value of REIT assets be securities of any one issuer.[34] However, under an exception, a REIT may hold any amount of securities of one or more ‘‘taxable REIT subsidiary’’ (TRS) corporations, provided that such TRS securities do not represent more than 20 percent of the fair market value of REIT assets at the end of any quarter.
A TRS is a C corporation that is subject to regular corporate tax on its income and that meets certain other requirements. A taxable REIT subsidiary may conduct activities that would produce disqualified non-passive or non-real estate income that could disqualify the REIT if conducted by a REIT itself. Such business could include business relating to processing timber, or holding timber products or other assets for sale to customers in the ordinary course of business. Such income would be subject to regular corporate rates of tax as income of the TRS.[35]

H.R. Report 110-249 reports it is desirable to provide greater equivalence to the capital gain tax treatment of timber gain, regardless of whether the gain is recognized by a C corporation or a REIT, or by an individual. The committee also believes it is desirable to provide changes to the statutory rules governing REITs, in order to clarify and facilitate timber REIT operations.

New Federal Law (IRC sections 55, 856, 857 and 1201)

Act section 15311 – Temporary Reduction in Rate of Tax on Qualified Timber Gain of Corporations

Changes to IRC section 55

The provision provides that the 15-percent maximum tax rate for qualified timber gain also applies for alternative minimum tax purposes.

Changes IRC section 1201

The provision provides that an alternative maximum tax rate of 15 percent will apply to the qualified timber gain of a C corporation for a tax year. The tax is equal to the sum of (1) 15 percent of the least of qualified timber gain, net capital gain, or taxable income, plus (2) 35 percent of any excess of taxable income over the sum of the amounts for which a tax was determined under IRC section 1201(a)(1).

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[34] IRC section 856(c)(4)(B)(ii) and (iii). Certain interests are not treated as ‘‘securities’’ for purposes of the rule forbidding the REIT to hold securities representing more than 10 percent of the value of securities of any one issuer. IRC section 856(m).
[35] A 100-percent excise tax is imposed on the amount of certain transactions involving a TRS and a REIT, to the extent such amount would exceed an arm’s length amount under IRC sections 482 and 857(b)(7).

Effective Date

The provision is effective for taxable years ending after June 18, 2008.

Act section 15312 – Temporary Reduction in Rate of Tax on Qualified Timber Gain of Corporations

Changes to IRC section 856

The provision amends the REIT provisions so that timber income will be treated as qualifying income for purposes of the REIT 95% and 75% income tests. Thus, the following gains are treated as real property gains that qualify under the income tests:

1) Gains recognized by a REIT on its timber under a IRC section 631(a) election to treat the cutting of the timber by the REIT's taxable REIT subsidiary as resulting in a capital gain.
2) Gains recognized under IRC section 631(b) on the disposal of timber with a retained economic interest (such as a royalty interest) or on an outright sale; or
3) Income which would be gain under items (1) or (2), but for the failure to meet the one-year holding period requirement.

In addition, gains recognized by a REIT on its timber under a IRC section 631(a) election to treat the cutting of standing timber by the REIT's taxable REIT subsidiary as resulting in a capital gain and gains that would be treated as such, but for the failure to meet the one-year holding period requirement are (i) treated as sold to the taxable REIT subsidiary on the first day of the tax year for tax purposes and (ii) are not treated as the sale of inventory or property held primarily for sale to customers in the ordinary course of business. The remainder of the gain will be taxable to the taxable REIT subsidiary.

The above rule does not apply to dispositions after the termination date (IRC section. 856(c)(5)(H)(iii)). The termination date means the last day of the REIT's first tax year beginning after June 18, 2008, and before the date that is one year after June 18, 2008.

Effective Date

The provision is effective for dispositions in taxable years beginning after June 18, 2008.

HEARTLAND, HABITAT, HARVEST, AND HORTICULTURE ACT OF 2008 (HHHHA)(PL 110-246, JUNE 18, 2008)

Act section 15313 – Mineral Royalty Income Qualifying Income for Timber REITs

Changes to IRC section 856

The provision provides that mineral royalty income earned in the first tax year beginning after June 18, 2008, from real property owned by a timber REIT and held, or once held, in connection with the trade or business of producing timber by the REIT is qualifying income for purposes of the 95% test.

The provision also provides that a timber REIT is a REIT in which more than 50% of the value of its total assets consists of real property held in connection with the trade or business of producing timber.

<u>Effective Date</u>

The provision is effective for taxable years beginning after June 18, 2008.

Act section 15314 – Modification of Taxable REIT Subsidiary Asset Test for Timber REITS

Changes to IRC section 856

The provision amends the assets test so that in the case of a quarter that closes on or before the termination date 25% of the assets of a timber REIT may consist of securities of one or more taxable REIT subsidiaries.

<u>Effective Date</u>

The provision is effective for taxable years beginning after June 18, 2008.

Act section 15315 – Modification of Taxable REIT Subsidiary Asset Test for Timber REITS

The provision provides a third safe harbor from the prohibited transaction rules for sales of timber property by a REIT to a qualified tax exempt organization exclusively for conservation purposes. The new requirements are the same for the timber property safe harbor, except that the REIT only has to hold the property for at least two years rather than four years. In addition the measuring periods for the aggregate capital expenditures are reduced from four years to two years. The new safe harbor is limited to sales on or before the termination date, which is the last day of the taxpayer's first tax year beginning after June 18, 2008, and before the date that is one year after June 18, 2008.

The provision provides that the sale of property that is not a prohibited transaction pursuant to the new timber property safe harbor relating to income from prohibited transaction that occurs on or before the termination date will be considered a sale of property held for investment or for use in a trade or business and not a capital asset under IRC section 1221(a)(1).

Effective Date

The provision is effective for dispositions in taxable years beginning after June 18, 2008.

California Law – **Act sections 15311 – 15315**

California Law (R&TC sections 17062, 17062.5, 23400, and 23455)

Changes to IRC section 55

California conforms to Part VI of Subchapter A of Chapter 1 of Subtitle A of the Internal Revenue Code in R&TC section 23400, as of the "specified date" of January, 2005, relating to alternative minimum tax, with modifications. California law imposes an alternative minimum tax (AMT). The AMT is the amount by which the tentative minimum tax (TMT) exceeds the regular income tax. California conforms by reference to IRC sections 55 thru 59, relating to the computation of TMT, as of the "specified date" of January 1, 2005, in R&TC section 17602, with significant modifications.

California law provides that an individual's TMT is 7% of the amount that alternative minimum taxable income (AMTI) exceeds the exemption amount. For general business corporations, the alternative minimum tax is the excess of the tentative minimum tax over the regular tax. The corporate TMT is 6.65%. For banks and financial corporations, the alternative minimum tax is added to their regular tax. S corporations are not subject to the alternative minimum tax. Thus, the federal change to IRC section 55, relating to the maximum rate of tax on qualified timber gains of a corporation, does not apply to California.

Impact on California Revenue

Not applicable.

California Law (R&TC sections 17088, 24870, 24872, 24872.4, and 24872.6)

Changes to IRC sections 856 and 857

California law conforms by reference to Subchapter M of Chapter 1 of Subtitle A of the IRC In R&TC sections 17088 and 24870, relating to regulated investment companies (RIC), real estate investment trusts (REIT), real estate mortgage investment conduits (REMIC), and financial asset securitization investment trusts, as of the “specified date” of January 1, 2005, with substantial modification in R&TC sections 24872, 24872.4, and 24872.6.

Qualification as a California REIT is dependent on qualification as a federal REIT for the taxable year, and no separate state election is allowed. Under R&TC section 24872.6, an entity that is a REIT for any taxable year for federal purposes under the IRC (as applicable for federal purposes) shall be a REIT for California purposes for the same taxable year. Thus, a qualified federal REIT is a qualified state REIT for the same taxable year. The termination or revocation of a federal election is treated as termination or revocation for state purposes. The above rules apply to any election to be a REIT that is effective for federal purposes for tax years starting on or after on January 1, 2001. If a REIT makes an election under IRC section 856(e)(5) regarding treatment of property as foreclosure property for federal income tax purposes, it will not be able to make a separate election for California purposes and therefore will be bound by its federal election. Similarly, the failure to make a federal election prevents the REIT from making a California election, and any revocation of a federal election applies in California as well. Thus, California automatically conforms to the IRC changes made to IRC sections 856 and 857.

California does not impose excise taxes on REITs.

<u>Impact on California Revenue</u>

Baseline.

<u>California Law (R&TC sections 18151, 24990, and 24990.5)</u>

Changes to IRC section 1201

California conforms to Subchapter P of Chapter 1 of Subtitle A of the IRC sections 1201 through 1298 as of the specified date of January 1, 2005, relating to capital gains and losses in R&TC sections 18151 and 24990, with modifications. However, California specifically does not conform to IRC section 1201, relating to alternative tax for corporations.

<u>Impact on California Revenue</u>

Baseline. To the extent the lower federal capital gains rate would encourage the unlocking of capital gains, additional income would be reported on the California return and taxed as ordinary income, resulting in additional baseline revenue for the state. The baseline revenue gain is estimated to be $6 million in 2009-10, $2.5 million in 20010-11, and $2 million in 2011-12. Estimates are based on federal projections developed for the Heartland, Habitat, Harvest and Horticulture Act of 2008 and adjusted to reflect California differences.

HEARTLAND, HABITAT, HARVEST, AND HORTICULTURE ACT OF 2008 (HHHHA)(PL 110-246, JUNE 18, 2008)

Section	Section Title
15316	Qualified Forestry Conservation Bonds

Background

Tax-Exempt Bonds

In general

Subject to certain IRC restrictions, interest on bonds issued by state and local government generally is excluded from gross income for federal income tax purposes. Bonds issued by state and local governments may be classified as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental functions or which are repaid with governmental funds. Private activity bonds are bonds in which the state or local government serves as a conduit providing financing to nongovernmental persons. For this purpose, the term “nongovernmental person” generally includes the federal government and all other individuals and entities other than States or local governments. The exclusion from income for interest on state and local bonds does not apply to private activity bonds unless the bonds are issued for certain permitted purposes (“qualified private activity bonds”) and other IRC requirements are met.

Private-activity-bond tests

Present law provides two tests for determining whether a state or local bond is in substance a private activity bond, the private business test and the private loan test[36]

Private-business tests

Private business use and private payments result in state and local bonds being private activity bonds if both parts of the two-part private business test are satisfied— (1) More than 10 percent of the bond proceeds is to be used (directly or indirectly) by a private business (the “private business use test”); and (2) More than 10 percent of the debt service on the bonds is secured by an interest in property to be used in a private business use or to be derived from payments in respect of such property (the “private payment test”).[37]

Private business use generally includes any use by a business entity (including the federal government), which occurs pursuant to terms not generally available to the general public.

[36] IRC section 141(b) and (c).
[37] The 10-percent private business use and payment threshold is reduced to five percent for private business uses that are unrelated to a governmental purpose also being financed with proceeds of the bond issue. In addition, as described more fully below, the 10-percent private business use and private payment thresholds are phased-down for larger bond issues for the financing of certain “output” facilities. The term output facility includes electric generation, transmission, and distribution facilities.

For example, if bond-financed property is leased to a private business (other than pursuant to certain short-term leases for which safe harbors are provided under Treasury regulations), bond proceeds used to finance the property are treated as used in a private business use, and rental payments are treated as securing the payment of the bonds. Private business use also can arise when a governmental entity contracts for the operation of a governmental facility by a private business under a management contract that does not satisfy Treasury regulatory safe harbors regarding the types of payments made to the private operator and the length of the contract.[38]

Private loan test

The second standard for determining whether a state or local bond is a private activity bond is whether an amount exceeding the lesser of (1) five percent of the bond proceeds or (2) $5 million is used (directly or indirectly) to finance loans to private persons. Private loans include both business and other (e.g., personal) uses and payments by private persons; however, in the case of business uses and payments, all private loans also constitute private business uses and payments subject to the private business test. Present law provides that the substance of a transaction governs in determining whether the transaction gives rise to a private loan. In general, any transaction which transfers tax ownership of property to a private person is treated as a loan.

Qualified private activity bonds

As stated, interest on private activity bonds is taxable unless the bonds meet the requirements for qualified private activity bonds. Qualified private activity bonds permit States or local governments to act as conduits providing tax-exempt financing for certain private activities. The definition of qualified private activity bonds includes an exempt facility bond, or qualified mortgage, veterans' mortgage, small issue, redevelopment, IRC section 501(c)(3) , or student loan bond (IRC section 141(e)). The definition of exempt facility bond includes bonds issued to finance certain transportation facilities (airports, ports, mass commuting, and high-speed intercity rail facilities); qualified residential rental projects; privately owned and/or operated utility facilities (sewage, water, solid waste disposal, and local district heating and cooling facilities, certain private electric and gas facilities, and hydroelectric dam enhancements); public/private educational facilities; qualified green building and sustainable design projects; and qualified highway or surface freight transfer facilities (IRC section 142(a)). In most cases, the aggregate volume of these tax-exempt private activity bonds is restricted by annual aggregate volume limits imposed on bonds issued by issuers within each State. For calendar year 2007, the state volume cap, which is indexed for inflation, equals $85 per resident of the state, or $256.24 million, if greater.

[38] Treas. Reg. sec. 1.141-3(b)(4) and, 1997-1 C.B. 632.

Arbitrage restrictions

The tax exemption for state and local bonds also does not apply to any arbitrage bond.[39] An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments.[40] In general, arbitrage profits may be earned only during specified periods (e.g., defined “temporary periods”) before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., “reasonably required reserve or replacement funds”). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the federal government.

Indian tribal governments

Indian tribal governments are provided with a tax status similar to State and local governments for specified purposes under the IRC.[41] Among the purposes for which a tribal government is treated as a State is the issuance of tax-exempt bonds. However, bonds issued by tribal governments are subject to limitations not imposed on State and local government issuers. Tribal governments are authorized to issue tax-exempt bonds only if substantially all of the proceeds are used for essential governmental functions or certain manufacturing facilities.[42]

Clean renewable energy bonds

As an alternative to traditional tax-exempt bonds, states and local governments may issue clean renewable energy bonds (“CREBs”). CREBs are defined as any bond issued by a qualified issuer if, in addition to the requirements discussed below, 95 percent or more of the proceeds of such bonds are used to finance capital expenditures incurred by qualified borrowers for qualified projects. “Qualified projects” are facilities that qualify for the tax credit under IRC section 45 (other than Indian coal production facilities), without regard to the placed-in-service date requirements of that section.[43] The term “qualified issuers” includes (1) governmental bodies (including Indian tribal governments); (2) mutual or cooperative electric companies (described in section 501(c)(12) or section 1381(a)(2)(C), or a not-for-profit electric utility which has received a loan or guarantee under the Rural Electrification Act); and (3) clean renewable energy bond lenders. The term “qualified borrower” includes a governmental body (including an Indian tribal government) and a mutual or cooperative electric company. A clean renewable energy bond lender means a cooperative which is

[39] IRC section 103(a) and (b)(2).
[40] IRC section 148.
[41] IRC section 7871.
[42] IRC section 7871(c).
[43] In addition, Notice 2006-7 provides that qualified projects include any facility owned by a qualified borrower that is functionally related and subordinate to any facility described in IRC sections 45(d)(1) through (d)(9) and owned by such qualified borrower.

owned by, or has outstanding loans to, 100 or more cooperative electric companies and is in existence on February 1, 2002.

In addition, Notice 2006-7 provides that qualified projects include any facility owned by a qualified borrower that is functionally related and subordinate to any facility described in section 45(d)(1) through (d)(9) and owned by such qualified borrower.

Unlike tax-exempt bonds, CREBs are not interest-bearing obligations. Rather, the taxpayer holding CREBs on a credit allowance date is entitled to a tax credit. The amount of the credit is determined by multiplying the bond's credit rate by the face amount on the holder's bond. The credit rate on the bonds is determined by the Secretary and is to be a rate that permits issuance of CREBs without discount and interest cost to the qualified issuer. The credit accrues quarterly and is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability.

CREBs are subject to a maximum maturity limitation. The maximum maturity is the term that the Secretary estimates will result in the present value of the obligation to repay the principal on a CREBs being equal to 50 percent of the face amount of such bond. In addition, the Code requires level amortization of CREBs during the period such bonds are outstanding. CREBs also are subject to the arbitrage requirements of IRC section 148 that apply to traditional tax-exempt bonds. Principles under IRC section 148 and the regulations thereunder apply for purposes of determining the yield restriction and arbitrage rebate requirements applicable to CREBs.

In addition to the above requirements, at least 95 percent of the proceeds of CREBs must be spent on qualified projects within the five-year period that begins on the date of issuance. To the extent less than 95 percent of the proceeds are used to finance qualified projects during the five-year spending period, bonds will continue to qualify as CREBs if unspent proceeds are used within 90 days from the end of such five-year period to redeem any “nonqualified bonds.” The five-year spending period may be extended by the Secretary upon the qualified issuer's request demonstrating that the failure to satisfy the five-year requirement is due to reasonable cause and the projects will continue to proceed with due diligence.

Issuers of CREBs are required to report issuance to the IRS in a manner similar to the information returns required for tax-exempt bonds. There is a national CREB limitation of $1.2 billion. The maximum amount of CREBs that may be allocated to qualified projects of governmental bodies is $750 million. CREBs must be issued before January 1, 2009.

New Federal Law (IRC sections 54, 54A, 54B, 1397E, 1400N, and 6401)

The act creates a new category of tax-credit bonds and qualified forestry conservation bonds. Qualified forestry conservation bonds are bonds issued by qualified issuers to finance qualified forestry conservation projects. The term “qualified issuer” means a state or an IRC section 501(c)(3) organization. The term “qualified forestry conservation project” means the acquisition by a state or an IRC section 501(c)(3) organization from an unrelated person of forest and forest land that meets the following qualifications: (1) some portion of the land acquired must be adjacent to United States Forest Service Land; (2) at least half of the land acquired must be transferred to the United States Forest Service at no net cost and not more than half of the land acquired may either remain with or be donated to a state; (3) all of the land must be subject to a habitat conservation plan for native fish approved by the United States Fish and Wildlife Service; and (4) the amount of acreage acquired must be at least 40,000 acres.

There is a national limitation on qualified forestry conservation bonds of $500 million. Allocations of qualified forestry conservation bonds are among qualified forestry conservation projects in the manner the Secretary determines appropriate so as to ensure that all of such limitation is allocated before the date that is 24 months after the date of enactment. This act section also requires the Secretary to solicit applications for allocations of qualified forestry conservation bonds no later than 90 days after the date of enactment.

The act provision requires 100 percent of the available project proceeds of qualified forestry conservation bonds to be used within the three-year period that begins on the date of issuance. The act provision defines available project proceeds as proceeds from the sale of the issue less issuance costs (not to exceed two percent) and any investment earnings on such sale proceeds. To the extent less than 100 percent of the available project proceeds are used to finance qualified forestry conservation purposes during the three-year spending period, bonds will continue to qualify as qualified forestry conservation bonds if unspent proceeds are used within 90 days from the end of such three-year period to redeem bonds. The three-year spending period may be extended by the Secretary upon the issuer's request demonstrating that the failure to satisfy the three-year requirement is due to reasonable cause and the projects will continue to proceed with due diligence.

Qualified forestry conservation bonds generally are subject to the arbitrage requirements of IRC section 148. However, available project proceeds invested during the three-year spending period are not subject to the arbitrage restrictions (i.e., yield restriction and rebate requirements). In addition, amounts invested in a reserve fund are not subject to the arbitrage restrictions to the extent: (1) such fund is funded in a manner reasonably expected to result in an amount not greater than an amount necessary to repay the issue; and (2) the yield on such fund is not greater than the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified forestry conservation bonds are issued.

The maturity of qualified forestry conservation bonds is the term that the Secretary estimates will result in the present value of the obligation to repay the principal on such bonds being equal to 50 percent of the face amount of such bonds, using as a discount rate the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified forestry conservation bonds are issued.

As with present-law tax credit bonds, the taxpayer holding qualified forestry conservation bonds on a credit allowance date is entitled to a tax credit. The credit rate is set by the Secretary at 70 percent of the rate that would permit issuance of qualified forestry conservation bonds without discount and interest cost to the issuer. The amount of the tax credit to the holder is determined by multiplying the bond's credit rate by the face amount on the holder's bond. The credit accrues quarterly, is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability. Unused credits in one year may be carried forward to succeeding taxable years. In addition, credits may be separated from the ownership of the underlying bond similar to how interest coupons can be stripped for interest-bearing bonds.

Issuers of qualified forestry conservation bonds are required to certify that the financial disclosure requirements that apply to State and local bonds offered for sale to the general public are satisfied with respect to any federal, state, or local government official directly involved with the issuance of such bonds. This act section authorizes the Secretary to impose additional financial reporting requirements by regulation.

The act section provides that the credit rate on qualified forestry conservation bonds is determined by the Secretary at the rate that permits issuance of such bonds without discount and interest cost to the qualified issuer.

The act section also provides that a qualified issuer receiving an allocation to issue qualified forestry conservation bonds may, in lieu of issuing bonds, elect to treat such allocation as a deemed payment of tax (regardless of whether the issuer is subject to tax under chapter 1 of the IRC) that is equal to 50 percent of the amount of such allocation. An election to treat an allocation of qualified forestry conservation bonds as a deemed payment is not valid unless the qualified issuer certifies to the Secretary that any payment of tax refunded to the issuer will be used exclusively for one or more qualified forestry conservation purposes. The deemed tax payment may not be used as an offset or credit against any other tax and shall not accrue interest. In addition, if the qualified issuer fails to use any portion of the overpayment for qualified forestry conservation purposes, the issuer shall be liable to the United States in an amount equal to such portion, plus interest, for the period from the date such portion was refunded to the date such amount is paid.

Effective Date

The amendments made by this act section shall apply to obligations issued after June 18, 2008.

California Law

California has no comparable credits.

Impact on California Revenue

Not applicable.

PART II – ENERGY PROVISIONS
SUBPART A – CELLULOSIC BIOFUEL

Section	Section Title
15321 -15322	Credit of Production of Cellulosic Biofuel and Comprehensive Study for Fuel

Background

In the case of ethanol, the IRC provides a separate 10-cents-per gallon credit for up to 15 million gallons per year for small producers, defined generally as persons whose production capacity does not exceed 60 million gallons per year. The ethanol must (1) be sold by such producer to another person (a) for use by such other person in the production of a qualified alcohol fuel mixture in such person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or, (c) who sells such ethanol at retail to another person and places such ethanol in the fuel tank of such other person; or (2) used by the producer for any purpose described in (a), (b), or (c). A cooperative may pass through the small ethanol producer credit to its patrons. The credit is includible in income and is treated as a general business credit, subject to the ordering rules and carryforward/carryback rules that apply to business credits generally. The alcohol fuels tax credit, of which the small producer credit is a part, is scheduled to expire after December 31, 2010.

Under the Renewable Fuels Standard Program, all renewable fuel produced or imported on or after September 1, 2007 must have a renewable identification number (RIN) associated with it. Producers and importers must generate RINs to represent all the renewable fuel they produce or import and provide those RINs to the EPA. For cellulosic ethanol, 2.5 RINs are generated for every gallon produced.

HR 110-627 reports that the development of fuels from cellulosic materials, such as corn stover, switchgrass, and other organic materials that can be grown anywhere, is a significant component in establishing the nation's energy independence. Tax incentives are an important part of taking this industry from the level of demonstration projects into a practical and competitive fuel source. To encourage new production capacity for this fuel, the provision provides a new per-gallon incentive for cellulosic alcohol fuel producers.

New Federal Law (IRC sections 40 and 4101)

The HR 110-627 agreement adds a new component to IRC section 40, the ‘‘cellulosic biofuel producer credit.’’ This credit is a nonrefundable income tax credit for each gallon of qualified cellulosic fuel production of the producer for the taxable year. The amount of the credit per gallon is $1.01, except in the case of cellulosic biofuel that is alcohol. In the case of cellulosic biofuel that is alcohol, the $1.01 credit amount is reduced by (1) the credit amount applicable for such alcohol under the alcohol mixture credit as in effect at the time cellulosic biofuel is produced and (2) in the case of cellulosic biofuel that is ethanol, the credit amount for small ethanol producers as in effect at the time the cellulosic biofuel fuel is produced. The reduction applies regardless of whether the producer claims the alcohol mixture credit or small ethanol producer credit with respect to the cellulosic alcohol. When the alcohol mixture credit and small ethanol producer credit expire after December 31, 2010, cellulosic biofuel will receive the $1.01 without reduction.

‘‘Qualified cellulosic biofuel production’’ is any cellulosic biofuel that is produced by the taxpayer and is sold by the taxpayer to another person (a) for use by such other person in the production of a qualified biofuel fuel mixture in such person’s trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or, (c) who sells such biofuel at retail to another person and places such biofuel in the fuel tank of such other person; or (2) used by the producer for any purpose described in (a), (b), or (c).

‘‘Cellulosic biofuel’’ means any liquid fuel that (1) is produced in the United States and used as fuel in the United States,[44] (2) is derived from any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis, and (3) meets the registration requirements for fuels and fuel additives established by the Environmental Protection Agency under section 211 of the Clean Air Act. Thus, to qualify for the credit the fuel must be approved by the Environmental Protection Agency. Cellulosic biofuel does not include any alcohol with a proof of less than 150. Examples of lignocellulosic or hemicellulosic matter that is available of a renewable or recurring basis include dedicated energy crops and trees, wood and wood residues, plants, grasses, agricultural residues, fibers, animal wastes and other waste materials, and municipal solid waste.

A ‘‘qualified cellulosic biofuel mixture’’ is a mixture of cellulosic biofuel and a special fuel or of cellulosic biofuel and gasoline, which is sold by the person producing such mixture to any person for use as a fuel, or is used as a fuel by the person producing such mixture.
The term ‘‘special fuel’’ includes any liquid fuel (other than gasoline) which is suitable for use in an internal combustion engine.

[44] For this purpose, “United States” includes any possession of the United States.

The cellulosic biofuel producer credit terminates on December 31, 2012. The conference agreement requires cellulosic biofuel producers to be registered with the IRS. The cellulosic biofuel producer credit cannot be claimed unless the taxpayer is registered with the IRS as a producer of cellulosic biofuel.
With respect to the small ethanol producer credit, the conference agreement also waives the 15 million gallon limitation for cellulosic biofuel that is ethanol. Thus the small ethanol producer credit may be claimed for cellulosic ethanol in excess of 15 million gallons. The other requirements for the small ethanol producer credit continue to apply for ethanol other than cellulosic ethanol, including the 15 million gallon limitation.

HR 110-627 reports, cellulosic biofuel and alcohols cannot qualify as biodiesel, renewable diesel, or alternative fuel for purposes of the credit and payment provisions relating to those fuels.

The act requires a comprehensive study report of biofuels to be submitted to congress no later than six months after June 18, 2008.

Effective Date

The provision is effective for fuel produced after December 31, 2008.

California Law

California has no comparable credit.

Impact on California Revenue

Not applicable.

SUBPART B – REVENUE PROVISIONS

Section	Section Title
15331	Modification of Alcohol Credit

Background

Income tax credit

The alcohol fuels credit is the sum of three credits: the alcohol mixture credit, the alcohol credit, and the small ethanol producer credit. Generally, the alcohol fuels credit expires after

December 31, 2010.[45] Taxpayers are eligible for an income tax credit of 51 cents per gallon of ethanol (60 cents in the case of alcohol other than ethanol) used in the production of a qualified mixture (the ''alcohol mixture credit''). A ''qualified mixture'' means a mixture of alcohol and gasoline, (or of alcohol and a special fuel) sold by the taxpayer as fuel, or used as fuel by the taxpayer producing such mixture. The term ''alcohol'' includes methanol and ethanol but does not include (1) alcohol produced from petroleum, natural gas, or coal (including peat), or (2) alcohol with a proof of less than 150. Taxpayers may reduce their income taxes by 51 cents for each gallon of ethanol, which is not in a mixture with gasoline or other special fuel, that they sell at the retail level as vehicle fuel or use themselves as a fuel in their trade or business (''the alcohol credit''). For alcohol other than ethanol, the rate is 60 cents per gallon.[46]

In the case of ethanol, the IRC provides an additional 10-cents per-gallon credit for up to 15 million gallons per year for small producers. Small producer is defined generally as persons whose production capacity does not exceed 60 million gallons per year. The ethanol must (1) be sold by such producer to another person (a) for use by such other person in the production of a qualified alcohol fuel mixture in such person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or, (c) who sells such ethanol at retail to another person and places such ethanol in the fuel tank of such other person; or (2) used by the producer for any purpose described in (a), (b), or (c). A cooperative may pass through the small ethanol producer credit to its patrons. The alcohol fuels credit is includible in income and is treated as a general business credit, subject to the ordering rules and carryforward/carryback rules that apply to business credits generally. The credit is allowable against the alternative minimum tax.

Excise tax credit and payment provision for alcohol fuel mixtures

The IRC also provides an excise tax credit and payment provision for alcohol fuel mixtures. Like the income tax credit, the amount of the credit is 60 cents per gallon of alcohol used as part of a qualified mixture (51 cents in the case of ethanol). For purposes of the excise tax credit and payment provisions, alcohol includes methanol and ethanol but does not include (1) alcohol produced from petroleum, natural gas, or coal (including peat), or (2) alcohol with a proof of less than 190. Such term also includes an alcohol gallon equivalent of ethyl tertiary butyl either or other ethers produced from alcohol. In lieu of a tax credit, a person making a qualified mixture eligible for the credit may seek a payment from the Secretary in the amount of the credit. The payment provisions and credits are coordinated such that the incentive is not claimed more than once for each gallon of alcohol used as part of qualified mixture.

[45] The alcohol fuels credit is unavailable when, for any period before January 1, 2011, the tax rates for gasoline and diesel fuels drop to 4.3 cents per gallon.

[46] In the case of any alcohol (other than ethanol) with a proof that is at least 150 but less than 190, the credit is 45 cents per gallon (the ''low-proof blender amount''). For ethanol with a proof that is at least 150 but less than 190, the low-proof blender amount is 37.78 cents.

Renewable Fuels Standard Program

Under the Renewable Fuels Standard Program, all renewable fuel produced or imported on or after September 1, 2007 must have a renewable identification number (RIN) associated with it. Producers and importers must generate RINs to represent all the renewable fuel they produce or import and provide those RINs to the Environmental Protection Agency. For cellulosic ethanol, 2.5 RINs are generated for every gallon produced.

As the ethanol industry further matures, the congressional committee believes it is appropriate to reduce the amount of the tax incentive.

New Federal Law (IRC sections 40 and 6426)

The 51–cent-per-gallon incentive for ethanol is adjusted to 45 cents per gallon for the calendar year 2009 and thereafter.[47] If the Secretary makes a determination, in consultation with the Administrator of the Environmental Protection Agency, that 7,500,000,000 gallons of ethanol (including cellulosic ethanol) were not produced in or imported into the United States in 2008, the reduction in the credit amount will be delayed. If a determination is made that the threshold was not reached in 2008, the reduction for 2010 also will be delayed if the Secretary determines 7,500,000,000 gallons were not produced or imported in 2009. In the absence of a determination, the reduction remains in effect. In the event the determination is made subsequent to the start of a calendar year, those persons claiming the reduced amount prior to the Secretary's determination will be entitled to the difference between the correct credit amount for that year and the credit amount claimed, e.g. between 51 cents per gallon and 45 cents per gallon.

Effective Date

The provision is effective June 18, 2008.

California Law

California has no comparable credit.

Impact on California Revenue

Not applicable.

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[47] The low-proof blender amount is adjusted accordingly to 33.33 cents.

HEARTLAND, HABITAT, HARVEST, AND HORTICULTURE ACT OF 2008 (HHHHA)(PL 110-246, JUNE 18, 2008)

Section	Section Title
15332	Calculation of Volume of Alcohol for Fuel Credits

Background

The IRC provides a per-gallon credit for the volume of alcohol used as a fuel or in a qualified mixture. For purposes of determining the number of gallons of alcohol with respect to which the credit is allowable, the volume of alcohol includes any denaturant, including gasoline.[48] The denaturant must be added under a formula approved by the Secretary and the denaturant cannot exceed five percent of the volume of such alcohol (including denaturants).

Gasoline can be used as a denaturant of alcohol. The congressional committee believes it is inappropriate to allow a credit that is intended to be for alcohol to be claimed on liquids that do not constitute alcohol.

New Federal Law (IRC sections 40 and 6429)

The act provision reduces the amount of allowable denaturants to two percent of the volume of the alcohol.

Effective Date

The provision applies to fuel sold or used after December 31, 2008.

California Law

California has no comparable credit.

Impact on California Revenue

Not applicable.

[48] IRC section 40(d)(4).

HEARTLAND, HABITAT, HARVEST, AND HORTICULTURE ACT OF 2008 (HHHHA)(PL 110-246, JUNE 18, 2008)

PART III – AGRICULTURAL PROVISIONS

Section	Section Title
15341	Increase in Loan Limits on Agricultural Bonds

Background

Qualified small issue bonds are tax-exempt bonds issued by State and local governments to finance private business manufacturing facilities (including certain directly related and ancillary facilities) or the acquisition of land and equipment by certain first-time farmers. A first-time farmer means any individual who has not at any time had any direct ownership interest in substantial farmland in the operation of which such individual materially participated. In addition, an individual does not qualify as a first-time farmer if such individual has received more than $250,000 in qualified small issue bond financing. Substantial farmland means any parcel of land unless (1) such parcel is smaller than 30 percent of the median size of a farm in the county in which such parcel is located, and (2) the fair market value of the land does not at any time while held by the individual exceed $125,000.

New Federal Law (IRC section 147)

The provision increases the maximum amount of qualified small issue bond proceeds available to first-time farmers to $450,000 and indexes this amount for inflation. The provision also eliminates the fair market value test from the definition of substantial farmland.

Effective Date

This provision shall apply to bonds issued after June 18, 2008.

California Law (R&TC section 17143)

California specifically does not conform to IRC sections 103 and 141 through 150, relating to other requirements applicable to certain private activity bonds.

Impact on California Revenue

Not applicable.

HEARTLAND, HABITAT, HARVEST, AND HORTICULTURE ACT OF 2008 (HHHHA)(PL 110-246, JUNE 18, 2008)

Section	Section Title
15342	Allowance of Section 1031 Treatment for Exchange Involving Certain Mutual Ditch, Reservoir, or Irrigation Company Stock

Background

An exchange of property, like a sale, 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’’ that is to be held for productive use in a trade or business or for investment[49] 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. In general, IRC section 1031 does not apply to any exchange of stock in trade or other property held primarily for sale; stocks, bonds or notes; other securities or evidences of indebtedness or interest; interests in a partnership; certificates of trust or beneficial interests; or choses in action.[50]

The Senate Committee report states that IRC section 1031 should be clarified to remove any doubt that an exchange of shares in mutual ditch, reservoir, and irrigation company stock qualifies for tax deferral treatment under IRC section 1031. The committee intends this clarification would be for cases in which the highest court or statute of the state in which the company is organized recognize such shares as constituting or representing real property or an interest in real property.

New Federal Law (IRC section 1031(i))

The provision provides that the general exclusion from IRC section 1031 treatment for stocks shall not apply to shares in a mutual ditch, reservoir, or irrigation company, if at the time of the exchange: (1) the company is an organization described in IRC section 501(c)(12)(A) (determined without regard to the percentage of its income that is collected from its members for the purpose of meeting losses and expenses); and (2) the shares in the company have been recognized by the highest court of the State in which such company was organized or by applicable State statute as constituting or representing real property or an interest in real property.

Effective Date

This provision is effective for transfers after June 18, 2008.

[49] IRC section 1031(a)(1).
[50] IRC section 1031(a)(2).

California Law (R&TC sections 18031, 24473 and 24941)

California conforms to IRC section 1031 as of the “specified date” of January 1, 2005, relating to exchange of property held for productive use or treatment in R&TC section 18031 and 24941, with modifications. Thus, the exchange of shares in mutual, ditch, reservoir, and irrigation company stock is not eligible for like-kind exchange treatment.

California does not conform to the tax exemption in IRC section 501(c)(12)(A) for mutual ditch, reservoir, or irrigation companies. California does not explicitly exempt mutual ditch, reservoir, or irrigation companies from being subject to the franchise tax. However, Mutual water companies that were formed before September 26, 1977, are allowed to transfer assets to community services districts tax-free. Thus, changes to IRC section 1031, relating to special rules for mutual ditch, reservoir, or irrigation company stock does not apply.

Impact on California Revenue

Not applicable.

Section	Section Title
15343	Agricultural Chemicals Security Credit

Background

Present law does not provide a credit for agricultural business security.

New Federal Law (IRC sections 38, 280C, and 45O)

The provision establishes a 30 percent credit for qualified chemical security expenditures for the taxable year with respect to eligible agricultural businesses. The credit is a component of the general business credit. The credit is limited to $100,000 per facility and this amount is reduced by the aggregate amount of the credits allowed for the facility in the prior five years. In addition, each taxpayer’s annual credit is limited to $2,000,000. The credit only applies to expenditures paid or incurred before December 31, 2012. The taxpayer’s deductible expense is reduced by the amount of the credit claimed.

Qualified chemical security expenditures are amounts paid by for: (1) employee security training and background checks; (2) limitation and prevention of access to controls of specific agricultural chemicals stored at a facility; (3) tagging, locking tank valves, and chemical additives to prevent the theft of specific agricultural chemicals or to render such chemicals unfit for illegal use; (4) protection of the perimeter of specified agricultural chemicals; (5) installation of security lighting, cameras, recording equipment and intrusion detection sensors; (6) implementation of measures to increase computer or computer network security; (7) conducting security vulnerability assessments; (8) implementing a site security plan; and (9) other measures provided for by regulation. Amounts described in the preceding sentences are only eligible to the extent they are incurred by an eligible agricultural business for protecting specified agricultural chemicals.

Eligible agricultural businesses are businesses that: (1) sell agricultural products, including specified agricultural chemicals, at retail predominantly to farmers and ranchers; or (2) manufacture, formulate, distribute, or aerially apply specified agricultural chemicals.

Specified agricultural chemicals means: (1) fertilizer commonly used in agricultural operations that is listed under section 302(a)(2) of the Emergency Planning and Community Right-To Know Act of 1986, section 101 or part 172 of title 49, Code of Federal Regulations, or part 126, 127 or 154 of title 33, Code of Federal Regulations; and (2) any pesticide (as defined in section 2(u) of the Federal Insecticide, Fungicide, and Rodenticide Act) including all active and inert ingredients that are used on crops grown for food, feed, or fiber.

Effective Date

The provision is effective for expenses paid or incurred after June 18, 2008.

California Law

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
15344	Three Year Depreciation for Race Horses That are Two Years Old or Younger

Background

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system (MACRS). The class lives of assets placed in service after 1986 are generally set forth in IRC section 168. Any race horse that is more than two years old at the time it is placed in service is assigned a three-year recovery period.[51] A seven-year recovery period is assigned to any race horse that is two years old or younger at the time it is placed in service.[52]

New Federal Law (IRC section 168)

This provision provides a three years recovery period for any race horse that it is placed in service before January 1, 2014, and for any race horse that is two years old or younger that is placed in service after December 31, 2013.

Effective Date

This provision is effective and applies to property placed in service after December 31, 2008.

California Law (R&TC section 17201, 17250 and 24349)

Under the Personal Income Tax Law (PITL), California law, as it relates to MACRS, in general, conforms to IRC section 168 as of a specified date of January 1, 2005 in R&TC section 17201, with certain modification provided in R&TC section 17250.

Under current California law, S corporations (and their shareholders) are allowed to use MACRS under the PITL.

Under the Corporation Tax Law (CTL), California did not conform to the pre-1986 federal ACRS depreciation deduction and currently does not conform to the federal law MACRS depreciation. The CTL is in substantial conformity to the pre-1981 federal asset depreciation range (ADR) deduction. The ADR is based on the "useful life" of depreciable property.

Prior to the adoption of ACRS by the Economic Recovery Tax Act (ERTA) of 1981, taxpayers were allowed to depreciate (under the ADR) the various components of a building as separate assets with separate useful lives.

Impact on California Revenue

Estimated Revenue Impact of Three-Year Depreciation for Race Horses Two Years Old or Younger For Tax Years Beginning On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$1,800,000	-$1,900,000	-$2,000,000

Estimates are based on a proration of federal projections developed for the Heartland, Habitat, Harvest and Horticulture Act of 2008. The revenue losses would decline to -$1,700,000 in 2012 -13 and to -$900,000 in 2013 -14.

[51] IRC section 168(e)(3)(A)(i).
[52] 1987-2 C.B. 674, asset class 01.225.

HEARTLAND, HABITAT, HARVEST, AND HORTICULTURE ACT OF 2008 (HHHHA)(PL 110-246, JUNE 18, 2008)

Section	Section Title
15345	Temporary Tax Relief for Kiowa County, Kansas and Surrounding Area

Background

In 2005, a series of hurricanes hit the Gulf region. Congress passed the Katrina Emergency Tax Relief Act of 2005 (Public Law 109-73) and the Gulf Opportunity Zone Act of 2005 (Public Law 109-135) to provide relief assistance to taxpayers who were affected by the storms and hurricanes.

The uncodified KETRA provision provides that the following definitions apply. The term "Hurricane Katrina disaster area" means an area with respect to which a major disaster has been declared by the President before September 14, 2005, under IRC section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina.

The States for which such a disaster has been declared are Alabama, Florida, Louisiana, and Mississippi. The term "core disaster area" means that portion of the Hurricane Katrina disaster area determined by the President to warrant individual or individual and public assistance from the federal government under such Act.

New Federal Law (IRC sections 1400N, 1400Q, 1400R, and 1400S)

In this uncodified provision, the act extends a variety of tax relief measures provided in KETRA and GO Zone to victims of storms and tornadoes that hit Greensburg, KS. The area designated for tax relief is the "Kansas disaster area," which is an area with respect to which a major disaster has been declared by the President under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of severe storms and tornadoes beginning on May 4, 2007, and determined by the President to warrant individual or individual and public assistance from the federal government under such Act with respect to damages attributable to storms and tornadoes.

This act section provides the application of certain provisions of the IRC by providing rules for the selective extension, and modified application, of the current provisions to Kansas tornado victims.

Effective Date

This provision is effective for losses arising on or after May 4, 2007.

California Law (R&TC sections 17201, 17207 and 18572)

California conforms to the federal disaster loss rules, as of the "specified date" of January 1, 2005, with modifications. For example, California has its own rules relating to excess disaster loss carryover and carrybacks for disasters occurring in California. Additionally, California conforms to IRC section 7508A, relating to postponement of certain tax-related deadlines, as of the "specified date" of January 1, 2005.

However, in the aftermath of the series of hurricanes that hit the Gulf region in 2005, federal law provided a variety of tax-relief provisions in IRC sections 1400M – 1400T, which have been extended to apply to the 2008 storms and tornadoes that hit Greensburg, KS. California does not conform to these provisions.

Impact on California Revenue

Not applicable.

Section	Section Title
15346	Competitive Certification Awards Modification Authority

Background

Advanced coal project credit

An investment tax credit is available for power generation projects that use integrated gasification combined cycle ("IGCC") or other advanced coal-based electricity generation technologies.[53] The credit amount is 20 percent for investments in qualifying IGCC projects and 15 percent for investments in qualifying projects that use other advanced coal-based electricity generation technologies.

To qualify, an advanced coal project must be located in the United States and use an advanced coal-based generation technology to power a new electric generation unit or to retrofit or repower an existing unit. Generally, an electric generation unit using an advanced coal-based technology must be designed to achieve a 99 percent reduction in sulfur dioxide and a 90 percent reduction in mercury, as well as to limit emissions of nitrous oxide and particulate matter.

[53] IRC section 48A.

For advanced coal project certification, applications submitted after October 2, 2006, an electric generation unit using advanced coal-based generation technology designed to use subbituminous coal can meet the performance requirement relating to the removal of sulfur dioxide if it is designed either to remove 99 percent of the sulfur dioxide or to achieve an emission limit of 0.04 pounds of sulfur dioxide per million British thermal units on a 30-day average.

The fuel input for a qualifying project, when completed, must use at least 75 percent coal. The project, consisting of one or more electric generation units at one site, must have a nameplate generating capacity of at least 400 megawatts, and the taxpayer must provide evidence that a majority of the output of the project is reasonably expected to be acquired or utilized.

Credits are available only for projects certified by the Secretary of the Treasury, in consultation with the Secretary of Energy. Certifications are issued using a competitive bidding process. The Secretary of Treasury must establish a certification program no later than 180 days after August 8, 2005, and each project application must be submitted during the three-year period beginning on the date such certification program is established. An applicant for certification has two years from the date the Secretary accepts the application to provide the Secretary with evidence that the requirements for certification have been met. Upon certification, the applicant has five years from the date of issuance of the certification to place the project in service.

The Secretary issued guidance establishing the certification program on February 21, 2006. The Secretary of the Treasury may allocate $800 million of credits to IGCC projects and $500 million to projects using other advanced coal-based electricity generation technologies. Qualified projects must be economically feasible and use the appropriate clean coal technologies. With respect to IGCC projects, credit-eligible investments include only investments in property associated with the gasification of coal, including any coal handling and gas separation equipment. Thus, investments in equipment that could operate by drawing fuel directly from a natural gas pipeline do not qualify for the credit. In determining which projects to certify that use IGCC technology, the Secretary must allocate power generation capacity in relatively equal amounts to projects that use bituminous coal, subbituminous coal, and lignite as primary feedstock. In addition, the Secretary must give high priority to projects which include greenhouse gas capture capability, increased by-product utilization, and other benefits.

Gasification project credit

A 20-percent investment tax credit is also available for investments in certain qualifying coal gasification projects.[54] Only property that is part of a qualifying gasification project and necessary for the gasification technology of such project is eligible for the gasification credit.

[54] IRC section 48B.

Qualified gasification projects convert coal, petroleum residue, biomass, or other materials recovered for their energy or feedstock value into a synthesis gas composed primarily of carbon monoxide and hydrogen for direct use or subsequent chemical or physical conversion. Qualified projects must be carried out by an eligible entity.[55] Credits are available only for projects certified by the Secretary of the Treasury, in consultation with the Secretary of Energy. Certifications are issued using a competitive bidding process. The Secretary of the Treasury must establish a certification program no later than 180 days after August 8, 2005,[56] and each project application must be submitted during the three-year period beginning on the date such certification program is established. The Secretary of the Treasury may not allocate more than $350 million in credits. In addition, the Secretary may certify a maximum of $650 million in qualified investment as eligible for credit with respect to any single project.

New Federal Law (Uncodified section 15246 of the Heartland, Habitat, Harvest, and Horticulture Act of 2008)

In implementing either IRC sections 48A or 48B, the uncodified provision directs the Secretary to modify the terms of any competitive certification award and any associated closing agreements in certain cases. Specifically, modification is required when it: (1) is consistent with the objectives of such section, (2) is requested by the recipient of the award, and (3) involves moving the project site to improve the potential to capture and sequester carbon dioxide emissions, reduce costs of transporting feedstock, and serve a broader customer base. However, no modification is required if the Secretary determines that the dollar amount of tax credits available to the taxpayer under the applicable section would increase as a result of the modification or such modification would result in such project not being originally certified. In considering any such modification, the Secretary must consult with other relevant federal agencies, including the Department of Energy.

Effective Date

This provision is effective on June 18, 2008, and is applicable to all competitive certification awards entered into under IRC sections 48A or 48B of the IRC of 1986, whether such awards were issued before, on, or after June 18, 2008.

California Law (R&TC sections 17053.84 and 23684)

California has no comparable credit.

[55] Eligible entity is defined as any person whose application for certification is principally intended for use in a domestic project which employs domestic gasification applications related to: (1) chemicals, (2) fertilizers, (3) glass, (4) steel, (5) petroleum residues, (6) forest products, and (7) agriculture, including feedlots and dairy operations.

[56] The Secretary issued guidance establishing the certification program on February 21, 2006.

Impact on California Revenue

Not applicable.

PART IV – OTHER REVENUE PROVISIONS

Section	Section Title
15351	Limitation of Excess Farm Losses of Certain Taxpayer

Background

Farming income and expenses are reported by individuals, estates, trusts, and partnerships on IRS Schedule F, Profit and Loss from Farming. For taxpayers who materially participate (as defined in IRC section 469(h)), net farming losses are reported in full as a reduction to income from both passive and nonpassive sources. To the extent taxpayers do not materially participate in the farming activity, the passive activity rules in IRC section 469 may limit the ability to use such losses to reduce income from nonpassive sources. Farming income generally includes sales of livestock, produce, grains, and other products; cooperative distributions; Agricultural Program Payments; certain Commodity Credit Corporation (''CCC'') loans (if an election is made to include loan proceeds in income in the year received); certain crop insurance proceeds and federal crop disaster payments; and other income. Farm expenses generally include feed, fertilizers, gasoline, fuel, and oil; insurance; interest; hired labor; rent and lease payments; repairs and maintenance; taxes; utilities; depreciation; and other business-related expenses. Living expenses and other personal expenses are not deductible farming expenses.

IRC section 263A(e)(4) defines a "farming business" as "the trade or business of farming." The term "farming business" also includes operating a nursery or sod farm, raising or harvesting fruit- or nut-bearing trees, or other crops and raising or harvesting ornamental trees. The Treasury Regulations provides further guidance, stating that a farming business generally involves the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity, including raising, shearing, feeding, caring for and training and management of animals.[57] However, a farming business does not include the mere buying and reselling of plants and animals raised by another where the taxpayer has not held the plant or animal for further cultivation and development prior to sale. The term "farming business" also includes processing activities that are normally incidental to growing, raising, or harvesting agricultural or horticultural products.

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[57] Treasury Reg. sec. 1.263A-4(a)(4).

HEARTLAND, HABITAT, HARVEST, AND HORTICULTURE ACT OF 2008 (HHHHA)(PL 110-246, JUNE 18, 2008)

HR 110-627 report explains that taxpayers receiving government assistance through payment programs and loan programs should not be allowed to claim unlimited amounts of losses from farming activities.

New Federal Law (IRC section 461)

This act provision limits the farming loss of a taxpayer, other than a C corporation, for any taxable year in which any applicable subsidies are received to the greater of: (1) $300,000 ($150,000 in the case of a married person filing a separate return), or (2) the taxpayer's total net farm income for the prior five taxable years. For purposes of this provision, applicable subsidies are: (1) any direct or counter-cyclical payments under Title I of the Food, Conservation, and Energy Act of 2008 (or any payment elected in lieu of any such payment), or (2) any CCC loan. Total net farm income is an aggregation of all income and loss from farming businesses for the prior five taxable years.

Effective Date

This provision applies to taxable years beginning after December 31, 2009.

California Law (R&TC sections 17551 and 24681)

California conforms by reference as of the “specified date” of January 1, 2005, to IRC section 461, relating to the general rule for taxable year of deduction, in R&TC section 17551, with modifications, and in R&TC section 24681. Because the changes to IRC section 461 were made after the “specified date,” California is not conformed.

Impact on California Revenue

Estimated Revenue Impact of Limitation of Excess Farm Losses of Certain Taxpayers Effective for Tax years Beginning On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
$1,400,000	$4,000,000	$4,100,000

Estimates are based on a proration of federal projections developed for the Heartland, Habitat, Harvest, and Horticulture Act of 2008.

HEARTLAND, HABITAT, HARVEST, AND HORTICULTURE ACT OF 2008 (HHHHA)(PL 110-246, JUNE 18, 2008)

Section	Section Title
15352	Modification to Optional Method of Computing Net Earnings from Self-Employment

Background

In general

Tax under the Self-Employment Contributions Act (SECA) is imposed on the self-employment income of an individual. SECA tax has two components. Under the old-age, survivors, and disability insurance component, the rate of tax is 12.40 percent on self-employment income up to the Social Security wage base ($97,500 for 2007). Under the hospital insurance component, the rate is 2.90 percent of all self-employment income (without regard to the Social Security wage base). Self-employment income subject to the SECA tax is determined as the net earnings from self-employment. An individual may use one of three methods to calculate net earnings from self-employment. Under the generally applicable rule, net earnings from self-employment means gross income (including the individual's net distributive share of partnership income) derived by an individual from any trade or business carried on by the individual, less the deductions attributable to the trade or business that are allowed under the SECA tax rules. Alternatively, an individual may elect to use one of two optional methods for calculating net earnings from self-employment. These methods are: (1) the farm optional method; and (2) the nonfarm optional method. The farm optional method allows individuals to pay SECA taxes (and secure Social Security benefit coverage) when they have low net income or losses from farming. The nonfarm optional method is similar to the farm optional method.

Farm optional method

If an individual is engaged in a farming trade or business, either as a sole proprietor or as a partner, the individual may elect to use the farm optional method in one of two instances. The first instance is an individual engaged in a farming business who has gross farm income of $2,400 or less for the taxable year. In this instance, the individual may elect to report two-thirds of gross farm income as net earnings from self-employment. In the second instance, an individual engaged in a farming business may elect the farm optional method even though gross farm income exceeds $2,400 for the taxable year but only if the net farm income is less than $1,733 for the taxable year. In this second instance, the individual may elect to report $1,600 as net earnings from self-employment for the taxable year. In all other instances (i.e., more than $2,400 of gross farm income and net farm income of at least $1,733) a person engaged in a farming business must compute net earnings from self-employment under the generally applicable rule. There is no limit on the number of years that an individual may elect the farm optional method during such individual's lifetime.

The dollar limits in the farm optional method are not indexed for inflation.

Nonfarm optional method

The nonfarm optional method is available only to individuals who have been self-employed for at least two of the three years before the year in which they seek to elect the nonfarm optional method and who meet certain other requirements. Specifically, an individual may elect the nonfarm optional method if the individual's: (1) net nonfarm income for the taxable year is less than $1,733; and (2) net nonfarm income for the taxable year is less than 72.189 percent of gross nonfarm income. If a qualified individual engaged in a nonfarming business who elects the nonfarm optional method has gross nonfarm income of $2,400 or less for the taxable year, then the individual may elect to report two-thirds of gross nonfarm income as net earnings from self-employment. If the electing individual engaged in a nonfarming business has gross nonfarm income of at least $2,400 for the taxable year, then the individual may elect to report $1,600 as net earnings from self-employment for the taxable year. In all other instances, a person engaged in a nonfarming business must compute net earnings from self-employment under the generally applicable rule. An individual may elect to use the nonfarm optional method for no more than five years in the course of the individual's lifetime.

The dollar limits in the nonfarm optional method are not indexed for inflation.

Other rules applicable to farm optional and nonfarm optional methods

In the case of a cash method trade or business, gross income is defined as the gross receipts from such trade or business less the cost or other basis of property sold in carrying out such trade or business with certain adjustments. In the case of an accrual method trade or business, gross income is defined as the gross income from the trade or business with certain adjustments. If an individual (including a member of a partnership) derives gross income from more than one trade or business then such gross income (including the individual's distributive share of the gross income of any partnership) is treated as derived from a single trade or business.

Social Security benefit eligibility

Generally, Social Security benefits can be paid to an individual (and dependents or survivors) only if that individual has worked long enough in covered employment to be insured. Insured status is measured in terms of "credits," previously called "quarters of coverage." For this purpose, Social Security uses the lifetime record of earnings reported for that individual. In the case of a self-employed individual, net earnings from self-employment is used to calculate Social Security benefit eligibility.

Up to four quarters of coverage can be earned for a year, depending on covered wages for the year and the amount needed to earn each quarter of coverage. For 2007, credit for a quarter of coverage is provided for each $1,000 of wages.

New Federal Law (IRC section 1402)

This act section modifies the farm optional method so that electing taxpayers may be eligible to secure four credits of Social Security benefit coverage each taxable year by increasing an indexing the thresholds. The proposal makes a similar modification to the nonfarm optional method.

Effective Date

The provision applies to taxable years beginning after December 31, 2007.

California Law

The Employment Development Department (EDD), rather than the Franchise Tax Board, administers the employment tax. Defer to EDD.

Impact on California Revenue

Defer to EDD.

Section	Section Title
15353	Information Reporting for Commodity Credit Corporation Transactions

Background

The Farm Security and Rural Investment Act of 2002[58] authorizes a marketing assistance loan program through the Commodity Credit Corporation ("CCC"). Under such program, the CCC may make loans for eligible commodities at a specified rate per unit of commodity (the original loan rate). The repayment amount for such a loan secured by an eligible commodity generally is based on the lower of the original loan rate or the alternative repayment rate, as determined by the CCC, as of the date of repayment. The alternative repayment rate may be adjusted to reflect quality and location for each type of commodity. A taxpayer receiving a CCC loan can use cash to repay such a loan, purchase CCC certificates for use in repayment of the loan, or deliver the pledged collateral as full payment for the loan at maturity.

If a taxpayer uses cash or CCC certificates to repay a CCC loan, and the loan is repaid at a time when the repayment rate is less than the original loan rate, the difference between the original loan amount and the lesser repayment amount is market gain. Regardless of whether a taxpayer repays a CCC loan in cash or uses CCC certificates in repayment of the

[58] Public Law 107-171.

loan, the market gain is taken into account either as income or as an adjustment to the basis of the commodity (if the taxpayer has made an election under IRC section 77).

If a farmer uses cash instead of certificates, the farmer will receive a Form CCC-1099-G Information Return showing the market gain realized. For transactions prior to January 1, 2001, however, if a farmer uses CCC certificates to facilitate repayment of a CCC loan, the farmer will not receive an information return. For transactions after January 1, 2001, IRS Notice 2007-63 provides that the CCC reports market gain associated with the repayment of a CCC loan whether the taxpayer repays the loan with cash or uses CCC certificates in repayment of the loan.[59] The CCC reports the market gain on Form 1099-G, Certain Government Payments.

New Federal Law (IRC section 6039J)

This act section codifies the requirements of IRS Notice 2007-63 providing that the CCC reports market gain associated with the repayment of a CCC loan, regardless of whether the taxpayer repays the loan with cash or uses CCC certificates in repayment of the loan.

Effective Date

The provision applies to loans repaid on or after January 1, 2007.

California Law (R&TC sections 17081, 18631, and 24273)

California does not conform by reference to IRC sections requiring information returns be filed, but instead provides in R&TC section 18631 that a copy of certain federal information returns are required to be filed with the FTB upon request. The new IRC section 6039J information reporting with respect to Commodity Credit Corporation transactions provision is not listed in R&TC section 18631 and, therefore, California has not automatically conformed to these new federal information return requirements.

In general, under the PITL California conforms by reference to Part II of Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to items that are specifically included in gross income in R&TC section 17081 as of the “specified date” of January 1, 2005. Under the CTL California does not conform to IRC section 77 by reference but provides stand-alone language in R&TC section 24273 that mirrors IRC section 77. California allows a taxpayer who receives a loan from the Commodity Credit Corporation to elect to include the amount of such loan in its gross income for the taxable year in which the loan is received. If a taxpayer exercises the election provided for in R&TC section 24273, then the method of computing income adopted shall be adhered to with respect to all subsequent taxable years, unless with the approval of the Franchise Tax Board a change to a different method is authorized.

[59] 2007-33 IRB.

Impact on California Revenue

Estimated Revenue Impact of Information Reporting for Commodity Credit Corporation Transactions For Tax Years Beginning On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
$0	$0	$0

The Joint Committee on Taxation did not identify any revenue impact for this provision.

HEROES EARNINGS ASSISTANCE AND RELIEF TAX ACT OF 2008 (HEARTA)(PL 110-245, JUNE 17, 2008)

TITLE I – BENEFITS FOR MILITARY

Section	Section Title
101	Recovery Rebate Provided to Military Families

Background

Present law includes a recovery rebate credit for 2008 which is refundable. The credit mechanism (and the issuance of checks described below) is intended to deliver an expedited fiscal stimulus to the economy.

The credit is computed with two components in the following manner:

Basic credit

Eligible individuals receive a basic credit (for the first taxable year beginning) in 2008 equal to the greater of the following:

- Net income tax liability not to exceed $600 ($1,200 in the case of a joint return).
- $300 ($600 in the case of a joint return) if: (1) the eligible individual has qualifying income of at least $3,000; or (2) the eligible individual has a net income tax liability of at least $1 and gross income greater than the sum of the applicable basic standard deduction amount and one personal exemption (two personal exemptions for a joint return).

An eligible individual is any individual other than: (1) a nonresident alien; (2) an estate or trust; or (3) a dependent.

For these purposes, “net income tax liability” means the excess of the sum of the individual’s regular tax liability and alternative minimum tax over the sum of all nonrefundable credits (other than the child credit). Net income tax liability as determined for these purposes is not reduced by the credit added by this provision or any credit which is refundable under present law.

Qualifying income is the sum of the eligible individual’s: (a) earned income; (b) Social Security benefits (within the meaning of sec. 86(d)); and (c) veteran’s payments (under Chapters 11, 13, or 15 of title 38 of the U. S. Code). The definition of earned income has the same meaning as used in the earned income credit except that it includes certain combat pay and does not include net earnings from self-employment which are not taken into account in computing taxable income.

Qualifying child credit

If an individual is eligible for any amount of the basic credit, the individual also may be eligible for a qualifying child credit. The qualifying child credit equals $300 for each qualifying child of such individual. For these purposes, the child credit definition of qualifying child applies.

Limitation based on adjusted gross income

The amount of the credit (i.e., the sum of the amounts of the basic credit and the qualifying child credit) is phased out at a rate of five percent of adjusted gross income above certain income levels. The beginning point of this phase-out range is $75,000 of adjusted gross income ($150,000 in the case of joint returns).

Rebate checks

Most taxpayers will receive this credit in the form of a check issued by the Department of the Treasury. The amount of the payment is computed in the same manner as the credit, except that it is done on the basis of tax returns filed for 2007 (instead of 2008).

In no event may the Department of the Treasury issue checks after December 31, 2008. Payment of the credit (or the check) is treated, for all purposes of the IRC, as a payment of tax. Any resulting overpayment under this provision is subject to the refund offset provisions, such as those applicable to past-due child support under IRC section 6402.

Valid identification numbers

No credit is allowed to an individual who does not include a valid identification number on the individual’s income tax return. In the case of a joint return which does not include valid identification numbers for both spouses, no credit is allowed. In addition, a child shall not be taken into account in determining the amount of the credit if a valid identification number for the child is not included on the return. For this purpose, a valid identification number means a Social Security number issued to an individual by the Social Security Administration. A taxpayer identification number issued by the Internal Revenue Service (the “IRS”) is not a valid identification number for purposes of this credit (e.g., an ITIN).

If an individual fails to provide a valid identification number, the omission is treated as a mathematical or clerical error. As under present law, the IRS may summarily assess additional tax due as a result of a mathematical or clerical error without sending the taxpayer a notice of deficiency and giving the taxpayer an opportunity to petition the Tax Court. Where the IRS uses the summary assessment procedure for mathematical or clerical errors, the taxpayer must be given an explanation of the asserted error and given 60 days to request that the IRS abate its assessment.

HEROES EARNINGS ASSISTANCE AND RELIEF TAX ACT OF 2008 (HEARTA)(PL 110-245, JUNE 17, 2008)

New Federal Law (IRC section 6428)

The provision makes a modification to the rules relating to valid identification numbers in the case of the recovery rebate credit.

Effective Date

The provision is effective as if included in the amendments made by section 101 of the Economic Stimulus Act of 2008 (Public Law 110-185).

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
102	Election to Include Combat Pay as Earned Income for Purpose of Earned Income Tax Credit

Background

Subject to certain limitations, military compensation earned by members of the Armed Forces while serving in a combat zone may be excluded from gross income. In addition, for up to two years following service in a combat zone, military personnel may also exclude compensation earned while hospitalized from wounds, disease, or injuries incurred while serving in the combat zone.

Child credit

Combat pay that is otherwise excluded from gross income under IRC section 112 is treated as earned income which is taken into account in computing taxable income for purposes of calculating the refundable portion of the child credit.

Earned income credit

Any taxpayer may elect to treat combat pay that is otherwise excluded from gross income under IRC section 112 as earned income for purposes of the earned income credit. This election is available with respect to any taxable year ending after June 17, 2008 and before January 1, 2008.

New Federal Law (IRC section 32)

The provision permanently extends the availability of the election to treat combat pay that is otherwise excluded from gross income under IRC section 112 as earned income for purposes of the Earned Income Credit.

Effective Date

The provision is effective for taxable years beginning after December 31, 2007.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
103	Modification of Mortgage Revenue Bonds for Veterans

Background

In general

Private activity bonds are bonds that are issued by states or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such private person. The exclusion from income for interest paid on state and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds"). The definition of qualified private activity bonds includes both qualified mortgage bonds and qualified veterans' mortgage bonds.

Qualified mortgage bonds

Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for owner-occupied residences. The IRC imposes several limitations on qualified mortgage bonds, including income limitations for homebuyers and purchase price limitations for the home financed with bond proceeds. In addition, qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage (the "first-time homebuyer" requirement).

Under a special rule, qualified mortgage bonds may be issued to finance mortgages for veterans who served in the active military without regard to the first-time homebuyer requirement. Present-law income and purchase price limitations apply to loans to veterans financed with the proceeds of qualified mortgage bonds. Veterans are eligible for the exception from the first-time homebuyer requirement without regard to the date they last served on active duty or the date they applied for a loan after leaving active duty. However, veterans may only use the exception one time and the exception only applies to financing provided from bonds issued before January 1, 2008.

Qualified veterans mortgage bonds

Qualified veterans' mortgage bonds are private activity bonds the proceeds of which are used to make mortgage loans to certain veterans. Authority to issue qualified veterans' mortgage bonds is limited to states that had issued such bonds before June 22, 1984. Qualified veterans' mortgage bonds are not subject to the state volume limitations generally applicable to private activity bonds. Instead, annual issuance in each state is subject to a separate state volume limitation. The five states eligible to issue these bonds are Alaska, California, Oregon, Texas, and Wisconsin.

In the case of qualified veterans' mortgage bonds issued by California or Texas, mortgage loans only can be made to veterans who served on active duty before 1977 and who applied for the financing before the date 30 years after the last date on which such veteran left active service. In the case of qualified veterans' mortgage bonds issued by the states of Alaska, Oregon, and Wisconsin, mortgage loans can be made to veterans who apply for financing before the date 25 years after the last date on which such veteran left active service, without regard to the calendar year the veteran served on active duty.

The annual volume of qualified veterans' mortgage bonds that can be issued in California or Texas is based on the average amount of bonds issued in the respective state between 1979 and 1984. In Alaska, Oregon, and Wisconsin, the annual limit on qualified veterans' mortgage bonds that can be issued in years after 2009 is $25 million.

This $25 million per-state limit is phased in from 2006 through 2009 by allowing the applicable percentage of the $25 million limit. The following table provides those percentages.

Calendar Year:	Applicable Percentage is:
2006	20 percent
2007	40 percent
2008	60 percent
2009	80 percent

Unused allocation cannot be carried forward to subsequent years.

New Federal Law (IRC section 143)

Qualified mortgage bonds

The provision permanently extends the limited exception from the first-time homebuyer rule for veterans under the qualified mortgage bond program.

Qualified veterans' mortgage bonds

The provision increases the annual limit on qualified veterans' mortgage bonds that can be issued in Alaska, Oregon, and Wisconsin in years after 2009 to $100 million. For 2008 and 2009, the $100 million limit is phased in by applying the present-law applicable percentages for those years (i.e., 60 percent in 2008 and 80 percent in 2009).

With respect to qualified veterans' mortgage bonds issued in California or Texas, the provision repeals the requirement that veterans receiving loans financed with qualified veterans' mortgage bonds must have served before 1977 and reduces the eligibility period to 25 years (rather than 30 years) following release from military service.

Effective Date

The provision generally applies to bonds issued after December 31, 2007. In the case of any bond issued after December 31, 2007, and before the date of enactment, the eligibility period for a loan financed with qualified veterans' mortgage bonds is 30 years following release from military service.

California Law (R&TC sections 17143 and 24272)

California specifically does not conform to IRC sections 103 and 141 through 150, relating to the federal rules exempting the interest earned on state or municipal bonds and the arbitrage rebate rules. In addition, the federal "private-activity-bond" rules have not been adopted by

California. Also, California has never conformed to the federal tax law treatment of Indian tribal governments as states.

California state and municipal bonds

The general rule in California is that for income tax purposes all interest received or accrued is fully taxable, except for interest on federal obligations (such as Treasury bills, notes, and bonds, as more fully described below) and tax-exempt bonds issued by this state or a local government in this state.

Unlike federal law, the interest earned on bonds issued by other states and municipalities in other states is fully taxable to a resident of California. The California exemption from income taxation of interest on bonds of the state and its political subdivisions is contained in the California Constitution (Art. XIII, § 26. subd. (b)). The Revenue and Taxation Code further provides, by statute, that the federal "private-activity-bond" analysis shall not be made in determining whether interest on bonds issued by the state or a political subdivision thereof shall be exempt from California income tax. Thus, in California, if the use of the bond proceeds of a state or local California issue is for private business use or is secured by property used for a private business use, the interest on that bond is still treated for California income tax purposes as tax exempt, even though the interest on the bond may well be taxable for federal income tax purposes.

California conduit revenue bonds

Conduit revenue bonds are issued by a governmental (state or municipal) entity for various purposes, including economic development, educational and health facilities construction, and multi-family housing. The funds obtained from the financing are loaned to a nongovernmental borrower who builds and operates the project. The use by a private firm (via expenditure of the bond proceeds) of a governmental agency's authority to issue tax-exempt debt is premised on the fact that the project will provide public benefit. A conduit revenue bond is payable solely from the loan payments received from the non-governmental party (unless the bond is insured by a third party who guarantees payment in the event of a default by the private firm who has pledged the revenue source). The governmental issuer typically has no liability for debt service on the bonds, except for the administration of the bond. Although the issuer has no actual liability on the bonds, their reputation and standing with respect to future debt financing may be negatively affected in the event of a default on the bonds. More importantly, should the bonds go into default, the governmental entity will likely be drawn into the settlement process. Most conduit revenue bonds are sold at negotiated sales with the interest rate and other terms of the bonds negotiated between the issuer, the non-governmental borrower, and an underwriter. The security for some of these transactions is sufficient to allow the underwriter to act as a pass-through for the bonds and in so doing act as a placement agent rather than an underwriter. Since the public agency's credit is not on the line, many issuers do not participate in any substantive fashion in the sale of the bonds. Rather, they may limit their role to reviewing the bond purchase contract and other legal and disclosure documents to ensure that they are adequately indemnified against liabilities and to accurately describe their role to investors as issuers and not as borrowers or guarantors of the debt.

Because the conduit revenue bonds issued in California are issued by this state or a local government in this state, the interest paid on such bonds is exempt from state income taxation under the California Constitution.

California treatment of federal bond interest

Interest earned on federal bonds is also tax-exempt for California income tax purposes. This results from federal law (31 U.S.C. § 3124(a)) that prohibits all states from imposing an income tax on interest income from direct obligations of the U. S. government. Examples of bonds that are exempt for California income tax purposes include those issued by federal land banks, the Federal Home Loan Bank, and Banks for Cooperatives. Not all federal bonds are direct obligations of the U.S. government and interest on those bonds is taxable.

Examples of federal bonds not exempt are those issued by the Federal National Mortgage Association (Fannie Maes), Government National Mortgage Association (Ginnie Maes), and Federal Loan Home Mortgage Corporation (Freddie Macs).

California franchise tax treatment

Interest received from federal, state, municipal, or other bonds is includable in the gross income of corporations taxable under the franchise tax. The franchise tax is a nondiscriminatory privilege tax for the right to exercise the corporate franchise and is not a tax on the income received, but instead merely uses that income of the year as the measure of the tax for the privilege of exercising the corporate franchise.

Impact on California Revenue

Not applicable.

Section	Section Title
104	Survivor and Disability Payments with Respect to Qualified Military Service

Background

Under the Uniformed Services Employment and Reemployment Rights Act of 1994 (“USERRA”),[60] which revised and restated the federal law protecting veterans’ reemployment

[60] Public Law 103-353.

rights, an employee who leaves a civilian job for qualified military service generally is entitled to be reemployed by the civilian employer if the individual returns to employment within a specified time period. In addition to reemployment rights, a returning veteran also is entitled to the restoration of certain pension, profit sharing and similar benefits that would have accrued, but for the employee's absence due to the qualified military service. The protections provided under USERRA do not apply if the veteran is not reemployed by the veteran's civilian employer.

USERRA generally provides that for a reemployed veteran, service in the uniformed services is considered service with the employer for retirement plan vesting and benefit accrual purposes. The employer that reemploys the returning veteran is liable for funding any resulting obligation. USERRA also provides that the reemployed veteran is entitled to any accrued benefits that are contingent on the making of, or derived from, employee contributions or elective deferrals only to the extent the reemployed veteran makes payment to the plan with respect to such contributions or deferrals. No such payment may exceed the amount the reemployed veteran would have been permitted or required to contribute had the person remained continuously employed by the employer throughout the period of uniformed service. Under USERRA, any such payment to the plan must be made during the period beginning with the date of reemployment and whose duration is three times the reemployed veteran's period of uniform service, not to exceed five years.

The Small Business Job Protection Act of 1996[61] added IRC section 414(u) to provide rules regarding the interaction of the USERRA protections with generally applicable rules that govern tax qualified retirement plans. For example, IRC section 414(u) provides that if any make-up contribution is made by an employer or employee with respect to a reemployed veteran, then such contribution is not subject to the otherwise applicable plan contribution and deduction limits for the year in which the contribution is made (such as the IRC section 402(g) annual limit on elective deferrals, which is generally $15,500 in 2008). Such limits are instead applied for the year to which the contribution relates had the individual continued to be employed by the employer during the period of uniformed service.

Under IRC section 414(u), a plan to which a make-up contribution is made on account of a reemployed veteran is not treated as failing to meet the qualified plan nondiscrimination, coverage, minimum participation, and top heavy rules[62] by reason of the making of such contribution. Consequently, for purposes of applying the requirements and tests associated with these rules, make-up contributions are not taken into account either for the year in which they are made or for the year to which they relate.

In addition, IRC section 414(u) provides for a special rule in the case of make-up contributions of salary reduction, employer matching, and after-tax employee amounts. A plan that provides for elective deferrals or employee contributions is treated as meeting the

[61] Public Law 104-188.
[62] These include IRC sections 401(a)(4), 401(a)(26), 401(k)(3), 401(k)(11), 401(k)(12), 401(m), 403(b)(12), 408(k)(3), 408(k)(6), 408(p), 410(b), and 416.

requirements of USERRA if the employer permits reemployed veterans to make additional elective deferrals or employee contributions under the plan during the period which begins on the date of reemployment and has the same length as the lesser of: (1) the period of the individual's absence due to uniformed service multiplied by three, or (2) five years. The employer is required to match any additional elective deferrals or employee contributions at the same rate that would have been required had the deferrals or contributions actually been made during the period of uniformed service. Additional elective deferrals, employer matching contributions, and employee contributions are treated as make-up contributions for purposes of the rule exempting such contributions from qualified plan nondiscrimination, coverage, minimum participation, and top heavy rules described above.

New Federal Law (IRC sections 401, 403, 404, 414, and 457)

The act provision adds a new tax qualification requirement for retirement plans that are qualified under IRC section 401(a) of the IRC (a "tax-qualified plan"). Under the new requirement, a tax-qualified plan must provide that, in the case of a participant who dies while performing qualified military service, the survivors of the participant must be entitled to any additional benefits (other than benefit accruals relating to the period of qualified military service) that would be provided under the plan had the participant resumed employment with the employer maintaining the plan and then terminated employment on account of death. Thus, if a plan provides for accelerated vesting, ancillary life insurance benefits, or other survivor benefits that are contingent upon a participant's termination of employment on account of death, the plan must provide such benefits to the beneficiary of a participant who dies during qualified military service.

Under the provision, conforming amendments apply the new tax qualification requirement to IRC section 403(b) tax-deferred annuities and eligible deferred compensation plans (described in IRC section 457(b)) maintained by state and local governments. The provision also conditions the deduction timing rule of IRC section 404(a)(2) (permitting contributions for the purchase of employee retirement annuities that meet certain requirements applicable to tax-qualified retirement plans to be deducted in the year of payment) on satisfaction of the new qualification requirement.

In addition, for benefit accrual purposes, the provision permits a retirement plan to treat an individual who leaves service with the plan's sponsoring employer for qualified military service, and who cannot be reemployed on account of death or disability, as if the individual had been rehired as of the day before death or disability (a "deemed rehired employee") and then had terminated employment on the date of death or disability. In the case of a deemed rehired employee, the plan is permitted to comply fully or partially with the benefit accrual restoration provisions that would be required under IRC section 414(u) had the individual actually been rehired.

Subject to several conditions, if a plan complies fully or partially with the benefit accrual requirements of IRC section 414(u), the special IRC section 414(u) rules regarding the interaction of USERRA with the otherwise applicable benefit limitation and nondiscrimination rules apply. The first condition is that all employees performing qualified military service of the employer maintaining the plan who die or become disabled must be credited with benefits on a reasonably equivalent basis. Thus, differences in credited benefits on account of different compensation levels are permissible, but complying fully with the IRC section 414(u) benefit accrual requirements with respect to highly compensated employees and complying partially with respect to non-highly compensated employees is not permissible. The second condition is that if the plan credits deemed rehired employees with benefits that are contingent on employee contributions or elective contributions, the plan must determine the rate of employee contributions or elective deferrals on the basis of the actual average contributions or deferrals made by the employee during the 12-month period prior to military service (or if less, the average for the actual period of service).

The provision provides rules regarding the date by which a plan must be amended to comply with the provision. In general, a plan must be amended on or before the last day of the plan year beginning on or after January 1, 2010.

Effective Date

The provision applies in the case of deaths and disabilities occurring on or after January 1, 2007.

California Law (R&TC sections 17501 and 17551)

In general, California conforms by reference to Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of IRC sections 401 through 424, inclusive, in R&TC section 17501(a) as of the “specified date” of January 1, 2005. Additionally, California conforms by reference to Subchapter E of Chapter 1 of Subtitle A of the IRC, relating to accounting periods and methods of accounting, consisting of IRC sections 441 through 483, inclusive, in R&TC section 17551(a) as of the “specified date” of January 1, 2005. However, except for increases in the maximum amount of elective deferrals, R&TC sections 17501(b) and 17551(c) specifically provide that federal changes to Part I of Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of IRC sections 401 through 420, inclusive, and IRC section 457, relating to deferred compensation plans of state and local governments and tax-exempt organizations, automatically apply without regard to taxable year to the same extent as applicable for federal income tax purposes and thus adopt all changes made to those IRC sections without regard to the “specified date” contained in R&TC section 17024.5. Thus, the federal changes to IRC sections 401, 403, 404, 414, and 457 made by the act provision automatically apply under California law without regard to taxable year to the same extent as applicable for federal income tax purposes.

Impact on California Revenue

Baseline.

HEROES EARNINGS ASSISTANCE AND RELIEF TAX ACT OF 2008 (HEARTA)(PL 110-245, JUNE 17, 2008)

Section	Section Title
105	Treatment of Differential Military Pay as Wages

Background

In general

In the case of an employee who is called to active duty with the United States uniformed services, some employers voluntarily agree to continue paying the level of compensation that the service member would otherwise have received from the employer during the service member's period of active duty. Such compensation is commonly referred to as "differential pay."

Wage withholding

Differential pay is not treated as wages for purposes of the federal income tax withholding rules that apply to an employer's payment of wages. This is because the service member is treated as terminating the employment relationship with the employer that pays the differential pay upon being called for active duty.[63]

Retirement plans

IRC section 415 imposes limitations on the benefits that may be provided under a retirement plan that is qualified under IRC section 401(a) (a "qualified plan"). For a defined contribution plan, IRC section 415 limits the annual additions to a participant's account under the plan to the lesser of a dollar amount ($46,000 in 2008) or 100 percent of the participant's compensation. In the case of a defined benefit plan, IRC section 415 generally limits the annual benefit payable under the plan to the lesser of a dollar amount ($185,000 in 2008) or 100 percent of the participant's average compensation for the participant's high three years. Final regulations issued in 2007 generally permit a plan to treat differential pay as compensation for purposes of IRC section 415.[64] The IRC section 415 limitations also apply to tax deferred annuities[65] and simplified employee pensions[66] ("SEPs"). The definition of compensation in IRC section 415 is used in limiting the amount that may be deferred under an eligible deferred compensation plan (described in IRC section 457(b)).

[63] See Rev. Rul. 69-136, 1969-1 C.B. 252.
[64] Treas. Reg. sec. 1.415(c)-2(e)(4), 72 Fed. Reg. 16,878 (Apr. 5, 2007).
[65] IRC section 403(b).
[66] IRC section 408(k).

Limitation on in-service distributions

Under present law, certain types of contributions to a retirement plan are subject to restrictions that generally limit distributions to a participant prior to the participant severing employment with the employer that sponsors the plan. This limitation on in-service distributions applies to: (1) elective deferrals under a qualified cash or deferred compensation arrangement ("IRC section 401(k) plan"); (2) amounts attributable to a salary reduction agreement under an IRC section 403(b) tax-sheltered annuity; (3) amounts contributed to a custodial account described in IRC section 403(b)(7); and (4) amounts deferred under an eligible deferred compensation plan (described in IRC section 457(b)).

USERRA

Under the Uniformed Services Employment and Reemployment Rights Act of 1994 ("USERRA"), which revised and restated the federal law protecting veterans' reemployment rights, an employee who leaves a civilian job for qualified military service generally is entitled to be reemployed by the civilian employer if the individual returns to employment within a specified time period. In addition to reemployment rights, a returning veteran also is entitled to the restoration of certain pension, profit sharing and similar benefits that would have accrued, but for the employee's absence due to the qualified military service. IRC section 414(u) provides special rules that permit defined benefit plans and individual account plans to satisfy the requirements of USERRA. An individual account plan for this purpose is any defined contribution plan (such as a IRC section 401(k) plan), and includes a section 403(b) tax sheltered annuity, a SEP, a qualified salary reduction arrangement under IRC section 408(p) ("SIMPLE"), and an eligible deferred compensation plan (described in IRC section 457(b)). IRC section 414(u) does not apply to a plan to which Chapter 43 of Title 38 of the United States Code does not apply.

IRA contributions

There are two general types of individual retirement arrangements ("IRAs"): traditional IRAs and Roth IRAs.[67] Under IRC section 219, the total amount that an individual may contribute to one or more IRAs for a year is generally limited to the lesser of: (1) a dollar amount ($5,000 for 2008); or (2) the amount of the individual's compensation that is includible in gross income for the year. In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses that is includible in gross income is at least equal to the contributed amount. For purposes of the IRA contribution limitations, compensation includes an individual's net earnings from self employment.

[67] IRC sections 408 and 408A.

HEROES EARNINGS ASSISTANCE AND RELIEF TAX ACT OF 2008 (HEARTA)(PL 110-245, JUNE 17, 2008)

New Federal Law (IRC sections 219, 414 and 3401)

Wage withholding

The provision amends the definition of wages for purposes of the federal income tax withholding rules applicable to an employer's payment of wages. The provision includes as wages the employer's payment of any differential wage payment to the employee. Differential wage payment is defined as any payment that: (1) is made by an employer to an individual with respect to any period during which the individual is performing service in the uniformed services while on active duty for a period of more than 30 days; and (2) represents all or a portion of the wages that the individual would have received from the employer if the individual were performing services for the employer.

Retirement plans

The provision also provides rules relating to differential wage payments (as defined for purposes of wage withholding) for purposes of a retirement plan that is subject to IRC section 414(u). Specifically, an individual receiving a differential wage payment is required to be treated as an employee of the employer making the payment, and the differential wage payment is required to be treated as compensation. In addition, a retirement plan that is subject to IRC section 414(u) is not treated as failing to meet certain requirements relating to minimum participation and nondiscrimination standards[68] by reason of any contribution or benefit that is based on the differential wage payment if all of the sponsoring employer's employees: (1) are entitled to differential wage payments on reasonably equivalent terms; and (2) if all employees eligible to participate in a retirement plan maintained by the employer are entitled to make contributions based on such differential payments on reasonably equivalent terms. Under the provision, an individual is treated as having been severed from employment during any period the individual is performing service in the uniformed services while on active duty for a period of more than 30 days for purposes of the limitation on in-service distributions with respect to: (1) elective deferrals under a IRC section 401(k) plan; (2) amounts attributable to a salary reduction agreement under a IRC section 403(b) tax-sheltered annuity; (3) amounts contributed to a custodial account described in IRC section 403(b)(7); and (4) amounts deferred under an eligible deferred compensation plan (described in section 457(b)). Thus, such individuals are not prohibited from receiving distributions on account of not severing employment. However, if any amounts are distributed on account of

[68] These standards include the following: IRC section 401(a)(4) (prohibiting discrimination in contributions or benefits provided under qualified plans); IRC section 401(a)(26) (providing minimum participation rules for qualified defined benefit plans); IRC section 401(k)(3), (11), and (12) (providing nondiscrimination rules for elective deferrals under qualified cash or deferred arrangements); IRC section 401(m) (providing non-discrimination rules for employee contributions and employer matching contributions to qualified plans); IRC section 403(b)(12) (providing non-discrimination rules for IRC section 403(b) tax sheltered annuities); IRC section 408(k)(3), (k)(6), and (p) (providing non-discrimination rules for SEPs and SIMPLEs); IRC section 410(b) (providing minimum coverage rules for qualified plans); and IRC section 416 (requiring minimum benefits in the case of top heavy qualified plans).

the foregoing rule, the individual is not permitted to make elective deferrals or employee contributions to the plan during the six-month period beginning on the date of distribution.

IRAs

For purposes of the limitation on contributions to an IRA, the provision amends the term "compensation" to include differential wage payments (as defined for purposes of wage withholding).

Plan amendment timing

In general, the provision permits a plan or annuity contract to be retroactively amended to comply with the provision provided that the amendment is made no later than the last day of the first plan year beginning on or after January 1, 2010. Subject to certain conditions, a plan or annuity contract is treated as being operated in accordance with its terms during the period prior to amendment and, except as provided by the Secretary of the Treasury, the plan or annuity contract does not fail to meet the requirements of the IRC or the Employee Retirement Income Security Act of 1974 by reason of the amendment.

Effective Date

For purposes of the wage withholding rules, the provision is effective with respect to remuneration paid after December 31, 2008. Otherwise, the provision is effective with respect to years beginning after December 31, 2008.

California Law (R&TC sections 17201, 17203, 17501, and 17551)

Wage withholding

In California wage withholding is administered by the Employment Development Department (EDD) and not the Franchise Tax Board.

Retirement plans

In general, California conforms by reference to Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of IRC sections 401 through 424, inclusive, in R&TC section 17501(a) as of the "specified date" of January 1, 2005. Additionally, California conforms by reference to Subchapter E of Chapter 1 of Subtitle A of the IRC, relating to accounting periods and methods of accounting, consisting of IRC sections 441 through 483, inclusive, in R&TC section 17551(a) as of the "specified date" of January 1, 2005. However, except for increases in the maximum amount of elective deferrals, R&TC sections 17501(b) and 17551(c) specifically provide that federal changes to Part I of Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of IRC sections 401 through 420, inclusive, and IRC section 457, relating to deferred compensation plans of state and local governments and tax-exempt organizations, automatically apply without regard to taxable year to the same extent as applicable for federal income tax purposes and thus adopt all changes made to those IRC sections without regard to the "specified date" contained in R&TC section 17024.5. Thus, the federal changes to IRC section 414 made by the act provision automatically apply under California law without regard to taxable year to the same extent as applicable for federal income tax purposes.

IRAs

Under R&TC section 17203, California law specifically provides that any references to "compensation" or "earned income" for purposes of computing federal limitations on the deductions for IRA, shall apply also to California. Thus, the changes to IRC section 219 that amends the term "compensation" to include differential wage payments, automatically apply under California law.

Impact on California Revenue

Wage withholding

Defer to EDD.

Retirement plans

Any revenue impact is considered baseline because California is effectively pre-conformed to this federal change.

Section	Section Title
106	Special Period of Limitation When Uniformed Services Retired Pay is Reduced as a Result of Award of Disability Compensation

Background

In general, a taxpayer must file a claim for credit or refund within three years of the filing of the tax return or within two years of the payment of the tax, whichever expires later (if no tax return is filed, the two-year limit applies). A claim for credit or refund that is not filed within these time periods is rejected as untimely. Generally, military retirement benefits based on length of service are included in income, whereas veterans' benefits based on a service-connected disability are excluded from income. If an individual receives includible retirement benefits and is later retroactively determined to be eligible for service-connected disability benefits, the portion of the retirement benefits attributable to the disability is retroactively excluded from income. In that case, the individual may claim a refund of the tax paid on the retroactively excluded benefits, subject to the statute of limitations on filing a refund claim.

New Federal Law (IRC section 6511)

The provision extends the time period for filing claims for credits or refunds for retired military personnel who receive disability determinations from the Department of Veterans Affairs (e.g., determinations after the tax return is filed). Specifically, in the case of a determination after the date of enactment, the provision extends the period for filing such a refund claim until one year after the date of the disability determination (if later than the time periods allowed under present law). The provision applies to any taxable year that begins five years before the date of the determination or thereafter. In the case of a determination after December 31, 2000, and on or before June 17, 2008, the period for filing a claim for credit or refund is extended until one year after June 17, 2008 (if later than the time periods allowed under present law).

Effective Date

The provision is effective for claims for credits or refunds filed after June 17, 2008.

California Law (R&TC section 19311)

California does not conform by reference to IRC section 6511 limitations on credit and refund, but instead provides in R&TC section 19311 that California extends the statute of limitation if a change or correction to taxpayer's federal return is allowed or required by the IRS. Under R&TC section 19311, a claim for refund resulting from a federal adjustment may be filed within the later of: (1) two years from the date of final determination, (2) four years from due date of return, (3) one year from date of overpayment, or (4) the close of the period which the FTB may issue a notice of proposed deficiency assessment as a result of an extension agreement between the FTB or IRS and the taxpayer.

Impact on California Revenue

Any revenue impact is considered baseline because California is effectively pre-conformed to this federal change.

Section	Section Title
107	Distribution from Retirement Plans to Individuals Called to Active Duty

Background

Under present law, a taxpayer who receives a distribution from a qualified retirement plan prior to age 59½, death, or disability generally is subject to a 10-percent early withdrawal tax on the amount includible in income, unless an exception to the tax applies. Among other exceptions, the early distribution tax does not apply to distributions made to an employee who separates from service after age 55, or to distributions that are part of a series of substantially equal periodic payments made for the life (or life expectancy) of the employee or the joint lives (or life expectancies) of the employee and his or her beneficiary.

Certain amounts held in a qualified cash or deferred arrangement (IRC section 401(k) plan) or in a tax-sheltered annuity (IRC section 403(b) annuity) may not be distributed before severance from employment, age 59½, death, disability, or financial hardship of the employee.

Pursuant to amendments to IRC section 72(t) made by the Pension Protection Act of 2006, the 10-percent early withdrawal tax does not apply to a qualified reservist distribution. A qualified reservist distribution is a distribution: (1) from an IRA or attributable to elective deferrals under a section 401(k) plan, section 403(b) annuity, or certain similar arrangements; (2) made to an individual who (by reason of being a member of a reserve component as defined in section 101 of title 37 of the United States Code) was ordered or called to active duty for a period in excess of 179 days or for an indefinite period; and (3) that is made during the period beginning on the date of such order or call to duty and ending at the close of the active duty period. An IRC section 401(k) plan or IRC section 403(b) annuity does not violate the distribution restrictions applicable to such plans by reason of making a qualified reservist distribution.

An individual who receives a qualified reservist distribution may, at any time during the two-year period beginning on the day after the end of the active duty period, make one or more contributions to an IRA of such individual in an aggregate amount not to exceed the amount of such distribution. The dollar limitations otherwise applicable to contributions to IRAs do not apply to any contribution made pursuant to this special repayment rule. No deduction is allowed for any contribution made under the special repayment rule.

The special rules applicable to a qualified reservist distribution apply to individuals ordered or called to active duty after September 11, 2001, and before December 31, 2007.

New Federal Law (IRC section 72)

The provision makes permanent the rules applicable to qualified reservist distributions to individuals ordered or called to active duty on or after December 31, 2007.

Effective Date

The provision is effective June 17, 2008.

California Law (R&TC sections 17085, 17501 and 17551)

California conforms to IRC section 72, relating to early withdrawal tax, as of the "specified date" of January 1, 2005, in R&TC section 17081, with modifications in R&TC section 17085, including the modification of the early withdrawal tax to be 2 ½ percent for California purposes, rather than 10 percent for federal purposes. California has not conformed to the changes made by the Pension Protection Act of 2006 and will use the IRC section 72 rules that existed on the "specified date," including imposing the 2 ½ percent early-withdrawal tax on these distributions.

Impact on California Revenue

Estimated Revenue Impact of Distributions from Retirement Plans to Individuals Called to Active Duty Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$8,000	-$6,000	-$8,000

Estimates are based on a proration of federal projections developed for the Heroes Earnings Assistance and Relief Tax Act of 2008, adjusted to reflect California differences.

Section	Section Title
108	Authority to Disclose Return Information for Certain Veteran Programs Made Permanent

Background

The IRC prohibits disclosure of returns and return information, except to the extent specifically authorized by the IRC (IRC section 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (IRC section 7213). An action for civil damages also may be brought for unauthorized disclosure (IRC section 7431). 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 (IRC section 6103(p)).

Among the disclosures permitted under the IRC is disclosure of certain tax information to the Department of Veterans Affairs. Disclosure is permitted to assist the Department of Veterans Affairs in determining eligibility for, and establishing correct benefit amounts under, certain of its needs-based pension, health care, and other programs (IRC section 6103(1)(7)(D)(viii)).

The Department of Veterans Affairs disclosure provisions do not apply after September 30, 2008.

New Federal Law (IRC section 6103)

The provision makes permanent the authority to make disclosures to the Department of Veteran's Affairs. The provision also corrects the cross-references to Title 38.

Effective Date

The provision is effective for requests made after September 30, 2008.

California Law (R&TC section 19551)

California does not conform by reference to IRC section 6103, relating to confidentiality and disclosure of returns and return information, but instead provides in R&TC section 19551 that disclosure of tax information is allowed to federal and other state tax authorities, the Multistate Tax Commission, or the tax officials of Mexico (if a reciprocal agreement exists). Thus, the federal changes to IRC 6103 do not apply to California.

Impact on California Revenue

Not applicable.

Section	Section Title
109	Contributions of Military Death Gratuities to Roth IRAs and Education Savings Accounts

Background

Military death gratuities and SGLI

Section 1477 of Title 10 of the United States Code provides for the payment of a military death gratuity to an eligible survivor of a service member. Under IRC section 134, as amended by the Military Family Tax Relief Act of 2003, the full amount of the military death gratuity is excludable from gross income. Pursuant to section 1967 of Title 38 of the United States Code, certain members of the uniformed services are automatically insured against death under the Service-members' Group Life Insurance ("SGLI") program. In general, life insurance proceeds are excludable from gross income under IRC section 101.

Roth IRAs

There are two general types of individual retirement arrangements ("IRAs"): traditional IRAs and Roth IRAs.[69] In general, contributions (other than a rollover contribution) to a traditional IRA may be deductible, and distributions from a traditional IRA are includible in gross income to the extent not attributable to a return of nondeductible contributions. Contributions to a Roth IRA are not deductible, and qualified distributions from a Roth IRA are excludable from gross income. Distributions from a Roth IRA that are not qualified distributions are includible in gross income to the extent attributable to earnings. In general, a qualified distribution is a distribution that is made on or after the individual attains age 59½, death, or disability or which is a qualified special purpose distribution. A distribution is not a qualified distribution if it is made within the five-taxable year period beginning with the taxable year for which an individual first made a contribution to a Roth IRA.

The total amount that an individual may contribute to one or more IRAs for a year is generally limited to the lesser of: (1) a dollar amount ($5,000 for 2008); or (2) the amount of the individual's compensation that is includible in gross income for the year. IRA contributions in excess of the applicable limit are generally subject to an excise tax of six percent per year until withdrawn. The contribution limit is reduced to the extent an individual makes contributions to any other IRA for the same taxable year.

As under the rules relating to traditional IRAs, a contribution of up to the dollar limit for each spouse may be made to a Roth IRA provided the combined compensation of the spouses is at least equal to the contributed amount. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with adjusted gross income for the taxable year over certain indexed levels. The adjusted gross income phase-out ranges for 2008 are: (1) for single taxpayers, $101,000 to $116,000; (2) for married taxpayers filing joint returns, $159,000 to $169,000; and (3) for married taxpayers filing separate returns, $0 to $10,000.

The foregoing contribution limitations generally do not apply in the case of a rollover contribution to an IRA. If certain requirements are satisfied, a participant in a tax-qualified retirement plan, a tax-sheltered annuity,[70] or a governmental IRC section 457 plan may roll over distributions from the plan or annuity into a traditional IRA. For distributions after December 31, 2007, certain taxpayers are permitted to make qualified rollover contributions from such plans or annuities into a Roth IRA (subject to inclusion in gross income of any amount that would be includible were it not part of the qualified rollover contribution).

Coverdell education savings accounts

Annual contributions to a Coverdell education savings account[71] may not exceed $2,000 (except in cases involving certain tax-free rollovers) and may not be made after the

[69] Traditional IRAs are described in IRC section 408, and Roth IRAs in IRC section 408A.
[70] IRC section 403(b).
[71] Coverdell education savings accounts are described in IRC section 530.

designated beneficiary reaches age 18. The maximum annual contribution that can be made to a Coverdell education savings account is phased out for taxpayers with adjusted gross income for the taxable year over certain indexed levels. Contributions to a Coverdell education savings account are not deductible. In general, a rollover is permitted between Coverdell education savings accounts for the benefit of the same beneficiary or member of such beneficiary's family.

In general, a distribution from a Coverdell education savings account is includible in the gross income of the distributee. However, distributions from an account are excludable from the distributee's gross income to the extent that the total distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. Contributions to a Coverdell education savings account are treated as nontaxable investment in the contract. Thus, earnings on contributions are subject to tax if amounts withdrawn from the account exceed qualified education expenses. The portion of a distribution from a Coverdell education savings account that is includible in income (i.e., the portion allocable to earnings on contributions when a distribution exceeds qualified education expenses) is generally subject to an additional 10-percent tax.

New Federal Law (IRC sections 408A and 530)

In the case of an individual who receives a military death gratuity or SGLI payment, the provision permits the individual to contribute an amount no greater than the sum of the gratuity and SGLI payments received by the individual to a Roth IRA, notwithstanding the contributions limits that otherwise apply to contributions to Roth IRAs (e.g., the annual contribution limit and the income phase-out of the contribution dollar limit). The provision also permits such an individual to contribute the gratuity and SGLI payments that the individual receives to one or more Coverdell education savings accounts, notwithstanding the $2,000 annual contribution limit and the income phase-out of the limit that would otherwise apply. The maximum amount that can be contributed to a Roth IRA or one or more Coverdell education savings accounts in the aggregate under the provision is limited to the sum of the gratuity and SGLI payments that the individual receives.

The contribution of a military death gratuity or SGLI payment to a Roth IRA is treated as a qualified rollover contribution to the Roth IRA. Similarly, the contribution of a military death gratuity or SGLI payment to a Coverdell education savings account is treated as a permissible rollover to such an account. The contribution of a military death gratuity or SGLI payment to a Roth IRA or Coverdell education savings account cannot be made later than one year after the date on which the gratuity or SGLI payment is received by the individual.

In the event of a subsequent distribution from a Roth IRA that is not a qualified distribution or a distribution from a Coverdell education savings account that is not a qualified education distribution, the amount of the distribution attributable to the contribution of the military death gratuity or SGLI payment is treated as nontaxable investment in the contract.

HEROES EARNINGS ASSISTANCE AND RELIEF TAX ACT OF 2008 (HEARTA)(PL 110-245, JUNE 17, 2008)

Effective Date

The provision is generally effective with respect to payments made on account of deaths from injuries occurring on or after June 17, 2008. In addition, the provision permits the contribution to a Roth IRA or a Coverdell education savings account of a military death gratuity or SGLI payment received by an individual with respect to a death from injury occurring on or after October 7, 2001, and before June 17, 2008, if the individual makes the contribution to the account no later than one year after June 17, 2008.

California Law (R&TC sections 17501 and 17551)

Changes to IRC 408A

California conforms by reference to Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of IRC sections 401 through 424, inclusive, in R&TC section 17501. Additionally, California conforms by reference to IRC 457, relating to deferred compensation plans of state and local governments and tax-exempt organizations, in R&TC section 17551. However, except for increases in the maximum amount of elective deferrals, R&TC sections 17501(b) and 17551(c) specifically provide that federal changes to Part I of Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of IRC sections 401 through 420, inclusive, and IRC section 457, relating to deferred compensation plans of state and local governments and tax-exempt organizations, automatically apply without regard to taxable year to the same extent as applicable for federal income tax purposes and thus adopt all changes made to those IRC sections without regard to the “specified date” contained in R&TC section 17024.5. The federal changes to IRC section 408A that permits recipients of a military death gratuity to transfer the amount into an IRA or Roth IRA automatically apply under California law without regard to taxable year to the same extent as applicable for federal income tax purposes.

Changes to IRC section 530

California conforms by reference to IRC section 530, relating to Coverdell Education Savings Account, as of the “specified date” of January 1, 2005, in R&TC section 23712 with modifications. California has not conformed to the changes to IRC section 530 that permits recipients of a military death gratuity to transfer into an education savings account because the changes were made after the “specified date.”

Impact on California Revenue

Changes to IRC 408A

There is no conformity revenue impact because the changes to the pension plan funding rules are mandatory whether or not California conforms. Any revenue impact is considered baseline.

HEROES EARNINGS ASSISTANCE AND RELIEF TAX ACT OF 2008 (HEARTA)(PL 110-245, JUNE 17, 2008)

Changes to IRC section 530

Estimated Revenue Impact of Contributions to Military Death Gratuities to Roth IRAs and Education Savings Accounts Effective On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$12,000	-$6,000	-$6,000

Estimates are based on an adjusted proration of federal projections developed for the Heroes Earnings Assistance and Relief Tax Act Of 2008.

Section	Section Title
110	Suspension of 5-Year Period During Service with the Peace Corps

Background

In general

Under present law, an individual taxpayer may 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. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years ending on the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met.

Uniformed services and Foreign Service

Present law also contains special rules relating to members of the uniformed services or the Foreign Service of the United States. An individual may elect to suspend for a maximum of 10 years the five-year test period for ownership and use during certain absences due to service in the uniformed services or the Foreign Service of the United States. The uniformed services include: (1) the Armed Forces (the Army, Navy, Air Force, Marine Corps, and Coast Guard); (2) the commissioned corps of the National Oceanic and Atmospheric Administration; and (3) the commissioned corps of the Public Health Service. If the election is made, the five-year period ending on the date of the sale or exchange of a principal residence does not include any period up to 10 years during which the taxpayer or the taxpayer's spouse is on qualified official extended duty as a member of the uniformed services or in the Foreign Service of the United States. For these purposes, qualified official extended duty is any period of extended duty while serving at a place of duty at least 50 miles away from the taxpayer's principal residence or under orders compelling residence in government furnished quarters. Extended duty is defined as any period of duty pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period. The election may be made with respect to only one property for a suspension period.

Intelligence community

Specified employees of the intelligence community may elect to suspend the running of the five-year test period during any period in which they are serving on extended duty. The term "employee of the intelligence community" means an employee of the Office of the Director of National Intelligence, the Central Intelligence Agency, the National Security Agency, the Defense Intelligence Agency, the National Geospatial-Intelligence Agency, or the National Reconnaissance Office. The term also includes employment with: (1) any other office within the Department of Defense for the collection of specialized national intelligence through reconnaissance programs; (2) any of the intelligence elements of the Army, the Navy, the Air Force, the Marine Corps, the Federal Bureau of Investigation, the Department of the Treasury, the Department of Energy, and the Coast Guard; (3) the Bureau of Intelligence and Research of the Department of State; and (4) the elements of the Department of Homeland Security concerned with the analyses of foreign intelligence information. To qualify, a specified employee must move from one duty station to another and the new duty station must be located outside of the United States. The five-year period may not be extended more than 10 years. The provision relating to employees of the intelligence community is effective for sales and exchanges before January 1, 2011.

New Federal Law (IRC section 121)

The act provision creates a new rule for Peace Corps volunteers similar to the rules applicable to the uniformed services and Foreign Service and the intelligence community. Under this new rule, an individual may elect to suspend for a maximum of 10 years the five-year test period for ownership and use during certain absences due to volunteer service in the Peace Corps. If the election is made, the five-year period ending on the date of the sale or exchange of a principal residence does not include any period up to 10 years during which the taxpayer or the taxpayer's spouse is serving as a Peace Corps volunteer.

Effective Date

The provision is effective for taxable years beginning after December 31, 2007.

HEROES EARNINGS ASSISTANCE AND RELIEF TAX ACT OF 2008 (HEARTA)(PL 110-245, JUNE 17, 2008)

California Law (R&TC sections 17131 and 17152)

California conforms by reference to IRC section 121, relating to the exclusion of gain from the sale of a principal residence, in R&TC section 17131 as of the "specified date" of January 1, 2005, with modifications in R&TC section 17152. The California modifications include special rules for a taxpayer's service in the Peace Corps that allows a reduction in required use of a principal residence for Peace Corps volunteers. The two-year period may be reduced for time a taxpayer served in the Peace Corps during the five-year measuring period. The two-year period is reduced by the lesser of time served or 18 months. Because the changes to IRC section 121 were made after the "specified date," California has not conformed to the federal provision that provides a new rule allowing active Peace Corps volunteers an election to suspend the running of the five-year period for determining ownership and use of principal residence for purposes of the tax exclusion of the gain from the sale of such residence.

Impact on California Revenue

Estimated Revenue Impact of Suspension of 5-Year Period During Service with the Peace Corps For Tax Years Beginning On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$6,000	-$4,000	-$4,000

Estimates are based on a proration of federal projections developed for the Heroes Earnings Assistance and Relief Tax Act of 2008.

Section	Section Title
111	Credit for Employer Differential Wage Payments to Employees Who are Active Duty Members of the Uniformed Services

Background

In general, compensation paid by an employer to an employee is deductible by the employer under IRC section 162(a)(1), unless the expense must be capitalized. In the case of an employee who is called to active duty with respect to the armed forces of the United States, some employers voluntarily pay the employee the difference between the compensation that the employer would have paid to the employee during the period of military service less the amount of pay received by the employee from the military. This payment of the difference is often referred to as "differential pay."

HEROES EARNINGS ASSISTANCE AND RELIEF TAX ACT OF 2008 (HEARTA)(PL 110-245, JUNE 17, 2008)

New Federal Law (IRC sections 38, 45P, and 280C)

If a taxpayer qualifies as an eligible small business employer, the provision allows the taxpayer to take a credit against the taxpayer's income tax liability for a taxable year in an amount equal to 20 percent of the sum of the eligible differential wage payments for each of the taxpayer's qualified employees for the taxable year.

A qualified employee of a taxpayer is a person who has been an employee for the 91-day period immediately preceding the period for which any differential wage payment is made. Differential wage payments means any payment that: (1) is made by an employer to an individual with respect to any period during which the individual is performing service in the uniformed services of the United States while on active duty for a period of more than 30 days; and (2) represents all or a portion of the wages that the individual would have received from the employer if the individual were performing services for the employer. The term eligible differential wage payments means so much of the differential wage payments paid to a qualified employee as does not exceed $20,000.

An eligible small business employer means, with respect to a taxable year, any taxpayer that: (1) is employed on average less than 50 employees on business days during the taxable year; and (2) under a written plan of the taxpayer, provides eligible differential wage payments to every qualified employee of the taxpayer. Taxpayers under common control are aggregated for purposes of determining whether a taxpayer is an eligible small business employer. The credit is not available with respect to a taxpayer who has failed to comply with the employment and reemployment rights of members of the uniformed services (as provided under Chapter 43 of Title 38 of the United States Code).

Under the provision, no deduction may be taken for that portion of compensation which is equal to the credit. In addition, the amount of any other credit otherwise allowable under Chapter 1 (Normal Taxes and Surtaxes) of Subtitle A (Income Taxes) of the IRC with respect to compensation paid to an employee must be reduced by the differential wage payment credit allowed with respect to such employee.

Under the provision, the differential wage payment credit is part of the general business credit, and thus this credit is subject to the rules applicable to business credits. For example, an unused credit generally may be carried back to the taxable year that precedes an unused credit year or carried forward to each of the 20 taxable years following the unused credit year. The credit is not allowable against a taxpayer's alternative minimum tax liability.

Effective Date

The provision is effective with respect to amounts paid after June 17, 2008, and before January 1, 2010.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
112	State Payments to Service Members Treated as Qualified Military Benefits

Background

Subject to certain limitations, military compensation earned by members of the Armed Forces while serving in a combat zone is excludable from gross income.[72] Military personnel may also exclude, for up to two years following service in a combat zone, compensation earned while hospitalized from wounds, disease, or injuries incurred while serving in the zone. In addition, certain qualified military benefits, including certain death gratuities and other payments, are excludable from gross income.[73] Finally, the IRS has ruled that certain bonuses paid by states to military personnel are gifts that are not includible in gross income.[74]

New Federal Law (IRC section 134)

The act provision provides that gross income does not include state or local payments of bonuses to active or former military personnel or their dependents by reason of such personnel's service in a combat zone.

Effective Date

The proposal is effective for payments made before, on, or after June 17, 2008.

California Law (R&TC section 17131)

California conforms to Part III of Subchapter B of Chapter 1 of Subtitle A of the IRC, relating to items that are specifically excluded from gross income, as of the "specified date" of January 1, 2005. California has not conformed to the changes in IRC section 134 that provides for the treatment of state or local payments of bonuses to active or former military

[72] IRC section 112.
[73] IRC section 134.
[74] Rev. Rul. 68-158, 1968-1 C.B. 47; Chief Counsel Advice 200708003 (Feb. 23, 2007).

personnel or their dependents by reason of such individual's service in a combat zone because the change was after the "specified date."

Impact on California Revenue

Estimated Revenue Impact of State Payments to Service Members Treated as Qualified Military Benefits For Payments Made Before, On or After Date of Enactment Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
$0	$0	$0

The Joint Committee on Taxation estimated that this provision would result in a negligible revenue loss.

Section	Section Title
113	Permanent Exclusion of Gain from Sale of a Principle Residence by Certain Employees of the Intelligence Community

Background

In general

Under present law, an individual taxpayer may 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. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years ending on the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met.

Uniformed services and Foreign Service

Present law also contains special rules relating to members of the uniformed services or the Foreign Service of the United States. An individual may elect to suspend for a maximum of 10 years the five-year test period for ownership and use during certain absences due to service in the uniformed services or the Foreign Service of the United States. The uniformed services include: (1) the Armed Forces (the Army, Navy, Air Force, Marine Corps, and Coast

Guard); (2) the commissioned corps of the National Oceanic and Atmospheric Administration; and (3) the commissioned corps of the Public Health Service. If the election is made, the five-year period ending on the date of the sale or exchange of a principal residence does not include any period up to 10 years during which the taxpayer or the taxpayer's spouse is on qualified official extended duty as a member of the uniformed services or in the Foreign Service of the United States. For these purposes, qualified official extended duty is any period of extended duty while serving at a place of duty at least 50 miles away from the taxpayer's principal residence or under orders compelling residence in government furnished quarters. Extended duty is defined as any period of duty pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period. The election may be made with respect to only one property for a suspension period.

Intelligence community

Specified employees of the intelligence community may elect to suspend the running of the five-year test period during any period in which they are serving on extended duty. The term "employee of the intelligence community" means an employee of the Office of the Director of National Intelligence, the Central Intelligence Agency, the National Security Agency, the Defense Intelligence Agency, the National Geospatial-Intelligence Agency, or the National Reconnaissance Office. The term also includes employment with: (1) any other office within the Department of Defense for the collection of specialized national intelligence through reconnaissance programs; (2) any of the intelligence elements of the Army, the Navy, the Air Force, the Marine Corps, the Federal Bureau of Investigation, the Department of the Treasury, the Department of Energy, and the Coast Guard; (3) the Bureau of Intelligence and Research of the Department of State; and (4) the elements of the Department of Homeland Security concerned with the analyses of foreign intelligence information. To qualify, a specified employee must move from one duty station to another and the new duty station must be located outside of the United States. The five-year period may not be extended more than 10 years.

The provision relating to employees of the intelligence community is effective for sales and exchanges before January 1, 2011.

<u>New Federal Law (IRC section 121)</u>

The provision permanently extends the provision relating to employees of the intelligence community. The provision repeals the requirement that members of the intelligence community must move to a duty station outside of the United States to qualify for the exclusion.

<u>Effective Date</u>

The provision is effective for sales and exchanges after June 17, 2008.

California Law (R&TC sections 17131 and 17152)

California conforms by reference to IRC section 121, relating to the exclusion of gain from the sale of a principal residence, in R&TC section 17131 as of the "specified date" of January 1, 2005, with modifications in R&TC section 17152. California has not conformed to the changes made in the Tax Relief and Health Care Act of 2006 that provides employees of the intelligence community as another category of individuals serving on qualified official extended duty whose five year ownership and use period can be suspended for up to ten years for sales or exchanges before 2011. California has also not conformed to the provision of IRC section 121 that permanently extends the provision relating to employees of the intelligence community because these changes were made after the "specified date."

Impact on California Revenue

Estimated Revenue Impact of Permanent Exclusion of Gain From Sale of Principal Residence by Certain Employees of the Intelligence Community For Tax Years Beginning On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$7,000	-$7,000	-$7,000

Estimates are based on a proration of federal projections developed for the Heroes Earnings Assistance and Relief Act of 2008.

Section	Section Title
114	Special Disposition Rules for Unused Benefits in Health Flexible Spending Arrangements of Individuals Called to Active Duty

Background

A flexible spending arrangement ("FSA") is a reimbursement account or other arrangement under which an employee is reimbursed for medical expenses or other nontaxable employer-provided benefits, such as dependent care. Typically, FSAs are part of a cafeteria plan and may be funded through salary reduction. FSAs may also be provided by an employer outside of a cafeteria plan. FSAs are commonly used, for example, to reimburse employees for medical expenses not covered by insurance (referred to as a "health FSA").

There is no special exclusion for benefits provided under an FSA. Thus, benefits provided under an FSA are excludable from income only if there is a specific exclusion for the benefits in the IRC (e.g., the exclusion for employer-provided health care (other than long-term care) or dependant care assistance coverage). If certain requirements are satisfied, contributions to a health FSA and all distributions to pay medical expenses are excludable from income and from wages for FICA tax purposes.

FSAs that are part of a cafeteria plan must comply with the rules applicable to cafeteria plans generally. One of these rules is that a cafeteria plan may not offer deferred compensation except through a qualified cash or deferred arrangement.[75] Under proposed Treasury regulations, a cafeteria plan is considered to permit the deferral of compensation if it includes a health FSA which reimburses participants for medical expenses incurred beyond the end of the plan year.[76] Thus, amounts in an employee's account that are not used for medical expenses incurred before the end of a plan year must be forfeited. This rule is often referred to as the "use it or lose it" rule. In 2005, the IRS issued guidance allowing a grace period immediately following the end of a plan year during which unused benefits or contributions remaining at the end of the plan year may be paid or reimbursed to plan participants for qualified benefit expenses incurred during a grace period.[77] A plan may allow benefits not used during the plan year to be used to reimburse qualified expenses incurred during the period, not to exceed two and one-half months, immediately following the end of the plan year.

Proposed Treasury regulations contain additional requirements with which health FSAs must comply in order for the coverage and benefits provided under the FSA to be excludable from income.[78] These rules apply with respect to a health FSA without regard to whether the health FSA is provided through a cafeteria plan (i.e., without regard to whether an employee has an election to take cash or benefits).

<u>New Federal Law (IRC section 125)</u>

Under the provision, a plan does not fail to be treated as a cafeteria plan or health FSA merely because the plan provides for qualified reservist distributions. A qualified reservist distribution means a distribution to a participant in a health FSA of all or a portion of the participant's FSA balance if: (1) the participant is a reservist called to active duty for a period of at least 180 days (or is called for an indefinite period), and (2) the distribution is made during the period beginning with the call to active duty and ending on the last day of the coverage period of the FSA that includes the date of the call to active duty.

<u>Effective Date</u>

The provision is effective for distributions made after June 17, 2008.

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[75] IRC section 125(d).
[76] Prop. Treas. Reg. 1.125-5(c).
[77] Notice 2005-42, 2005-1 C.B. 1204; see also Prop. Treas. Reg. 1.125-1(e).
[78] Prop. Treas. Reg. 1.125-5.

California Law (R&TC section 17131)

California conforms by reference to IRC section 125, relating cafeteria plans, in R&TC section 17131 as of the “specified date” of January 1, 2005, with modifications. California allows an employer’s contributions to, and benefits derived from, a plan that allows employees to choose from a menu of benefits consisting of cash and “qualified benefits” are excluded from the employee’s gross income. California has not conformed to the federal changes that allow a tax-free distribution of unused benefits in a health flexible spending arrangement to any member of an Armed Forces reserve component who is ordered or called to active duty because the changes were made after the “specified date.”

Impact on California Revenue

Estimated Revenue Impact of Special Disposition Rules for Unused Benefits in Health Flexible Spending Arrangements of Individuals Called to Active Duty For Tax Years Beginning On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
$0	$0	$0

The Joint Committee on Taxation estimated that this provision would result in a negligible revenue loss.

Section	Section Title
115	Technical Correction Related to Exclusion of Certain Property Tax Rebates and Other Benefits Provided to Volunteer Firefighters and Emergency Medical Responders

Background

Deduction for certain state or local taxes

For purposes of determining regular tax liability, an itemized deduction is permitted for certain state and local taxes paid, including individual income taxes, real property taxes, and personal property taxes. The itemized deduction is not permitted for purposes of determining a taxpayer’s alternative minimum taxable income. For taxable years beginning before January 1, 2008, at the election of the taxpayer, an itemized deduction may be taken for state and local general sales taxes in lieu of the itemized deduction provided under present law for state and local income taxes. The otherwise allowable itemized deduction for these state or local taxes is not reduced by the amount of any reduction or rebate on account of services performed as a member of a qualified volunteer emergency response organization.

Charitable deduction for certain expenses

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in IRC section 501(c)(3), to a federal, state, or local governmental entity, or to certain other organizations.[79] The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced or limited depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer. Within certain limitations, donors also are entitled to deduct their contributions to IRC section 501(c)(3) organizations for federal estate and gift tax purposes.

Certain tax reductions or tax rebates provided by a state or local government

In general

Present law provides an exclusion from gross income to members of qualified volunteer emergency response organizations for: (1) any qualified state or local tax benefit; and (2) any qualified reimbursement payment. A qualified state or local tax benefit is any reduction or rebate of certain taxes provided by state or local governments on account of services performed by individuals as members of a qualified volunteer emergency response organization. These taxes are limited to state or local income taxes, state or local real property taxes, and state or local personal property taxes. A qualified reimbursement payment is a payment provided by a state or political subdivision thereof on account of reimbursement for expenses incurred in connection with the performance of services as a member of a qualified volunteer emergency for each month during which the taxpayer performs such services.

A qualified volunteer emergency response organization is any volunteer organization: (1) organized and operated to provide firefighting or emergency medical services for persons in the state or its political subdivision; and (2) required (by written agreement) by the state or political subdivision to furnish firefighting or emergency medical services in such state or political subdivision.

Denial of double benefits

Present law provides that the amount of state or local taxes taken into account in determining the deduction for taxes is reduced by the amount of any qualified state or local tax benefit. Also, present law provides that expenses paid or incurred by the taxpayer in connection with the performance of services as a member of a qualified volunteer emergency response

[79] IRC section 170(a), (c), and (e).

organization is taken into account for purposes of the charitable deduction only to the extent such expenses exceed the amount of any qualified reimbursement payment excluded from income under the bill.

Sunset

The rules related to certain tax reductions or tax rebates provided by a state or local government provided to volunteer firefighters and emergency medical responders do not apply to taxable years beginning after December 31, 2010.

New Federal Law (IRC sections 3121, 3306, and 3401)

The provision clarifies that any qualified state or local tax benefit and any qualified reimbursement payment excluded from gross income is not subject to social security tax or unemployment tax.

Effective Date

The provision is effective as if included in section 5 of the Mortgage Forgiveness Debt Relief Act of 2007.

California Law

The California employment taxes are administered by the Employment Development Department (EDD) and not the Franchise Tax Board.

Impact on California Revenue

Defer to EDD.

TITLE III – REVENUE PROVISIONS

Section	Section Title
301	Revision of Tax Rules on Expatriation

Background

Income tax

U.S. citizens and residents generally are subject to U.S income taxation on their worldwide income. The U.S. tax may be reduced or offset by a credit allowed for foreign income taxes paid with respect to foreign source income. Nonresident aliens are taxed at a flat rate of 30 percent (or a lower treaty rate) on certain types of passive income derived from U.S. sources, and at regular graduated rates on net profits derived from a U.S. trade or business.

Certain special rules (IRC sections 671 - 679) apply to certain trust interests deemed to be owned by the grantor or other person (a "grantor trust"). In that case, the deemed owner must include in income the items of income and deduction (and credits against tax) of the portion of such trust deemed to be owned by such person.

Except to the extent a trust is a grantor trust, a transfer of property by a U.S. person to a foreign estate or trust is treated (under IRC section 684) by the transferor as if the property had been sold to such estate or trust. The same rule applies if a domestic trust becomes a foreign trust.

Estate tax

The estates of U.S. citizens and residents are subject to estate tax on all property, wherever located. The estates of nonresident aliens generally are subject to estate tax on U.S.-situated property (e.g., real estate and tangible property located within the United States and stock in a U.S. corporation).

Gift tax

U.S. citizens and residents generally are subject to gift tax on transfers by gift of any property, wherever situated. Nonresident aliens generally are subject to gift tax on transfers by gift of U.S.-situated property (e.g., real estate and tangible property located within the United States), but excluding intangibles, such as stock, regardless of where they are located.

Income tax rules with respect to expatriates

For the 10 taxable years after an individual relinquishes his or her U.S. citizenship or terminates his or her U.S. long-term residency, unless certain conditions are met, the individual is subject to an alternative method of income taxation than that generally applicable to nonresident aliens (the "alternative tax regime"). Generally, the individual is subject to income tax for the 10-year period at the rates applicable to U.S. citizens, but only on U.S.-source income.[80]

A "long-term resident" is a noncitizen who is a lawful permanent resident of the United States for at least eight taxable years during the period of 15 taxable years ending with the taxable year during which the individual either ceases to be a lawful permanent resident of the United States or commences to be treated as a resident of a foreign country under a tax treaty between such foreign country and the United States (and does not waive such benefits).

[80] For this purpose, however, U.S.-source income has a broader scope than it does typically in the IRC.

HEROES EARNINGS ASSISTANCE AND RELIEF TAX ACT OF 2008 (HEARTA)(PL 110-245, JUNE 17, 2008)

A former citizen or former long-term resident is subject to the alternative tax regime for a 10-year period following citizenship relinquishment or residency termination, unless the former citizen or former long-term resident: (1) establishes that his or her average annual net income tax liability for the five preceding years does not exceed $124,000 (adjusted for inflation after 2004) and his or her net worth is less than $2 million, or alternatively satisfies limited, objective exceptions for certain dual citizens and minors who have had no substantial contacts with the United States; and (2) certifies under penalties of perjury that he or she has complied with all U.S. federal tax obligations for the preceding five years and provides such evidence of compliance as the Secretary may require.

Anti-abuse rules are provided to prevent the circumvention of the alternative tax regime.

Estate tax rules with respect to expatriates

Special estate tax rules apply to individuals who die during a taxable year in which they are subject to the alternative tax regime. Under these special rules, certain closely-held foreign stock owned by the former citizen or former long-term resident is includible in his or her gross estate to the extent that the foreign corporation owns U.S.-situated assets. The special rules apply if, at the time of death, the former citizen or former long-term resident: (1) owns, directly or indirectly, 10 percent or more of the total combined voting power of all classes of stock of the foreign corporation entitled to vote; and (2) is considered to own, directly or indirectly, more than 50 percent of (a) the total combined voting power of all classes of stock of the foreign corporation entitled to vote, or (b) the total value of the stock of such corporation. If this stock ownership test is met, then the gross estate of the former citizen or former long-term resident includes that proportion of the fair market value of the foreign stock owned by the individual at the time of death, which the fair market value of any assets owned by such foreign corporation and situated in the United States (at the time of death) bears to the total fair market value of all assets owned by such foreign corporation (at the time of death).

Gift tax rules with respect to expatriates

Special gift tax rules apply to individuals who make gifts during a taxable year in which they are subject to the alternative tax regime. The individual is subject to gift tax on gifts of U.S.-situated intangibles made during the 10 years following citizenship relinquishment or residency termination. In addition, gifts of stock of certain closely-held foreign corporations by a former citizen or former long-term resident are subject to gift tax, if the gift is made during the time that such person is subject to the alternative tax regime. The operative rules with respect to these gifts of closely-held foreign stock are the same as described above relating to the estate tax, except that the relevant testing and valuation date is the date of gift rather than the date of death.

Termination of U.S. citizenship or long-term resident status for U.S. federal income tax purposes

An individual continues to be treated as a U.S. citizen or long-term resident for U.S. federal tax purposes, including for purposes of IRC section 7701(b)(10), until the individual: (1) gives notice of an expatriating act or termination of residency (with the requisite intent to relinquish citizenship or terminate residency) to the Secretary of State or the Secretary of Homeland Security, respectively; and (2) provides a statement to the Secretary of the Treasury in accordance with IRC section 6039G.

Sanction for individuals subject to the individual tax regime who return to the United States for extended periods

The alternative tax regime does not apply to any individual for any taxable year during the 10-year period following citizenship relinquishment or residency termination if such individual is present in the United States for more than 30 days in the calendar year ending in such taxable year. Such individual is treated as a U.S. citizen or resident for such taxable year and, therefore, is taxed on his or her worldwide income.

Similarly, if an individual subject to the alternative tax regime is present in the United States for more than 30 days in any calendar year ending during the 10-year period following citizenship relinquishment or residency termination, and the individual dies during that year, he or she is treated as a U.S. resident, and the individual's worldwide estate is subject to U.S. estate tax. Likewise, if an individual subject to the alternative tax regime is present in the United States for more than 30 days in any year during the 10-year period following citizenship relinquishment or residency termination, the individual is subject to U.S. gift tax on any transfer of his or her worldwide assets by gift during that taxable year.

For purposes of these rules, an individual 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 that day. The present-law exceptions to the U.S. presence rules for residency purposes generally do not apply.[81] However, for individuals with certain ties to countries other than the United States[82] and individuals with minimal prior physical presence in the United States,[83] a day of physical presence in the United States is disregarded if the individual is performing services in the United States on such day for an unrelated employer (within the meaning of IRC sections 267 and 707(b)), that meets such requirements as the Secretary may prescribe in

[81] IRC sections 7701(b)(3)(D), 7701(b)(5), and 7701(b)(7)(B)-(D).

[82] An individual has such a relationship to a foreign country if (1) the individual becomes a citizen or resident of the country in which the individual was born, such individual's spouse was born, or either of the individual's parents was born, and (2) the individual becomes fully liable for income tax in such country.

[83] An individual has a minimal prior physical presence in the United States if the individual was physically present for no more than 30 days during each year in the ten-year period ending on the date of loss of United States citizenship or termination of residency. However, for purposes of this test, an individual is not treated as being present in the United States on a day if the individual remained in the United States because of a medical condition that arose while the individual was in the United States. IRC section 7701(b)(3)(D)(ii).

regulations. No more than 30 days may be disregarded during any calendar year under this rule.

Annual return

Former citizens and former long-term residents are required to file an annual return for each year in which they are subject to the alternative tax regime. The annual return is required even if no U.S. federal income tax is due. The annual return requires certain information, including information on the permanent home of the individual, the individual's country of residence, the number of days the individual was present in the United States for the year, and detailed information about the individual's income and assets that are subject to the alternative tax regime. This requirement includes information relating to foreign stock potentially subject to the special estate and gift tax rules.

If the individual fails to file the statement in a timely manner or fails correctly to include all the required information, the individual is required to pay a penalty of $10,000. The $10,000 penalty does not apply if it is shown that the failure is due to reasonable cause and not to willful neglect.

New Federal Law (IRC sections 877, 877A, 2001, 2801, 3121 and 7701)

In general

The provision imposes tax on certain U.S. citizens who relinquish their U.S. citizenship and certain long-term U.S. residents who terminate their U.S. residency. Such individuals are subject to income tax on the net unrealized gain in their property as if the property had been sold for its fair market value on the day before the expatriation or residency termination ("mark-to-market tax"). Gain from the deemed sale is taken into account at that time without regard to other IRC provisions. Any loss from the deemed sale generally is taken into account to the extent otherwise provided in the IRC, except that the wash sale rules of IRC section 1091 do not apply. Any net gain on the deemed sale is recognized to the extent it exceeds $600,000. The $600,000 amount is increased by a cost of living adjustment factor for calendar years after 2008. Any gains or losses subsequently realized are to be adjusted for gains and losses taken into account under the deemed sale rules, without regard to the $600,000 exemption.

The mark-to-market tax described above applies to most types of property interests held by the individual on the date of relinquishment of citizenship or termination of residency, with certain exceptions. Deferred compensation items, interests in nongrantor trusts, and specified tax deferred accounts are excepted from the mark-to-market tax but are subject to the special rules described below.

In addition, the provision imposes a transfer tax on certain transfers to U.S. persons from certain U.S. citizens who relinquished their U.S. citizenship and certain long-term U.S. residents who terminated their U.S. residency, or from their estates.

Individuals covered

The provision applies to any U.S. citizen who relinquishes citizenship and any long-term resident who terminates U.S. residency, if such individual ("covered expatriate"): (1) has an average annual net income tax liability for the five preceding years ending before the date of the loss of U.S. citizenship or residency termination that exceeds $124,000 (as adjusted for inflation after 2004 – $139,000 in 2008); (2) has a net worth of $2 million or more on such date; or (3) fails to certify under penalties of perjury that he or she has complied with all U.S. federal tax obligations for the preceding five years or fails to submit such evidence of compliance as the Secretary may require.

Exceptions to an individual's classification as a covered expatriate due to (1) or (2) above (but not (3)) are provided in two situations. The first exception applies to an individual who was born with citizenship both in the United States and in another country; provided that: (1) as of the expatriation date, the individual continues to be a citizen of, and is taxed as, a resident of, such other country, and (2) the individual has been a resident of the United States (under the substantial presence test of IRC section 7701(b)(1)(A)(ii)) for not more than 10 taxable years during the 15-year taxable year period ending with the taxable year of expatriation. The second exception applies to a U.S. citizen who relinquishes U.S. citizenship before reaching age 18½, provided that the individual was a resident of the United States (under the substantial presence test of IRC section 7701(b)(1)(A)(ii)) for no more than 10 taxable years before such relinquishment.

The definition of "long-term resident" under the provision is generally the same as that under present law. As under present law, an individual is considered to terminate long-term U.S. residency when the individual ceases to be a lawful permanent resident of the United States (i.e., loses his or her green card status through revocation or has been administratively or judicially determined to have abandoned such status). Under the provision, however, an individual ceases to be treated as a lawful permanent resident of the United States for all tax purposes if such individual commences to be treated as a resident of a foreign country under a tax treaty between the United States and such foreign country, does not waive the benefits of the treaty applicable to residents of such foreign country, and notifies the Secretary of the commencement of such treatment.

The provision provides that, for all tax purposes, a U.S. citizen continues to be treated as a U.S. citizen for tax purposes until that individual's citizenship is treated as relinquished under the following rules. An individual is treated as having relinquished U.S. citizenship on the earliest of four possible dates: (1) the date that the individual renounces U.S. nationality before a diplomatic or consular officer of the United States (provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (2) the date that the individual furnishes to the State Department a signed statement of voluntary relinquishment of U.S. nationality confirming the performance of an expatriating act (again, provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (3) the date that the State Department issues a certificate of loss of nationality; or (4) the date that a U.S. court cancels a naturalized citizen's certificate of naturalization. Notwithstanding the two immediately preceding sentences, relinquishment may occur earlier under Treasury regulations with respect to an individual who became at birth a citizen of the United States and of another country.

In the case of a long-term resident, the date that long-term residency is terminated is the “expatriation date.” In the case of a citizen, the date that the individual relinquishes citizenship is the “expatriation date.”

The foregoing rules replace the present-law rules that provide that an individual continues to be treated as a U.S. citizen or long-term resident for U.S. federal tax purposes until the individual gives notice of an expatriating act or termination of residency.

If an individual who is a covered expatriate becomes subject to tax as a citizen or resident of the United States for any period beginning after the expatriation date, the individual is not treated as a covered expatriate during that period for purposes of applying the withholding rules relating to deferred compensation items, the rules relating to interests in nongrantor trusts, and the rules relating to gifts and bequests from covered expatriates. If the individual again relinquishes citizenship or terminates long-term residency (after meeting anew the requirements to become a long-term resident), the mark-to-market tax and other provisions are re-triggered with the new expatriation date.

Deferral of payment of mark-to-market tax

Under the provision, an individual may elect to defer payment of the mark-to-market tax imposed on the deemed sale of property. Interest is charged for the period the tax is deferred at the rate normally applicable to individual underpayments. The election is irrevocable and is made on a property-by-property basis. Under the election, the deferred tax attributable to a particular property is due when the return is due for the taxable year in which the property is disposed (or, if the property is disposed of in a transaction in which gain is not recognized in whole or in part, at such other time as the Secretary may prescribe). The deferred tax attributable to a particular property is an amount which bears the same ratio to the total mark-to-market tax as the gain taken into account with respect to such property bears to the total gain taken into account for the mark-to-market tax. The deferral of the mark-to-market tax may not be extended beyond the due date of the return for the taxable year which includes the individual’s death.

In order to elect deferral of the mark-to-market tax, the individual is required to furnish a bond to the Secretary. The bond must be conditioned upon payment of the amount of tax due, plus interest thereon, and must be in accordance with such requirements relating to terms, conditions, form of the bond, and sureties, as may be specified by regulations. The bond must be accepted by the Secretary. Other security mechanisms, including letters of credit, are permitted provided that they meet such requirements as the Secretary may prescribe. In the event that the security provided with respect to a particular property subsequently fails to meet the requirements of these rules and the individual fails to correct such failure, the deferred tax and the interest with respect to such property will become due. As a further condition to making the election, the individual is required to consent to the waiver of any treaty rights that would preclude the assessment or collection of the tax.

Deferred compensation items

The provision contains special rules for interests in deferred compensation items. For purposes of the provision, a "deferred compensation item" means any interest in a plan or arrangement described in IRC section 219(g)(5), any interest in a foreign pension plan or similar retirement arrangement or program, any item of deferred compensation, and any property, or right to property, which the individual is entitled to receive in connection with the performance of services to the extent not previously taken into account under IRC section 83 or in accordance with IRC section 83.

The plans and arrangements described in IRC section 219(g)(5) are: (i) a plan described in IRC section 401(a), which includes a trust exempt from tax under IRC section 501(a); (ii) an annuity plan described in IRC section 403(a); (iii) a plan established for its employees by the United States, by a state or political subdivision thereof, or by an agency or instrumentality of any of the foregoing, but excluding an eligible deferred compensation plan (within the meaning of IRC section 457(b)); (iv) an annuity contract described in IRC section 403(b); (v) a simplified employee pension (within the meaning of section 408(k)); (vi) a simplified retirement account (within the meaning of IRC section 408(p)); and (vii) a trust described in IRC section 501(c)(18).

If a deferred compensation item is an eligible deferred compensation item, the payor must deduct and withhold from a "taxable payment" to the covered expatriate a tax equal to 30 percent of such taxable payment. This withholding requirement is in lieu of any withholding requirement under present law. A taxable payment is subject to withholding to the extent it would be included in gross income of the covered expatriate if such person were subject to tax as a citizen or resident of the United States. A deferred compensation item is taken into account as a payment when such item would be so includible. A deferred compensation item that is subject to the 30 percent withholding requirement is subject to tax under IRC section 871.

If a deferred compensation item is not an eligible deferred compensation item (and is not subject to IRC section 83), an amount equal to the present value of the covered expatriate's deferred compensation item is treated as having been received on the day before the expatriation date. In the case of a deferred compensation item that is subject to IRC section 83, the item is treated as becoming transferable and no longer subject to a substantial risk of forfeiture on the day before the expatriation date. Appropriate adjustments shall be made to subsequent distributions to take into account the foregoing treatment. In addition, these deemed distributions are not subject to early distribution tax. For this purpose, "early distribution tax" means any increase in tax imposed under IRC sections 72(t), 220(e)(4), 223(f)(4), 409A(a)(1)(B), 529(c)(6), or 530(d)(4).

An “eligible deferred compensation item” means any deferred compensation item with respect to which: (i) the payor is either a U.S. person or a non-U.S. person who elects to be treated as a U.S. person for purposes of withholding and who meet the requirements prescribed by the Secretary to ensure compliance with the withholding requirements, and (ii) the covered expatriate notifies the payor of his status as a covered expatriate and irrevocably waives any claim of withholding reduction under any treaty with the United States.

The foregoing taxing rules regarding eligible deferred compensation items and items that are not eligible deferred compensation items do not apply to deferred compensation items to the extent attributable to services performed outside the United States while the covered expatriate was not a citizen or resident of the United States.

Specified tax deferred accounts

There are special rules for interests in specified tax deferred accounts. If a covered expatriate holds any interest in a specified tax deferred account on the day before the expatriation date, such covered expatriate is treated as receiving a distribution of his entire interest in such account on the day before the expatriation date. Appropriate adjustments are made for subsequent distributions to take into account this treatment. As with deferred compensation items, these deemed distributions are not subject to early distribution tax.

The term “specified tax deferred account” means an individual retirement plan (as defined in IRC section 7701(a)(37)), a qualified tuition plan (as defined in IRC section 529), a Coverdell education savings account (as defined in IRC section 530), a health savings account (as defined in IRC section 223), and an Archer MSA (as defined in IRC section 220). However, simplified employee pensions (within the meaning of IRC section 408(k)) and simplified retirement accounts (within the meaning of IRC section 408(p)) of a covered expatriate are treated as deferred compensation items and not as specified tax deferred accounts.

Interests in trusts

Grantor trusts

In the case of the portion of any trust for which the covered expatriate is treated as the owner under the grantor trust provisions of the IRC, as determined immediately before the expatriation date, the assets held by that portion of the trust are subject to the mark-to-market tax. If a trust that is a grantor trust immediately before the expatriation date subsequently becomes a nongrantor trust, such trust remains a grantor trust for purposes of the provision.

Nongrantor trusts

Special rules apply to trusts with respect to which the covered expatriate is a beneficiary on the day before the expatriation date. The mark-to-market tax does not apply with respect to the portion of any such trust not treated (under the grantor trust provisions of the IRC) as owned by a covered expatriate immediately before the expatriation date. Instead, in the case of any direct or indirect distribution from such a portion of a trust ("nongrantor trust") to a covered expatriate, the trustee must deduct and withhold from the distribution an amount equal to 30 percent of the portion of the distribution which would be includible in the gross income of the covered expatriate if the covered expatriate continued to be subject to tax as a citizen or resident of the United States. Such portion of such distribution (that is subject to the 30 percent withholding requirement) is subject to tax under IRC section 871. The covered expatriate is treated as having waived any right to claim any reduction in withholding under any treaty with the United States.

In addition, if the nongrantor trust distributes appreciated property to a covered expatriate, the trust must recognize gain as if the property were sold to the covered expatriate at its fair market value.

If a trust that is a nongrantor trust immediately before the expatriation date subsequently becomes a grantor trust of which a covered expatriate is treated as the owner, directly or indirectly, such conversion is treated under the provision as a distribution to such covered expatriate to the extent of the portion of the trust of which the covered expatriate is treated as the owner.

Special rules

Notwithstanding any other provision of the IRC, any period for acquiring property which results in the reduction of gain recognized with respect to property disposed of by the taxpayer terminates on the day before the expatriation date. This rule applies to certain incomplete transactions such as deferred like-kind exchanges and involuntary conversions. In addition, notwithstanding any other provision of the IRC, any extension of time for payment of tax ceases to apply on the day before relinquishment of citizenship or termination of residency, and the unpaid portion of such tax becomes due and payable at the time and in the manner prescribed by the Secretary.

For purposes of determining the tax imposed under the mark-to-market tax, property that was held by an individual on the date that such individual first became a resident of the United States (within the meaning of IRC section 7701(b)) is treated as having a basis on such date of not less than the fair market value of such property on such date. An individual may make an irrevocable election not to have this rule apply.

In the case of a domestic trust that becomes a foreign trust due to the expatriation of an individual, the general income tax rules pertaining to transfers by U.S. persons to foreign trusts (i.e., IRC section 684) apply before the rules of the provision.

Regulatory authority

The provision authorizes the Secretary to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the income tax rules of the provision.

Treatment of gifts and bequests from a former citizen or former long-term resident

Under the provision, a special transfer tax applies to certain “covered gifts or bequests” received by a U.S. citizen or resident. A covered gift or bequest is any property acquired (i) by gift directly or indirectly from an individual who is a covered expatriate at the time of such acquisition, or (ii) directly or indirectly by reason of the death of an individual who was a covered expatriate immediately before death. A covered gift or bequest, however, does not include (i) any property shown as a taxable gift on a timely filed gift tax return by the covered expatriate, (ii) any property included in the gross estate of the covered expatriate for estate tax purposes and shown on a timely filed estate tax return of the estate of the covered expatriate, and (iii) any property with respect to which a deduction would be allowed under IRC sections 2055, 2056, 2522 or 2523, whichever is appropriate (these sections allow deductions for transfers for charitable purposes or to spouses, for purposes of determining estate and gift taxes).

The tax is calculated as the product of (i) the highest marginal rate of tax specified in the table applicable to estate tax (i.e., IRC section 2001(c)) or, if greater, the highest marginal rate of tax specified in the table applicable to gift tax (i.e., IRC section 2502(a)), both as in effect on the date of receipt of the covered gift or bequest; and (ii) the value of the covered gift or bequest.

The tax is imposed upon the recipient of the covered gift or bequest and is imposed on a calendar-year basis. The tax applies to a recipient of a covered gift or bequest only to the extent that the total value of covered gifts and bequests received by such recipient during a calendar year exceeds the amount in effect under IRC section 2503(b) for that calendar year ($12,000 for 2008).[84] The tax on covered gifts and bequests is reduced by the amount of any gift or estate tax paid to a foreign country with respect to such covered gift or bequest.

Special rules apply to the tax on covered gifts or bequests made to domestic or foreign trusts. In the case of a covered gift or bequest made to a domestic trust, the tax applies as if the trust is a U.S. citizen, and the trust is required to pay the tax. In the case of a covered gift or bequest made to a foreign trust, the tax applies to any distribution from such trust (whether from income or corpus) attributable to such covered gift or bequest to a recipient that is a U.S. citizen or resident, in the same manner as if such distribution were a covered gift or bequest. Such a recipient is entitled to deduct the amount of such tax for income tax purposes to the extent such tax is imposed on the portion of such distribution that is included in the gross income of the recipient. For purposes of these rules, a foreign trust may elect to be treated as a domestic trust. The election may not be revoked without the Secretary’s consent.

[84] Rev. Proc. 2007-66, sec. 3.32(1), 2007-45 I.R.B. 970.

Coordination with present-law alternative tax regime

Under the provision, the present-law expatriation income tax rules under IRC section 877 do not apply with respect to a covered expatriate whose expatriation or residency termination occurs on or after June 17, 2008.

Information reporting

Certain information reporting requirements under the law presently applicable to former citizens and former long-term residents (IRC section 6039G) also apply for purposes of the provision.

Effective Date

The provision generally is effective for U.S. citizens who relinquish citizenship or long-term residents who terminate their residency on or after June 17, 2008. The portion of the provision relating to covered gifts and bequests is effective for gifts and bequests received on or after June 17, 2008, from former citizens or former long-term residents (or the estates of such persons) whose expatriation date is on or after June 17, 2008.

California Law (R&TC sections 17014, 17016, 17015, 17015.5, and 17024.5)

California specifically does not conform to federal rules relating to nonresident aliens. Additionally California taxation of individuals is not based on citizenship but on residency principles.

The term “resident” includes:

- Every individual who is in this state for other than temporary or transitory purpose; and
- Every individual who has his permanent home (domicile) in California but who is outside this state for a temporary or transitory purpose.

“Nonresidents” are individuals who are not residents.

Residents of California are taxed on their entire income wherever derived. Nonresidents are taxed only on income derived from sources in California and are generally not taxed on income from intangible assets such as interest and dividends. Special rules apply to employment-related absences.

Impact on California Revenue

Not applicable.

HEROES EARNINGS ASSISTANCE AND RELIEF TAX ACT OF 2008 (HEARTA)(PL 110-245, JUNE 17, 2008)

Section	Section Title
302	Certain Domestically Controlled Foreign Persons Performing Services Under Contract With the United States Government Treated as American Employers

Background

In general

Under the Federal Insurance Contributions Act ("FICA"), separate taxes are imposed on every employer and employee with respect to wages paid to such employer's employees.[85] These two taxes are commonly referred to as the employer's and the employee's share of FICA. The employee's share of FICA is collected by means of payroll withholding by the employee's employer.

For both the employer and the employee's share of FICA, the tax consists of two parts: (1) old age, survivor, and disability insurance ("OASDI"), which correlates to the Social Security program that provides monthly benefits after retirement, disability, or death; and (2) Medicare hospital insurance ("HI"). The OASDI tax rate is 6.2 percent on both the employee and employer (for a total rate of 12.4 percent). The OASDI tax rate applies to wages up to the OASDI wage base ($102,000 for 2008). The HI tax rate is 1.45 percent on both the employee and the employer (for a total rate of 2.9 percent). Unlike the OASDI tax, the HI tax is not limited to a specific amount of wages, but applies to all wages.

For purposes of the employer's and employee's share of FICA, wages generally means all remuneration for employment including the cash value of all remuneration paid in a medium other than cash. However, the general definition of wages is subject to a number of special rules and exceptions.[86]

Employment for FICA purposes generally means any service of whatever nature performed by an employee for the employer (irrespective of the citizenship or residence of either) within the United States. In the case of service outside the United States, employment also includes service performed by a United States citizen or resident as an employee for an American employer. As in the case of the definition of wages, the definition of employment is also subject to a number of exceptions and special rules.[87] An American employer is defined as an employer which is: (1) the United States or any instrumentality thereof; (2) an individual who is a resident of the United States; (3) a partnership, if at least two-thirds of the partners are United States residents; (4) a trust, if all of the trustees are United States residents; or (5) a corporation organized under the laws of the United States or any of the states.[88]

[85] IRC section 3101-3128 (FICA). IRC sections 3501and 3510 provide additional rules.
[86] IRC section 3121(a).
[87] IRC section 3121(b). For example, employment for FICA purposes includes certain service with respect to American vessels or aircrafts and also includes service that is designated as employment under an agreement entered into under section 233 of the Social Security Act.
[88] IRC section 3121(h).

IRC section 3121(l) agreements

An American employer may enter into a voluntary agreement with the Secretary of the Treasury to extend coverage of the insurance system of Title II of the Social Security Act to service performed outside the United States in the case of certain employees. Specifically, such an agreement may be entered into with respect to employees of a foreign affiliate of the American employer who are United States citizens or residents. Such an agreement is commonly referred to as an "IRC section 3121(l) agreement", and is entered into by completing Internal Revenue Service Form 2032. A foreign affiliate for purposes of the IRC section 3121(l) agreement is any foreign entity in which the American employer has at least a 10-percent interest.

If an IRC section 3121(l) agreement is entered into, the American employer agrees to pay the Secretary of the Treasury amounts equivalent to the employer and employee's share of FICA (including amounts equivalent to interest, additional taxes, and penalties which would be applicable) with respect to the remuneration which would be wages if the services covered by the agreement constituted employment for purposes of FICA. In addition, the American employer agrees to comply with such regulations relating to payments and reports as the Secretary of the Treasury may prescribe. An IRC section 3121(l) agreement may not be terminated with respect to a foreign affiliate after June 15, 1989.

In the case of a domestic corporation, a deduction is allowed for amounts paid or incurred pursuant to an IRC section 3121(l) agreement with respect to services performed by United States citizens employed by foreign subsidiary corporations. Any reimbursement of any amount previously allowed as a deduction is included in gross income in the year received.

Totalization agreements

Under IRC section 233 of the Social Security Act, the President of the United States is authorized to enter into agreements establishing totalization arrangements between the social security system of the United States and the social security system of a foreign country (referred to as a "totalization agreement").[89] The purposes of a totalization agreement are: (1) to establish entitlement to and the amount of old-age, survivors, disability, or derivative benefits based on a combination of an individual's periods of coverage under the United States social security system and the social security system of a foreign country, and (2) to prevent imposition of employment taxes by two countries on the same wages.

For purposes of FICA, during any period in which a totalization agreement is in effect, wages paid to an individual are exempt from the employer's and employee's share of FICA to the extent such wages are subject under the agreement exclusively to the laws applicable to the foreign country's social security system.[90]

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[89] 42 U.S.C. section 433.

[90] IRC sections 3101(c) and 3111(c).

HEROES EARNINGS ASSISTANCE AND RELIEF TAX ACT OF 2008 (HEARTA)(PL 110-245, JUNE 17, 2008)

New Federal Law (IRC section 3121)

Under the provision, a foreign person is treated as an American employer with respect to certain employees for purposes of determining whether their employment is subject to the employer's and employee's share of FICA. Specifically, a foreign person is treated as an American employer with respect to an employee of the foreign person who is performing services in connection with a contract between the United States government (or any instrumentality thereof) and any member of any domestically controlled group of entities which includes such foreign person. Thus, under the provision, service performed as an employee for such an employer outside of the United States by a United States citizen or resident in connection with such a contract is employment that is subject to FICA. A domestically controlled group of entities is a controlled group of entities the common parent of which is a domestic corporation. For this purpose, a controlled group of entities is as defined in IRC section 1563(a)(1) except that the ownership threshold is 50 percent rather than 80 percent and certain other changes are made, including that certain partnerships may be considered members of a controlled group.

The IRC sections 3101(c) and 3111(c) exceptions for wages not subject to FICA as a result of a totalization agreement apply under the provision. Also, this provision does not apply to any services covered by an agreement under IRC section 3121(l). In addition, the provision does not apply to services if the employer establishes to the satisfaction of the Secretary that the remuneration paid by such employer for such services is subject to a tax imposed by a foreign country which is substantially equivalent to FICA. It is intended that a tax is substantially equivalent to FICA only if the tax is imposed on wages at a rate equivalent to at least 80 percent of the combined employer and employee rates under FICA (i.e., 15.3 percent).

The provision provides that the common parent of the domestically controlled group of entities is jointly and severally liable for the FICA taxes for which the foreign person is liable as a result of the provision. In addition, the common parent is liable for any penalty imposed on the foreign person with respect to any failure to pay the FICA taxes or any failure to file any return or statement with respect to such tax or wages subject to such tax. No deduction is allowed for any liability imposed on the common parent as a result of these joint and several liability rules.

Effective Date

The provision is effective for services performed in calendar months beginning more than 30 days after June 17, 2008.

California Law

The California employment taxes are administered by the Employment Development Department (EDD) and not the Franchise Tax Board.

Impact on California Revenue

Defer to EDD.

Section	Section Title
303	Increase in Minimum Penalty on Failure to File a Return of Tax

Background

Under present law, a taxpayer who fails to file a tax return on a timely basis is subject to a penalty equal to five percent of the net amount of tax due for each month that the return is not filed, up to a maximum of five months or 25 percent.[91] An exception from the penalty applies if the failure is due to reasonable cause. The net amount of tax due is the excess of the amount of the tax required to be shown on the return over the amount of any tax paid on or before the due date prescribed for the payment of tax.[92]

In the case of a failure to file a tax return within 60 days of the due date, present law imposes a minimum penalty equal to the lesser of $100 or 100 percent of the amount of tax required to be shown on the return.

New Federal Law (IRC section 6651)

The provision increases the minimum penalty for a failure to file a tax return within 60 days of the due date to the lesser of $135 or 100 percent of the amount of tax required to be shown on the return.

Effective Date

The provision is effective for tax returns required to be filed after December 31, 2008.

California Law (R&TC section 19131)

California does not conform by reference to IRC section 6651, relating to failure to file tax return or to pay tax but instead has stand-alone language that parallels the federal provision. California law provides in R&TC section 19131 that the penalty for failure to file a return by the original or the extended due date is 5% of the tax (less any earlier payments and credits) for each month or fraction thereof from the due date, determined without regard to any extension of time for filing, to the date on which the return was filed, but not in excess of 25%

[91] IRC section 6651(a)(1).
[92] IRC section 6651(b)(1).

of the tax. Additionally, an individual or fiduciary that fails to file a tax return within 60 days of its due date (including extensions) is subject to a penalty of the lesser of $100 or 100% of the amount of tax required to be shown on the return, reduced by the amount of tax that has been paid by the due date, or any credit claimed on the return. The penalty may be waived, if the late filing was due to reasonable cause and not due to willful neglect.

Impact on California Revenue

Estimated Revenue Impact of Increase Minimum Penalty on Failure to File a Return of Tax For Tax Returns Required to be Filed On or After January 1, 2010 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
No Impact	$150,000	$350,000

Estimates are based on a proration of federal projections developed for the Heroes Earnings Assistance and Relief Tax Act of 2008.

TITLE IV – PARITY IN THE APPLICATION OF CERTAIN LIMITS TO MENTAL HEALTH BENEFITS

Section	Section Title
401	Parity in the Application of Certain Limits to Health Benefits

Background

The IRC, the Employee Retirement Income Security Act of 1974 (“ERISA”) and the Public Health Service Act (“PHSA”) contain provisions under which 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 (“mental health parity requirements”). In the case of a group health plan which provides benefits for mental health, the mental health parity requirements do not affect the terms and conditions (including cost sharing, limits on numbers of visits or days of coverage, and requirements relating to medical necessity) relating to the amount, duration, or scope of mental health benefits under the plan, except as specifically provided in regard to parity in the imposition of aggregate lifetime limits and annual limits.

The IRC imposes an excise tax on group health plans that fail to meet the mental health parity requirements. The excise tax is equal to $100 per day during the period of noncompliance and is generally imposed on the employer sponsoring the plan if the plan fails to meet the requirements. The maximum tax that can be imposed during a taxable year cannot exceed the lesser of 10 percent 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 in exercising reasonable diligence would not have known, that the failure existed.

New Federal Law (IRC section 9812)

The mental health parity requirements do not apply to group health plans of small employers nor do they apply if their application results in an increase in the cost under a group health plan of at least one percent. Further, the mental health parity requirements do not require group health plans to provide mental health benefits.

The IRC, ERISA, and PHSA mental health parity requirements expired with respect to benefits for services furnished after December 31, 2007.

Effective Date

The provision is effective June 17, 2008.

California Law (None)

IRC Changes

California law contains no provision comparable to IRC section 9812, relating to federal requirements for mental health parity for group health plans.

ERISA Changes

Impact on California Revenue

IRC Changes

Not applicable.

ERISA Changes

Baseline.

HOUSING AND ECONOMIC RECOVERY ACT OF 2008 (HERA)(PL 110-289, JULY 30, 2008)
TITLE I – HOUSING TAX INCENTIVES
SUBTITLE A – MULTI-FAMILY HOUSING
PART I – LOW-INCOME HOUSING TAX CREDIT

<u>Section</u>	<u>Section Title</u>
3001 - 3005	Low-Income Housing Tax Credit

Act section 3001 - Temporary Increase in Volume Cap for Low-Income Housing Tax Credit

<u>Background</u>

In general

The low-income housing credit may be claimed over a 10-year period by owners of certain residential rental property for the cost of rental housing occupied by tenants having incomes below specified levels (IRC section 42). The amount of the credit for any taxable year in the credit period is the applicable percentage of the qualified basis of each qualified low-income building. The qualified basis of any qualified low-income building for any taxable year equals the applicable fraction of the eligible basis of the building.

Volume limits

A low-income housing credit is allowable only if the owner of a qualified building receives a housing credit allocation from the state or local housing credit agency. Generally, the aggregate credit authority provided annually to each state for calendar year 2008 is $2.00 per resident, with a minimum annual cap of $2,325,000 for certain small population states (federal Rev. Proc. 2007-66). These amounts are indexed for inflation. Projects that also receive financing with proceeds of tax-exempt bonds issued subject to the private-activity-bond volume limit do not require an allocation of the low-income housing credit.

<u>New Federal Law (IRC section 42)</u>

The provision increases from $2.00 per resident to $2.20 per resident the allocation authority provided annually to each state for calendar years 2008 and 2009. Also, the provision increases the minimum annual cap for certain small population states by ten percent of the otherwise available amounts in 2008 and 2009, respectively. In 2010, the volume limits will return to the prescribed levels had this provision not been enacted.

<u>Effective Date</u>

The provision is effective for low-income credit allocations made for calendar years 2008 and 2009.

HOUSING AND ECONOMIC RECOVERY ACT OF 2008 (HERA)
(PL 110-289, JULY 30, 2008)

Act section 3002 - Determination of Credit Rate

Background

In general

The low-income housing credit may be claimed over a ten-year credit period after each low-income building is placed-in-service. The amount of the credit for any taxable year in the credit period is the applicable percentage of the qualified basis of each qualified low-income building.

Present value credit

The calculation of the applicable percentage is designed to produce a credit equal to: (1) 70 percent of the present value of the building's qualified basis in the case of newly constructed or substantially rehabilitated housing that is not federally subsidized (the "70-percent credit"); or (2) 30 percent of the present value of the building's qualified basis in the case of newly constructed or substantially rehabilitated housing that is federally subsidized and existing housing that is substantially rehabilitated (the "30-percent credit"). Where existing housing is substantially rehabilitated, the existing housing is eligible for the 30-percent credit and the qualified rehabilitation expenses (if not federally subsidized) are eligible for the 70-percent credit.

Calculation of the applicable percentage

The credit percentage for a low-income building is set for the earlier of: (1) the month the building is placed in service; or (2) at the election of the taxpayer, (a) the month the taxpayer and the housing credit agency enter into a binding agreement with respect to such building for a credit allocation, or (b) in the case of a tax-exempt bond-financed project for which no credit allocation is required, the month in which the tax-exempt bonds are issued.

These credit percentages (used for the 70-percent credit and 30-percent credit) are adjusted monthly by the IRS on a discounted after-tax basis (assuming a 28-percent tax rate) based on the average of the Applicable Federal Rates for mid-term and long-term obligations for the month the building is placed in service. The discounting formula assumes that each credit is received on the last day of each year and that the present value is computed on the last day of the first year. In a project consisting of two or more buildings placed in service in different months, a separate credit percentage may apply to each building.

New Federal Law (IRC section 42)

The provision provides a temporary applicable percentage of 9 percent for newly constructed non-federally subsidized buildings placed in service after July 30, 2008, and before December 31, 2013.

Effective Date

The provision is effective for buildings placed in service after July 30, 2008.

Act section 3003 – Modification to Definition of Eligible Basis

A. Modifications to the applicable percentage

Generally, buildings located in two types of high-cost areas (i.e., qualified census tracts and difficult development areas) are eligible for an enhanced credit. Under the enhanced credit, the 70-percent and 30-percent credits are increased to a 91-percent and 39-percent credit, respectively. The mechanism for this increase is through an increase from 100 to 130 percent of the otherwise applicable eligible basis of a new building or the rehabilitation expenditures of an existing building. A further requirement for the enhanced credit is that the portions of each metropolitan statistical area or nonmetropolitan statistical area designated as difficult to develop areas cannot exceed an aggregate area having 20 percent of the population of such statistical area.

New Federal Law (IRC section 42)

The provision adds a third type of high-cost area eligible for an enhanced credit. The third type is defined as any building designated by the State Housing Credit Agency as requiring the enhanced credit in order for such building to be financially feasible. This new type of high-cost area is not subject to the present-law limitation limiting high cost areas to 20 percent of the population of each metropolitan statistical area or nonmetropolitan statistical area.

It is expected that the state allocating agencies shall set standards for determining which areas shall be designated difficult development areas and which projects shall be allocated additional credits in such areas in the state allocating agency's allocation plan. It is also expected that the state allocating agency shall publicly express its reasons for such area designations and the basis for allocating additional credits to a project.

B. Modification to the definition of a federally subsidized building

Background

Rehabilitation expenditures[93] paid or incurred by a taxpayer with respect to a low-income building are treated as a separate building and may be eligible for the 70-percent credit if they

[93] Rehabilitation expenditures are amounts chargeable to a capital account and incurred for property (or additions or improvements to property) of a character subject to the allowance for depreciation in connection with the rehabilitation of a building. Such term does not include the cost of acquiring the building (or any interest therein). Other rules apply.

satisfy the otherwise applicable credit rules.[94] To qualify for the credit, the rehabilitation expenditures must equal the greater of an amount that is: (1) at least 10 percent of the adjusted basis of the building being rehabbed; or (2) at least $3,000 per low-income unit in the building being rehabbed.

At the election of the taxpayer, a special rule applies allowing the 30-percent credit to both existing buildings and rehabilitation expenditures if the second prong (i.e., at least $3,000 of rehabilitation expenditures per low-income unit) of the rehabilitation expenditures test is satisfied. This special rule applies only in the case where the taxpayer acquired the building and immediately prior to that acquisition the building was owned by or on behalf of a government unit.

<u>New Federal Law (IRC section 42)</u>

The provision increases the minimum expenditure requirements. Under the provision, the rehabilitation expenditures must equal the greater of an amount that is: (1) at least 20 percent of the adjusted basis of the building being rehabbed; or (2) at least $6,000 per low-income unit in the building being rehabbed. The provision also indexes the $6,000 amount for inflation. The other present-law rules apply.[95]

The provision retains the taxpayer election allowing the 30-percent credit to both existing building and the rehabilitation expenditures if the second prong (i.e., at least $6,000 of rehabilitation expenditures per low-income unit) of the rehabilitation expenditures test is satisfied.

<u>Effective Date</u>

The provision is effective for buildings that receive credit allocations after July 30, 2008, and substantially tax-exempt bond financed buildings (which satisfy the requirements of IRC section 42(h)(4) and therefore do not require a credit allocation) receiving a tax-exempt bond allocation after July 30, 2008.

[94] The credit period for an existing building does not begin before the credit period for the rehabilitation expenditures.
[95] A present-law rule reduces the $3,000 amount to $2,000 for any building substantially assisted, financed, or operated under Housing and Urban Development ("HUD") section 8, section 221(d)(3), or section 236 programs, or under the USDA Rural Development section 515 program where an assignment of the mortgage secured by the property in the project to HUD or the USDA Rural Development otherwise would occur or when a claim against a federal mortgage insurance fund would occur. A conforming change is made by the provision so that that the $2,000 amount will be increased to two-thirds of the $6,000 amount as indexed.

C. Community service facility eligibility for the credit

Background

In general, the qualified basis of a low-income building is limited to that portion of the building dedicated to qualified low-income use (either living space or certain common areas). However, certain "community service facilities" used by non-tenants of the low-income building may be included in the qualified basis of the low-income building if certain requirements are satisfied. For this purpose, a community service facility: (1) means any facility to serve primarily individuals whose income is 60 percent or less of area median income; and (2) may not exceed 10 percent of the eligible basis of the qualified low-income housing credit project of which it is a part.

New Federal Law (IRC section 42)

The provision expands the size of the community service facility with respect to which the low-income housing credit may be claimed. Under the provision, the size of the community service facility may not exceed the sum of: (1) 25 percent of so much of the eligible basis of the qualified low-income housing credit project of which it is a part as does not exceed $15,000,000; and (2) 10 percent of any excess over $15,000,000 of the eligible basis of the qualified low-income housing credit project of which it is a part.

Effective Date

The provision is effective for buildings placed in service after July 30, 2008.

D. Clarification of the treatment of federal grants

Background

The compliance period for any low-income credit building is the period of fifteen taxable years beginning with the taxable year in which the building is placed in service, or at the election of the taxpayer the succeeding taxable year. If during any year of the compliance period a grant is made with respect to any building or the operation thereof and any portion of the grant is funded with federal funds, the eligible basis of the building must be reduced by the portion of the grant that is federally-funded. This basis reduction must be made for the taxable year in which the grant is made and all succeeding taxable years.

New Federal Law (IRC section 42)

The provision clarifies the basis reduction rule to apply to federally-funded grants received before the compliance period. It also provides that no basis reduction is required for federally-funded grants to enable the property to be rented to low-income tenants received during the compliance period if those grants do not otherwise increase the taxpayer's eligible basis in the building.

The provision also directs the modification of Treasury Regulation section 1.42-16(b) to provide that none of the following shall be considered a grant made with respect to a building or its operation for purposes of IRC section 42(d)(5)(A): (1) rental assistance under section 521 of the Housing Act of 1949 (42 U.S.C. 1490a); (2) assistance under section 538(f)(5) of the Housing Act of 1949 (42 U.S.C. 1490p-2(f)(5)); (3) interest reduction payments under section 236 of the National Housing Act (12 U.S.C. 1715z-1); (4) rental assistance under section 202 of the Housing Act of 1959 (12 U.S.C. 1701q); (5) rental assistance under section 811 of the Cranston-Gonzalez National Affordable Housing Act (42 U.S.C. 8013); (6) modernization, operating, and rental assistance pursuant to section 202 of the Native American Housing Assistance and Self-Determination Act of 1996 (25 U.S.C. 4132); (7) assistance under title IV of the Stewart B. McKinney Homeless Assistance Act (42 U.S.C. 11361 et seq.); (8) tenant-based rental assistance under section 212 of the Cranston-Gonzalez National Affordable Housing Act (42 U.S.C. 12742); (9) assistance under the AIDS Housing Opportunity Act (42 U.S.C. 12901 et seq.); (10) per diem payments under section 2012 of title 38, United States Code; (11) rent supplements under section 101 of the Housing and Urban Development Act of 1965 (12 U.S.C. 1701s); (12) assistance under section 542 of the Housing Act of 1949 (42 U.S.C. 1490r); and (13) any other ongoing payment used to enable the property to be rented to low-income tenants. Further, no basis reduction is required for loans (regardless of interest rate) made to owners of qualified low-income housing projects from the proceeds of federally-funded grants. Nothing contained in this direction to modify the regulations is intended to create any inference with respect to the consideration of any program specified under subsection (a) of a grant made with respect to a building or its operation for purposes of IRC section 42(d)(5)(A) as in effect on July 29, 2008.

Effective Date

The provision is effective for buildings placed in service after July 30, 2008.

E. Modification to the definition of related persons

Background

With certain exceptions,[96] the eligible basis of an existing building is zero for low-income housing credit purposes unless: (1) the building was acquired by purchase; (2) there has been a period of at least 10 years between the acquisition by purchase and the later of the date the building was last placed in service or the date of the most recent nonqualified substantial improvement of the building (e.g., improvements equaling at least 25 percent of

[96] The Internal Revenue Service may waive the 10-year requirement for any building substantially assisted, financed, or operated under Housing and Urban Development ("HUD") section 8, section 221(d)(3), or section 236 programs, or under the Farmers' Home Administration section 515 program where an assignment of the mortgage secured by the property in the project to HUD or the Farmers' Home Administration otherwise would occur or when a claim against a federal mortgage insurance fund would occur.

the adjusted basis of the building before such improvements); and (3) the building was not previously placed-in-service by the taxpayer or a related person (IRC section 42(d)(2)(B)). For a building to be acquired by purchase, it may not be acquired from a related party.

The definition of related persons for purposes of these rules is the same as the definition used in IRC sections 267(b) and 707(b)(1) (relating to the disallowance of losses) with one modification.[97] Under the modification, in determining whether two persons are related, "10 percent" is substituted for "50 percent" in determining the threshold level of ownership in certain partnerships and corporations. For example, under the low-income credit provision, two partnerships are related if the same persons own more than ten percent of the capital interests or profits interest in each partnership.

<u>New Federal Law (IRC section 42)</u>

The provision repeals the ten-percent attribution rule used to determine whether parties are related for purposes of determining whether an existing building qualifies for the low-income housing credit. Under the provision, two persons are related for this purpose if they bear a relationship to each other specified in IRC sections 267(b) or 707(b)(1).

<u>Effective Date</u>

The provision is effective for buildings placed in service after July 30, 2008.

F. Exception to 10-year period rule related to prior placement in service of certain buildings

In general, the low income housing credit is not allowed with respect to existing buildings unless there was a period of at least ten years between the date of it's acquisition by the taxpayer and the later of the date the building was last placed-in-service or the date of the most recent nonqualified substantial improvement of the buildings (the "ten-year" rule").

Under one exception from this general rule, the Secretary of the Treasury (after consultation with the appropriate federal official) may waive the ten-year rule with respect to any federally-assisted building if such waiver is necessary: (1) to avert an assignment of the mortgage secured by property in the project (of which the building is a part) to the Department of Housing and Urban Development or the Farmers Home Administration, or (2) to avert a claim against a federal mortgage insurance fund (or such department or Administration) with respect to a mortgage which is so secured. For these purposes, a federally-assisted building is any building which is substantially assisted, financed, or operated under: (1) section 8 of the United States Housing Act of 1937; (2) section 221(d)(3) or 236 of the National Housing Act; or (3) section 515 of the Housing Act of 1949, as such Acts are in effect on the date of the enactment of the Tax Reform Act of 1986.

[97] In addition, certain businesses under common control are related persons for purposes of these rules.

Also, a waiver may be granted with respect to certain federally-assisted building if: (1) the mortgage on such building is eligible for prepayment under subtitle B of the Emergency Low Income Housing Preservation Act of 1987 or under section 502(c) of the Housing Act of 1949 at any time within one year after the date of the application for such waiver; (2) the appropriate federal official certifies to the Secretary of the Treasury that it is reasonable to expect that, if the waiver is not granted, such building will cease complying with its low-income occupancy requirements; and (3) the eligibility to prepay such mortgage without the approval of the appropriate federal official is waived by all persons who are so eligible and such waiver is binding on all successors of such persons. For purposes of this rule, a federally-assisted building is a building which is substantially assisted, financed, or operated under: (1) section 221(d)(3) or 236 of the National Housing Act; or (2) section 515 of the Housing Act of 1949, as such Acts are in effect on the date of the enactment of the Tax Reform Act of 1986). An appropriate federal official means, for these purposes, the Secretary of Housing and Urban Development (in certain instances) and the Secretary of Agriculture (in certain instances).

Finally, a waiver may be granted with respect to any building acquired from an insured depository institution in default (as defined in section 3 of the Federal Deposit Insurance Act) or from a receiver or conservator of such an institution.

New Federal Law (IRC section 42)

The provision replaces the first two exceptions to the ten-year rule under present law with one new exception. The new exception waives the ten-year rule in the case of any federally- or state-assisted building. For these purposes, the definition of federally-assisted building is expanded to include any building which is substantially assisted, financed, or operated under section 8 of the United States Housing Act of 1937, section 221(d)(3), 221(d)(4) or 236 of the National Housing Act, section 515 of the Housing Act of 1949, or any other housing program administered by the Depart of Housing and Urban Development or the Rural Housing Service of the Department of Agriculture. The term state-assisted building means any building that is substantially assisted, financed, or operated under any state law similar in purposes to those of the federal laws used in the definition of a federally-assisted building. The present-law exception related to certain depository institutions in default is retained.

Effective Date

The provision is effective for buildings placed in service after July 30, 2008.

HOUSING AND ECONOMIC RECOVERY ACT OF 2008 (HERA)
(PL 110-289, JULY 30, 2008)

Act section 3004 – Other Simplification and Reform of Low-Income Housing Tax Incentives

A. Repeal prohibition of the credit for buildings receiving HUD moderate rehabilitation assistance

Background

Generally, the low-income housing credit is available to otherwise qualifying buildings that also receive direct assistance under HUD Section 8 programs. No credit is allowed to any building with respect to which moderate rehabilitation assistance is provided at any time during the compliance period, under section 8(e)(2) of the United States Housing Act of 1937 (other than assistance under the Stewart B. McKinney Homeless Assistance Act).

New Federal Law (IRC section 42)

The provision eliminates the present-law prohibition against providing the low-income housing credit to buildings receiving moderate rehabilitation assistance under section 8(e)(2) of the United States Housing Act of 1937.

Effective Date

The provision is effective for buildings placed in service after July 30, 2008.

B. Carryover allocation rule

Background

In general, the allocation of the low-income housing credit must be made not later than the close of the calendar year in which the building is placed in service. One exception to this rule is a carryover allocation. In a carryover allocation, an allocation may be made to a building that has not yet been placed in service, provided that: (1) more than 10 percent of the taxpayer's reasonably expected basis in the project (as of the close of the second calendar year following the calendar year of the allocation) is incurred as of the later of six months after the allocation is made or the end of the calendar year in which the allocation is made; and (2) the building is placed in service not later than the close of the second calendar year following the calendar year of the allocation.

New Federal Law (IRC section 42)

The provision modifies the first prong of the carryover allocation rule. Under this modification, such an allocation will satisfy the first prong provided that more than 10 percent of the taxpayer's reasonably expected basis in the project (as of the close of the second calendar year following the calendar year of the allocation) is incurred as of 12 months after the allocation is made. The second prong of the carryover allocation rules is unchanged.

Effective Date

The provision is effective for buildings placed in service after July 30, 2008.

C. Repeal of bond posting requirement

Background

The compliance period for any building is the period beginning on the first day of the first taxable year of the credit period of such building and ending 15 years from such date.

The penalty for any building subject to the 15-year compliance period failing to remain part of a qualified low-income project (due, for example, to noncompliance with the minimum set aside requirement, or the gross rent requirement, or other requirements with respect to the units comprising the set aside) is recapture of the accelerated portion of the credit, with interest, for all prior years.

Generally, any change in ownership by a taxpayer of a building subject to the compliance period is also a recapture event. An exception is provided if the seller satisfies certain bond posting requirements (in an amount and manner prescribed by Treasury), and if it can reasonably be expected that such building will continue to be operated as a qualified low-income building for the remainder of the compliance period.

New Federal Law (IRC section 42)

The provision eliminates the bond posting requirement. In its place, the provision extends the otherwise applicable statute of limitation until three years after the Secretary of the Treasury is notified of noncompliance with the low-income housing credit rules.

Also, at the election of the taxpayer, the provision applies with respect to dispositions of interests in a building on or before the date of enactment if it is reasonably expected that such building will continue to be a qualified low-income building for the remaining compliance period.

Effective Date

The provision applies with respect to dispositions of interests in buildings after July 30, 2008.

D. Additions of energy efficiency and historic nature criteria to housing credit agency allocation plan criteria

Each state must develop a plan for allocating credits, and such plan must include certain allocation criteria including: (1) project location; (2) housing needs characteristics; (3) project characteristics (including whether the project uses existing housing as part of a community revitalization plan; (4) sponsor characteristics; (5) tenant populations with special needs; (6)

tenant populations of individuals with children; and (7) projects intended for eventual tenant ownership.

The state-allocation plan must also give preference to housing projects that: (1) serve the lowest-income tenants; (2) are obligated to serve qualified tenants for the longest periods; and (3) are located in qualified census tracts and the development of which contributes to a concerted community revitalization plan. For this purpose, a qualified census tract is defined as a census tract: (1) designated by the Secretary of HUD; and (2) for the most recent year for which census data is available for such tract, either 50 percent or more of the households have a income that is less than 60 percent of the area median income for that year or which has a poverty rate of at least 25 percent.

Present law also requires that housing credit agencies perform a comprehensive market study of the housing needs of the low-income individuals in the area to be served by the project and a written explanation, available to the general public, for any allocation not made in accordance with the established priorities and selection criteria of the housing credit agency. It also requires that the housing credit agency conduct site visits to monitor for compliance with habitability standards.

New Federal Law (IRC section 42)

The provision adds two additional criteria that states must use in its allocation of credits among potential low-income housing projects. The additional criteria are: (1) the energy efficiency of the project; and (2) the historic nature of the project (e.g., encouraging rehabilitation of certified historic structures (sec. 47(c)(3))).

Effective Date

The provision is effective for allocations made after December 31, 2008.

E. Treatment of individuals who previously received foster care assistance

Background

In general, student housing does not qualify for the low-income housing credit. Two exceptions are provided from this general rule.[98] These two exceptions are units occupied by an individual: (1) who is a student and receiving assistance under title IV of the Social Security Act (Temporary Assistance for Needy Families); or (2) enrolled in a job training program receiving assistance under the Job Training Partnership Act or under other similar federal, state, or local laws.

[98] See also the discussion of the full-time student rule below.

New Federal Law (IRC section 42)

The provision adds a third exception to the general rule that student housing is not eligible for the low-income housing credit. This new exception applies in the case of a student who was previously under the care and placement responsibility of a foster care program (under part B or E of title IV of the Social Security Act).

Effective Date

The provision is effective for determinations after July 30, 2008.

F. Measurement of area median gross income for certain projects located in certain nonmetropolitan areas

In order to be eligible for the low-income housing credit, a qualified low-income building must be part of a qualified low-income housing project. In general, a qualified low-income housing project is defined as a project which satisfies one of two tests at the election of the taxpayer. The first test is met if 20 percent or more of the residential units in the project are both rent-restricted and occupied by individuals whose income is 50 percent or less of area median gross income (the "20-50 test"). The second test is met if 40 percent or more of the residential units in such project are both rent-restricted and occupied by individuals whose income is 60 percent or less of area median gross income (the "40-60 test").
In the case of property placed in service during 2006, 2007, and 2008 in a nonmetropolitan area within the Gulf Opportunity Zone, the income targeting rules of the low-income housing credit are applied by replacing the area median gross income standard with a national nonmetropolitan median gross income standard. These new income targeting rules apply to all such buildings in the Gulf Opportunity Zone regardless of whether the building receives its credit allocation under the otherwise applicable low-income housing credit cap or the additional credit cap (described above). The income targeting rules are not changed for buildings in metropolitan areas in the Gulf Opportunity Zone.

New Federal Law (IRC section 42)

The measurement of area median gross income applied for residential rental property located in certain rural areas is modified in the case of projects subject to the low-income housing credit volume limits. In the case of such properties located in rural areas (as defined in section 520 of the Housing Act of 1949), the income targeting rules of the low-income housing credit are applied by reference to the greater of the otherwise applicable area median gross income standard, or the national nonmetropolitan median gross income. This new income targeting rule applies to all such buildings if the building receives a low-income housing credit allocation under the otherwise applicable low-income housing credit volume limit. It does not apply in the case of buildings that do not require a low-income housing credit allocation because they are substantially bond-financed. The area median gross income rules are not changed for buildings in metropolitan areas.

Effective Date

The provision is effective for determinations after July 30, 2008.

G. Clarification of general public use rule

Background

In order to be eligible for the low-income housing credit, the residential units in a qualified low-income housing project must be available for use by the general public. A project is available for general public use if: (1) the project complies with housing non-discrimination policies including those set forth in the Fair Housing Act (42. U.S.C. 3601), and (2) the project does not restrict occupancy based on membership in a social organization or employment by specific employers.[99] In addition, any residential unit that is part of a hospital, nursing home, sanitarium, lifecare facility, trailer park, or intermediate care facility for the mentally or physically handicapped is not available for use by the general public.

New Federal Law (IRC section 42)

The provision clarifies that a project, which otherwise meets the general public use requirements above, shall not fail to meet the general public use requirement solely because of occupancy restrictions or preferences that favor tenants: (1) with special needs; or (2) who are members of specified group under a federal program or state program or policy that supports housing for such a specified group; or (3) who are involved in artistic and literary activities.

Effective Date

The provision applies to buildings placed in service before, on, or after July 30, 2008.

H. GAO study

Background

There are no current GAO studies planned of the low-income housing credit.

New Federal Law (IRC section 42)

The Comptroller General of the United States is directed to analyze the changes to the low-income housing credit made by this Act. The report shall be submitted to Congress not later than December 31, 2012.

[99] See Treas. Reg. sec. 1.42-9.

HOUSING AND ECONOMIC RECOVERY ACT OF 2008 (HERA)
(PL 110-289, JULY 30, 2008)

Act section 3005 – Treatment of Military Basic Pay

Background

In order to be eligible for the low-income housing credit, a qualified low-income building must be part of a qualified low-income housing project. In general, a qualified low-income housing project is defined as a project that satisfies one of two tests at the election of the taxpayer. The first test is met if 20 percent or more of the residential units in the project are both rent-restricted, and occupied by individuals whose income is 50 percent or less of area median gross income (the "20-50 test"). The second test is met if 40 percent or more of the residential units in such project are both rent-restricted, and occupied by individuals whose income is 60 percent or less of area median gross income (the "40-60 test"). These income figures are adjusted for family size.

The military provides the basic housing allowance. The recipients of the military basic housing allowance must include these amounts for purposes of low-income credit eligibility.

New Federal Law (IRC section 42)

In general

Under the provision the basic housing allowance (i.e., payments under 37 U.S.C. sec. 403) is not included in income for the low-income credit income eligibility rule. The provision is limited in application to qualified buildings. A qualified building is defined as any building located in:

1. Any county that contains a qualified military installation to which the number of members of the Armed Forces assigned to units based out of such qualified military installation has increased by 20 percent or more as of June 1, 2008, over the personnel level on December 31, 2005; and
2. Any counties adjacent to county described in (1), above.

For these purposes, a qualified military installation is any military installation or facility with at least 1,000 members of the Armed Forces assigned to it.

Applicability

The provision applies to income determinations: (1) made after July 30, 2008, and before January 1, 2012, in the case of qualified buildings which received credit allocations on or before July 30, 2008, or qualified buildings placed in service on or before July 30, 2008, to the extent a credit allocation was not required with respect to such building by reason of IRC section 42(h)(4) (i.e. such qualified building was at least 50% tax bond financed with bonds subject to the private-activity-bonds volume cap) but only with respect to bonds issued before July 30, 2008; and (2) made after July 30, 2008, in the case of qualified buildings that received credit allocations after July 30, 2008, and before January 1, 2012, or qualified buildings placed in service after July 30, 2008, and before January 1, 2012, to the extent a credit allocation was not required with respect to such qualified building by reason of IRC section 42(h)(4) (i.e. such qualified building was at least 50% tax bond financed with bonds subject to the private-activity-bond volume cap) but only with respect to bonds issued after July 30, 2008, and before January 1, 2012.

Effective Date

The provision is effective for income determinations after July 30, 2008.

California Law – Act sections 3001 - 3005 (R&TC sections 17057.5, 17058, 23610.4, and 23610.5)

California conforms by reference to IRC section 42, relating to the low-income housing credit, as of the “specified date” of January 1, 2005, with modifications. In order to qualify for the California low-income housing credit, the low-income housing project must be located in California. Additional modifications include the following:

California Tax Credit Allocation Committee

The California Tax Credit Allocation Committee is required to allocate this credit based on the project’s need for economic feasibility. Thus, the amount of the California tax credit allocated to a project cannot exceed the amount that, in addition to the federal credit allocated to that project, is necessary for the financial feasibility of the project and its viability throughout the extended use period.

Credit amount and credit period

Generally, the percentage of costs for which the credit may be taken in the first three years is the highest percentage allowed under federal law in the month the building is placed in service. For the fourth year, the percentage is the difference between 30% and the sum of the credit percentage for the first three years.

For new buildings that are federally subsidized and existing buildings that are at risk of conversion to market rental rates, the percentage of creditable costs in the first three years is the same as the federal percentage applicable to the subsidized new buildings. For the fourth year, the percentage is the difference between 13 percent and the sum of the credit percentages for the first three years.

Compliance period

California uses a 30-year compliance period instead of the federal 15-year period.

Basis adjustments

California modifies the federal rule for the increase in qualified basis after the first year of the credit period.[100] When the basis of a building that has been granted a low-income housing tax credit is increased and exceeds the basis at the end of the first year of the four-year credit period, the taxpayer is eligible for a credit on the excess basis. This additional credit is also taken over a four-year period beginning with the taxable year in which the increase in qualified basis occurs.

Partnership allocations

For partnership allocations of low-income housing credits occurring on or after January 1, 2009, and before January 1, 2016, the credit must be allocated to the partners of a partnership owning the project based on the partnership agreement, regardless how the federal credit is allocated and regardless of whether the allocation of the credit under the partnership agreement has "substantial economic effect" within the meaning of IRC section 704(b). To the extent the allocation of the credit to a partner lacks substantial economic effect, any loss or deduction attributable to the sale, transfer, exchange, abandonment, or any other disposition of a partnership interest prior to the federal credit's expiration is deferred and treated as if it occurred in the first taxable year immediately following the taxable year in which the federal credit period expires.[101]

<u>Impact on California Revenue – Act sections 3001 - 3005</u>

Estimated Revenue Impact of Various Incentives Related to the Low-Income Housing Tax Credit (Act sections 3001 to 3005) For Allocations Made with Respect to State-Low Income Housing Credits for Calendar Years Beginning 2009 and After Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
$0	$0	$0

California has its own method for increasing the amount of the state low-income housing credit. The credit amount was set at $70 million and is adjusted annually for inflation; the current amount of state credit is about $85 million. To the extent that California would conform to federal changes to the low-income housing credit, no net revenue loss would result because the California Tax Credit Allocation Committee currently allocates the entire amount of state credit available.

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[100] IRC section 42(f)(3).
[101] R&TC section 23610.5(b)(1)(C).

HOUSING AND ECONOMIC RECOVERY ACT OF 2008 (HERA)
(PL 110-289, JULY 30, 2008)

PART II – MODIFICATION TO TAX-EXEMPT HOUSING BOND RULES

Section	Section Title
3007-3008	Tax-Exempt Housing Bond Rules

Act section 3007 - Recycling of Tax-Exempt Debt for Financing Residential Products

Background

In general

Private activity bonds are bonds that nominally are issued by state or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such private person. The exclusion from income for interest paid on state and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds"). The definition of a qualified private activity bond includes, but is not limited to, qualified mortgage bonds, qualified veterans' mortgage bonds, and bonds for qualified residential rental projects.

Qualified residential rental projects

Residential rental property may be financed with qualified private activity bonds if the financed project is a "qualified residential rental project." A project is a qualified residential rental project if 20 percent or more of the residential units in such project are occupied by individuals whose income is 50 percent or less of area median gross income (the "20-50 test"). Alternatively, a project is a qualified residential rental project if 40 percent or more of the residential units in such project are occupied by individuals whose income is 60 percent or less of area median gross income (the "40-60 test"). The issuer must elect to apply either the 20-50 test or the 40-60 test. Operators of qualified residential rental projects must annually certify that such project meets the requirements for qualification, including meeting the 20-50 test or the 40-60 test.

As with most qualified private activity bonds, bonds for qualified residential rental projects are subject to annual state volume limitations (the "state volume cap"). For calendar year 2008, the state volume cap, which is indexed for inflation, equals $85 per resident of the state, or $262.09 million, if greater.

Bonds issued to finance qualified residential rental projects are subject to a term to maturity rule which limits the period of time such bonds may remain outstanding. Generally, this rule provides that the average maturity of a qualified private activity bond cannot exceed 120 percent of the economic life of the property being financed.[102]

[102] IRC section 147(b).

New Federal Law (IRC section 146)

Under the provision, if within six months after receipt of a repayment of a conduit loan used to finance a qualified residential rental project, such repayment is used to finance a second qualified residential rental project, any bond issued to refinance the first issue of bonds (i.e., the bond financing the original conduit loan) shall be treated as a refunding issue. A loan to a person other than the governmental entity from the proceeds of a bond issue to carry out the defined qualified purpose of the issue is a conduit loan. Thus, under the provision, the refinancing bond is treated as a refunding notwithstanding a change in obligors under the first and second conduit loans. The provision only applies to the first refunding of the refunded bond and only if such refunding bond is issued within four years of the date of issue of the refunded bond. In addition, the final maturity date for the refunding bonds cannot be later than 34 years after the date of issuance of the refunded bond.

Effective Date

The provision applies to repayments of loans received after July 30, 2008.

Act Section 3008 – Coordination of Certain Rules Applicable to Low-Income Housing Credit and Qualified Residential Rental Project Exempt Facility Bonds

A. Next available unit rule

Background

In order to be eligible for the low-income housing credit, each of the residential units with respect to which the credit is claimed must be: (1) occupied by low-income tenants; and (2) rent-restricted. If the incomes of any such tenants rise above certain levels, then the credit with respect to that unit is denied unless the next available unit in the low-income building (of a size comparable or smaller than such unit) is rented to a new tenant who satisfies the income and rent-restriction requirements (the "next-available-unit rule").[103]

Subject to certain requirements, tax-exempt bonds may be issued to finance qualified residential rental projects. The tax-exempt bond rules for qualified residential projects have similar tenant income limitations as the low-income credit, but apply the next available unit rule on a project basis rather than a building-by-building basis.[104] Therefore, to avoid noncompliance when the income of a tenant rises above certain levels, the next available unit (of a size comparable or smaller than such unit) in the entire project (rather than just the same building) must be rented to a new tenant who satisfies the income and rent-restriction requirements.

[103] IRC section 42(g)(2)(D)(ii).
[104] IRC section 142(d)(3)(B).

New Federal Law (IRC section 142)

In the case of a low-income building which is tax-exempt bond financed and eligible for the low-income housing credit, the provision provides that both the bond and credit restrictions will be satisfied if the next available unit in the building is rented to a new tenant who satisfies the income and rent-restriction requirements. It therefore conforms the tax-exempt bond rule to the low-income housing credit rule.

Effective Date

The provision applies to determinations of the status of qualified residential rental projects for periods beginning after July 30, 2008, with respect to bonds issued before, on, or after July 30, 2008.

B. Students

Background

In general

The low-income housing credit is not available for any residential unit unless it is available for use by the general public. For these purposes, a residential unit generally is available for use by the general public if the unit is rented in a manner consistent with housing policy governing nondiscrimination as evidenced by the rules and regulations of the Department of Housing and Urban Development ("HUD"). Notwithstanding compliance with the HUD rules and regulations, a residential rental unit is not available for use by the general public if such unit is: (1) provided only for a member of a social organization; or (2) provided by an employer for its employees. Other rules may apply.

Rules for full-time students

For purposes of the low-income housing credit, no credit is allowed with respect to an otherwise eligible unit occupied entirely by full-time students: (1) unless those students are comprised entirely of single parents and their children; or (2) are married and file a joint return. Further, the single parents may not be dependents of another individual and the children may not be dependents of another individual other than of their parents. For purposes of the tax-exempt bond rules, a slightly different full-time student rule applies. The tax-exempt bond rule provides that a residential unit will not satisfy the income tests if all the occupants are students (as defined in IRC section 152(f)(2)) and are not entitled to file a joint tax return.

New Law (IRC section 142)

The provision conforms the tax-exempt bond rule with respect to students to the low-income housing credit rule.

Effective Date

The full-time student provision applies to determinations of the status of qualified residential rental projects for periods beginning after July 30, 2008, with respect to bonds issued before, on, or after July 30, 2008.

C. Single-room occupancy units

Background

Unlike the requirements for projects financed with tax-exempt bonds, certain single-room occupancy housing used on a nontransient basis may qualify for the low-income credit, even though such housing may provide eating, cooking, and sanitation facilities on a shared basis. An example of housing that may qualify for the credit is a residential hotel used on a nontransient basis that is available to all members of the public.

Among other requirements, qualified residential rental projects financed with tax-exempt bonds generally cannot be used on a transient basis. Treasury regulations clarify that a residential unit will not be treated as used on a transient basis if the unit contains complete facilities for living, including living, sleeping, eating, cooking, and sanitation.[105]

New Federal Law (IRC section 142)

The provision conforms the tax-exempt bond rule to the low-income housing credit rule.

Effective Date

The provision applies to determinations of the status of qualified residential rental projects for periods beginning after July 30, 2008, with respect to bonds issued before, on, or after July 30, 2008.

California Law (R&TC sections 17143 and 24272)

California law specifically does not conform to IRC sections 103 and 141 through 150, relating to the federal rules exempting the interest earned on state or municipal bonds and the arbitrage rebate rules. In addition, the federal "private-activity-bond" rules have not been adopted by California. Also, California has never conformed to the federal tax law treatment of Indian tribal governments as states.

[105] Treas. Reg. sec. 1.103-8(b)(10)(ii).

California state and municipal bonds

The general rule in California is that for income tax purposes all interest received or accrued is fully taxable, except for interest on federal obligations (such as Treasury bills, notes, and bonds, as more fully described below) and tax-exempt bonds issued by this state or a local government in this state.

Unlike federal law, the interest earned on bonds issued by other states and municipalities in other states is fully taxable to a resident of California. The California exemption from income taxation of interest on bonds of the state and its political subdivisions is contained in the California Constitution (Art. XIII, § 26. subd. (b)). The Revenue and Taxation Code further provides, by statute, that the federal “private-activity-bond” analysis shall not be made in determining whether interest on bonds issued by the state or a political subdivision thereof shall be exempt from California income tax. Thus, in California, if the use of the bond proceeds of a state or local California issue is for private business use or is secured by property used for a private business use, the interest on that bond is still treated for California income tax purposes as tax exempt, even though the interest on the bond may well be taxable for federal income tax purposes.

California conduit revenue bonds

Conduit revenue bonds are issued by a governmental (state or municipal) entity for various purposes, including economic development, educational and health facilities construction, and multi-family housing. The funds obtained from the financing are loaned to a nongovernmental borrower who builds and operates the project. The use by a private firm (via expenditure of the bond proceeds) of a governmental agency's authority to issue tax-exempt debt is premised on the fact that the project will provide public benefit. A conduit revenue bond is payable solely from the loan payments received from the non-governmental party (unless the bond is insured by a third party who guarantees payment in the event of a default by the private firm who has pledged the revenue source). The governmental issuer typically has no liability for debt service on the bonds, except for the administration of the bond. Although the issuer has no actual liability on the bonds, their reputation and standing with respect to future debt financing may be negatively affected in the event of a default on the bonds. More importantly, should the bonds go into default, the governmental entity will likely be drawn into the settlement process. Most conduit revenue bonds are sold at negotiated sales with the interest rate and other terms of the bonds negotiated between the issuer, the non-governmental borrower, and an underwriter. The security for some of these transactions is sufficient to allow the underwriter to act as a pass-through for the bonds and in so doing act as a placement agent rather than an underwriter. Since the public agency's credit is not on the line, many issuers do not participate in any substantive fashion in the sale of the bonds. Rather, they may limit their role to reviewing the bond purchase contract and other legal and disclosure documents to ensure that they are adequately indemnified against liabilities and to accurately describe their role to investors as issuers and not as borrowers or guarantors of the debt.

Since the conduit revenue bonds issued in California are issued by this state or a local government in this state, the interest paid on such bonds is exempt from state income taxation under the California Constitution.

California treatment of federal bond interest

Interest earned on federal bonds is also tax-exempt for California income tax purposes. This results from federal law (31 U.S.C. § 3124(a)) that prohibits all states from imposing an income tax on interest income from direct obligations of the U. S. government. Examples of bonds that are exempt for California income tax purposes include those issued by federal land banks, the Federal Home Loan Bank, and Banks for Cooperatives. Not all federal bonds are direct obligations of the U.S. government and interest on those bonds is taxable.

Examples of federal bonds not exempt are those issued by the Federal National Mortgage Association (Fannie Maes), Government National Mortgage Association (Ginnie Maes), and Federal Loan Home Mortgage Corporation (Freddie Macs).

California franchise tax treatment

Interest received from federal, state, municipal, or other bonds is includable in the gross income of corporations taxable under the franchise tax. The franchise tax is a nondiscriminatory privilege tax for the right to exercise the corporate franchise and is not a tax on the income received, but instead merely uses that income of the year as the measure of the tax for the privilege of exercising the corporate franchise.

Impact on California Revenue – Act sections 3007 and 3008

Not applicable.

HOUSING AND ECONOMIC RECOVERY ACT OF 2008 (HERA) (PL 110-289, JULY 30, 2008)

PART III – REFORMS RELATED TO THE LOW-INCOME HOUSING CREDIT AND TAX-EXEMPT HOUSING BONDS

Section	Section Title
3009 – 3010	Tax Exempt Housing Bond Rules

Act section 3009 – Hold Harmless for Reductions in Area Median Gross Income

Background

Tax rules

Tax-exempt bonds

Residential rental property may be financed with exempt facility bonds if the financed project is a "qualified residential rental project." A project is a qualified residential rental project if 20 percent or more of the residential units in such project are occupied by individuals whose income is 50 percent or less of area median gross income (the "20-50 test"). Alternatively, a project is a qualified residential rental project if 40 percent or more of the residential units in such project are occupied by individuals whose income is 60 percent or less of area median gross income (the "40-60 test"). The issuer must elect to apply either the 20-50 test or the 40-60 test (IRC section 142).

Low-income housing tax credit

To be eligible for the low-income housing credit, a qualified low-income building must be part of a qualified low-income housing project. In general, a qualified low-income housing project is defined as a project that satisfies one of two tests at the election of the taxpayer.[106] The first test is met if 20 percent or more of the residential units in the project are both rent-restricted, and occupied by individuals whose income is 50 percent or less of area median gross income (the "20-50 test"). The second test is met if 40 percent or more of the residential units in such project are both rent-restricted, and occupied by individuals whose income is 60 percent or less of area median gross income (the "40-60 test"). These income figures are adjusted for family size.

Determination of income and area median gross income

The income of individuals and area median gross income are determined by the Secretary of the Treasury in a manner consistent with determinations of lower-income families and area median gross income under section 8 of the Housing Act of 1937 (sec. 142(d)). These determinations under section 8 are made by HUD. These determinations also include adjustments for family size.

[106] IRC section 42(g).

Therefore, such determinations (individual and area median gross income) are applicable for purposes of tax-exempt bonds and the low-income housing credit.

HUD hold harmless policy

Generally, HUD releases its calculation of area median gross income for a calendar year early in that year. Historically, HUD has used the most recent decennial census data and updated it with other data on income, employment, and earnings.

Recently, HUD modified its methodology to include additional data in its calculation of area median gross income. In some instances, this change in methodology resulted in significantly lower numbers for area median gross income in some areas. In response to this result, HUD provided that such areas are not treated as having a lower area median gross income for purposes of HUD housing programs.

New Federal Law (IRC section 142)

In general

The provision makes two modifications to the determination of area median gross income for purposes of tax-exempt bonds and the low-income housing credit.

Determination of income and area median gross income

The provision provides that any determination of area median gross income with respect to a project may not be less than the determination of area median gross income with respect to that project for the preceding calendar year. This modification applies to all projects and is not limited to projects benefiting from the HUD hold harmless policy.

HUD hold harmless policy

In the case of a HUD hold harmless impacted project, the determination of area median gross income for the project is the greater of: (1) the amount determined without regard to the special rule for HUD hold harmless impacted projects, or (2) the sum of the area median gross income determined under the HUD hold harmless policy with respect to the project for 2008 plus any increase in area median gross income after 2008.

Effective Date

The provision applies to determinations of area median gross income for calendar years after 2008.

HOUSING AND ECONOMIC RECOVERY ACT OF 2008 (HERA) (PL 110-289, JULY 30, 2008)

Act section 3010 - Exception to Annual Current Income Determination Requirement Where Determination Not Relevant

Background

Tax rules - In general

Tax-exempt bonds

Residential rental property may be financed with exempt facility bonds if the financed project is a "qualified residential rental project." A project is a qualified residential rental project if 20 percent or more of the residential units in such project are occupied by individuals whose income is 50 percent or less of area median gross income (the "20-50 test"). Alternatively, a project is a qualified residential rental project if 40 percent or more of the residential units in such project are occupied by individuals whose income is 60 percent or less of area median gross income (the "40-60 test"). The issuer must elect to apply either the 20-50 test or the 40-60 test (IRC section 142).

Low-income housing tax credits

In order to be eligible for the low-income housing credit, a qualified low-income building must be part of a qualified low-income housing project. In general, a qualified low-income housing project is defined as a project that satisfies one of two tests at the election of the taxpayer.[107] The first test is met if 20 percent or more of the residential units in the project are both rent-restricted, and occupied by individuals whose income is 50 percent or less of area median gross income (the "20-50 test"). The second test is met if 40 percent or more of the residential units in such project are both rent-restricted, and occupied by individuals whose income is 60 percent or less of area median gross income (the "40-60 test"). These income figures are adjusted for family size.

Determination of income and area median gross income

The income of individuals and area median gross income are determined by the Secretary of the Treasury in a manner consistent with determinations of lower-income families and area median gross income under section 8 of the Housing Act of 1937.[108] These determinations also include adjustments for family size.

[107] IRC section 42(g).
[108] IRC section 142(d).

Certification

The IRC provides that the operator of any qualified residential rental project must submit to the Secretary of the Treasury (at such time and in such manner as the Secretary prescribes) an annual certification that the project continues to satisfy the requirements of a qualified residential rental project. Any failure to comply with the annual certification to the Secretary of the Treasury will subject the operator to penalties but will not affect the tax-exempt status of the underlying bonds.[109]

Similar rules apply for the low-income housing credit regarding tenant incomes.[110] IRS Revenue Procedure 1994-64 allows a taxpayer to request a waiver of this certification under certain circumstances with the consent of the state agency responsible for monitoring the low-income credit project.

Treatment of tenants whose incomes rise above the income limits

Generally a low-income unit will continue to be treated as such even when the tenant's income rises above the income limits provided that the next available unit (of a size comparable to or smaller than such unit) in the project is occupied by a new resident who satisfies the income limits.

HUD rules

A family's eligibility for various types of HUD housing assistance is based on its income and family composition. The HUD Handbook 4350.3 contains the certification and annual recertification rules to be followed by project operators. Under the HUD program requirements, tenants have the responsibility to provide timely information to the project operators. Operators have the responsibility to review and verify the tenant information and to make changes to assistance payment and tenant rent to satisfy program requirements.

New Federal Law (IRC section 142)

The provision waives the annual recertification requirements under tax-exempt bonds for any project as long as no residential unit in the project is occupied by tenants who fail to satisfy the otherwise applicable income limits. The provision does not modify the HUD rules; therefore, some projects must continue annual certification notwithstanding this provision.

Effective Date

The provision is effective for years ending after July 30, 2008.

[109] IRC section 142(d)(7).
[110] IRC section 42(g)(4).

California Law (R&TC sections 17143 and 24272)

California law specifically does not conform to IRC sections 103 and 141 through 150, relating to the federal rules exempting the interest earned on state or municipal bonds and the arbitrage rebate rules. In addition, the federal "private-activity-bond" rules have not been adopted by California. Also, California has never conformed to the federal tax law treatment of Indian tribal governments as states.

California state and municipal bonds

The general rule in California is that for income tax purposes all interest received or accrued is fully taxable, except for interest on federal obligations (such as Treasury bills, notes, and bonds, as more fully described below) and tax-exempt bonds issued by this state or a local government in this state.

Unlike federal law, the interest earned on bonds issued by other states and municipalities in other states is fully taxable to a resident of California. The California exemption from income taxation of interest on bonds of the state and its political subdivisions is contained in the California Constitution (Art. XIII, § 26. subd. (b)). The Revenue and Taxation Code further provides, by statute, that the federal "private-activity-bond" analysis shall not be made in determining whether interest on bonds issued by the state or a political subdivision thereof shall be exempt from California income tax. Thus, in California, if the use of the bond proceeds of a state or local California issue is for private business use or is secured by property used for a private business use, the interest on that bond is still treated for California income tax purposes as tax exempt, even though the interest on the bond may well be taxable for federal income tax purposes.

California conduit revenue bonds

Conduit revenue bonds are issued by a governmental (state or municipal) entity for various purposes, including economic development, educational and health facilities construction, and multi-family housing. The funds obtained from the financing are loaned to a nongovernmental borrower who builds and operates the project. The use by a private firm (via expenditure of the bond proceeds) of a governmental agency's authority to issue tax-exempt debt is premised on the fact that the project will provide public benefit. A conduit revenue bond is payable solely from the loan payments received from the non-governmental party (unless the bond is insured by a third party who guarantees payment in the event of a default by the private firm who has pledged the revenue source). The governmental issuer typically has no liability for debt service on the bonds, except for the administration of the bond. Although the issuer has no actual liability on the bonds, their reputation and standing with respect to future debt financing may be negatively affected in the event of a default on the bonds. More importantly, should the bonds go into default, the governmental entity will likely be drawn into the settlement process. Most conduit revenue bonds are sold at negotiated sales with the interest rate and other terms of the bonds negotiated between the issuer, the non-governmental borrower, and an underwriter. The security for some of these transactions is sufficient to allow the underwriter to act as a pass-through for the bonds and in so doing act as a placement agent rather than an underwriter. Because the public agency's credit is not on the line, many issuers do not participate in any substantive fashion in the sale of the bonds. Rather, they may limit their role to reviewing the bond purchase contract and other legal and disclosure documents to ensure that they are adequately indemnified against liabilities and to accurately describe their role to investors as issuers and not as borrowers or guarantors of the debt.

Because the conduit revenue bonds issued in California are issued by this state or a local government in this state, the interest paid on such bonds is exempt from state income taxation under the California Constitution.

California treatment of federal bond interest

Interest earned on federal bonds is also tax-exempt for California income tax purposes. This results from federal law (31 U.S.C. § 3124(a)) that prohibits all states from imposing an income tax on interest income from direct obligations of the U. S. government. Examples of bonds that are exempt for California income tax purposes include those issued by federal land banks, the Federal Home Loan Bank, and Banks for Cooperatives. Not all federal bonds are direct obligations of the U.S. government and interest on those bonds is taxable.

Examples of federal bonds not exempt are those issued by the Federal National Mortgage Association (Fannie Maes), Government National Mortgage Association (Ginnie Maes), and Federal Loan Home Mortgage Corporation (Freddie Macs).

California franchise tax treatment

Interest received from federal, state, municipal, or other bonds is includable in the gross income of corporations taxable under the franchise tax. The franchise tax is a nondiscriminatory privilege tax for the right to exercise the corporate franchise and is not a tax on the income received, but instead merely uses that income of the year as the measure of the tax for the privilege of exercising the corporate franchise.

Impact on California Revenue – Act sections 3009 and 3010

Not applicable.

HOUSING AND ECONOMIC RECOVERY ACT OF 2008 (HERA)
(PL 110-289, JULY 30, 2008)

SUBTITLE B – SINGLE FAMILY HOUSING

Section	Section Title
3011	First Time Home-Buyer Credit

Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for owner-occupied residences. The subsidy provided for qualified mortgage bonds allows issuers to finance mortgages for homebuyers at reduced interest rates. The IRC imposes several limitations on qualified mortgage bonds, including a "first-time homebuyer" requirement. The first-time homebuyer requirement provides that qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage. In addition, bond proceeds generally only can be used for new mortgages, i.e., proceeds cannot be used to acquire or refinance existing mortgages.

In addition, prior to 2008, first-time homebuyers of a principal residence in the District of Columbia were eligible for a nonrefundable tax credit of up to $5,000 of the amount of the purchase price. The $5,000 maximum credit applies both to individuals and married couples filing a joint return. A married individual filing separately can claim a maximum credit of $2,500. The instructions to IRS Form 8859 (District of Columbia First-Time Homebuyer Credit) state that if "two or more unmarried individuals buy a main home, they can allocate the credit among the individual owners in any manner they choose." The credit phases out for individual taxpayers with modified adjusted gross income between $70,000 and $90,000 ($110,000 - $130,000 for joint filers). For purposes of eligibility, "first-time homebuyer" means any individual if such individual did not have a present ownership interest in a principal residence in the District of Columbia in the one-year period ending on the date of the purchase of the residence to which the credit applies. The credit expired for residences purchased after December 31, 2007.[111]

<u>New Federal Law (New IRC section 36)</u>

Under the provision, a taxpayer who is a first-time homebuyer is allowed a refundable tax credit equal to the lesser of $7,500 ($3,750 for a married individual filing separately) or 10 percent of the purchase price of a principal residence. The credit is allowed for the tax year in which the taxpayer purchases the home.

The credit phases out for individual taxpayers with modified adjusted gross income between $75,000 and $95,000 ($150,000 - $170,000 for joint filers) for the year of purchase.

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[111] IRC section 1400C. The credit was enacted as part of the Taxpayer Relief Act of 1997 and was originally scheduled to expire on December 31, 2000. It has been extended several times, the last extension through December 31, 2007.

A taxpayer is considered a first-time homebuyer if such individual had no ownership interest in a principal residence in the United States during the three-year period prior to the purchase of the home to which the credit applies.

No credit is allowed if the D.C. homebuyer credit is allowable for the taxable year the residence is purchased or a prior taxable year. A taxpayer is not permitted to claim the credit if the taxpayer's financing is from tax-exempt mortgage revenue bonds, if the taxpayer is a nonresident alien, or if the taxpayer disposes of the residence (or it ceases to be a principal residence) before the close of a taxable year for which a credit otherwise would be allowable.

The credit is recaptured ratably over fifteen years with no interest charge beginning in the second taxable year after the taxable year in which the home is purchased. For example, if the taxpayer purchases a home in 2008, the credit is allowed on the 2008 tax return, and repayments commence with the 2010 tax return. If the taxpayer sells the home (or the home ceases to be used as the principal residence of the taxpayer or the taxpayer's spouse) prior to complete repayment of the credit, any remaining credit repayment amount is due on the tax return for the year in which the home is sold (or ceases to be used as the principal residence). However, the credit repayment amount may not exceed the amount of gain from the sale of the residence to an unrelated person. For this purpose, gain is determined by reducing the basis of the residence by the amount of the credit to the extent not previously recaptured. No amount is recaptured after the death of a taxpayer. In the case of an involuntary conversion of the home, recapture is not accelerated if a new principal residence is acquired within a two year period. In the case of a transfer of the residence to a spouse or to a former spouse incident to divorce, the transferee spouse (and not the transferor spouse) will be responsible for any future recapture.

An election is provided to treat a home purchased in the eligible period in 2009 as if purchased on December 31, 2008, for purposes of claiming the credit on the 2008 tax return and for establishing the beginning of the recapture period. Taxpayers may amend their returns for this purpose.

Effective Date

The provision is effective for qualifying home purchases on or after April 9, 2008, and before July 1, 2009, for taxable years ending on or after April 9, 2008.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
3012	Additional Standard Deduction for Real Property Taxes for Nonitemizers

Background

An individual taxpayer's taxable income is computed by reducing adjusted gross income either by a standard deduction or, if the taxpayer elects, by the taxpayer's itemized deductions. Unless an individual taxpayer elects, no itemized deduction is allowed for the taxable year. The deduction for certain taxes, including income taxes, real property taxes, and personal property taxes, generally is an itemized deduction.[112]

New Federal Law (IRC section 63)

The provision increases an individual taxpayer's standard deduction for a taxable year beginning in 2008 by the lesser of: (1) the amount allowable[113] to the taxpayer as a deduction for state and local taxes described in IRC section 164(a)(1) (relating to real property taxes), or (2) $500 ($1,000 in the case of a married individual filing jointly). The increased standard deduction is determined by taking into account real estate taxes for which a deduction is allowable to the taxpayer under IRC section 164 and, in the case of a tenant-stockholder in a cooperative housing corporation, real estate taxes for which a deduction is allowable to the taxpayer under IRC section 216. No taxes deductible in computing adjusted gross income are taken into account in computing the increased standard deduction.

Effective Date

The provision applies to taxable years beginning in 2008.

California Law (R&TC sections 17073 and 17073.5)

California conforms to IRC section 63, relating to taxable income defined, as of the "specified date" of January 1, 2005, with modifications. California does not conform to the federal standard deduction, but instead has stand-alone law allowing a California standard deduction in lieu of the federal standard deduction.

Impact on California Revenue

Not applicable.

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[112] If the deduction for state and local taxes is attributable to business or rental income, the deduction is allowed in computing adjusted gross income and therefore is not an itemized deduction.
[113] In the case of an individual taxpayer who does not elect to itemize deductions, although no itemized deductions are allowed to the taxpayer, itemized deductions are nevertheless treated as "allowable." See IRC section 63(e).

HOUSING AND ECONOMIC RECOVERY ACT OF 2008 (HERA)
(PL 110-289, JULY 30, 2008)

SUBTITLE C – GENERAL PROVISIONS

<u>Section</u>	<u>Section Title</u>
3021	Temporary Increase in Volume Cap

<u>Background</u>

In general

Private activity bonds are bonds that nominally are issued by state or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such private person. The exclusion from income for interest paid on state and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds"). The definition of a qualified private activity bond includes, but is not limited to, qualified mortgage bonds, qualified veterans' mortgage bonds, and bonds for qualified residential rental projects.

Qualified private-activity-bond rules for housing

Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for owner-occupied residences. The IRC imposes several limitations on qualified mortgage bonds, including income limitations for homebuyers, purchase price limitations for the home financed with bond proceeds, and a "first-time homebuyer" requirement. The income limitations are satisfied if all financing provided by an issue is provided for mortgagors whose family income does not exceed 115 percent of the median family income for the metropolitan area or state, whichever is greater, in which the financed residences are located. The purchase price limitations provide that a residence financed with qualified mortgage bonds may not have a purchase price in excess of 90 percent of the average area purchase price for that residence. The first-time homebuyer requirement provides that qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage. In addition, bond proceeds generally only can be used for new mortgages, i.e., proceeds cannot be used to acquire or refinance existing mortgages. Under present law, the proceeds of qualified mortgage bonds generally must be used to finance mortgages within 42 months from the date of issuance of the bonds.

Residential rental property may be financed with qualified private activity bonds if the financed project is a "qualified residential rental project." A project is a qualified residential rental project if 20 percent or more of the residential units in such project are occupied by individuals whose income is 50 percent or less of area median gross income (the "20-50 test"). Alternatively, a project is a qualified residential rental project if 40 percent or more of the residential units in such project are occupied by individuals whose income is 60 percent or less of area median gross income (the "40-60 test").

As with most qualified private activity bonds, qualified mortgage bonds and bonds for qualified residential rental projects are subject to annual state volume limitations (the "state volume cap"). For calendar year 2008, the state volume cap, which is indexed for inflation, equals $85 per resident of the state, or $262.09 million, if greater. The interest income from qualified mortgage bonds and bonds for qualified residential rental projects is a preference item for purposes of calculating the alternative minimum tax ("AMT").

<u>New Federal Law (IRC sections 143 and 146)</u>

Temporary volume cap increase

The provision authorizes an additional $11 billion of volume cap for 2008 for the purpose of issuing qualified mortgage bonds or private activity bonds for qualified residential rental projects. The additional volume cap is allocated to each state in the same proportion as the total state volume is allocated to each of the states. Qualified mortgage bonds issued with respect to the additional volume cap may be used to finance either mortgages permitted under present law (e.g., new mortgages) or qualified subprime loans as defined under the bill. However, all proceeds of qualified mortgage bonds issued with respect to the additional volume cap must be used within 12 months of the date of issuance of such bonds. Additional volume cap that remains unused at the end of 2008 may be carried forward to 2009 and 2010, but solely for the purpose of issuing qualified mortgage bonds or private activity bonds for qualified residential rental projects.

Qualified mortgage bonds for certain refinancings

The provision creates an exception to the new mortgage requirement for qualified mortgage bonds by authorizing the use of such bonds to refinance a qualified subprime loan. The provision defines a qualified subprime loan as an adjustable rate residential mortgage loan originated after December 31, 2001, and before January 1, 2008, that the issuer determines would be reasonably likely to cause financial hardship to the borrower if not refinanced. Under the provision, proceeds of qualified mortgage bonds used to refinance qualified subprime loans must be so used within 12 months from the date of issuance of the bond. In addition, the provision also provides that qualified subprime loans cannot be refinanced by bonds issued after December 31, 2010.

<u>Effective Date</u>

The provision applies to bonds issued after July 30, 2008.

California Law (R&TC section 17143 and 24272)

California specifically does not conform to IRC sections 103 and 141 through 150, relating to the federal rules exempting the interest earned on state or municipal bonds and the arbitrage rebate rules. In addition, the federal “private-activity-bond” rules have not been adopted by California. Also, California has never conformed to the federal tax law treatment of Indian tribal governments as states.

California state and municipal bonds

The general rule in California is that for income tax purposes all interest received or accrued is fully taxable, except for interest on federal obligations (such as Treasury bills, notes, and bonds, as more fully described below) and tax-exempt bonds issued by this state or a local government in this state.

Unlike federal law, the interest earned on bonds issued by other states and municipalities in other states is fully taxable to a resident of California. The California exemption from income taxation of interest on bonds of the state and its political subdivisions is contained in the California Constitution (Art. XIII, § 26. subd. (b)). The Revenue and Taxation Code further provides, by statute, that the federal “private-activity-bond” analysis shall not be made in determining whether interest on bonds issued by the state or a political subdivision thereof shall be exempt from California income tax. Thus, in California, if the use of the bond proceeds of a state or local California issue is for private business use or is secured by property used for a private business use, the interest on that bond is still treated for California income tax purposes as tax exempt, even though the interest on the bond may well be taxable for federal income tax purposes.

California conduit revenue bonds

Conduit revenue bonds are issued by a governmental (state or municipal) entity for various purposes, including economic development, educational and health facilities construction, and multi-family housing. The funds obtained from the financing are loaned to a nongovernmental borrower who builds and operates the project. The use by a private firm (via expenditure of the bond proceeds) of a governmental agency's authority to issue tax-exempt debt is premised on the fact that the project will provide public benefit. A conduit revenue bond is payable solely from the loan payments received from the non-governmental party (unless the bond is insured by a third party who guarantees payment in the event of a default by the private firm who has pledged the revenue source). The governmental issuer typically has no liability for debt service on the bonds, except for the administration of the bond. Although the issuer has no actual liability on the bonds, their reputation and standing with respect to future debt financing may be negatively affected in the event of a default on the bonds. More importantly, should the bonds go into default, the governmental entity will likely be drawn into the settlement process. Most conduit revenue bonds are sold at negotiated sales with the interest rate and other terms of the bonds negotiated between the issuer, the non-governmental borrower, and an underwriter. The security for some of these transactions is sufficient to allow the underwriter to act as a pass-through for the bonds and in so doing act as a placement agent rather than an underwriter. Because the public agency's credit is not on the line, many issuers do not participate in any substantive fashion in the sale of the bonds. Rather, they may limit their role to reviewing the bond purchase contract and other legal and disclosure documents to ensure that they are adequately indemnified against liabilities and to accurately describe their role to investors as issuers and not as borrowers or guarantors of the debt.

Because the conduit revenue bonds issued in California are issued by this state or a local government in this state, the interest paid on such bonds is exempt from state income taxation under the California Constitution.

California treatment of federal bond interest

Interest earned on federal bonds is also tax-exempt for California income tax purposes. This results from federal law (31 U.S.C. § 3124(a)) that prohibits all states from imposing an income tax on interest income from direct obligations of the U. S. government. Examples of bonds that are exempt for California income tax purposes include those issued by federal land banks, the Federal Home Loan Bank, and Banks for Cooperatives. Not all federal bonds are direct obligations of the U.S. government and interest on those bonds is taxable.

Examples of federal bonds not exempt are those issued by the Federal National Mortgage Association (Fannie Maes), Government National Mortgage Association (Ginnie Maes), and Federal Loan Home Mortgage Corporation (Freddie Macs).

California franchise tax treatment

Interest received from federal, state, municipal, or other bonds is includable in the gross income of corporations taxable under the franchise tax. The franchise tax is a nondiscriminatory privilege tax for the right to exercise the corporate franchise and is not a tax on the income received, but instead merely uses that income of the year as the measure of the tax for the privilege of exercising the corporate franchise.

Impact on California Revenue

Not applicable.

HOUSING AND ECONOMIC RECOVERY ACT OF 2008 (HERA)
(PL 110-289, JULY 30, 2008)

Section	Section Title
3022	Repeal of Alternative Minimum Tax Limitations on Tax-Exempt Housing Bonds, Low-Income Housing Tax Credit, and Rehabilitation Credit

Background

In general

Present law imposes an alternative minimum tax ("AMT") on individuals and corporations. AMT is the amount by which the tentative minimum tax exceeds the regular income tax. The tentative minimum tax is computed based upon a taxpayer's alternative minimum taxable income ("AMTI"). AMTI is the taxpayer's taxable income modified to take into account certain preferences and adjustments.

Tax-exempt bonds

One of the preference items is tax-exempt interest on certain tax-exempt bonds issued for private activities (IRC section 57(a)(5)). Also, in the case of a corporation, an adjustment based on current earnings is determined, in part, by taking into account 75 percent of items, including tax-exempt interest, that are excluded from taxable income but included in the corporation's earnings and profits (IRC section 56(g)(4)(B)).

Low-income housing and rehabilitation credits

Business tax credits generally may not exceed the excess of the taxpayer's income tax liability over the tentative minimum tax (or, if greater, 25 percent of the regular tax liability in excess of $25,000). Thus, business tax credits generally cannot offset the alternative minimum tax liability.[114]

Credits in excess of the limitation may be carried back one year and carried forward for up to 20 years.

New Federal Law (IRC section 57)

Tax-exempt bonds

The bill provides that tax-exempt interest on: (1) exempt facility bonds issued as part of an issue 95 percent or more of the net proceeds of which are used to provide qualified residential rental projects (as defined in IRC section 142(d)), (2) qualified mortgage bonds (as defined in IRC section 143(a)), and (3) qualified veterans' mortgage bonds (as defined in IRC section 143(b)) is not an item of tax preference for purposes of the alternative minimum tax.

[114] A special rule treats the tentative minimum tax as being zero for purposes of determining the tax liability limitation with respect to certain energy credits, the work opportunity credit and the credit for taxes paid with respect to employee cash tips (IRC section 38(c)(4)). Thus, the credits listed in the preceding sentence may offset the alternative minimum tax liability.

Also, this interest is not included in the corporate adjustment based on current earnings. The provision does not apply to interest on any refunding bond unless interest on the refunded bond (or in the case of a series of refundings, the original bond) was not an item of tax preference.

Low-income housing and rehabilitation credits

The bill treats the tentative minimum tax as being zero for purposes of determining the tax liability limitation with respect to the low-income housing credit and the rehabilitation credit.

Thus, the low-income housing tax credit and the rehabilitation credit may offset the alternative minimum tax liability.

Effective Date

The provision applies to interest on bonds issued after the date of enactment. The provision applies to low-income housing credits determined under IRC section 42 attributable to buildings placed in service after December 31, 2007 (including any carryback of the credits).

The provision applies to rehabilitation credits determined under IRC section 47 attributable to qualified rehabilitation expenses properly taken into account for periods after December 31, 2007 (including any carryback of the credits).

California Law (R&TC sections 17039, 17062, 17062.3, 23036, 23400 and 23457)

In general

California law imposes an AMT. The AMT is the amount by which the tentative minimum tax (TMT) exceeds the regular income tax. An individual's TMT is 7% of the amount by which AMTI exceeds the exemption amount. California conforms by reference to IRC sections 55 thru 59, relating to the computation of TMT, as of the "specified date" of January 1, 2005, with significant modifications. For taxable years beginning in 1998 and later, California specifically modifies IRC section 55(d)(1), relating to exemption amount, to provide its own AMT exemption and phase-out amounts that are indexed annually. For the 2008 taxable year the exemption amount and phase-out amounts by filing status are as follows:

Filing Status	Exemption Amount	Phase-out Amount
Married/RDP filing jointly or qualifying widow(er)	$80,017	$300,065
Single or head of household	$60,014	$225,050
Married/RDP filing separately, estate or trust	$40,007	$150,031

Tax-exempt bonds

California specifically does not conform to IRC section 57(a)(5), relating to tax-exempt interest, in R&TC sections 17062(d) and 23457(a).

Low-income housing credit

Unlike federal law, California allows certain credits, including the low-income housing credit,[115] to reduce regular tax below the tentative minimum tax.

Rehabilitation credit

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
3023	Bonds Guaranteed by Federal Home Loan Banks Eligible for Treatment as Tax-Exempt Bonds

Background

Interest paid on bonds issued by state and local governments generally is excluded from gross income for federal income tax purposes. However, the exclusion generally does not apply to state and local bonds that are federally guaranteed. Under present law, a bond is federally guaranteed if: (1) the payment of principal or interest with respect to such bond is guaranteed (in whole or in part) by the United States (or any agency or instrumentality thereof); (2) such bond is issued as part of an issue and five percent or more of the proceeds of such issue is to be (a) used in making loans the payment of principal or interest with respect to which is guaranteed (in whole or in part) by the United States (or any agency or instrumentality thereof), or (b) invested directly or indirectly in federally insured deposits or accounts; or (3) the payment of principal or interest on such bond is otherwise indirectly guaranteed (in whole or in part) by the United States (or any agency or instrumentality thereof).

The federal guarantee restriction was enacted in 1984 with certain exceptions for certain guarantee programs in existence at that time. The exceptions include guarantees by: the Federal Housing Administration; the Department of Veterans' Affairs; the Federal National

[115] R&TC sections 17039(c)(1)(W), 23036(d)(1)(F).

Mortgage Association; the Federal Home Loan Mortgage Association; the Government National Mortgage Association; the Student Loan Marketing Association; and the Bonneville Power Authority. The exception also includes guarantees for certain housing programs. These are: (a) private activity bonds for a qualified residential rental project or a housing program obligation under section 11(b) of the United States Housing Act of 1937; (b) a qualified mortgage bond; or (c) a qualified veterans' mortgage bond.

New Federal Law (IRC section 149)

Under the provision, bonds issued by state and local governments are not treated as federally guaranteed by reason of any guarantee provided by any Federal Home Loan Bank of a bond issued after the date of enactment and before January 1, 2011, if such bank made a guarantee of such bond in connection with such issuance.

The exception to the federal guarantee prohibition does not apply to any guarantee by a federal home loan bank unless such bank meets safety and soundness collateral requirements for such guarantees which are at least as stringent as the regulatory requirements for guarantees by federal home loan banks as in effect on April 9, 2008.

Effective Date

The provision applies to guarantees made after July 30, 2008.

California Law (R&TC sections 17143 and 24272)

California specifically does not conform to IRC sections 103 and 141 through 150, relating to the federal rules exempting the interest earned on state or municipal bonds and the arbitrage rebate rules. In addition, the federal “private-activity-bond” rules have not been adopted by California. Also, California has never conformed to the federal tax law treatment of Indian tribal governments as states.

California state and municipal bonds

The general rule in California is that for income tax purposes all interest received or accrued is fully taxable, except for interest on federal obligations (such as Treasury bills, notes, and bonds, as more fully described below) and tax-exempt bonds issued by this state or a local government in this state.

Unlike federal law, the interest earned on bonds issued by other states and municipalities in other states is fully taxable to a resident of California. The California exemption from income taxation of interest on bonds of the state and its political subdivisions is contained in the California Constitution (Art. XIII, § 26. subd. (b)). The Revenue and Taxation Code further provides, by statute, that the federal “private-activity-bond” analysis shall not be made in determining whether interest on bonds issued by the state or a political subdivision thereof shall be exempt from California income tax. Thus, in California, if the use of the bond proceeds of a state or local California issue is for private business use or is secured by property used for a private business use, the interest on that bond is still treated for California income tax purposes as tax exempt, even though the interest on the bond may well be taxable for federal income tax purposes.

California conduit revenue bonds

Conduit revenue bonds are issued by a governmental (state or municipal) entity for various purposes, including economic development, educational and health facilities construction, and multi-family housing. The funds obtained from the financing are loaned to a nongovernmental borrower who builds and operates the project. The use by a private firm (via expenditure of the bond proceeds) of a governmental agency's authority to issue tax-exempt debt is premised on the fact that the project will provide public benefit. A conduit revenue bond is payable solely from the loan payments received from the non-governmental party (unless the bond is insured by a third party who guarantees payment in the event of a default by the private firm who has pledged the revenue source). The governmental issuer typically has no liability for debt service on the bonds, except for the administration of the bond. Although the issuer has no actual liability on the bonds, their reputation and standing with respect to future debt financing may be negatively affected in the event of a default on the bonds. More importantly, should the bonds go into default, the governmental entity will likely be drawn into the settlement process. Most conduit revenue bonds are sold at negotiated sales with the interest rate and other terms of the bonds negotiated between the issuer, the non-governmental borrower, and an underwriter. The security for some of these transactions is sufficient to allow the underwriter to act as a pass-through for the bonds and in so doing act as a placement agent rather than an underwriter. Because the public agency's credit is not on the line, many issuers do not participate in any substantive fashion in the sale of the bonds. Rather, they may limit their role to reviewing the bond purchase contract and other legal and disclosure documents to ensure that they are adequately indemnified against liabilities and to accurately describe their role to investors as issuers and not as borrowers or guarantors of the debt.

Because the conduit revenue bonds issued in California are issued by this state or a local government in this state, the interest paid on such bonds is exempt from state income taxation under the California Constitution.

California treatment of federal bond interest

Interest earned on federal bonds is also tax-exempt for California income tax purposes. This results from federal law (31 U.S.C. § 3124(a)) that prohibits all states from imposing an income tax on interest income from direct obligations of the U. S. government. Examples of bonds that are exempt for California income tax purposes include those issued by federal land banks, the Federal Home Loan Bank, and Banks for Cooperatives. Not all federal bonds are direct obligations of the U.S. government and interest on those bonds is taxable.

Examples of federal bonds not exempt are those issued by the Federal National Mortgage Association (Fannie Maes), Government National Mortgage Association (Ginnie Maes), and Federal Loan Home Mortgage Corporation (Freddie Macs).

California franchise tax treatment

Interest received from federal, state, municipal, or other bonds is includable in the gross income of corporations taxable under the franchise tax. The franchise tax is a nondiscriminatory privilege tax for the right to exercise the corporate franchise and is not a tax on the income received, but instead merely uses that income of the year as the measure of the tax for the privilege of exercising the corporate franchise.

Impact on California Revenue

Not applicable.

Section	Section Title
3024	Modification of Rules Pertaining to FIRPTA Nonforeign Affidavits

Background

In general, nonresident aliens and foreign corporations are not taxed on capital gains.[116] However, such foreign persons must take into account gains and losses from the disposition of an interest in United States real property ("USRPI"), as if such persons were engaged in a trade or business in the United States during the taxable year, and such gain or loss were effectively connected with such trade or business.[117]

Although tax is imposed upon such dispositions on a net basis, in the case of any disposition of a USRPI by a foreign person, the transferee is generally required to deduct and withhold a tax equal to ten percent of the amount realized.[118] The transferee is exempt from this withholding requirement if:

- In general, the transferred interest is not a USRPI;
- The transferee receives a "qualifying statement" from the Secretary of the Treasury (or his delegate) that states that the transferor is exempt from the tax on the disposition of

[116] Nonresident aliens present in the United States for a period or period aggregating 183 days or more during a taxable year are taxed at a flat 30 percent on their net U.S. source capital gains. IRC section 871(a)(2).
[117] IRC section 897(a)(1).
[118] IRC section 1445(a).

the USRPI or has reached agreement with the Secretary for payment of such tax, and that any withholding tax has been satisfied or secured;

- The USRPI is acquired by the transferee for use by him as a residence and the amount realized does not exceed $300,000; or
- The transferor furnishes to the transferee an affidavit by the transferor stating, under penalties of perjury, the transferor's United States taxpayer identification number and that the transferor is not a foreign person. However, this rule does not apply if the transferee has actual knowledge that such affidavit is false or if the transferee receives a notice from a transferor's agent or a transferee's agent that such affidavit is false, or if the transferee fails to meet the Secretary's requirement that the transferee furnish a copy of such affidavit to the Secretary.[119] Regulations require the transferee to retain the transferor's affidavit until the end of the fifth taxable year following the taxable year in which the transfer takes place.[120]

In certain circumstances, agents may be liable for some or all of the withholding tax. In general, if the transferor's agent or the transferee's agent has actual knowledge that the affidavit is false, then such agent is required to notify the transferee pursuant to regulations.[121] An agent that is required to notify the transferee pursuant to regulations yet fails to do so is under the same duty to deduct and withhold that the transferee would have been under if such agent had properly given such notice.122 However, an agent's liability under these circumstances is limited to the amount of the agent's compensation from the transaction.[123]

In the case of a real estate transaction, a "real estate reporting person" is required to file an information return and to furnish certain written statements to customers.[124] A real estate reporting person means the person (including any attorney or title company) responsible for closing the transaction, if there is such a person.[125]

<u>New Federal Law (IRC section 1445)</u>

The provision provides an alternate procedure with respect to the nonforeign affidavit. Under this procedure, in lieu of furnishing a nonforeign affidavit to the transferee, a transferor may furnish such affidavit to a "qualified substitute." Such qualified substitute is then required to furnish a statement to the transferee stating, under penalties of perjury, that the qualified substitute has such affidavit in his or her possession. With respect to a disposition of a

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[119] IRC section 1445(b).
[120] Treas. Reg. sec. 1.1445-2(b)(3).
[121] IRC section 1445(d)(1).
[122] IRC section 1445(d)(2)(A).
[123] IRC section 1445(d)(2)(B).
[124] IRC section 6045(e)(1). There is an exception to this requirement for a sale or exchange of a residence for $250,000 or less ($500,000 if the seller is married), if certain conditions are met. IRC section 6045(e)(5).
[125] If there is no such person, then the real estate reporting person with respect to that transaction is either the mortgage lender, seller's broker, buyer's broker, or other person designated under regulations, in that order. IRC section 6045(e)(2).

USRPI, the term "qualified substitute" means: (1) the person, including any attorney or title company, responsible for closing the transaction, other than the transferor's agent, and (2) the transferee's agent.

This exemption does not apply if the transferee or qualified substitute has actual knowledge that such affidavit or statement is false, if the transferee or qualified substitute receives a notice from a transferor's agent, transferee's agent, or qualified substitute that such affidavit or statement is false, or if the transferee or qualified substitute fails to meet a regulatory requirement that the transferee or qualified substitute furnish a copy of such affidavit or statement to the Secretary.

Moreover, if the transferor's agent, the transferee's agent, or the qualified substitute has actual knowledge that the affidavit or statement is false, then such agent or qualified substitute is required to notify the transferee. As under present law, the time and manner of such notice is to be specified by regulations. An agent or qualified substitute that is required to notify the transferee pursuant to regulations yet fails to do so has the same duty to deduct and withhold that the transferee would have had if such agent or qualified substitute had properly given such notice. An agent's or qualified substitute's liability under these circumstances is limited to the amount of the compensation that such agent or qualified substitute derives from the transaction.

The Secretary of the Treasury is required to prescribe such regulations as may be necessary or appropriate to carry out this provision. It is intended that such rules will require the qualified substitute and transferee to retain the documentation for a period commensurate with the period required under the present-law regulations.

<u>Effective Date</u>

The provision is effective for dispositions after July 30, 2008.

<u>California Law (R&TC sections 17024.5, 17041, 17952, 18662, 18668, and 25110)</u>

Nonresident and foreign corporation taxation in general

California does not generally conform to the federal rules for sourcing the income of nonresidents and foreign corporations. California specifically does not conform to the federal rules for nonresident aliens.

California taxes its residents on their entire taxable income and provides that nonresidents are taxed only on taxable income derived from sources within California. Nonresidents generally do not include intangible income as California-source income, but instead source this income to the state where they reside.

Withholding on nonresident and non-California corporation property dispositions

California does not conform to the federal withholding rules. Sales of California real property by both resident and nonresident individuals and corporations without a permanent place of business in California following the sale are subject to California withholding rules.

Impact on California Revenue

Not applicable.

Section	Section Title
3025	Modification of Definition of Tax-Exempt Use Property for Purposes of the Rehabilitation Credit

Background

A 10-percent credit is provided for rehabilitation expenditures with respect to buildings first placed in service before 1936. A 20-percent credit is provided for rehabilitation expenditures with respect to a certified historic structure.

Rehabilitation expenditures eligible for the credit do not include any expenditure in connection with the rehabilitation of a building that is allocable to the portion of the property that is (or may reasonably be expected to be) tax-exempt use property. In the case of nonresidential real property, tax-exempt use property generally means the portion of the property leased in a disqualified lease to tax-exempt entities (IRC section 168(h)(1)). For this purpose, a tax-exempt entity means: (1) the United States, a State or political subdivision, a U.S. possession, or an agency or instrumentality thereof; (2) a tax-exempt organization; (3) a foreign person or entity; or (4) an Indian tribal government.

A safe harbor provides, however, that in the case of nonresidential real property, the property is treated as tax-exempt use property only if the portion of the property leased to tax-exempt entities in disqualified leases is more than 35 percent of the property.

A disqualified lease for this purpose is a lease to a tax-exempt entity in specified circumstances. These are: (1) part or all of the property was financed, directly or indirectly, by tax-exempt bond financing and the entity (or a related entity) participated in the financing; (2) under the lease there is a fixed or determinable price purchase or sale involving the entity or a related entity (or the equivalent of such an option); (3) the term of the lease exceeds 20 years; or (4) there has been a sale and leaseback of the property and the entity (or a related entity) used the property before the sale, transfer, or lease (IRC section 168(h)(1)(B)).

New Federal Law (IRC section 47)

The provision increases from 35 percent to 50 percent the percentage of the property that may be leased to a tax-exempt entity in a disqualified lease without requiring allocation of rehabilitation expenditures under the rehabilitation credit. Under the provision, for determining rehabilitation expenditures eligible for the credit, nonresidential real property is treated as "tax-exempt use" property only if the portion of the property leased to tax-exempt entities in disqualified leases is more than 50 percent of the property. For this purpose, a tax-exempt entity continues to have the same meaning provided by present law.

Effective Date

The provision is effective for expenditures properly taken into account for periods after December 31, 2007.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
3026	Extension of Special Rule for Mortgage Revenue Bonds for Residences Located in Disaster Areas

Background

In general

Under present law, gross income does not include interest on state or local bonds.[126] State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds which are primarily used to finance governmental functions or which are repaid with governmental funds. Private activity bonds are bonds with respect to which the state or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). The exclusion from income for state and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds").[127]

[126] IRC section 103.
[127] IRC sections 103(b)(1) and 141.

Qualified mortgage bonds

The definition of a qualified private activity bond includes a qualified mortgage bond.[128] Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for the purchase, improvement, or rehabilitation of owner-occupied residences. The IRC imposes several limitations on qualified mortgage bonds, including income limitations for homebuyers and purchase price limitations for the home financed with bond proceeds. In addition to these limitations, qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage (the "first-time homebuyer" requirement). The first-time homebuyer requirement does not apply to targeted area residences. A targeted area residence is one located in either (1) a census tract in which at least 70 percent of the families have an income which is 80 percent or less of the state-wide median income or (2) an area of chronic economic distress.

A temporary provision waived the first-time homebuyer requirement for residences located in certain Presidentially-declared disaster areas.[129] In addition, residences located in such areas were treated as targeted area residences for purposes of the income and purchase price limitations. The special rule for residences located in Presidentially declared disaster areas does not apply to bonds issued after December 31, 1998.

New Federal Law (IRC section 143)

The provision waives the first-time homebuyer requirement for residences located in Presidentially declared disaster areas. In addition, residences located in such areas were treated as targeted area residences for purposes of the income and purchase price limitations. The provision applies to bonds issued after May 1, 2008, and before January 1, 2010.

Effective Date

The provision is effective on July 30, 2008.

California Law (R&TC sections 17143 and 24272)

California specifically does not conform to IRC sections 103 and 141 through 150, relating to the federal rules exempting the interest earned on state or municipal bonds and the arbitrage rebate rules. In addition, the federal “private-activity-bond” rules have not been adopted by California. Also, California has never conformed to the federal tax law treatment of Indian tribal governments as states.

[128] IRC section 143.
[129] IRC section 143(k)(11).

California state and municipal bonds

The general rule in California is that for income tax purposes all interest received or accrued is fully taxable, except for interest on federal obligations (such as Treasury bills, notes, and bonds, as more fully described below) and tax-exempt bonds issued by California or a local government in this state.

Unlike federal law, the interest earned on bonds issued by other states and municipalities in other states is fully taxable to a resident of California. The California exemption from income taxation of interest on bonds of the state and its political subdivisions is contained in the California Constitution (Art. XIII, § 26, subd. (b)). The Revenue and Taxation Code further provides, by statute, that the federal "private-activity-bond" analysis shall not be made in determining whether interest on bonds issued by the state or a political subdivision thereof shall be exempt from California income tax. Thus, in California, if the use of the bond proceeds of a California state or local issue is for private business use or is secured by property used for a private business use, the interest on that bond is still treated for California income tax purposes as tax exempt, even though the interest on the bond may well be taxable for federal income tax purposes.

California conduit revenue bonds

Conduit revenue bonds are issued by a governmental (state or municipal) entity for various purposes, including economic development, educational and health facilities construction, and multi-family housing. The funds obtained from the financing are loaned to a non-governmental borrower who builds and operates the project. The use by a private firm (via expenditure of the bond proceeds) of a governmental agency's authority to issue tax-exempt debt is premised on the fact that the project will provide public benefit. A conduit revenue bond is payable solely from the loan payments received from the non-governmental party (unless the bond is insured by a third party who guarantees payment in the event of a default by the private firm who has pledged the revenue source). The governmental issuer typically has no liability for debt service on the bonds, except for the administration of the bond.

Although the issuer has no actual liability on the bonds, their reputation and standing with respect to future debt financing may be negatively affected in the event of a default on the bonds. More importantly, should the bonds go into default, the governmental entity will likely be drawn into the settlement process. Most conduit revenue bonds are sold at negotiated sales with the interest rate and other terms of the bonds negotiated between the issuer, the non-governmental borrower, and an underwriter. The security for some of these transactions is sufficient to allow the underwriter to act as a pass-through for the bonds and in so doing act as a placement agent rather than an underwriter. Because the public agency's credit is not on the line, many issuers do not participate in any substantive fashion in the sale of the bonds. Rather, they may limit their role to reviewing the bond purchase contract and other legal and disclosure documents to ensure that they are adequately indemnified against liabilities and to accurately describe their role to investors as issuers and not as borrowers or guarantors of the debt.

Because the conduit revenue bonds issued in California are issued by this state or a local government in this state, the interest paid on such bonds is exempt from state income taxation under the California Constitution.

California treatment of federal bond interest

Interest earned on federal bonds is also tax-exempt for California income tax purposes. This results from federal law (31 U.S.C. § 3124(a)) that prohibits all states from imposing an income tax on interest income from direct obligations of the U. S. government. Examples of bonds that are exempt for California income tax purposes include those issued by federal land banks, the Federal Home Loan Bank, and Banks for Cooperatives. Not all federal bonds are direct obligations of the U.S. government and interest on those bonds is taxable. Examples of federal bonds not exempt are those issued by the Federal National Mortgage Association (Fannie Maes), Government National Mortgage Association (Ginnie Maes), and Federal Home Loan Mortgage Corporation (Freddie Macs).
California franchise tax treatment

Interest received from federal, state, municipal, or other bonds is includable in the gross income of corporations taxable under the franchise tax. The franchise tax is a nondiscriminatory privilege tax for the right to exercise the corporate franchise and is not a tax on the income received, but instead merely uses that income of the year as the measure of the tax for the privilege of exercising the corporate franchise.

Impact on California Revenue

Not applicable.

Section	Section Title
3027	Transfer of Funds Appropriated to Carry Out 2008 Recovery Rebates for Individuals

Background

The Economic Stimulus Act of 2008 (P.L. 110-185) appropriated the following sums, for the fiscal year ending September 30, 2008 to the Department of the Treasury: (1) an additional amount for the Financial Management Service --Salaries and Expenses", $64,175,000, to remain available until September 30, 2009; (2) an additional amount for the Internal Revenue Service --Taxpayer Services", $50,720,000, to remain available until September 30, 2009; and (3) an additional amount for Internal Revenue Service --Operations Support", $151,415,000, to remain available until September 30, 2009.

The Economic Stimulus Act also appropriated an additional amount for the "Social Security Administration --Limitation on Administrative Expenses," $31,000,000, to remain available until September 30, 2008.

New Federal Law (Uncodified section 3027 of HERA)

The Act provides that the Secretary of the Treasury may transfer funds among the three accounts specified for the Department of Treasury to carry out the purposes of the Economic Stimulus Act.

Effective Date

The provision is effective on July 30, 2008.

California Law (None)

California has no comparable provision.
Impact on California Revenue

Not applicable.

TITLE II – REFORMS RELATED TO REAL ESTATE INVESTMENT TRUSTS

Section	Section Title
3031 - 3071	Revisions to REITs

Background

In general

A real estate investment trust ("REIT") is an entity that otherwise would be taxed as a U.S. corporation but elects to be taxed under a special REIT tax regime. To qualify as a REIT, an entity must meet a number of requirements. At least 90 percent of REIT income (other than net capital gain) must be distributed annually;[130] the REIT must derive most of its income from passive, generally real-estate-related investments; and REIT assets must be primarily real-estate related. In addition, a REIT must have transferable interests and at least 100 shareholders, and no more than 50 percent of the REIT interests may be owned by 5 or

[130] Even if a REIT meets the 90 percent income distribution requirement for REIT qualification, more stringent distribution requirements must be met in order to avoid an excise tax under IRC section 4981.

fewer individual shareholders (as determined using specified attribution rules). Other requirements also apply.[131]

If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its shareholders each year as a dividend is deductible by the REIT (unlike the case of a regular subchapter C corporation, which cannot deduct dividends). As a result, the distributed income of the REIT is not taxed at the entity level; instead, it is taxed only at the investor level.[132]

Income tests

In general

A REIT is restricted to earning certain types of generally passive income. Among other requirements, at least 75 percent of the gross income of a REIT in each taxable year must consist of real-estate-related income. Such income includes: rents from real property; income from the sale or exchange of real property (including interests in real property) that is not stock in trade, inventory, or held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business; interest on mortgages secured by real property or interests in real property; and certain income from foreclosure property (the "75-percent income test").[133] Amounts attributable to most types of services provided to tenants (other than certain "customary services"), or to more than specified amounts of personal property, are not qualifying rents.[134] In addition, rents received from any entity in which the REIT owns more than 10 percent of the vote or value also generally are not qualifying income. However, there is an exception for certain rents received from taxable REIT subsidiaries (described further below), in which a REIT may own more than 10 percent of the vote or value.

In addition, 95 percent of the gross income of a REIT for each taxable year must be from the 75-percent income sources and a second permitted category of other, generally passive investments such as dividends, capital gains, and interest income (the "95-percent income test").[135]

[131] IRC sections 856 and 857.
[132] A REIT that has net capital gain can either distribute that gain as a "capital gain" dividend or retain that gain without distributing it but cause the shareholders to be treated as if they had received and reinvested a capital gain dividend. In either case, the gain in effect is taxed only as net capital gain of the shareholders. IRC section 857(b)(3).
[133] IRC sections 856(c)(3) and 1221(a)(1). Income from sales that are not prohibited transactions solely by virtue of IRC section 857(b)(6) also is qualified REIT income.
[134] IRC section 856(d). Amounts attributable to the provision of certain services by an independent contractor or by a taxable REIT subsidiary can be qualified rents. IRC section 856(d)(7).
[135] IRC section 856(c)(3).

Income from certain hedging transactions

Except as provided by Treasury regulations, income from a hedging transaction that is clearly identified,[136] including gain from the sale or disposition of such a transaction, is not included as gross income under the 95-percent income test, to the extent the transaction hedges any indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets.[137]

Foreign currency exchange gain

A REIT must be a U.S. domestic entity, but it is permitted to hold foreign real estate or other foreign-based assets, provided the 75-percent and 95-percent income tests and the other requirements for REIT qualification are met.[138] A REIT that holds foreign real estate or other foreign-based assets may have foreign currency exchange gain under the foreign currency transaction rules of the IRC (described below). Foreign currency exchange gain is not explicitly included in the statutory definitions of qualifying income for purposes of the 75-percent and 95-percent income tests, though the IRS has issued guidance that allows foreign currency gain to be treated as qualified income in certain circumstances.

The foreign currency transaction rules of IRC sections 985 through 989 apply whenever a taxpayer engages in a business or investment activity using a currency other than the taxpayer's functional currency (a "nonfunctional currency"). IRC section 985 provides in general that all determinations for federal income tax purposes are made in the taxpayer's functional currency.

A taxpayer's functional currency is the dollar except in the case of a qualified business unit ("QBU"), in which case the functional currency is "the currency of the economic environment in which a significant part of such unit's activities are conducted and which is used by such unit in keeping its books and records."[139] A QBU is any separate and clearly identified unit of a trade or business of a taxpayer if the unit maintains separate books and records.[140]

A taxpayer that engages in a business or investment activity using a currency other than the U.S. dollar may have gain or loss under IRC section 987 or 988, depending on the nature of the activity and type of entity (if any) through which the activity is conducted.

A U.S. taxpayer becomes subject to IRC section 988 when it enters into an "IRC section 988 transaction." Among other things, an "IRC section 988 transaction" includes the acquisition of a debt instrument, becoming an obligor under a debt instrument, the accrual of items of expense or gross income, or the disposition of any nonfunctional currency.[141]

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[136] A hedging transaction for this purpose is one defined in clause (ii) or (iii) of IRC section 1221(b)(2)(A). The identification requirement is defined in IRC section 1221(a)(7).
[137] IRC section 856(c)(5)(G).
[138] *See* Rev. Rul. 74-191, 1974-1 C.B. 170.
[139] IRC section 985(b)(1).
[140] IRC section 989(a).
[141] IRC section 988(c)(1)(B) and (C).

When a REIT holds a mortgage (or other instrument or arrangement described in IRC section 988)[142] denominated in a nonfunctional currency or determined by reference to the value of a nonfunctional currency and the applicable foreign currency exchange rate changes between the time interest on an obligation to (or an obligation of) the REIT accrues and the time it is paid, the REIT may have foreign currency gain or loss under the rules of IRC section 988. Foreign currency exchange gain under IRC section 988 also can result when a REIT receives payment of principal on a debt instrument denominated in a nonfunctional currency or sells such a debt instrument, or when a REIT incurs a debt obligation denominated in a nonfunctional currency and pays interest or principal in that currency.
In May 2007, the IRS ruled in Rev. Rul. 2007-33 that if IRC section 988 currency gain is recognized by a REIT with respect to an item of income, the IRC section 988 gain will be qualifying income for purposes of the 95-percent and 75-percent income tests of IRC section 856(c)(2) and (3), respectively, to the extent the underlying income so qualifies. Analogous relief was not provided for IRC section 988 gain with respect to any items other than income items.[143]

IRC section 987 applies when there is a remittance from a foreign business or investment activity conducted through a QBU that is a branch that keeps its books and records in a functional currency other than the dollar. If a REIT has a QBU that keeps its books and records in a foreign currency, the REIT could have foreign currency exchange gain or loss under IRC section 987 with respect to remittances.[144]

[142] IRC section 988 applies to (i) the acquisition of a debt instrument or becoming the obligor under a debt instrument; (ii) accruing (or otherwise taking into account) any item of expense or gross income or receipts which is to be paid after the date on which so accrued or taken into account, and (iii) entering into or acquiring any forward contract, futures contract, option, or similar financial instrument (except for any regulated futures contract or nonequity option which would be marked to market under IRC section 1256 if held on the last day of the taxable year). IRC section 988 also applies to the disposition of any nonfunctional currency. Nonfunctional currency includes "coin or currency, and nonfunctional currency denominated demand or time deposits or similar instruments issued by a bank or other financial institution." IRC section 988(c)(1).
[143] Rev. Rul. 2007-33, 2007-1 C.B. 1281. This ruling does not address the treatment of currency gain that might arise with respect to the payment of principal on an obligation that would produce qualified income. The ruling also does not address the treatment of foreign currency gain that might arise in connection with indebtedness denominated in a foreign currency that is incurred to acquire assets that produce qualifying income. A private letter ruling concluded that IRC section 988 currency gain attributable to fluctuation in the exchange rates of currency used to make payments on non-dollar debt obligations incurred to acquire investments that produced qualifying non-dollar income would be treated as qualifying income, where the borrowings were to be used to finance the acquisition of the investments on a cost-effective basis, and not to speculate in foreign currency. PLR 200808024. A private letter ruling may be relied upon only by the taxpayer to which the ruling is issued.
[144] Recent proposed regulations under IRC section 987 would replace previously proposed rules in an attempt to limit the ability of taxpayers to recognize non-economic foreign currency losses that could reduce otherwise taxable income, as well as to prevent non-economic currency gains that could arise. The 2006 proposed regulations would provide certain tracing-type rules. See REG-208270-86 (Sept. 7, 2006). See also, Notice 2000-20 (March 22, 2000), discussing concerns regarding earlier proposed regulations issued in 1991. The 2006 proposed regulations when originally issued did not by their terms apply to REITs, RICs, or certain other types of entities. Prop. Reg. Sec. 1.987-1(b)(iii). But see Notice 2007-42, 2007-1 C.B. 1288, *infra*.

The IRS has ruled in several private rulings that a REIT may establish a REIT subsidiary that itself qualifies as a separate REIT (and thus would not be treated as a branch) to conduct qualified REIT activity with respect to foreign investments in a particular foreign currency, and that subsidiary can itself be treated as a QBU whose functional currency is that particular foreign currency, if that subsidiary keeps its books and records in that particular foreign currency.[145] This structure provides a method for a REIT to conduct activities abroad and minimize any concerns regarding the treatment of foreign currency gain for purposes of the 75-percent and 95-percent income tests. However, this structure effectively requires a separate REIT subsidiary that itself qualifies as a REIT, for each different currency in which the REIT may conduct activities.[146]

At the same time that it issued Rev. Rul. 2007-33, the IRS also issued a notice regarding the application of IRC section 987 to a QBU of a REIT. The notice states that until further guidance is issued, a REIT that has a QBU that uses a functional currency other than the U.S. dollar may apply the principles of proposed regulations issued on September 7, 2006, to determine whether IRC section 987 currency gain is derived from income described in IRC sections 856(c)(2) or (3).[147]

Certain other items

Certain private letter rulings issued to particular taxpayers have permitted various other types of income to be ignored for purposes of the 75-percent or 95-percent income tests, due to the relationship of the income to REIT qualifying assets or income. A few examples include a settlement payment received by a REIT with respect to construction of a mall or a payment received as a "breakup" fee in a proposed merger.[148]

Asset tests

At least 75 percent of the value of a REIT's assets must be real estate assets, cash and cash items (including receivables), and government securities (the "75-percent asset test"). Real estate assets are real property (including interests in real property and mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs.[149]

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[145] *See, e.g.,* PLR 200625019 and PLR 200550025. A private letter ruling may be relied upon only by the taxpayer to which the ruling was issued.
[146] In this structure, the parent REIT treats the dividends paid by the subsidiary REIT as a qualified REIT dividend, minimizing any currency gains by exchanging the foreign currency into dollars at the time of the dividend distribution.
[147] Notice 2007-42, 2007-1 C.B. 1288. Compare REG-208270-86 (Sept. 7, 2006), which by its terms did not apply to REITs.
[148] PLR 200039027 and PLR 200127024. A private letter ruling may relied upon only by the taxpayer to which the ruling was issued.
[149] IRC section 856(c)(4)(A). Temporary investments in certain stock or debt instruments also can qualify if they are temporary investments of new capital, but only for the one-year period beginning on the date the REIT receives such capital. IRC section 856(c)(5)(B).

No more than 25 percent of a REIT's assets may be securities other than such real estate assets.[150]

Except with respect to a taxable REIT subsidiary (described further below), not more than 5 percent of the value of a REIT's assets may be securities of any one issuer, and the REIT may not possess securities representing more than 10 percent of the outstanding value or voting power of any one issuer.[151] In addition, (except in the case of certain timber REITs for a limited time period), not more than 20 percent of the value of a REIT's assets may be securities of one or more taxable REIT subsidiaries.[152]

The asset tests must be met as of the close of each quarter of a REIT's taxable year. However, a REIT that has met the asset tests as of the close of any quarter does not lose its REIT status solely because of a discrepancy during a subsequent quarter between the value of the REIT's investments and such requirements, unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition.[153]

Prohibited transactions tax

REITs are subject to a prohibited transaction tax ("PTT") of 100 percent of the net income derived from prohibited transactions. For this purpose, a prohibited transaction is a sale or other disposition of property by the REIT that is "stock in trade of a taxpayer or other property which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held for sale to customers by the taxpayer in the ordinary course of his trade or business" (IRC section 1221(a)(1))[154] and is not foreclosure property. The PTT for a REIT does not apply to a sale if the REIT satisfies certain safe harbor requirements in IRC sections 857(b)(6)(C) or (D), including an asset holding period of at least four years (2 years in the case of certain sales of timber property for a limited time period).[155]

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[150] IRC section 856(c)(4)(B)(i).

[151] IRC section 856(c)(4)(B)(iii).

[152] IRC section 856(c)(4)(B)(ii). In the case of a "timber REIT" defined as a REIT more than 50 percent of the value of whose assets consists of real property held in connection with the trade or business or producing timber, up to 25 percent of the value of the REITs assets may be securities of one or more taxable REIT subsidiaries. This special rule is in place only for taxable years beginning after the date of enactment of the Food, Conservation, and Energy Act of 2008 (H.R. 2419, P.L. No. 110-234, enacted on May 22, 2008) and before the date that is one year after such date of enactment.

[153] IRC section 856(c)(4). In the case of such an acquisition, the REIT also has a grace period of 30 days after the close of the quarter to eliminate the discrepancy.

[154] This definition is the same as the definition of certain property the sale or other disposition of which would produce ordinary income rather than capital gain under IRC section 1221(a)(1).

[155] Additional requirements for the safe harbor limit the amount of expenditures the REIT can make during the four-year period prior to the sale that are includible in the adjusted basis of the property, require marketing to be done by an independent contractor, and forbid a sales price that is based on the income or profits of any person. Under the Food, Conservation, and Energy Act of 2008 (H.R. 2419, P.L. No. 110-234, enacted on May 22, 2008), the four-year holding period is reduced to two years in the case of a sale of timber property under IRC section 857(b)(1)(D), provided the sale is to a qualified organization (as defined in IRC section 170(h)(3)), exclusively for conservation purposes (as defined in IRC section 170(h)(1)(C)). The rule is in place only for

If the conditions are met, a REIT may either: (1) make no more than 7 sales within a taxable year (other than sales of foreclosure property or involuntary conversions under IRC section 1033), or (2) sell no more than 10 percent of the aggregate bases of all its assets as of the beginning of the taxable year (computed without regard to sales of foreclosure property or involuntary conversions under IRC section 1033), without being subject to the PTT tax.

New Federal Law (IRC sections 856 and 857)

Act sections 3031, 3032 and 3033 – Revisions to REIT Income Tests, Revisions to REIT Asset Tests and Conforming Foreign Currency Revisions

Foreign currency gain

Exclusion of certain foreign currency gain for certain income tests

The provision excludes certain foreign currency gain recognized under IRC section 987 or IRC section 988 from the computation of qualifying income for purposes of the 75-percent income test or the 95-percent income test, respectively. The exclusion is solely for purposes of the computations under these tests.

The provision defines two new categories of income for purposes of the exclusion rules: "real estate foreign exchange gain" and "passive foreign exchange gain." Real estate foreign exchange gain is excluded from gross income for purposes of both the 75-percent and 95-percent income tests. Passive foreign exchange gain is excluded for purposes of the 95-percent income test but is included in gross income and treated as non-qualifying income to the extent that it is not real estate foreign exchange gain, for purposes of the 75-percent income test.

Real estate foreign exchange gain is foreign currency gain (as defined in IRC section 988(b)(1)), which is attributable to: (1) any item of income or gain described in IRC section 856(c)(3) (i.e., described in the 75-percent income test), (2) the acquisition or ownership of obligations secured by mortgages on real property or interests in real property; or (3) becoming or being the obligor under obligations secured by mortgages on real property or on interests in real property. Real estate foreign exchange gain also includes IRC section 987 gain attributable to a qualified business unit ("QBU") of the REIT if the QBU itself meets the 75-percent income test for the taxable year, and meets the 75-percent asset test at the close of each quarter of the REIT that has directly or indirectly held the QBU. The QBU is not required to meet the 95-percent income test in order for this IRC section 987 gain exclusion to apply. Real estate foreign exchange gain also includes any other foreign currency gain as determined by the Secretary of the Treasury.

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taxable years beginning after the date of enactment of that Act and before one year following such date of enactment. In addition, for the same one year period, any sale that is exempt from the prohibited transactions provision by virtue of IRC section 857(b)(1)(D) is treated for all purposes of subtitle A of the IRC as a sale of property held for investment or use in a trade or business, and not property described in IRC section 1221(a)(1).

Passive foreign exchange gain includes all real estate foreign exchange gain, and in addition includes foreign currency gain which is attributable to (i) any item of income or gain described in IRC section 856(c)(2) (i.e., described in the 95-percent income test), (ii) the acquisition or ownership of obligations, (iii) becoming or being the obligor under obligations, and (iv) any other foreign currency gain as determined by the Secretary of the Treasury.

Notwithstanding the foregoing rules, except in the case of certain income that is excluded under the hedging rules of IRC section 856(c)(5)(G) (as amended by the provision), any IRC section 988 gain derived from engaging in dealing, or substantial and regular trading, in securities (as defined in IRC section 475(c)(2)) shall constitute gross income that does not qualify under either the 75-percent or 95-percent income test.

The effect of these rules is to change the result of Rev. Rul. 2007-33 in the case of foreign currency gain attributable to an item of REIT income that qualifies under IRC sections 856(c)(2) or 856(c)(3), respectively, because the provision excludes such gain (solely for purposes of the relevant income test) rather than treating such gain as qualified income for purposes of that test. The provision in addition excludes foreign currency gain attributable to principal payments received on certain REIT assets, or to principal or interest payments with respect to certain liabilities of a REIT, situations not addressed in the revenue ruling.
The rules of the provision also supersede Notice 2007-42 in the case of remittances from a QBU that uses a functional currency other than the dollar. The provision excludes IRC section 987 gain on a remittance from such a QBU to the REIT from the computation of both the 75-percent and the 95-percent income tests of the REIT, provided the QBU itself both meets the 75-percent income test for the taxable year and meets the 75-percent asset test at the close of each quarter of the taxable year. If the QBU meets these requirements, the IRC section 987 gain is excluded entirely for purposes of the REIT gross income tests, and no tracing-type rules with respect to IRC section 987 gain are imposed, as would have been the case under Notice 2007-42. For this purpose, the QBU is tested as if it were a separate entity that is independently required to meet the 75-percent income test and the 75-percent asset test applicable to REIT qualification. However, the QBU need not meet any of the other REIT requirements, nor itself be treated as a REIT. It is expected that the Treasury Department will use its regulatory authority[156] to provide appropriate rules with respect to the treatment of IRC section 987 currency gain for purposes of the REIT gross income tests if a QBU does not meet the requirements of the provision.

In the case of an IRC section 988 transaction, it is intended that the provision only apply to foreign currency gain that is directly attributable to income items that otherwise are treated as qualifying income for purposes of the 75-percent and 95-percent income tests, respectively, (or directly attributable to the acquisition or ownership of, or to becoming the obligor under, obligations secured by mortgages on real property or on interests on real property). As one example, foreign currency gain attributable to exchange rate fluctuations between the time of the accrual of interest income on a foreign-currency denominated obligation secured by a

[156] *See, e.g.* IRC section 989(c).

mortgage on real property and the time of payment, would constitute excluded income for purposes of both the 75-percent and 95-percent income tests. However, any additional foreign currency gain arising from subsequent disposition of the foreign currency received upon payment of the accrued interest would be attributable to holding the foreign currency after its receipt and would not constitute excluded income under either test; rather it would be non-qualifying income.

Similarly, in the case of IRC section 987 foreign currency gain on remittances, only IRC section 987 gain as of the time of, and resulting from, the remittance is attributable to the QBU and is excluded income. Any currency gain arising from holding currency after remittance is not attributable to the QBU. Such gain is not excluded income for purposes of the 75-percent or 95-percent income tests and is not qualifying income for purposes of those tests.

The following examples demonstrate the operation of the distinction between "real estate foreign exchange gain", which is excluded for purposes of both the 75-percent and 95-percent income tests, and "passive foreign exchange gain," which is excluded only for purposes of the 95-percent income test and which is non-qualifying income for purposes of the 75-percent income test.

Example 1.-Assume that a REIT whose functional currency is the dollar holds an obligation that is secured by a mortgage on real property, which instrument pays interest at a date later than the date the interest is accrued by the REIT. The obligation is denominated in a foreign currency. Under IRC sections 856(c)(3) and 856(c)(2), the REIT's interest income accrued on such a mortgage obligation is qualified income for purposes of the 75-percent and 95-percent income tests. Under the provision, any IRC section 988 gain attributable to currency fluctuations between the time the interest is accrued by the REIT and the time the interest is paid to the REIT is real estate foreign exchange gain because it is directly attributable to the qualified interest income, and thus the IRC section 988 gain is excluded for purposes of the 75-percent and 95-percent income tests.

Example 2.-Assume the same facts as in Example 1, except that the instrument held by the REIT is a debt instrument that is not an obligation secured by a mortgage on real property or an interest in real property. Under IRC sections 856(c)(3) and 856(c)(2), interest income accrued by the REIT is qualified income for purposes of the 95-percent income test but is not qualified income for purposes of the 75-percent income test. Under the provision, any IRC section 988 gain attributable to currency fluctuations between the time the interest is accrued and the time the interest is paid is passive foreign exchange gain because it is directly attributable to the interest income that is qualified for purposes of the 95-percent income test. Such passive foreign exchange gain is excluded for purposes of the 95-percent income test but is not excluded (and is not qualified income) for purposes of the 75-percent income test.

Example 3.-Assume the same facts as in Example 1, and further assume that the REIT receives a repayment of the principal on the obligation. Under the provision, any IRC section 988 gain attributable to the receipt of principal is real estate foreign exchange gain because it is attributable to the acquisition or ownership of an obligation secured by a mortgage on real property. Such IRC section 988 gain is excluded for purposes of both the 75-percent and 95-percent income tests.

Example 4.-Assume the same facts as in Example 2, and further assume that the REIT receives a repayment of the principal on the obligation. Under the provision, any IRC section 988 gain attributable to the receipt of principal is passive foreign exchange gain because it is attributable to the acquisition or ownership of an obligation not secured by a mortgage on real property or an interest in real property. Such IRC section 988 gain is excluded for purposes of the 95-percent income test but is not excluded, and is not qualified income, for purposes of the 75-percent income test.

Other rules

The provision makes several changes to other REIT provisions.

First, the provision extends the present-law rule of IRC section 856(c)(5)(G), which excludes certain hedging income from the computation of the 95-percent income test, to exclude such hedging income from the computation of the 75-percent income test as well. As under present law, except to the extent determined by the Secretary of the Treasury, such income is income of a REIT from a hedging transaction (as defined in clause (ii) or (iii) of IRC section 1221(b)(2)(A)), which is clearly identified pursuant to IRC section 1221(a)(7), including gain from the sale or disposition of such a transaction, to the extent that the transaction hedges any indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets.

Second, the provision extends IRC section 856(c)(5)(G) to encompass, (except to the extent determined by the Secretary of the Treasury), income of a REIT from a transaction entered into by the REIT primarily to manage risk of currency fluctuations with respect to any item of income or gain that would be qualified income under the 75-percent or 95-percent income tests, (or any property which generates such income or gain) provided the transaction is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may prescribe). Such income is excluded from gross income for purposes of both the 75-percent and 95-percent income tests.

Third, the rule that if a REIT has met the asset tests as of the close of any quarter it will not fail them solely because of a discrepancy due to variations in value that are not attributable to the acquisition of investments is clarified to include a discrepancy caused solely by the change in the foreign currency exchange rate used to value a foreign asset.[157]

[157] For example, suppose a REIT meets the 75-percent asset test as of the close of a quarter, but as of the close of the following quarter, a change in the foreign currency exchange rate has increased the value of certain

Fourth, the term "cash" for purposes of the REIT asset qualification rules is defined to include foreign currency[158] if the REIT[159] or its QBU uses such currency as its functional currency, but only to the extent such foreign currency is held for use in the normal course of the activities of the REIT or the QBU giving rise to income or gain described in IRC sections 856(c)(2) or (3), or directly related to acquiring or holding assets described in IRC section 856(c)(4), and is not held in connection with a trade or business of trading or dealing in securities (as defined in IRC section 475(c)(2).[160]

Fifth, permitted foreclosure property income also includes foreign currency gain that is attributable to otherwise permitted income from foreclosure property.[161]

Finally, foreign currency gain under IRC section 988(b)(1), or loss under IRC section 988(b)(2), that is attributable to any prohibited transaction is taken into account in determining the amount of prohibited transaction net income subject to the 100-percent tax.

Treasury authority regarding other items of income

The provision authorizes the Treasury Department to issue guidance that would allow other items of income to be excluded for purposes of the computation of qualifying gross income

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foreign currency-denominated securities that are not qualifying assets for purposes of that test, such that the value of those securities exceeds the 25 percent permitted amount. If the REIT does not acquire any other asset during that next quarter, the REIT will not lose its status by reason of failure to meet the 75-percent asset test. However, if in that next quarter the REIT acquires another foreign-currency denominated (or any other) asset that is not a qualifying asset, and immediately after that acquisition the total value of non-qualifying assets, including the new acquisition, fails the test, then the REIT has until 30 days after the end of that quarter to adjust its asset value so that it satisfies the test.

[158] Although foreign currency thus may be considered a qualified asset for purposes of the 75-percent asset test of IRC section 856(c)(4), foreign currency gain with respect to such currency is excluded income for purposes of the 75-percent or 95-percent income tests only to the extent such gain is attributable to the income items or other specific IRC section 988 transactions described in the rules of the provision that govern such income exclusions.

[159] Because a REIT must be a U.S. entity, it is normally required to use the dollar as its functional currency. However, under private rulings, the IRS has permitted REITs to use a functional currency other than the dollar where the operations and record-keeping requirements for treatment as a QBU that uses a functional currency other than the dollar are met. See, e.g., PLR 200625019 and PLR 200550025. A private letter ruling may be relied upon only by the taxpayer to which the ruling was issued.

[160] This test applies to a REIT in determining whether it meets the 75-percent asset test. This test also independently applies to any QBU of a REIT in determining whether such QBU meets the 75-percent asset requirement. If that 75 percent asset requirement (along with the 75 percent income test) is met, then IRC section 987 gain of the REIT attributable to that QBU is excluded from the REIT's gross income for the 75-percent and 95-percent income tests. In applying the 75-percent asset test to the REIT or a QBU, respectively, it is intended that currency held by such REIT or QBU, respectively, is treated as cash only to the extent used in the normal course of the activities of such REIT or QBU giving rise to income or gain described in IRC sections 856(c)(2) or (3) or directly related to acquiring or holding assets described in IRC section 856(c)(4) (other than such cash), and not held in connection with a trade or business of trading or dealing in securities (as defined in IRC section 475(c)(2)).

[161] Such foreign currency gain is also included as foreclosure property income for purposes of any tax on such income under IRC section 857(b)(4)(B)(i).

under either the 75 percent or the 95 percent test, respectively, or to be included as qualifying income for either of such tests, respectively, in appropriate cases consistent with the purposes of the REIT provisions.[162]

Treasury authority regarding other items of income

The provision authorizes the Treasury Department to issue guidance that would allow other items of income to be excluded for purposes of the computation of qualifying gross income under either the 75 percent or the 95 percent test, respectively, or to be included as qualifying income for either of such tests, respectively, in appropriate cases consistent with the purposes of the REIT provisions.[163]

Act section 3041 – Conforming Taxable REIT Subsidiary Asset Test

Taxable REIT subsidiary limit increase

The provision increases the percentage of the value of REIT assets that can be held in securities of a taxable REIT subsidiary to 25 percent from the present 20 percent.[164]

Act section 3051 – Holding Period Under Safe Harbor

Holding period under safe harbor for prohibited transactions

The provision shortens from four years to two years the minimum holding period under the prohibited transactions tax safe harbors of IRC section 857(b)(6)(C) and IRC section 857(b)(6)(D). The requirement that timber property under IRC section 857(b)(6)(D) be sold to a qualified organization (as defined in section IRC section 170(h)(3)) exclusively for conservation purposes (as defined in IRC section 170(h)(1)(C)) in order for the 2-year holding period to apply under the safe harbor, and the one-year limited application of the 2-year holding period rule under IRC section 857(b)(6)(D), are generally removed. The provision makes clear that the safe harbor is an exception from the prohibited transactions tax only, and does not cause a gain on a sale that otherwise does not qualify for capital gains treatment (i.e., because it was a sale of property held for sale to customers in the ordinary course of business under IRC section 1221(a)(1)) to become a capital gain transaction.[165]

[162] Income that is statutorily excluded from gross income computations under the provision is not intended to be within the authority to include as qualifying income. In all cases, the Treasury regulatory authority applies solely for purposes of applying the relevant percentage tests for REIT qualification, and does not affect the substantive characterization of an item as income for purposes of computing the REIT's taxable income.
[163] Income that is statutorily excluded from gross income computations under the provision is not intended to be within the authority to include as qualifying income. In all cases, the Treasury regulatory authority applies solely for purposes of applying the relevant percentage tests for REIT qualification, and does not affect the substantive characterization of an item as income for purposes of computing the REIT’s taxable income.
[164] The special 25 percent rule for timber REITs is made permanent under the provision, since timber REITs are treated in the same manner as other REITs for this purpose.
[165] In the case of a sale of timber property that qualifies for the safe harbor under IRC section

Consequently, such capital gain treatment continues to be determined based on all the facts and circumstances as under present law, without regard to the prohibited transactions tax safe harbor. However, in the case of timber property under IRC section 857(b)(6)(D), the provision retains for the one-year period prescribed in the Food, Energy and Conservation Act of 2008 the rule that qualification of the sale under the safe harbor also means that the sale is considered to be a sale of property held for investment or use in a trade or business, and not of property described in IRC section 1221(a)(1), for all purposes of subtitle A of the IRC, but only if the sale would have qualified under IRC section 857(b)(6)(D) as in effect prior to the enactment of the provision.

Act section 3052 – Determining Value of Sales Under Safe Harbor

Permitted extent of sales under safe harbor for prohibited transactions

The provision changes the prohibited transactions tax safe harbor provisions concerning maximum amount of sales within a taxable year that are consistent with the alternative prohibited transactions tax safe harbor (that is an alternative to the test for no more than 7 sales). Instead of the present alternative limit of 10-percent of the aggregate bases of all the assets of the REIT as of the beginning of the taxable year, the limit under the provision is either 10-percent of such aggregate basis or 10 percent of the aggregate fair market value of all the assets of the REIT as of such time.

Act section 3061 – Conformity for Health Care Facilities

Health care facilities held by a taxable REIT subsidiary

The provision expands the taxable REIT subsidiary exception for hotel, motel, and other transient facilities so that it also applies to health care facilities. Thus, a taxable REIT subsidiary is permitted to rent a health care facility from its parent REIT and hire an independent contractor to operate such a facility; the rents paid to the parent REIT are qualifying rental income for purposes of the 75-percent and 95-percent income tests.

Rules regarding operating a health care or lodging facility through an independent contractor

Under the provision, a taxable REIT subsidiary is not to be considered to be operating or managing a qualified health care property or a qualified lodging facility other than through an independent contractor solely because the taxable REIT subsidiary directly or indirectly possesses a license, permit, or similar instrument enabling it to do so.

857(b)(1)(D), for the one year period prescribed in the Food, Conservation and Energy Act of 2008, such a sale is considered to be a sale of property held for investment or use in a trade or business, and not of property described in IRC section 1221(a)(1), for all purposes of subtitle A of the IRC, for such one-year period.

Under the provision, a taxable REIT subsidiary is not to be considered to be operating or managing a qualified health care property or qualified lodging facility solely because it employs individuals working at such property or facility located outside the United States, but only if an eligible independent contractor is responsible for the daily supervision and direction of such individuals on behalf of the taxable REIT subsidiary pursuant to a management agreement or similar service contract.

Act section 3071 – Effective Dates

Effective Dates

The provisions generally are effective for taxable years beginning after July 30, 2008. However, the rules treating certain foreign currency gain as excluded income for purposes of the income tests apply to gain and items of income recognized after July 30, 2008. The new rules of IRC section 856(c)(5)(G), relating to hedging and managing risk, are effective for transactions entered into after July 30, 2008. The Treasury authority to exclude items from income or to add items of qualifying income for purposes of the income qualification tests applies to gains and items of income recognized after July 30, 2008. The foreign currency amendment relating to gain from foreclosure property applies to gain recognized after July 30, 2008, and the provision relating to net prohibited transactions income applies to gain and deductions recognized after July 30, 2008. The provisions relating to the prohibited transactions tax safe harbor apply to sales made after July 30, 2008.

California Law (R&TC sections 24871 – 24875.5)

REIT Qualification Provisions – Act sections 3031, 3032, 3041, and 3061

California law is conformed to Subchapter M of Chapter 1 of Subtitle A of the IRC, relating to RICs, REITs, REMICs, and FASITs, as of the “specified date” of January 1, 2005, with modifications in R&TC sections 17088, and 24871 – 24875.5. However, under R&TC section 24872.6, an entity that is a REIT for any taxable year for federal purposes under the IRC (as applicable for federal purposes) shall be a REIT for California purposes for the same taxable year; therefore, as these federal changes are REIT qualification issues, they automatically apply to California.

Impact on California Revenue

Baseline.

California Law (R&T section 24872)

Excise Tax Provisions – Act sections 3033, 3051, and 3052

California specifically does not impose excise taxes on REITs.

Impact on California Revenue

Not applicable.

TITLE III – REVENUE PROVISION
SUBTITLE A –GENERAL PROVISIONS

Section	Section Title
3081	Election to Accelerate the AMT and Research Credits in Lieu of Bonus Depreciation

Background

Bonus depreciation

Taxpayers are permitted an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified property generally placed in service in 2008.[166] The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service. The basis of the property and the depreciation allowances in the year the property is placed in service and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. For property to qualify for the additional first-year depreciation deduction, it must meet all of the following requirements: (1) the property must be (a) property to which MACRS applies with an applicable recovery period of 20 years or less, (b) water utility property (as defined in section 168(e)(5)), (c) computer software other than computer software covered by section 197, or (d) qualified leasehold improvement property (as defined in section 168(k)(3)); (2) the original use of the property must commence with the taxpayer after December 31, 2007; (3) the taxpayer must purchase the property either (a) after December 31, 2007, and before January 1, 2009, but only if no binding written contract for the acquisition is in effect before January 1, 2008, or (b) pursuant to a binding written contract which was entered into after December 31, 2007, and before January 1, 2009;[167] and (4) the property must be placed in service after December 31, 2007, and before January 1, 2009. An extension of the placed

[166] H.R. 5140, section 103.

[167] Special rules apply to property manufactured, constructed, or produced by the taxpayer for use by the taxpayer.

in service date of one year (i.e., to January 1, 2010) is provided for certain property with a recovery period of 10 years or longer and certain transportation property.

Corporate AMT credit

If a corporation is subject to the alternative minimum tax ("AMT") in any year, the amount of AMT paid is allowed as a credit in any subsequent taxable year to the extent the taxpayer's regular tax liability exceeds its tentative minimum tax.

Research credit

As part of the general business credit, IRC section 38 limits credits for increasing research activities ("research credit") generally to the amount of regular tax in excess of tentative minimum tax.

New Federal Law (IRC section 168)

Corporations otherwise eligible for additional first year depreciation under IRC section 168(k) may elect to claim additional research or minimum tax credits in lieu of claiming depreciation under IRC section 168(k) for "eligible qualified property" placed in service after March 31, 2008.[168] A corporation making the election forgoes the depreciation deductions allowable under IRC section 168(k) and instead increases the limitation under IRC section 38(c) on the use of research credits or IRC section 53(c) on the use of minimum tax credits. The increases in the allowable credits are treated as refundable for purposes of this provision. The depreciation for qualified property is calculated for both regular tax and AMT purposes using the straight-line method in place of the method that would otherwise be used absent the election under this provision.

The research credit or minimum tax credit limitation is increased by an amount equal to 20 percent of the bonus depreciation amount[169] for certain eligible qualified property that would be claimed absent an election under this provision. Generally, eligible qualified property included in the calculation is bonus depreciation property that meets the following requirements: (1) the original use of the property must commence with the taxpayer after March 31, 2008; (2) the taxpayer must purchase the property either (a) after March 31, 2008, and before January 1, 2009, but only if no binding written contract for the acquisition is in effect before April 1, 2008,[170] or (b) pursuant to a binding written contract which was entered

[168] In the case of a electing corporation that is a partner in a partnership, the corporate partner's distributive share of partnership items is determined as if IRC section 168(k) does not apply to any eligible qualified property and the straight line method is used to calculate depreciation of such property.
[169] The bonus depreciation amount is the difference between the amount of depreciation, without regard to straight line elections, that would be determined if the election under this provision is not made and the amount if the election is made.
[170] In the case of passenger aircraft, the written binding contract limitation does not apply.

into after March 31, 2008, and before January 1, 2009;[171] and (3) the property must be placed in service after March 31, 2008, and before January 1, 2009 (January 1, 2010 for certain longer-lived and transportation property).

The bonus depreciation amount is limited to the lesser of: (1) $30 million, or (2) six percent of the sum of research credit carryforwards from taxable years beginning before January 1, 2006, and minimum tax credits allocable to the adjusted minimum tax imposed for taxable years beginning before January 1, 2006. All corporations treated as a single employer under IRC section 52(a) shall be treated as one taxpayer for purposes of the limitation, as well as for electing the application of this provision.

The provision also provides that an applicable partnership may elect to be treated as making a deemed payment of tax for any applicable taxable year in the amount of the least of the following: (1) the bonus depreciation amount that would be determined if an election under this provision were in effect for the partnership; (2) the amount of the partnership's research credit for the taxable year; or (3) $30 million (reduced by any deemed payment for any preceding taxable year). The deemed payment may not be used as an offset or credit against any tax liability of the partnership or any partner, but is instead refunded to the partnership. For purposes of this provision, an applicable partnership is a domestic partnership that was formed on August 3, 2007, and will produce in excess of 675,000 automobiles during the period beginning on January 1, 2008, and ending on June 30, 2008. An applicable taxable year is any taxable year during which eligible qualified property is placed in service. If an applicable partnership makes this election, the amount of the deduction allowable to the partnership or any partner for any eligible qualified property is computed without applying IRC section 168(k), the straight line method must be used by the partnership and any partner for such property, the election to increase minimum tax credits and research credits under this provision is not available, and the research credit amount for any applicable taxable year with respect to the partnership is reduced by the amount of the deemed payment.

Effective Date

The provision is effective for taxable years ending after March 31, 2008.

California Law (R&TC sections 17201, 17250, 24349, 24355.3, and 24355.4)

Modified accelerated cost recovery system (MACRS)

Under the PITL, California law, as it relates to MACRS, in general conforms to the federal rules as of the "specified date" of January 1, 2005, with certain modifications. California specifically does not conform to IRC section 168(k), which allows 30 percent and 50 percent

[171] Special rules apply to property manufactured, constructed, or produced by the taxpayer for use by the taxpayer.

bonus depreciation for certain property. Therefore, this provision is not applicable to California.

Impact on California Revenue

Not applicable.

Section	Section Title
3082	Certain GO Zone Incentives

Certain GO Zones incentives

A. Election to amend returns for hurricane-related casualty losses

Background

Under present law, a taxpayer may generally claim a deduction for any loss sustained during the taxable year and not compensated by insurance or otherwise.[172] For individual taxpayers, deductible losses must be incurred in a trade or business or other profit-seeking activity or consist of property losses arising from fire, storm, shipwreck, or other casualty, or from theft.[173] Generally, personal casualty or theft losses are deductible only if they exceed $100 per casualty or theft and net casualty and theft losses are deductible only to the extent it exceeds 10 percent of adjusted gross income.[174] However, for hurricane-related casualty losses, these two casualty loss limitations are removed.[175]

Casualty losses are generally allowed for the taxable year of the loss. However, in the case of a disaster loss arising in an area determined by the President of the United States to warrant assistance by the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act, the taxpayer may elect to take the loss into account for the taxable year immediately before the taxable year in which the disaster occurred.[176]

When a taxpayer receives reimbursement for such loss in a subsequent taxable year, the deductible loss is not recomputed for the taxable year in which the deduction was taken, the reimbursement amount is taken into income in the taxable year received.[177]

[172] IRC section 165.
[173] IRC section 165(c)(3).
[174] IRC section 165(h).
[175] IRC section 1400S(b).
[176] IRC section 165(i).
[177] Treas. Reg. sec. 165-1(d)(2)(iii).

New Federal Law (Uncodified section 3082(a) of HERA)

This uncodified provision allows a taxpayer who claimed a casualty loss to a principal residence (within the meaning of IRC section 121) resulting from Hurricane Katrina, Hurricane Rita, or Hurricane Wilma and in a subsequent year receives a grant as reimbursement of such loss to elect to file an amended return for the taxable year to which such deduction was allowed.[178] The casualty loss deduction is reduced, but not below zero, by the amount of such reimbursement.

The time for filing such amended return is the later of three years after the original due date for filing the tax return or November 30, 2008. Any underpayment of tax shall be subject to one year of interest, but no penalty or additional interest if paid not later than one year after the filing of the amended return.

Effective Date

The provision is effective on July 30, 2008.

California Law (None)

California has no comparable provision.

Impact on California Revenue

Not applicable.

B. Waiver of Deadline on Construction of GO Zone Property Eligible for Bonus Depreciation

In general

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (other than residential rental property and nonresidential real property) range from 3 to 25 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

[178] To qualify the grant must be received under Public Law 109-148, 109-234, or 110-116.

HOUSING AND ECONOMIC RECOVERY ACT OF 2008 (HERA)
(PL 110-289, JULY 30, 2008)

Gulf Opportunity Zone

The "Gulf Opportunity Zone" or "GO Zone" is defined as that portion of the Hurricane Katrina Disaster Area determined by the President to warrant individual or individual and public assistance from the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina. The term "Hurricane Katrina disaster area" means an area with respect to which a major disaster has been declared by the President before September 14, 2005, under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina.

Gulf Opportunity Zone property

Present law provides an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified Gulf Opportunity Zone property. In order to qualify, property generally must be placed in service on or before December 31, 2007 (December 31, 2008 in the case of nonresidential real property and residential rental property). The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service. The additional first-year depreciation deduction is subject to the general rules regarding whether an item is deductible under IRC section 162 or subject to capitalization under IRC section 263 or IRC section 263A. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, the provision provides that there is no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

In order for property to qualify for the additional first-year depreciation deduction, it must meet all of the following requirements. First, the property must be property: (1) to which the general rules of the Modified Accelerated Cost Recovery System ("MACRS") apply with an applicable recovery period of 20 years or less, (2) computer software other than computer software covered by IRC section 197, (3) water utility property (as defined in IRC section 168(e)(5)), (4) certain leasehold improvement property, or (5) certain nonresidential real property and residential rental property. Second, substantially all of the use of such property must be in the Gulf Opportunity Zone and in the active conduct of a trade or business by the taxpayer in the Gulf Opportunity Zone. Third, the original use of the property in the Gulf Opportunity Zone must commence with the taxpayer on or after August 28, 2005. (Thus, used property may constitute qualified property so long as it has not previously been used within the Gulf Opportunity Zone. In addition, it is intended that additional capital expenditures incurred to recondition or rebuild property the original use of which in the Gulf Opportunity Zone began with the taxpayer would satisfy the "original use" requirement. (See Treasury Regulation section 1.48-2 Example 5.) Finally, the property must be acquired by purchase (as defined under IRC section 179(d)) by the taxpayer on or after August 28, 2005, and placed in service on or before December 31, 2007. For qualifying nonresidential real property and residential rental property, the property must be placed in service on or before December 31, 2008, in lieu of December 31, 2007. Property does not qualify if a binding written contract for the acquisition of such property was in effect before August 28, 2005. However, property is not precluded from qualifying for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to August 28, 2005.

Property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer qualifies if the taxpayer begins the manufacture, construction, or production of the property on or after August 28, 2005 and before January 1, 2008, and the property is placed in service on or before December 31, 2007 (and all other requirements are met). In the case of qualified nonresidential real property and residential rental property, the property must be placed in service on or before December 31, 2008. Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.

Under a special rule, property any portion of which is financed with the proceeds of a tax-exempt obligation under IRC section 103 is not eligible for the additional first-year depreciation deduction. Recapture rules apply under the provision if the property ceases to be qualified Gulf Opportunity Zone property.

Gulf Opportunity Zone extension property

The placed-in-service deadline is extended for specified Gulf Opportunity Zone extension property to qualify for the additional first-year depreciation deduction. Specified Gulf Opportunity Zone extension property is defined as property substantially all the use of which is in one or more specified portions of the Gulf Opportunity Zone and which is either: (1) nonresidential real property or residential rental property which is placed in service by the taxpayer on or before December 31, 2010, or (2) in the case of a taxpayer who places in service a building described in (1), property described in IRC section 168(k)(2)(A)(i)[179] placed in service on or before December 31, 2010, if substantially all the use of such property is in such building and such property is placed in service within 90 days of the date the building is placed in service. However, in the case of nonresidential real property or residential rental property, only the adjusted basis of such property attributable to manufacture, construction, or production before January 1, 2010, ("progress expenditures") is eligible for the additional first-year depreciation.

[179] Property described in IRC section 168(k)(2)(A)(i) includes (1) property to which the general rules of the Modified Accelerated Cost Recovery System ("MACRS") apply with an applicable recovery period of 20 years or less, (2) computer software other than computer software covered by IRC section 197, (3) water utility property (as defined in IRC section 168(e)(5)), and (4) certain leasehold improvement property.

The specified portions of the Gulf Opportunity Zone are defined as those portions of the Gulf Opportunity Zone that are in a county or parish which is identified by the Secretary of the Treasury (or his delegate) as being a county or parish in which hurricanes occurring in 2005 damaged (in the aggregate) more than 60 percent of the housing units in such county or parish which were occupied (determined according to the 2000 Census). These areas include the Louisiana parishes of Calcasieu, Cameron, Orleans, Plaquemines, St. Bernard, St. Tammany, and Washington, and the Mississippi counties of Hancock, Harrison, Jackson, Pearl River, and Stone.[180]

New Federal Law (IRC section 1400N)

The bill removes the commencement date of January 1, 2008, for self-constructed Gulf Opportunity Zone extension property. The placed in service date of December 31, 2010, and the progress expenditure date of January 1, 2010, are not modified.

Effective Date

The provision applies to property placed in service after December 31, 2007.

California Law (None)

California does not conform to the IRC section 1400 series provisions.

Impact on California Revenue

Not applicable.

C. Inclusion of Certain Counties in GO Zone for Purposes of Tax-Exempt Bond Financing

Background

The Gulf Opportunity Zone Act of 2005 established certain tax benefits for areas affected by Hurricanes Katrina, Wilma, and Rita.[181] Under present law, the "Gulf Opportunity Zone" or "GO Zone" means that portion of the Hurricane Katrina disaster area determined by the President to warrant individual or individual and public assistance from the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act (the "Stafford Act") by reason of Hurricane Katrina.[182] The "Hurricane Katrina disaster area" is the area with respect to which a major disaster has been declared by the President before September 14, 2005, under section 401 of the Stafford Act by reason of Hurricane Katrina.[183] The IRC authorizes the states of Alabama, Louisiana and Mississippi to issue certain exempt

[180] Notice 2007-36, 2007-17 I.R.B. 1000.
[181] Public Law 109-135.
[182] IRC section 1400M(1).
[183] IRC section 1400M(2).

facility bonds and qualified mortgage bonds for property located in the GO Zone ("GO Zone bonds").[184] In Alabama, the following counties have been identified as warranting individual or individual and public assistance: Baldwin, Chocktaw, Clarke, Greene, Hale, Marengo, Mobile, Pickens, Sumter, Tuscaloosa, and Washington.[185]

New Federal Law (IRC section 1400N)

For purposes of GO Zone bonds only, the provision includes the following counties for purposes of defining the GO Zone: Colbert County, Alabama and Dallas County, Alabama.

Effective Date

The provision is effective as if included in the Gulf Opportunity Zone Act of 2005 to which it relates.

California Law (None)

California does not conform to the IRC section 1400 series provisions.

Impact on California Revenue

Not applicable.

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[184] IRC section 1400N(a). For purposes of these bonds, qualified project costs are the cost of any qualified residential rental project (as defined in IRC section 142(d)) located in the GO Zone, the cost of acquisition, construction, reconstruction and renovation of nonresidential real property (including fixed improvements associated with such property) located in the GO Zone, and the cost of acquisition, construction, reconstruction and renovation of public utility property (as defined in IRC section 168(i)(10) located in the GO Zone (IRC section 1400N(a)(4)). GO Zone bonds cannot be used for movable fixtures or equipment (IRC section 1400N(a)(3)(B)). Nor can GO Zone bonds be used to provide any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling or any store the principal businesses of which is the sale of alcoholic beverages for consumption off premises (IRC section 1400N(a)(2)(E) and IRC section 144(c)(6)(B)). GO Zone bonds are treated as qualified mortgage bonds if the issue meets the general requirements of a qualified mortgage issue and the residences financed with such bonds are located in the GO Zone. For these residences, the first-time homebuyer rule is waived and purchase and income rules for targeted area residences apply. In addition, 100 percent of the mortgages must be made to mortgagors whose family income is 140 percent or less of the applicable median family income.

[185] Internal Revenue Service, Notice 2006-21, GO Zone Resident Population Estimates (March 20, 2006).

SUBTITLE B – REVENUE OFFSETS

Section	Section Title
3091	Returns Relating to Payments Made in Settlement of Payment Card and Third-Party Network Transactions

Background

Present law imposes a variety of information reporting requirements on participants in certain transactions. These requirements are intended to assist taxpayers in preparing their income tax returns and to help the Internal Revenue Service ("IRS") determine whether such returns are correct and complete. For example, every person engaged in a trade or business generally is required to file information returns for each calendar year for payments of $600 or more made in the course of the payor's trade or business.[186] Payments to corporations generally are excepted from this requirement. Certain payments subject to information reporting also are subject to backup withholding if the payee has not provided a valid taxpayer identification number ("TIN").

Under present law, any person required to file a correct information return who fails to do so on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the correct information return is filed.

New Federal Law (New IRC section 6050W)

The provision requires any payment settlement entity making payment to a participating payee in settlement of reportable payment transactions to report annually to the IRS and to the participating payee the gross amount of such reportable payment transactions, as well as the name, address, and TIN of the participating payees. A "reportable payment transaction" means any payment card transaction and any third party network transaction.

Under the provision, a "payment settlement entity" means, in the case of a payment card transaction, a merchant acquiring entity and, in the case of a third party network transaction, a third party settlement organization. A "participating payee" means, in the case of a payment card transaction, any person who accepts a payment card as payment and, in the case of a third party network transaction, any person who accepts payment from a third party settlement organization in settlement of such transaction.

For purposes of the reporting requirement, the term "merchant acquiring entity" means the bank or other organization with the contractual obligation to make payment to participating payees in settlement of payment card transactions. A "payment card transaction" means any transaction in which a payment card is accepted as payment.[187] A "payment card" is defined

[186] IRC section 6041(a).
[187] For this purpose, the acceptance as payment of any account number or other indicia associated with a payment card also qualifies a payment card transaction.

as any card (e.g., a credit card or debit card) which is issued pursuant to an agreement or arrangement which provides for: (1) one or more issuers of such cards; (2) a network of persons unrelated to each other, and to the issuer, who agree to accept such cards as payment; and (3) standards and mechanisms for settling the transactions between the merchant acquiring entities and the persons who agree to accept such cards as payment. Thus, under the provision, a bank that enrolls a business to accept credit cards and contracts with the business to make payment on credit card transactions is required to report to the IRS the business's gross credit card transactions for each calendar year. The bank also is required to provide a copy of the information report to the business.

The provision also requires reporting on a third party network transaction. The term "third party network transaction" means any transaction which is settled through a third party payment network. A "third party payment network" is defined as any agreement or arrangement that: (1) involves the establishment of accounts with a central organization by a substantial number of persons (e.g., more than 50) who are unrelated to such organization, provide goods or services, and have agreed to settle transactions for the provision of such goods or services pursuant to such agreement or arrangement; (2) provides for standards and mechanisms for settling such transactions; and (3) guarantees persons providing goods or services pursuant to such agreement or arrangement that such persons will be paid for providing such goods or services. In the case of a third party network transaction, the payment settlement entity is the third party settlement organization, which is defined as the central organization which has the contractual obligation to make payment to participating payees of third party network transactions. Thus, an organization generally is required to report if it provides a network enabling buyers to transfer funds to sellers who have established accounts with the organization and have a contractual obligation to accept payment through the network. However, an organization operating a network which merely processes electronic payments (such as wire transfers, electronic checks, and direct deposit payments) between buyers and sellers, but does not have contractual agreements with sellers to use such network, is not required to report under the provision. Similarly, an agreement to transfer funds between two demand deposit accounts will not, by itself, constitute a third party network transaction.

A third party payment network does not include any agreement or arrangement that provides for the issuance of payment cards as defined by the provision. In addition, a third party settlement organization is not required to report unless the aggregate value of third party network transactions for the year exceeds $20,000 and the aggregate number of such transactions exceeds 200. For the avoidance of doubt, if a payment of funds is made *to* a third party settlement organization by means of a payment card (i.e., as part of a transaction that is a payment card transaction), the $20,000 and 200 transaction *de minimis* rule continues to apply to any reporting obligation with respect to payment of such funds to a participating payee *by* the third party settlement organization made as part of a third party network transaction.

The provision also imposes reporting requirements on intermediaries who receive payments from a payment settlement entity and distribute such payments to one or more participating payees. The provision treats such intermediaries as participating payees with respect to the payment settlement entity and as payment settlement entities with respect to the participating payees to whom the intermediary distributes payments. Thus, for example, in the case of a corporation that receives payment from a bank for credit card sales effectuated at the corporation's independently-owned franchise stores, the bank is required to report the gross amount of reportable payment transactions settled through the corporation (notwithstanding the fact that the corporation does not accept payment cards and would not otherwise be treated as a participating payee). In turn, the corporation, as an intermediary, would be required to report the gross amount of reportable payment transactions allocable to each franchise store. The bank would have no reporting obligation with respect to payments made by the corporation to its franchise stores.

If a payment settlement entity contracts with a third party to settle reportable payment transactions on behalf of the payment settlement entity, the provision requires the third party to file the annual information return in lieu of the payment settlement entity.

The provision grants authority to the Secretary to issue guidance to implement the reporting requirement, including rules to prevent the reporting of the same transaction more than once.

Under the provision, reportable payment transactions subject to information reporting generally are subject to backup withholding requirements. Finally, present-law penalties relating to the failure to file correct information returns would apply to the new information reporting requirements required under the provision.

Effective Date

The provision generally is effective for information returns for reportable payment transactions for calendar years beginning after December 31, 2010. The amendments to the backup withholding requirements apply to amounts paid after December 31, 2011.

California Law (R&TC section 18631)

California does not conform by reference to IRC sections requiring information returns to be filed, but instead provides in R&TC section 18631 that a copy of certain federal information returns are required to be filed with the FTB upon request. The new IRC section 6050W information reporting is not listed in R&TC section 18631 and, therefore, California has not automatically conformed to these new federal information return requirements.

Impact on California Revenue

The FTB would have access to this federal information through voluntary reporting on state income tax returns or through revenue agent reports received from the IRS, which would include the information returns filed. There would be baseline revenue gains each year beginning in 2010-11. It is expected that baseline revenue gains would increase in each future year.

Section	Section Title
3092	Gain from Sale of Principal Residence Allocated to Nonqualified Use Not Excluded from Income

Background

In general

Under present law, an individual taxpayer may 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. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years ending on the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met.

Present law also contains an election relating to members of the uniformed services, the Foreign Service, and certain employees of the intelligence community.[188] If the election is made, the five-year period ending on the date of the sale or exchange of a principal residence does not include any period up to 10 years during which the taxpayer or the taxpayer's spouse is on qualified official extended duty. For these purposes, qualified official extended duty is any period of extended duty while serving at a place of duty at least 50 miles away from the taxpayer's principal residence or under orders compelling residence in government furnished quarters. The election may be made with respect to only one property for a suspension period.

The exclusion does not apply to gain to the extent the gain is attributable to depreciation allowable with respect to the rental or business use of a principal residence for periods after May 6, 1997.

New Federal Law (IRC section 121)

Under the provision, gain from the sale or exchange of a principal residence allocated to periods of nonqualified use is not excluded from gross income. The amount of gain allocated to periods of nonqualified use is the amount of gain multiplied by a fraction the numerator of

[188] The provision relating to employees of the intelligence community is effective for sales and exchanges before January 1, 2011.

which is the aggregate periods of nonqualified use during the period the property was owned by the taxpayer and the denominator of which is the period the taxpayer owned the property.

A period of nonqualified use means any period (not including any period before January 1, 2009) during which the property is not used by the taxpayer or the taxpayer's spouse or former spouse as a principal residence. For purposes of determining periods of nonqualified use, (i) any period after the last date the property is used as the principal residence of the taxpayer or spouse (regardless of use during that period), and (ii) any period (not to exceed two years) that the taxpayer is temporarily absent by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances, are not taken into account. The present-law election for the uniformed services, Foreign Service and employees of the intelligence community is unchanged.

If any gain is attributable to post-May 6, 1997, depreciation, the exclusion does not apply to that amount of gain, as under present law, and that gain is not taken into account in determining the amount of gain allocated to nonqualified use.

These provisions may be illustrated by the following examples:

Example 1.–Assume that an individual buys a property on January 1, 2009, for $400,000, and uses it as rental property for two years claiming $20,000 of depreciation deductions. On January 1, 2011, the taxpayer converts the property to his principal residence. On January 1, 2013, the taxpayer moves out, and the taxpayer sells the property for $700,000 on January 1, 2014. As under present law, $20,000 gain attributable to the depreciation deductions is included in income. Of the remaining $300,000 gain, 40% of the gain (2 years divided by 5 years), or $120,000, is allocated to nonqualified use and is not eligible for the exclusion. Because the remaining gain of $180,000 is less than the maximum gain of $250,000 that may be excluded, gain of $180,000 is excluded from gross income.

Example 2.–Assume that an individual buys a principal residence on January 1, 2009, for $400,000, moves out on January 1, 2019, and on December 1, 2021 sells the property for $600,000. The entire $200,000 gain is excluded from gross income, as under present law, because periods after the last qualified use do not constitute nonqualified use.

Effective Date

The provision is effective for sales and exchanges after December 31, 2008.

California Law (R&TC section 17131)

California conforms by reference to IRC section 121 relating to exclusion of gain from sale of principal residence, as of the “specified date” of January 1, 2005, in R&TC section 17131 in the PITL, with modifications in R&TC section 17152. Because this federal change was made after the “specified date” of January 1, 2005, California is not conformed to this provision.

HOUSING AND ECONOMIC RECOVERY ACT OF 2008 (HERA)
(PL 110-289, JULY 30, 2008)

Impact on California Revenue

Estimated Revenue Impact of Gain from Sale of Principal Residence Allocated to Nonqualified Use Not Excluded from Income For Tax Years Beginning On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
$1,200,000	$3,000,000	$4,100,000

Estimates are based on a proration of federal projections developed for the Housing and Economic Recovery Act of 2008.

Section	Section Title
3093	Delay in Application of Worldwide Allocation of Interest

Background

In general

To compute the foreign tax credit limitation, a taxpayer must determine the amount of its taxable income from foreign sources. Thus, the taxpayer must allocate and apportion deductions between items of U.S.-source gross income, on the one hand, and items of foreign-source gross income, on the other.

In the case of interest expense, the rules generally are based on the approach that money is fungible and that interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid.[189] For interest allocation purposes, all members of an affiliated group of corporations generally are treated as a single corporation (the so-called “one-taxpayer rule”) and allocation must be made on the basis of assets rather than gross income. The term “affiliated group” in this context generally is defined by reference to the rules for determining whether corporations are eligible to file consolidated returns.

For consolidation purposes, the term “affiliated group” means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if: (1) the common parent owns directly stock possessing at least 80 percent of the total voting power and at least 80 percent of the total

[189] However, exceptions to the fungibility principle are provided in particular cases, some of which are described below.

value of at least one other includible corporation; and (2) stock meeting the same voting power and value standards with respect to each includible corporation (excluding the common parent) is directly owned by one or more other includible corporations.

Generally, the term "includible corporation" means any domestic corporation except certain corporations exempt from tax under IRC section 501 (for example, corporations organized and operated exclusively for charitable or educational purposes), certain life insurance companies, corporations electing application of the possession tax credit, regulated investment companies, real estate investment trusts, and domestic international sales corporations. A foreign corporation generally is not an includible corporation.

Subject to exceptions, the consolidated return and interest allocation definitions of affiliation generally are consistent with each other.[190] For example, both definitions generally exclude all foreign corporations from the affiliated group. Thus, while debt generally is considered fungible among the assets of a group of domestic affiliated corporations, the same rules do not apply as between the domestic and foreign members of a group with the same degree of common control as the domestic affiliated group.

Banks, savings institutions, and other financial affiliates

The affiliated group for interest allocation purposes generally excludes what are referred to in the Treasury regulations as "financial corporations" (Treas. Reg. section 1.861-11T(d)(4)). These include any corporation, otherwise a member of the affiliated group for consolidation purposes, that is a financial institution (described in IRC section 581 or IRC section 591), the business of which is predominantly with persons other than related persons or their customers, and which is required by state or federal law to be operated separately from any other entity which is not a financial institution (IRC section 864(e)(5)(C)). The category of financial corporations also includes, to the extent provided in regulations, bank holding companies (including financial holding companies), subsidiaries of banks and bank holding companies (including financial holding companies), and savings institutions predominantly engaged in the active conduct of a banking, financing, or similar business (IRC section 864(e)(5)(D)).

A financial corporation is not treated as a member of the regular affiliated group for purposes of applying the one-taxpayer rule to other non-financial members of that group. Instead, all such financial corporations that would be so affiliated are treated as a separate single corporation for interest allocation purposes.

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[190] One such exception is that the affiliated group for interest allocation purposes includes IRC section 936 corporations that are excluded from the consolidated group.

Worldwide interest allocation

In general

The American Jobs Creation Act of 2004 ("AJCA")[191] modifies the interest expense allocation rules described above (which generally apply for purposes of computing the foreign tax credit limitation) by providing a one-time election (the "worldwide affiliated group election") under which the taxable income of the domestic members of an affiliated group from sources outside the United States generally is determined by allocating and apportioning interest expense of the domestic members of a worldwide affiliated group on a worldwide-group basis (i.e., as if all members of the worldwide group were a single corporation). If a group makes this election, the taxable income of the domestic members of a worldwide affiliated group from sources outside the United States is determined by allocating and apportioning the third-party interest expense of those domestic members to foreign-source income in an amount equal to the excess (if any) of (1) the worldwide affiliated group's worldwide third-party interest expense multiplied by the ratio which the foreign assets of the worldwide affiliated group bears to the total assets of the worldwide affiliated group,[192] over (2) the third-party interest expense incurred by foreign members of the group to the extent such interest would be allocated to foreign sources if the principles of worldwide interest allocation were applied separately to the foreign members of the group.[193]

For purposes of the new elective rules based on worldwide fungibility, the worldwide affiliated group means all corporations in an affiliated group as well as all controlled foreign corporations that, in the aggregate, either directly or indirectly,[194] would be members of such an affiliated group if IRC section 1504(b)(3) did not apply (i.e., in which at least 80 percent of the vote and value of the stock of such corporations is owned by one or more other corporations included in the affiliated group). Thus, if an affiliated group makes this election, the taxable income from sources outside the United States of domestic group members generally is determined by allocating and apportioning interest expense of the domestic members of the worldwide affiliated group as if all of the interest expense and assets of 80-percent or greater owned domestic corporations (i.e., corporations that are part of the affiliated group, as modified to include insurance companies) and certain controlled foreign corporations were attributable to a single corporation.

The common parent of the domestic affiliated group must make the worldwide affiliated group election. It must be made for the first taxable year beginning after December 31, 2008, in which a worldwide affiliated group exists that includes at least one foreign corporation that

[191] P.L. 108-357, section 401 (2004).
[192] For purposes of determining the assets of the worldwide affiliated group, neither stock in corporations within the group nor indebtedness (including receivables) between members of the group is taken into account.
[193] Although the interest expense of a foreign subsidiary is taken into account for purposes of allocating the interest expense of the domestic members of the electing worldwide affiliated group for foreign tax credit limitation purposes, the interest expense incurred by a foreign subsidiary is not deductible on a U.S. return.
[194] Indirect ownership is determined under the rules of IRC section 958(a)(2) or through applying rules similar to those of IRC section 958(a)(2) to stock owned directly or indirectly by domestic partnerships, trusts, or estates.

meets the requirements for inclusion in a worldwide affiliated group. Once made, the election applies to the common parent and all other members of the worldwide affiliated group for the taxable year for which the election was made and all subsequent taxable years, unless revoked with the consent of the Secretary of the Treasury.

Financial institution group election

Taxpayers are allowed to apply the bank group rules to exclude certain financial institutions from the affiliated group for interest allocation purposes under the worldwide fungibility approach. The rules also provide a one-time "financial institution group" election that expands the bank group. At the election of the common parent of the pre-election worldwide affiliated group, the interest expense allocation rules are applied separately to a subgroup of the worldwide affiliated group that consists of: (1) all corporations that are part of the bank group, and (2) all "financial corporations." For this purpose, a corporation is a financial corporation if at least 80 percent of its gross income is financial services income (as described in IRC section 904(d)(2)(C)(i) and the regulations thereunder) that is derived from transactions with unrelated persons.[195] For these purposes, items of income or gain from a transaction or series of transactions are disregarded if a principal purpose for the transaction or transactions is to qualify any corporation as a financial corporation.

The common parent of the pre-election worldwide affiliated group must make the election for the first taxable year beginning after December 31, 2008, in which a worldwide affiliated group includes a financial corporation. Once made, the election applies to the financial institution group for the taxable year and all subsequent taxable years. In addition, anti-abuse rules are provided under which certain transfers from one member of a financial institution group to a member of the worldwide affiliated group outside of the financial institution group are treated as reducing the amount of indebtedness of the separate financial institution group.

Regulatory authority is provided with respect to the election to provide for the direct allocation of interest expense in circumstances in which such allocation is appropriate to carry out the purposes of these rules, to prevent assets or interest expense from being taken into account more than once, or to address changes in members of any group (through acquisitions or otherwise) treated as affiliated under these rules.

Effective date of worldwide interest allocation under AJCA

The worldwide interest allocation rules under AJCA are effective for taxable years beginning after December 31, 2008.

[195] See Treas. Reg. sec. 1.904-4(e)(2).

New Federal Law (IRC section 864)

The provision delays the effective date of worldwide interest allocation rules for two years, until taxable years beginning after December 31, 2010. The required dates for making the worldwide affiliated group election and the financial institution group election are changed accordingly.

The provision also provides a special phase-in rule in the case of the first taxable year to which the worldwide interest allocation rules apply. For that year, the amount of the taxpayer's taxable income from foreign sources is reduced by 70 percent of the excess of (i) the amount of its taxable income from foreign sources as calculated using the worldwide interest allocation rules over (ii) the amount of its taxable income from foreign sources as calculated using the present-law interest allocation rules. Any foreign tax credits disallowed by virtue of this reduction in foreign-source taxable income may be carried back or forward under the normal rules for carrybacks and carryforwards of excess foreign tax credits.

Effective Date

The provision is effective on July 30, 2008.

California Law (R&TC sections 24344 and 24425)

California does not conform to IRC section 864 by reference. California instead has its own stand-alone interest expense allocation rules.

California does not allow a foreign tax credit.

Impact on California Revenue

Not applicable.

Section	Section Title
3094	Time for Payment of Corporate Estimated Taxes

Background

In general

In general, corporations are required to make quarterly estimated tax payments of their income tax liability. For a corporation whose taxable year is a calendar year, these estimated tax payments must be made by April 15, June 15, September 15, and December 15.

HOUSING AND ECONOMIC RECOVERY ACT OF 2008 (HERA)
(PL 110-289, JULY 30, 2008)

Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA")

TIPRA provided the following special rules:

In case of a corporation with assets of at least $1 billion, the payments due in July, August, and September, 2012, shall be increased to 106.25 percent of the payment otherwise due and the next required payment shall be reduced accordingly. In case of a corporation with assets of at least $1 billion, the payments due in July, August, and September, 2013, shall be increased to 100.75 percent of the payment otherwise due and the next required payment shall be reduced accordingly.

Subsequent legislation

Several public laws have been enacted since TIPRA which further increase the percentage of payments due under each of the two special rules enacted by TIPRA described above.

<u>New Federal Law (IRC section 6655)</u>

The provision makes two modifications to the corporate estimated tax payment rules.

First, in case of a corporation with assets of at least $1 billion, the payments due in July, August, and September, 2013, are increased by 16.75 percent points of the payment otherwise due and the next required payment shall be reduced accordingly.

Second, in case of a corporation with assets of at least $1 billion, the increased payments due in July, August, and September, 2012, under the special rules in TIPRA and subsequent legislation are repealed. In effect, the general rule is applied (i.e., such corporations are required to make quarterly estimated tax payments based on their income tax liability.)

<u>Effective Date</u>

The provision is effective on July 30, 2008.

<u>California Law (R&TC sections 19142 – 19150, inclusive)</u>

California does not conform to IRC section 6655 by reference, but instead has its own stand-alone rules for estimated tax payments. In general, corporations are required to make quarterly estimated tax payments of their California tax liability. For a corporation whose taxable year is a calendar year, these estimated tax payments must be made by April 15, June 15, September 15, and December 15.

HOUSING AND ECONOMIC RECOVERY ACT OF 2008 (HERA) (PL 110-289, JULY 30, 2008)

For taxable years beginning before January 1, 2009, corporate estimated tax payments were required in four equal installments. For taxable years beginning on or after January 1, 2009, corporate estimated tax payments are required as follows:

- 1st quarter installment- 30% of estimated tax
- 2nd quarter installment- 30% of estimated tax
- 3rd quarter installment- 20% of estimated tax
- 4th quarter installment- 20% of estimated tax

For corporate taxpayers who are not required to make an estimate payment installment in the first quarter, the subsequent installments are:

- 2nd quarter installment- 40% of estimated tax
- 3rd quarter installment- 30% of estimated tax
- 4th quarter installment- 30% of estimated tax.

Impact on California Revenue

Not applicable.

HUBBARD ACT OF 2008 (PL 110-317) AUGUST 29, 2008

Section	Section Title
9	Repeal of Dollar Limitation on Contributions to Funeral Trusts

Background

A qualified funeral trust is a taxable trust that arises as a result of a contract with a person engaged in the trade or business of providing funeral or burial services or property necessary to provide such services, and which meets certain other requirements. A qualified funeral trust must have as its sole purpose holding, investing, and reinvesting funds in the trust, and using such funds solely to make payments for the above-described services or property for the benefit of the beneficiaries of the trust. A qualified funeral trust may have as beneficiaries only individuals with respect to whom the above-described services or property are to be provided at death, and the trust may only accept contributions by or for the benefit of such beneficiaries. In addition, to qualify, the trust must be one that, but for the making of a required election, would be treated under the grantor trust rules as owned by the purchaser of the funeral or burial contract. Because a qualified funeral trust is not treated as a grantor trust, the trust (rather than the purchaser of the contract) is taxed on income from the trust.

A trust is not a qualified funeral trust if it accepts aggregate contributions by or for the benefit of an individual in excess of a statutory dollar limit, which is $9,000 for 2008 (and which periodically is adjusted for inflation).

New Federal Law (IRC section 685)

The provision repeals the dollar limit on contributions to qualified funeral trusts.

Effective Date

The provision is effective for taxable years beginning after August 29, 2008.

California Law (R&TC sections 17731, and 17760.5)

California conforms by reference to IRC section 685 as of the "specified date" of January 1, 2005; thus, California is not conformed to the repeal of the contribution limitation.

Impact on California Revenue

Estimated Revenue Impact of Repeal of Dollar Limitation on Contributions to Funeral Trusts For Tax Years Beginning On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
$50,000	$40,000	$40,000

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA)(PL 110-343, OCTOBER 3, 2008)
DIVISION A – EMERGENCY ECONOMIC STABILIZATON
TITLE III – TAX PROVISIONS

Section	Section Title
301	Gain or Loss from Sale or Exchange of Certain Preferred Stock

Background

Under IRC section 582(c)(1), the sale or exchange of a bond, debenture, note, or certificate or other evidence of indebtedness by a financial institution described in IRC section 582(c)(2) is not considered a sale or exchange of a capital asset. The financial institutions described in IRC section 582(c)(2) are (i) any bank (including any corporation which would be a bank except for the fact that it is a foreign corporation), (ii) any financial institution referred to in IRC section 591, which includes mutual savings banks, cooperative banks, domestic building and loan associations, and other savings institutions chartered and supervised as savings and loan or similar associations under federal or state law, (iii) any small business investment company operating under the federal Small Business Investment Act of 1958, and (iv) any business development corporation, defined as a corporation which was created by or pursuant to an act of a state legislature for purposes of promoting, maintaining, and assisting the economy and industry within such state on a regional or statewide basis by making loans to be used in trades and businesses which would generally not be made by banks within such region or state in the ordinary course of their business (except on the basis of a partial participation) and which is operated primarily for such purposes. In the case of a foreign corporation, IRC section 582(c)(1) applies only with respect to gains or losses that are effectively connected with the conduct of a banking business in the United States.

Preferred stock issued by the Federal National Mortgage Corporation ("Fannie Mae") or the Federal Home Loan Mortgage Corporation ("Freddie Mac") is not treated as indebtedness for federal income tax purposes, and therefore is not treated as an asset to which IRC section 582(c)(1) applies. Accordingly, a financial institution described in IRC section 582(c)(2) that holds Fannie Mae or Freddie Mac preferred stock as a capital asset generally will recognize capital gain or loss upon the sale or taxable exchange of that stock. IRC section 1211 provides that, in the case of a corporation, losses from sales or exchanges of capital assets are allowed only to the extent of gains from such sales or exchanges.[196] Thus, in taxable

[196] In general, corporations (other than S corporations) may carry capital losses back to each of the three taxable years preceding the loss year and forward to each of the five taxable years succeeding the loss year (IRC section 1212(a)). In the case of an S corporation, net capital losses flow through to the corporation's shareholders. Banks hold a wide range of financial assets in the ordinary course of their banking business. For convenience, those assets often are described as "loans" or "investments," but both serve the same overall purpose (to earn a return on the bank's capital and borrowings consistent with prudent banking practices). A bank's investments are subject to the same regulatory capital adequacy supervision as are its loans, and a bank may acquire only certain types of financial assets as permitted investments. Banks determine how much of their assets to hold as loans or as investments based on the exercise of their commercial and financial judgment, taking into account such factors as return on the asset, relative liquidity, and diversification objectives. As a

years in which a corporation does not recognize gain from the sale of capital assets, its capital losses do not reduce its income.

New Federal Law (Act Section 301 affecting IRC section 1211)

This uncodified provision provides that gain or loss recognized by an "applicable financial institution" from the sale or exchange of "applicable preferred stock" is treated as ordinary income or loss. An applicable financial institution is a financial institution referred to in IRC section 582(c)(2) or a depository institution holding company (as defined in section 3(w)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(w)(1)). Applicable preferred stock is preferred stock of Fannie Mae or Freddie Mac that was (i) held by the applicable financial institution on September 6, 2008, or (ii) was sold or exchanged by the applicable financial institution on or after January 1, 2008, and before September 7, 2008.[197]

In the case of a sale or exchange of applicable preferred stock on or after January 1, 2008, and before September 7, 2008, the provision applies only to taxpayers that were applicable financial institutions at the time of such sale or exchange. In the case of a sale or exchange of applicable preferred stock after September 6, 2008, by a taxpayer that held such preferred stock on September 6, 2008, the provision applies only where the taxpayer was an applicable financial institution at all times during the period beginning on September 6, 2008, and ending on the date of the sale or exchange of the applicable preferred stock. Thus, the provision is generally inapplicable to any Fannie Mae or Freddie Mac preferred stock held by a taxpayer that was not an applicable financial institution on September 6, 2008 (even if such taxpayer subsequently became an applicable financial institution).

The provision grants the Secretary authority to extend the provision to cases in which gain or loss is recognized on the sale or exchange of applicable preferred stock acquired in a carryover basis transaction by an applicable financial institution after September 6, 2008.

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result, for Federal income tax purposes, gains and losses on a bank's investment portfolio ordinarily would be considered an integral part of the business operations of the bank, and ordinary losses that pass through to the shareholder of a bank that is an S corporation therefore could comprise part of such shareholder's net operating loss for the year attributable to that banking business.

IRC section 1366(d) provides that losses that flow through to an S corporation shareholder are limited to the sum of (i) the shareholder's adjusted basis in his S corporation stock and (ii) the shareholder's adjusted basis in any indebtedness of the S corporation to the shareholder; losses in excess of basis are suspended (and allowed to the extent of basis in subsequent years). An S corporation shareholder's ability to utilize any flow-through capital loss is subject to all limitations otherwise imposed by the IRC on such shareholder. In general, under IRC section 1211, an individual (including an individual S-corporation shareholder) may deduct capital losses only against capital gains plus up to $3,000 of ordinary income; in addition, an individual may carry excess capital losses forward but not back.

[197] On September 7, 2008, the Federal Housing Finance Agency ("FHFA") placed both Fannie Mae and Freddie Mac in a conservatorship. Also on September 7, 2008, FHFA and the Treasury Department entered into Preferred Stock Purchase Agreements, contractual agreements between the Treasury and the conserved entities. Under these agreements, the Treasury Department received senior preferred stock in the two companies and warrants to buy 79.9% of the common stock of such companies.

For example, if after September 6, 2008, Bank A, an entity that was an applicable financial institution at all times during the period beginning on September 6, 2008, acquired assets of Bank T, an entity that also was an applicable financial institution at all times during the period beginning on September 6, 2008, in a transaction in which no gain or loss was recognized under IRC section 368(a)(1), regulations could provide that Fannie Mae and Freddie Mac stock that was applicable preferred stock in the hands of Bank T will continue to be applicable preferred stock in the hands of Bank A.

In addition, the Secretary may, through regulations, extend the provision to cases in which the applicable financial institution is a partner in a partnership that (i) held preferred stock of Fannie Mae or Freddie Mac on September 6, 2008, and later sold or exchanged such stock, or (ii) sold or exchanged such preferred stock on or after January 1, 2008, and before September 7, 2008. It is intended that Treasury guidance will provide that loss (or gain) attributable to Fannie Mae or Freddie Mac preferred stock of a partnership is characterized as ordinary in the hands of a partner only if the partner is an applicable financial institution, and only if the institution would have been eligible for ordinary treatment under this section of EESA had the institution held the underlying preferred stock directly for the time period during which both (i) the partnership holds the preferred stock and (ii) the institution holds substantially the same partnership interest.

In particular, substantial amounts of the preferred stock of Fannie Mae and Freddie Mac are held through “pass-through trusts” analyzed as partnerships for federal income tax purposes. Substantially all the assets of such a pass-through trust comprise Fannie Mae or Freddie Mac preferred stock, and the trust in turn passes through dividends received on such stock to its two outstanding classes of certificates (partnership interests): an auction-rate class, where the share of the underlying preferred stock dividend is determined by periodic auctions, and a residual class, which receives the remainder of any dividends received on the underlying stock. The bill’s delegation of authority to the Secretary anticipates that regulations will promptly be issued confirming in general that losses recognized by such a trust on or after January 1, 2008, in respect of the preferred stock of Fannie Mae or Freddie Mac that it acquired before September 6, 2008, will be characterized as ordinary loss in the hands of a certificate holder that is an applicable financial institution and that would be eligible for the relief contemplated by this provision if the applicable financial institution had held the underlying preferred stock directly for the same period that it held the pass-through certificate. In light of the substantial amount of such pass-through certificates in the marketplace, and the importance of the prompt resolution of the character of any resulting losses allocated to certificate holders that are applicable financial institutions for purposes of their regulatory and investor financial statement filings, unnecessary disruptions to the marketplace could best be avoided if the Secretary were to exercise the regulatory authority granted under the provision to address this case as soon as possible and, in any event, by October 31, 2008.

Effective Date

This provision applies to sales or exchanges occurring after December 31, 2007, in taxable years ending after such date.

California Law (R&TC sections 18151, 24347 and 24990)

California conforms to IRC sections 582 and 1211 as of the "specified date" of January 1, 2005. Thus, California is not conformed to this provision.

Impact on California Revenue

Estimated Revenue Impact of Gain or Loss from Sale or Exchange of Certain Preferred Stock For Tax Years Beginning On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$46,000,000	-$2,900,000	$500,000

Estimates are based on a proration of federal projections developed for the Emergency Economic Stabilization Act of 2008.

Section	Section Title
302	Special Rules for Tax Treatment of Executive Compensation of Employers Participating in the Troubled Assets Relief Program

Background

In general

An employer generally may deduct reasonable compensation for personal services as an ordinary and necessary business expense. IRC sections 162(m) and 280G provide explicit limitations on the deductibility of compensation expenses in the case of corporate employers.

IRC section 162(m)

In general

The otherwise allowable deduction for compensation paid or accrued with respect to a covered employee of a publicly held corporation[198] is limited to no more than $1 million per year.[199] The deduction limitation applies when the deduction would otherwise be taken. Thus, for example, in the case of compensation resulting from a transfer of property in connection with the performance of services, such compensation is taken into account in applying the deduction limitation for the year for which the compensation is deductible under IRC section 83 (i.e., generally the year in which the employee's right to the property is no longer subject to a substantial risk of forfeiture).

Covered employees

IRC section 162(m) defines a covered employee as (1) the chief executive officer of the corporation (or an individual acting in such capacity) as of the close of the taxable year and (2) the four most highly compensated officers for the taxable year (other than the chief executive officer). Treasury regulations under IRC section 162(m) provide that whether an employee is the chief executive officer or among the four most highly compensated officers should be determined pursuant to the executive compensation disclosure rules promulgated under the Securities Exchange Act of 1934 ("Exchange Act").

In 2006, the Securities and Exchange Commission amended certain rules relating to executive compensation, including which executive officers' compensation must be disclosed under the Exchange Act. Under the new rules, such officers consist of (1) the principal executive officer (or an individual acting in such capacity), (2) the principal financial officer (or an individual acting in such capacity), and (3) the three most highly compensated executive officers, other than the principal executive officer or financial officer.

In response to the Securities and Exchange Commission's new disclosure rules, the Internal Revenue Service issued updated guidance on identifying which employees are covered by IRC section 162(m). [200] The new guidance provides that "covered employee" means any employee who is (1) the principal executive officer (or an individual acting in such capacity) defined in reference to the Exchange Act, or (2) among the three most highly compensated officers for the taxable year (other than the principal executive officer), again defined by reference to the Exchange Act. Thus, under current guidance, only four employees are covered under IRC section 162(m) for any taxable year. Under Treasury regulations, the

[198] A corporation is treated as publicly held if it has a class of common equity securities that is required to be registered under section 12 of the Securities Exchange Act of 1934.
[199] IRC section 162(m). This deduction limitation applies for purposes of the regular income tax and the alternative minimum tax.
[200] IRS Notice 2007-49, 2007-25 I.R.B. 1429.

requirement that the individual meet the criteria as of the last day of the taxable year applies to both the principal executive officer and the three highest compensated officers.[201]

Compensation subject to the deduction limitation

In general

Unless specifically excluded, the deduction limitation applies to all remuneration for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash. If an individual is a covered employee for a taxable year, the deduction limitation applies to all compensation not explicitly excluded from the deduction limitation, regardless of whether the compensation is for services as a covered employee and regardless of when the compensation was earned. The $1 million cap is reduced by excess parachute payments (as defined in IRC section 280G, discussed below) that are not deductible by the corporation.

Certain types of compensation are not subject to the deduction limit and are not taken into account in determining whether other compensation exceeds $1 million. The following types of compensation are not taken into account: (1) remuneration payable on a commission basis; (2) remuneration payable solely on account of the attainment of one or more performance goals if certain outside director and shareholder approval requirements are met ("performance-based compensation"); (3) payments to a tax-qualified retirement plan (including salary reduction contributions); (4) amounts that are excludable from the executive's gross income (such as employer-provided health benefits and miscellaneous fringe benefits (IRC section 132)); and (5) any remuneration payable under a written binding contract which was in effect on February 17, 1993. In addition, remuneration does not include compensation for which a deduction is allowable after a covered employee ceases to be a covered employee. Thus, the deduction limitation often does not apply to deferred compensation that is otherwise subject to the deduction limitation (e.g., is not performance-based compensation) because the payment of compensation is deferred until after termination of employment.

Performance-based compensation

Compensation qualifies for the exception for performance-based compensation only if: (1) it is paid solely on account of the attainment of one or more performance goals, (2) the performance goals are established by a compensation committee consisting solely of two or more outside directors,[202] (3) the material terms under which the compensation is to be paid, including the performance goals, are disclosed to and approved by the shareholders in a

[201] Treas. Reg. sec. 1.162-27(c)(2).
[202] A director is considered an outside director if he or she is not a current employee of the corporation (or related entities), is not a former employee of the corporation (or related entities) who is receiving compensation for prior services (other than benefits under a tax-qualified retirement plan), was not an officer of the corporation (or related entities) at any time, and is not currently receiving compensation for personal services in any capacity (e.g., for services as a consultant) other than as a director.

separate vote prior to payment, and (4) prior to payment, the compensation committee certifies that the performance goals and any other material terms were in fact satisfied.

Compensation (other than stock options or other stock appreciation rights) is not treated as paid solely on account of the attainment of one or more performance goals unless the compensation is paid to the particular executive pursuant to a pre-established objective performance formula or standard that precludes discretion. Stock options or other stock appreciation rights generally are treated as meeting the exception for performance-based compensation, provided that the requirements for outside director and shareholder approval are met (without the need for certification that the performance standards have been met), because the amount of compensation attributable to the options or other rights received by the executive would be based solely on an increase in the corporation's stock price. Stock-based compensation is not treated as performance-based if it is dependent on factors other than corporate performance. For example, if a stock option is granted to an executive with an exercise price that is less than the current fair market value of the stock at the time of grant, then the executive would have the right to receive compensation on the exercise of the option even if the stock price decreases or stays the same. In contrast to options or other stock appreciation rights, grants of restricted stock are not inherently performance-based because the executive may receive compensation even if the stock price decreases or stays the same. Thus, a grant of restricted stock does not satisfy the definition of performance-based compensation unless the grant or vesting of the restricted stock is based upon the attainment of a performance goal and otherwise satisfies the standards for performance-based compensation.

IRC section 280G

In general

In some cases, a compensation agreement for a corporate executive may provide for payments to be made if there is a change in control of the executive's employer, even if the executive does not lose his or her job as part of the change in control. Such payments are sometimes referred to as "golden parachute payments." The IRC contains limits on the amount of certain types of such payments, referred to as "excess parachute payments." Excess parachute payments are not deductible by a corporation.[203] In addition, an excise tax is imposed on the recipient of any excess parachute payment equal to 20 percent of the amount of such payment.[204]

Definition of Parachute Payment

A "parachute payment" is any payment in the nature of compensation to (or for the benefit of) a disqualified individual which is contingent on a change in the ownership or effective control of a corporation or on a change in the ownership of a substantial portion of the assets of a

[203] IRC section 280G.
[204] IRC section 4999.

corporation (“acquired corporation”), if the aggregate present value of all such payments made or to be made to the disqualified individual equals or exceeds three times the individual’s “base amount.” The individual’s base amount is the average annual compensation payable by the acquired corporation and includible in the individual’s gross income over the five-taxable years of such individual preceding the individual’s taxable year in which the change in ownership or control occurs.

The term parachute payment also includes any payment in the nature of compensation to a disqualified individual if the payment is made pursuant to an agreement which violates any generally enforced securities laws or regulations.

Certain amounts are not considered parachute payments, including payments under a qualified retirement plan, and payments that are reasonable compensation for services rendered on or after the date of the change in control. In addition, the term parachute payment does not include any payment to a disqualified individual with respect to a small business corporation or a corporation no stock of which was readily tradable, if certain shareholder approval requirements are satisfied.

Disqualified individual

A disqualified individual is any individual who is an employee, independent contractor, or other person specified in Treasury regulations who performs personal services for the corporation and who is an officer, shareholder, or highly compensated individual of the corporation. Personal service corporations and similar entities generally are treated as individuals for this purpose. A highly compensated individual is defined for this purpose as an employee (or a former employee) who is among the highest-paid one percent of individuals performing services for the corporation (or an affiliated corporation) or the 250 highest paid individuals who perform services for a corporation (or affiliated group).

Excess parachute payments

In general, excess parachute payments are any parachute payments in excess of the base amount allocated to the payment. The amount treated as an excess parachute payment is reduced by the portion of the payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered before the change in control.

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA) (PL 110-343, OCTOBER 3, 2008)

<u>New Federal Law (IRC sections 162 and 280G)</u>

IRC section 162

In general

The provision provides that the IRC section 162(m) limit is reduced to $500,000 in the case of otherwise deductible compensation of a covered executive for any applicable taxable year of an applicable employer.

An applicable employer means any employer from which one or more troubled assets are acquired under the “troubled assets relief program” (“TARP”) established by the bill if the aggregate amount of the assets so acquired for all taxable years (including assets acquired through a direct purchase by the Treasury Department, within the meaning of section 113(c) of Title I of EESA) exceeds $300,000,000. However, such term does not include any employer from which troubled assets are acquired by the Treasury Department solely through direct purchases (within the meaning of section 113(c) of Title I of EESA). For example, if a firm sells $250,000,000 in assets through an auction system managed by the Treasury Department, and $100,000,000 to the Treasury Department in direct purchases, then the firm is an applicable employer.

Conversely, if all $350,000,000 in sales take the form of direct purchases, then the firm would not be an applicable employer. Unlike IRC section 162(m), an applicable employer under this provision is not limited to publicly held corporations (or even limited to corporations). For example, an applicable employer could be a partnership if the partnership is an employer from which a troubled asset is acquired. The aggregation rules of IRC sections 414(b) and (c) apply in determining whether an employer is an applicable employer. However, these rules are applied disregarding the rules for brother-sister controlled groups and combined groups in IRC sections 1563(a)(2) and (3). Thus, this aggregation rule only applies to parent-subsidiary controlled groups. A similar controlled group rule applies for trades and businesses under common control.

The result of this aggregation rule is that all corporations in the same controlled group are treated as a single employer for purposes of identifying the covered executives of that employer and all compensation from all members of the controlled group are taken into account for purposes of applying the $500,000 deduction limit. Further, all sales of assets under the TARP from all members of the controlled group are considered in determining whether such sales exceed $300,000,000.

An applicable taxable year with respect to an applicable employer means the first taxable year which includes any portion of the period during which the authorities for the TARP established under the bill are in effect (the “authorities period”) if the aggregate amount of troubled assets acquired from the employer under that authority during the taxable year (when added to the aggregate amount so acquired for all preceding taxable years) exceeds

$300,000,000, and includes any subsequent taxable year which includes any portion of the authorities period.

A special rule applies in the case of compensation that relates to services that a covered executive performs during an applicable taxable year but that is not deductible until a later year ("deferred deduction executive remuneration"), such as nonqualified deferred compensation. Under the special rule, the unused portion (if any) of the $500,000 limit for the applicable tax year is carried forward until the year in which the compensation is otherwise deductible, and the remaining unused limit is then applied to the compensation.

For example, assume a covered executive is paid $400,000 in cash salary by an applicable employer in 2008 (assuming 2008 is an applicable taxable year) and the covered executive earns $100,000 in nonqualified deferred compensation (along with the right to future earnings credits) payable in 2020. Assume further that the $100,000 has grown to $300,000 in 2020. The full $400,000 in cash salary is deductible under the $500,000 limit in 2008. In 2020, the applicable employer's deduction with respect to the $300,000 will be limited to $100,000 (the lesser of the $300,000 in deductible compensation before considering the special limitation, and $500,000 less $400,000, which represents the unused portion of the $500,000 limit from 2008).

Deferred deduction executive remuneration that is properly deductible in an applicable taxable year (before application of the limitation under the provision) but is attributable to services performed in a prior applicable taxable year is subject to the special rule described above and is not double-counted. For example, assume the same facts as above, except that the nonqualified deferred compensation is deferred until 2009 and that 2009 is an applicable taxable year. The employer's deduction for the nonqualified deferred compensation for 2009 would be limited to $100,000 (as in the example above). The limit that would apply under the provision for executive remuneration that is in a form other than deferred deduction executive remuneration and that is otherwise deductible for 2009 is $500,000. For example, if the covered executive is paid $500,000 in cash compensation for 2009, all $500,000 of that cash compensation would be deductible in 2009 under the provision.

Covered executive

The term covered executive means any individual who is the chief executive officer or the chief financial officer of an applicable employer, or an individual acting in that capacity, at any time during a portion of the taxable year that includes the authorities period. It also includes any employee who is one of the three highest compensated officers of the applicable employer for the applicable taxable year (other than the chief executive officer or the chief financial officer and only taking into account employees employed during any portion of the taxable year that includes the authorities period).

The determination of the three highest compensated officers is made on the basis of the shareholder disclosure rules for compensation under the Exchange Act, except to the extent that the shareholder disclosure rules are inconsistent with the provision.[205] Such shareholder disclosure rules are applied without regard to whether those rules actually apply to the employer under the Exchange Act. If an employee is a covered executive with respect to an applicable employer for any applicable taxable year, the employee will be treated as a covered executive for all subsequent applicable taxable years (and will be treated as a covered executive for purposes of any subsequent taxable year for purposes of the special rule for deferred deduction executive remuneration).

Executive remuneration

The provision generally incorporates the present law definition of applicable employee remuneration. However, the present law exceptions for remuneration payable on commission and performance-based compensation do not apply for purposes of the new $500,000 limit. In addition, the new $500,000 limit only applies to executive remuneration which is attributable to services performed by a covered executive during an applicable taxable year. For example, assume the same facts as in the example above, except that the covered executive also receives in 2008 a payment of $300,000 in nonqualified deferred compensation that was attributable to services performed in 2006. Such payment is not treated as executive remuneration for purposes of the new $500,000 limit.

Other rules

The modification to IRC section 162(m) provides the same coordination rules with disallowed parachute payment and stock compensation of insiders in expatriated corporations as exist under present law IRC section 162(m). Thus, the $500,000 deduction limit under this section is reduced (but not below zero) by any parachute payments (including parachute payments under the expanded definition under this provision) paid during the authorities period and any payment of the excise tax under IRC section 4985 for stock compensation of insiders in expatriated corporations.

[205] For example, the shareholder disclosure rules require the reporting of the compensation of the three most highly compensated executive officers (other than the principal executive officer and the principal financial officer) who were serving as executive officers at the end of the last completed fiscal year and up to two additional individuals from whom disclosure would have been provided but for the fact that the individual was not serving as an executive officer at the end of the last completed fiscal year. 17 C.F.R. sec. 229.402(a)(3)(iii), (iv). For purposes of the provision, the term “officer” is intended to mean those “executive officers” whose compensation is subject to reporting under the Exchange Act. Under the provision, however, an individual’s status as one of the three most highly-compensated officers takes into account only executive officers employed during the authorities period, regardless of whether the individual serves as an executive officer at year end. Additionally, the shareholder disclosure rules measure compensation for purposes of determining “high three” status by reference to total compensation for the last completed fiscal year, and compensation is measured without regard to whether the compensation is includible in an executive officer’s gross income. It is intended that this broad measurement of compensation apply for purposes of the provision; however, the measurement period for purposes of the provision is the applicable taxable year for which “high three” status is being determined.

The modification authorizes the Secretary of the Treasury to prescribe such guidance, rules, or regulations as are necessary to carry out the purposes of the $500,000 deduction limit, including the application of the limit in the case of any acquisition, merger, or reorganization of an applicable employer.

IRC section 280G

The EESA also modifies IRC section 280G by expanding the definition of parachute payment in the case of a covered executive of an applicable employer. For this purpose, the terms “covered executive,” “applicable taxable year,” and “applicable employer” have the same meaning as under the modifications to IRC section 162(m) (described above).

Under the modification, a parachute payment means any payments in the nature of compensation to (or for the benefit of) a covered executive made during an applicable taxable year on account of an applicable severance from employment during the authorities period if the aggregate present value of such payments equals or exceeds an amount equal to three times the covered executive’s base amount. An applicable severance from employment is any severance from employment of a covered executive (1) by reason of an involuntary termination of the executive by the employer or (2) in connection with a bankruptcy, liquidation, or receivership of the employer.

Whether a payment is on account of the employee’s severance from employment is generally determined in the same manner as under present law. Thus, a payment is on account of the employee’s severance from employment if the payment would not have been made at that time if the severance from employment had not occurred. Such payments include amounts that are payable upon severance from employment (or separation from service), vest, or are no longer subject to a substantial risk of forfeiture on account of such a separation, or are accelerated on account of severance from employment. As under present law, the modified definition of parachute payment does not include amounts paid to a covered executive from certain tax qualified retirement plans.

A parachute payment during an applicable taxable year that is paid on account of a covered executive’s applicable severance from employment is nondeductible on the part of the employer (and the covered executive is subject to the IRC section 4999 excise tax) to the extent of the amount of the payment that is equal to the excess over the employee’s base amount that is allocable to such payment. For example, assume that a covered executive’s annualized includible compensation is $1 million and the covered executive’s only parachute payment under the provision is a lump sum payment of $5 million. The covered executive’s base amount is $1 million and the excess parachute payment is $4 million.

The modifications to IRC section 280G do not apply in the case of a payment that is treated as a parachute payment under present law. The modifications further authorize the Secretary of Treasury to issue regulations to carry out the purposes of the provision, including the application of the provision in the case of a covered executive who receives payments some of which are treated as parachute payments under present law IRC section

280G and others of which are treated as parachute payments on account of this provision, and the application of the provision in the event of any acquisition, merger, or reorganization of an applicable employer. The regulations shall also prevent the avoidance of the application of the provision through the mischaracterization of a severance from employment as other than an applicable severance from employment. It is intended that the regulations prevent the avoidance of the provision through the acceleration, delay, or other modification of payment dates with respect to existing compensation arrangements.

Effective Date

The provision is effective for taxable years ending on or after date of enactment, except that the modifications to IRC section 280G are effective for payments with respect to severances occurring during the authorities period.

California Law (R&TC sections 17201 and 24343)

IRC section 162

California conforms under the PITL and the CTL to the federal treatment of certain excessive employee remuneration under IRC section 162 as of the "specified date" of January 1, 2005.

IRC section 280G

California conforms under the PITL to the federal treatment of golden parachute payments under IRC section 280G as of the "specified date" of January 1, 2005. There is no provision in the CTL for golden parachute payments; thus, for corporations, California is not conformed to this provision.

Impact on California Revenue

Estimated Revenue Impact of Special Rules for Tax Treatment of Executive Compensation of Employers Participating in the Troubled Assets Relief Program (TARP) For Tax Years Ending After October 3, 2008, and for Severances Generally Occurring After October 3, 2008 and Before January 1, 2010 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
Indeterminate	Indeterminate	Indeterminate

The Joint Committee on Taxation, in its estimate of the federal bill, notes that the amount of revenue gain is indeterminate. It will depend on how the underlying TARP program is implemented, including how many and which firms sell troubled assets to the Treasury, and whether sold directly or through an auction process. At this time, data is not available to make an independent estimate of the revenue that would be generated from conforming to this provision.

Section	Section Title
303	Extension of Exclusion of Income from Discharge of Qualified Principal Residence Indebtedness

Background

In general

Gross income includes income that is realized by a debtor from the discharge of indebtedness, subject to certain exceptions for debtors in Title 11 bankruptcy cases, insolvent debtors, certain student loans, certain farm indebtedness, and certain real property business indebtedness (IRC sections 61(a)(12) and 108).[206] In cases involving discharges of indebtedness that are excluded from gross income under the exceptions to the general rule, taxpayers generally reduce certain tax attributes, including basis in property, by the amount of the discharge of indebtedness.

The amount of discharge of indebtedness excluded from income by an insolvent debtor not in a Title 11 bankruptcy case cannot exceed the amount by which the debtor is insolvent. In the case of a discharge in bankruptcy or where the debtor is insolvent, any reduction in basis may not exceed the excess of the aggregate bases of properties held by the taxpayer immediately after the discharge over the aggregate of the liabilities of the taxpayer immediately after the discharge (IRC section 1017).

For all taxpayers, the amount of discharge of indebtedness generally is equal to the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy the debt. These rules generally apply to the exchange of an old obligation for a new obligation, including a modification of indebtedness that is treated as an exchange (a debt-for-debt exchange).

Qualified principal residence indebtedness

An exclusion from gross income is provided for any discharge of indebtedness income by reason of a discharge (in whole or in part) of qualified principal residence indebtedness.

[206] A debt cancellation which constitutes a gift or bequest is not treated as income to the donee debtor (IRC section 102).

Qualified principal residence indebtedness means acquisition indebtedness (within the meaning of section 163(h)(3)(B), except that the dollar limitation is $2,000,000) with respect to the taxpayer's principal residence. Acquisition indebtedness with respect to a principal residence generally means indebtedness which is incurred in the acquisition, construction, or substantial improvement of the principal residence of the individual and is secured by the residence. It also includes refinancing of such indebtedness to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness. For these purposes, the term "principal residence" has the same meaning as under IRC section 121.

If, immediately before the discharge, only a portion of a discharged indebtedness is qualified principal residence indebtedness, the exclusion applies only to so much of the amount discharged as exceeds the portion of the debt which is not qualified principal residence indebtedness. Thus, assume that a principal residence is secured by an indebtedness of $1 million, of which $800,000 is qualified principal residence indebtedness. If the residence is sold for $700,000 and $300,000 debt is discharged, then only $100,000 of the amount discharged may be excluded from gross income under the qualified principal residence indebtedness exclusion.

The basis of the individual's principal residence is reduced by the amount excluded from income under the provision. The qualified principal residence indebtedness exclusion does not apply to a taxpayer in a Title 11 case; instead the general exclusion rules apply. In the case of an insolvent taxpayer not in a Title 11 case, the qualified principal residence indebtedness exclusion applies unless the taxpayer elects to have the general exclusion rules apply instead.

The exclusion does not apply to the discharge of a loan if the discharge is on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or to the financial condition of the taxpayer.

The exclusion for qualified principal residence indebtedness is effective for discharges of indebtedness before January 1, 2010.

New Federal Law (IRC Section 108)

The provision extends for three additional years the exclusion from gross income for discharges of qualified principal residence indebtedness.

Effective Date

The provision is effective for discharges of indebtedness on or after January 1, 2010, and before January 1, 2013.

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA)
(PL 110-343, OCTOBER 3, 2008)

California Law (R&TC section 17144.5)

California conforms to the federal rules relating to the exclusion of income from qualified mortgage debt forgiveness with the following modifications:[207]

- The California exclusion applies to discharges of qualified principal residence indebtedness occurring on or after January 1, 2007, and before January 1, 2009.
- The maximum amount of qualified principal residence indebtedness is $800,000 ($400,000 in the case of a married/registered domestic partner (RDP) individual filing a separate return).
- The total amount that may be excluded from gross income is limited to $250,000 ($125,000 in the case of a married/RDP individual filing a separate return).

Impact on California Revenue

Estimated Revenue Impact of Extension of Exclusion of Income from Discharge of Qualified Principal Residence For Tax Years Beginning On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$10,000,000	-$9,000,000	-$7,000,000

Estimates are based on a proration of federal projections developed for the Emergency Economic Stabilization Act of 2008, adjusted to reflect California differences. The federal liability amount is prorated to California using proration factor of 4.3 percent for 2009 and 2010, 4.7percent for 2011, and 5.0 percent for 2012. California liability estimates are also adjusted to reflect a maximum amount of qualified principal residence indebtedness of $800,000, as well as a maximum amount eligible to be excluded form gross income of $250,000.

[207] Ch. 282, Laws of 2008 (SB 1055); R&TC section 17144.5.

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA) (PL 110-343, OCTOBER 3, 2008)

DIVISION B, ENERGY IMPROVEMENT AND EXTENSION ACT OF 2008, TITLE I – ENERGY PRODUCTION INCENTIVES

SUBTITLE A – RENEWABLE ENERGY INCENTIVES

Sections	Section Title
101 & 102	Renewable Energy Credit / Production Credit for Electricity Produced from Marine Renewables

Background

In general

An income tax credit is allowed for the production of electricity from qualified energy resources at qualified facilities.[208] Qualified energy resources comprise wind, closed-loop biomass, open-loop biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, and qualified hydropower production. Qualified facilities are, generally, facilities that generate electricity using qualified energy resources. To be eligible for the credit, electricity produced from qualified energy resources at qualified facilities must be sold by the taxpayer to an unrelated person.

Credit amounts and credit period

In general

The base amount of the electricity production credit is 1.5 cents per kilowatt-hour (indexed annually for inflation) of electricity produced. The amount of the credit was 2.1 cents per kilowatt-hour for 2008. A taxpayer may generally claim a credit during the 10-year period commencing with the date the qualified facility is placed in service. The credit is reduced for grants, tax-exempt bonds, subsidized energy financing, and other credits.

Credit phaseout

The amount of credit a taxpayer may claim is phased out as the market price of electricity exceeds certain threshold levels. The electricity production credit is reduced over a 3 cent phaseout range to the extent the annual average contract price per kilowatt-hour of electricity sold in the prior year from the same qualified energy resource exceeds 8 cents (adjusted for inflation; 11.8 cents for 2008).

[208] IRC section 45. In addition to the electricity production credit, IRC section 45 also provides income tax credits for the production of Indian coal and refined coal at qualified facilities.

Reduced credit periods and credit amounts

Generally, in the case of open-loop biomass facilities (including agricultural livestock waste nutrient facilities), geothermal energy facilities, solar energy facilities, small irrigation power facilities, landfill gas facilities, and trash combustion facilities placed in service before August 8, 2005, the 10-year credit period is reduced to five years commencing on the date the facility was originally placed in service. However, for qualified open-loop biomass facilities (other than a facility described in IRC section 45(d)(3)(A)(i) that uses agricultural livestock waste nutrients) placed in service before October 22, 2004, the five-year period commences on January 1, 2005. In the case of a closed-loop biomass facility modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, the credit period begins no earlier than October 22, 2004.

In the case of open-loop biomass facilities (including agricultural livestock waste nutrient facilities), small irrigation power facilities, landfill gas facilities, trash combustion facilities, and qualified hydropower facilities, the otherwise allowable credit amount is 0.75 cent per kilowatt-hour, indexed for inflation measured after 1992 (1 cent per kilowatt-hour for 2008).

Other limitations on credit claimants and credit amounts

In general, in order to claim the credit, a taxpayer must own the qualified facility and sell the electricity produced by the facility to an unrelated party. A lessee or operator may claim the credit in lieu of the owner of the qualifying facility in the case of qualifying open-loop biomass facilities and in the case of closed-loop biomass facilities modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass. In the case of a poultry waste facility, the taxpayer may claim the credit as a lessee or operator of a facility owned by a governmental unit.

For all qualifying facilities, other than closed-loop biomass facilities modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, the amount of credit a taxpayer may claim is reduced by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits, but the reduction cannot exceed 50 percent of the otherwise allowable credit. In the case of closed-loop biomass facilities modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, there is no reduction in credit by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits.

The credit for electricity produced from renewable sources is a component of the general business credit.[209] Generally, the general business credit for any taxable year may not exceed the amount by which the taxpayer's net income tax exceeds the greater of the tentative minimum tax or so much of the net regular tax liability as exceeds $25,000. Excess credits may be carried back one year and forward up to 20 years.

[209] IRC section 38(b)(8).

A taxpayer's tentative minimum tax is treated as being zero for purposes of determining the tax liability limitation with respect to the section 45 credit for electricity produced from a facility (placed in service after October 22, 2004) during the first four years of production beginning on the date the facility is placed in service.

Qualified facilities

Wind energy facility

A wind energy facility is a facility that uses wind to produce electricity. To be a qualified facility, a wind energy facility must be placed in service after December 31, 1993, and before January 1, 2009.

Closed-loop biomass facility

A closed-loop biomass facility is a facility that uses any organic material from a plant that is planted exclusively for the purpose of being used at a qualifying facility to produce electricity. In addition, a facility can be a closed-loop biomass facility if it is a facility that is modified to use closed-loop biomass to co-fire with coal, with other biomass, or with both coal and other biomass, but only if the modification is approved under the Biomass Power for Rural Development Programs or is part of a pilot project of the Commodity Credit Corporation.

To be a qualified facility, a closed-loop biomass facility must be placed in service after December 31, 1992, and before January 1, 2009. In the case of a facility using closed-loop biomass but also co-firing the closed-loop biomass with coal, other biomass, or coal and other biomass, a qualified facility must be originally placed in service and modified to co-fire the closed-loop biomass at any time before January 1, 2009.

Open-loop biomass (including agricultural livestock waste nutrients) facility

An open-loop biomass facility is a facility that uses open-loop biomass to produce electricity. For purposes of the credit, open-loop biomass is defined as: (1) any agricultural livestock waste nutrients, or (2) any solid, nonhazardous, cellulosic waste material or any lignin material that is segregated from other waste materials and which is derived from:

- Forest-related resources, including mill and harvesting residues, precommercial thinnings, slash, and brush;
- Solid wood waste materials, including waste pallets, crates, dunnage, manufacturing and construction wood wastes, and landscape or right-of-way tree trimmings; or
- Agricultural sources, including orchard tree crops, vineyard, grain, legumes, sugar, and other crop by-products or residues.

Agricultural livestock waste nutrients are defined as agricultural livestock manure and litter, including bedding material for the disposition of manure. Wood waste materials do not qualify as open-loop biomass to the extent they are pressure treated, chemically treated, or painted. In addition, municipal solid waste, gas derived from the biodegradation of solid waste, and paper which is commonly recycled do not qualify as open-loop biomass. Open-loop biomass does not include closed-loop biomass or any biomass burned in conjunction with fossil fuel (co-firing) beyond such fossil fuel required for start up and flame stabilization.

In the case of an open-loop biomass facility that uses agricultural livestock waste nutrients, a qualified facility is one that was originally placed in service after October 22, 2004, and before January 1, 2009, and has a nameplate capacity rating which is not less than 150 kilowatts. In the case of any other open-loop biomass facility, a qualified facility is one that was originally placed in service before January 1, 2009.

Geothermal facility

A geothermal facility is a facility that uses geothermal energy to produce electricity. Geothermal energy is energy derived from a geothermal deposit that is a geothermal reservoir consisting of natural heat that is stored in rocks or in an aqueous liquid or vapor (whether or not under pressure). To be a qualified facility, a geothermal facility must be placed in service after October 22, 2004, and before January 1, 2009.

Solar facility

A solar facility is a facility that uses solar energy to produce electricity. To be a qualified facility, a solar facility must be placed in service after October 22, 2004, and before January 1, 2006.

Small irrigation facility

A small irrigation power facility is a facility that generates electric power through an irrigation system canal or ditch without any dam or impoundment of water. The installed capacity of a qualified facility must be at least 150 kilowatts but less than five megawatts. To be a qualified facility, a small irrigation facility must be originally placed in service after October 22, 2004, and before January 1, 2009.

Landfill gas facility

A landfill gas facility is a facility that uses landfill gas to produce electricity. Landfill gas is defined as methane gas derived from the biodegradation of municipal solid waste. To be a qualified facility, a landfill gas facility must be placed in service after October 22, 2004, and before January 1, 2009.

Trash combustion facility

Trash combustion facilities are facilities that burn municipal solid waste (garbage) to produce steam to drive a turbine for the production of electricity. To be a qualified facility, a trash combustion facility must be placed in service after October 22, 2004, and before January 1, 2009. A qualified trash combustion facility includes a new unit, placed in service after October 22, 2004, that increases electricity production capacity at an existing trash combustion facility. A new unit generally would include a new burner/boiler and turbine. The new unit may share certain common equipment, such as trash handling equipment, with other pre-existing units at the same facility. Electricity produced at a new unit of an existing facility qualifies for the production credit only to the extent of the increased amount of electricity produced at the entire facility.

Hydropower facility

A qualifying hydropower facility is: (1) a facility that produced hydroelectric power (a hydroelectric dam) prior to August 8, 2005, at which efficiency improvements or additions to capacity have been made after such date and before January 1, 2009, that enable the taxpayer to produce incremental hydropower, or (2) a facility placed in service before August 8, 2005, that did not produce hydroelectric power (a nonhydroelectric dam) on such date, and to which turbines or other electricity generating equipment have been added after such date and before January 1, 2009.

At an existing hydroelectric facility, the taxpayer may claim credit only for the production of incremental hydroelectric power. Incremental hydroelectric power for any taxable year is equal to the percentage of average annual hydroelectric power produced at the facility attributable to the efficiency improvement or additions of capacity determined by using the same water flow information used to determine an historic average annual hydroelectric power production baseline for that facility. The Federal Energy Regulatory Commission will certify the baseline power production of the facility and the percentage increase due to the efficiency and capacity improvements.

At a nonhydroelectric dam, the facility must be licensed by the Federal Energy Regulatory Commission and meet all other applicable environmental, licensing, and regulatory requirements and the turbines or other generating devices must be added to the facility after August 8, 2005 and before January 1, 2009. In addition, there must not be any enlargement of the diversion structure, construction or enlargement of a bypass channel, or the impoundment or any withholding of additional water from the natural stream channel.

Table 1 - Summary of Section 45 Credit for Electricity Produced from Certain Renewable Resources

Eligible electricity production activity	Credit amount for 2007 (cents per kilowatt-hour)	Credit period for facilities placed in service on or before August 8, 2005 (years from placed-in-service date)	Credit period for facilities placed in service after August 8, 2005 (years from placed-in-service date)
Wind	2.1	10	10
Closed-loop biomass	2.1	10[1]	10
Open-loop biomass (including agricultural livestock waste nutrient facilities)	1	5[2]	10
Geothermal	2	5	10
Solar (pre-2006 facilities only)	2	5	10
Small irrigation power	1	5	10
Municipal solid waste (including landfill gas facilities and trash combustion facilities)	1	5	10
Qualified hydropower	1	N/A	10

[1] In the case of certain co-firing closed-loop facilities, the credit period begins no earlier than October 22, 2004.
[2] For certain facilities placed in service before October 22, 2004, the five-year credit period commences on January 1, 2005.

Taxation of cooperatives and their patrons

For federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one exception: the cooperative may exclude from its taxable income distributions of patronage dividends. Generally, a cooperative that is subject to the cooperative tax rules of subchapter T of the IRC[210] is permitted a deduction for patronage dividends paid only to the extent of net income that is derived from transactions with patrons who are members of the cooperative.[211] The availability of such deductions from taxable income has the effect of allowing the cooperative to be treated like a conduit with respect to profits derived from transactions with patrons who are members of the cooperative.

Eligible cooperatives may elect to pass any portion of the credit through to their patrons. An eligible cooperative is defined as a cooperative organization that is owned more than 50 percent by agricultural producers or entities owned by agricultural producers. The credit may be apportioned among patrons eligible to share in patronage dividends on the basis of the quantity or value of business done with or for such patrons for the taxable year.

[210] IRC sections 1381-1383.
[211] IRC section 1382.

The election must be made on a timely filed return for the taxable year and, once made, is irrevocable for such taxable year.

New Federal Law (IRC section 45)

Act section 101 – Renewable Energy Credit

The provision extends and modifies the electricity production credit.

Extension of placed-in-service date for qualifying facilities

The provision extends for one year, through December 31, 2009, the placed-in-service date for the renewable electricity production tax credit in the case of qualified wind and refined coal production facilities.

The provision extends for two years, through December 31, 2010, the placed-in-service dates for the renewable electricity production credit in the case of qualified facilities producing electricity from closed-loop biomass, open-loop biomass, geothermal energy, small irrigation power, municipal solid waste, and qualified hydropower.

Phaseout replaced by limitation based on investment in facility

The provision replaces the electricity production credit phaseout with an annual limit on the total credits that may be claimed with respect to any qualified facility placed in service after 2009 based on the investment in the facility. Under the limitation, the electricity production credit determined for any taxable year may not exceed the eligible basis of the facility multiplied by a limitation percentage (the "applicable percentage") determined by the Secretary for the month during which the facility is originally placed in service. The applicable percentage for any month is the percentage that yields over a 10-year period amounts of limitation that have a present value equal to 35 percent of the eligible basis of the facility. The discount rate for purposes of this calculation is the greater of 4.5 percent or 110 percent of the long-term federal rate. The provision does not impose this limitation on the credit for electricity produced at qualified wind facilities. Whether it will apply in the future is a determination for another Congress.

Generally, the eligible basis of a facility is the basis of such facility at the time it is originally placed in service. In the case of a qualified geothermal facility, the eligible basis for purposes of the limitation includes intangible drilling and development costs described in IRC section 263(c).

At the election of the taxpayer, all qualified facilities which are part of the same project and which are placed in service during the same calendar year may be treated as a single facility placed in service at either the mid-point of such year or the first day of the following calendar year.

Special rules apply for the first and last year of a facility's 10-year credit period to allocate the limitation across a taxpayer's taxable years. In addition, if a facility's production is less than the limitation amount for any taxable year, the limitation with respect to such facility for the next taxable year is increased by the amount of the unused limitation. Similarly, if the electricity production credit exceeds the limitation amount for any taxable year, but falls under the limit the following year, the credit for the following taxable year is increased, up to that year's limitation amount, by the amount of such excess, but not beyond the facility's 10-year credit eligibility period.

Clarification of the definition of trash combustion facility

The provision modifies the definition of qualified trash combustion facility to permit facilities that use municipal solid waste as part of an electricity generation process to qualify for the electricity production credit, whether or not such facilities utilize a process that involves burning the waste.

Modification of the definitions of open-loop biomass facility and closed-loop biomass facility to include new units added to existing qualified facilities

The definitions of qualified open-loop biomass facility and qualified closed-loop biomass facility are modified to include new power generation units placed in service at existing qualified facilities, but only to the extent of the increased amount of electricity produced at such facilities by reason of such new units.

Modification to definition of nonhydroelectric dam for purposes of qualified hydropower production

The provision modifies the definition of nonhydroelectric dam for purposes of qualified hydropower production. Under the new definition, the nonhydroelectric dam must have been operated for flood control, navigation, or water supply purposes.

The provision replaces the requirement that the project not enlarge the diversion structure or bypass channel, or impound additional water from the natural stream channel, with a requirement that the project be operated so that the water surface elevation at any given location and time be the same as would occur in absence of the project, subject to any license requirements aimed at improving the environmental quality of the affected waterway.

The hydroelectric project installed on the nonhydroelectric dam must still be licensed by the Federal Energy Regulatory Commission and meet all other applicable environmental, licensing, and regulatory requirements, including applicable fish passage requirements.

Effective Date

The extension of the electricity production credit applies to property originally placed in service after December 31, 2008. The provision relating to the modification of refined coal as a qualified energy resource applies to coal produced and sold from facilities placed in service after December 31, 2008. The provision concerning trash facility clarification applies to electricity produced and sold after October 3, 2008. The provision relating to the expansion of biomass facilities applies to property placed in service after October 3, 2008.

The extension of the electricity production credit is effective for facilities originally placed in service after December 31, 2008. The addition of marine and hydrokinetic renewable energy as a qualified energy resource is effective for electricity produced at qualified facilities and sold after the date of enactment in taxable years ending after such date. The repeal of the credit phaseout adjustment is effective for taxable years ending after 2008. The limitation based on investment is effective for facilities originally placed in service after 2009. The clarification of the definition of trash combustion facility is effective for electricity produced and sold after the date of enactment. The modifications to the definitions of open-loop biomass facility, closed-loop biomass facility, and nonhydroelectric dam are effective for property placed in service after October 3, 2008.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

Act section 102 – Production Credit for Electricity Produced from Marine Renewables

New Federal Law (IRC section 45)

Addition of marine and hydrokinetic renewable energy as a qualified resource

The provision adds marine and hydrokinetic renewable energy as a qualified energy resource and marine and hydrokinetic renewable energy facilities as qualified facilities. Marine and hydrokinetic renewable energy is defined as energy derived from: (1) waves, tides, and currents in oceans, estuaries, and tidal areas; (2) free flowing water in rivers, lakes, and streams; (3) free flowing water in an irrigation system, canal, or other man-made channel, including projects that utilize nonmechanical structures to accelerate the flow of water for electric power production purposes; or (4) differentials in ocean temperature (ocean thermal energy conversion). The term does not include energy derived from any source that uses a dam, diversionary structure (except for irrigation systems, canals, and other man-made channels), or impoundment for electric power production. A qualified marine and hydrokinetic renewable energy facility is any facility owned by the taxpayer and placed in service after the

October 3, 2008 and before January 1, 2012 that produces electric power from marine and hydrokinetic renewable energy and that has a nameplate capacity rating of at least 150 kilowatts.

Under the provision, marine and hydrokinetic renewable energy facilities subsume small irrigation power facilities. The provision, therefore, terminates as a separate category of qualified facility small irrigation power facilities placed in service on or after the date of enactment. Such facilities qualify for the electricity production credit as marine and hydrokinetic renewable energy facilities.

Effective Date

The addition of marine and hydrokinetic renewable energy as a qualified energy resource applies to electricity produced and sold after October 3, 2008, in tax years ending after October 3, 2008.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

Sections	Section Title
103 & 104	Energy Credit / Energy Credit for Small Wind Property

Background

A nonrefundable, 10-percent business energy credit[212] is allowed for the cost of new property that is equipment that either: (1) uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) is used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage. Property used to generate energy for the purposes of heating a swimming pool is not eligible solar energy property.

[212] IRC section 48.

The energy credit is a component of the general business credit[213] and as such is subject to the alternative minimum tax. An unused general business credit generally may be carried back one year and carried forward 20 years.[214] The taxpayer's basis in the property is reduced by one-half of the amount of the credit claimed. For projects whose construction time is expected to equal or exceed two years, the credit may be claimed as progress expenditures are made on the project, rather than during the year the property is placed in service. Similarly, the credit only applies to expenditures made after the effective date of the provision.

In general, property that is public utility property is not eligible for the credit. Public utility property is property that is used predominantly in the trade or business of the furnishing or sale of: (1) electrical energy, water, or sewage disposal services, (2) gas through a local distribution system, or (3) telephone service, domestic telegraph services, or other communication services (other than international telegraph services), if the rates for such furnishing or sale have been established or approved by a state or political subdivision thereof, by an agency or instrumentality of the United States, or by a public service or public utility commission. This rule is waived in the case of telecommunication companies' purchases of fuel cell and microturbine property.

Special rules for solar energy property

The credit for solar energy property is increased to 30 percent in the case of periods after December 31, 2005, and prior to January 1, 2009. Additionally, equipment that uses fiber-optic distributed sunlight to illuminate the inside of a structure is solar energy property eligible for the 30-percent credit.

Fuel cells and microturbines

The business energy credit also applies for the purchase of qualified fuel cell power plants, but only for periods after December 31, 2005, and prior to January 1, 2009. The credit rate is 30 percent.

A qualified fuel cell power plant is an integrated system composed of a fuel cell stack assembly and associated balance of plant components that: (1) converts a fuel into electricity using electrochemical means, and (2) has an electricity-only generation efficiency of greater than 30 percent and a capacity of at least on-half kilowatt. The credit may not exceed $500 for each 0.5 kilowatt of capacity.

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[213] IRC section 38(b)(1).
[214] IRC section 39.

The business energy credit also applies for the purchase of qualifying stationary microturbine power plants, but only for periods after December 31, 2005, and prior to January 1, 2009. The credit is limited to the lesser of 10 percent of the basis of the property or $200 for each kilowatt of capacity.

A qualified stationary microturbine power plant is an integrated system comprised of a gas turbine engine, a combustor, a recuperator or regenerator, a generator or alternator, and associated balance of plant components that converts a fuel into electricity and thermal energy. Such system also includes all secondary components located between the existing infrastructure for fuel delivery and the existing infrastructure for power distribution, including equipment and controls for meeting relevant power standards, such as voltage, frequency and power factors. Such system must have an electricity-only generation efficiency of not less than 26 percent at International Standard Organization conditions and a capacity of less than 2,000 kilowatts.

Additionally, for purposes of the fuel cell and microturbine credits, and only in the case of telecommunications companies, the general present-law IRC section 48 restriction that would otherwise prohibit telecommunication companies from claiming the new credit due to their status as public utilities is waived.

<u>New Federal Law (IRC section 48)</u>

Act section 103 – Energy Credit:

The provision extends the otherwise expiring credits and credit rates for eight years, through December 31, 2016. The provision raises the $500 per half kilowatt of capacity credit cap with respect to fuel cells to $1500 per half kilowatt of capacity. Also, the restrictions on public utility property being eligible for the credit are repealed. The provision makes the energy credit allowable against the alternative minimum tax.

The provision makes combined heat and power (“CHP”) property eligible for the 10-percent energy credit through December 31, 2016.

CHP property is property: (1) that uses the same energy source for the simultaneous or sequential generation of electrical power, mechanical shaft power, or both, in combination with the generation of steam or other forms of useful thermal energy (including heating and cooling applications); (2) that has an electrical capacity of not more than 50 megawatts or a mechanical energy capacity of no more than 67,000 horsepower or an equivalent combination of electrical and mechanical energy capacities; (3) that produces at least 20 percent of its total useful energy in the form of thermal energy that is not used to produce electrical or mechanical power, and produces at least 20 percent of its total useful energy in the form of electrical or mechanical power (or a combination thereof); and (4) the energy efficiency percentage of which exceeds 60 percent. CHP property does not include property used to transport the energy source to the generating facility or to distribute energy produced by the facility.

The otherwise allowable credit with respect to CHP property is reduced to the extent the property has an electrical capacity or mechanical capacity in excess of any applicable limits. Property in excess of the applicable limit (15 megawatts or a mechanical energy capacity of more than 20,000 horsepower or an equivalent combination of electrical and mechanical energy capacities) is permitted to claim a fraction of the otherwise allowable credit. The fraction is equal to the applicable limit divided by the capacity of the property. For example, a 45 megawatt property would be eligible to claim 15/45ths, or one third, of the otherwise allowable credit. Again, no credit is allowed if the property exceeds the 50 megawatt or 67,000 horsepower limitations described above.

Additionally, the provision provides that systems whose fuel source is at least 90 percent open-loop biomass and that would qualify for the credit but for the failure to meet the efficiency standard are eligible for a credit that is reduced in proportion to the degree to which the system fails to meet the efficiency standard. For example, a system that would otherwise be required to meet the 60-percent efficiency standard, but which only achieves 30-percent efficiency, would be permitted a credit equal to one-half of the otherwise allowable credit (i.e., a 5-percent credit).

Effective Date

The provision is generally effective on October 3, 2008.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

Act section 104 – Energy Credit for Small Wind Property:

The provision provides a new 30-percent credit for qualified small wind energy property expenses made by the taxpayer during the taxable year. Qualified small wind energy property is property which uses a qualifying small wind turbine to generate electricity. The credit is limited to $500 with respect to each half kilowatt of capacity, not to exceed $4,000. The credit for qualified small wind energy property is allowed for expenditures after December 31, 2007, for property placed in service before January 1, 2017.

Effective Date

The provision is effective on October 3, 2008, for taxable years ending after October 3, 2008.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
105	Energy Credit for Geothermal Heat Pump Systems

Background

In general

A nonrefundable, 10-percent business energy credit[215] is allowed for the cost of new property that is equipment that either: (1) uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) is used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage. Property used to generate energy for the purposes of heating a swimming pool is not eligible solar energy property.

The energy credit is a component of the general business credit[216] and as such is subject to the alternative minimum tax. An unused general business credit generally may be carried back one year and carried forward 20 years.[217] The taxpayer's basis in the property is reduced by one half of the amount of the credit claimed. For projects whose construction time is expected to equal or exceed two years, the credit may be claimed as progress expenditures are made on the project, rather than during the year the property is placed in service. Similarly, the credit only applies to expenditures made after the effective date of the provision.

In general, property that is public utility property is not eligible for the credit. Public utility property is property that is used predominantly in the trade or business of the furnishing or sale of: (1) electrical energy, water, or sewage disposal services, (2) gas through a local distribution system, or (3) telephone service, domestic telegraph services, or other communication services (other than international telegraph services), if the rates for such furnishing or sale have been established or approved by a state or political subdivision

[215] IRC section 48.
[216] IRC section 38(b)(1).
[217] IRC section 39.

thereof, by an agency or instrumentality of the United States, or by a public service or public utility commission. This rule is waived in the case of telecommunication companies' purchases of fuel cell and microturbine property.

Special rules for solar energy property

The credit for solar energy property is increased to 30 percent in the case of periods after December 31, 2005, and prior to January 1, 2009. Additionally, equipment that uses fiber-optic distributed sunlight to illuminate the inside of a structure is solar energy property eligible for the 30-percent credit.

New Federal Law (IRC section 48)

The provision provides a 10-percent credit for geothermal heat pump systems for periods ending before January 1, 2017. Such systems include any equipment that uses the ground or ground water as a thermal energy source to heat a structure.

Effective Date

This provision is effective on October 3, 2008, for taxable years beginning after October 3, 2008, for property placed in service prior to January 1, 2017.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
106	Credit for Residential Energy Efficient Property

Background

IRC section 25D provides a personal tax credit for the purchase of qualified solar electric property and qualified solar water heating property that is used exclusively for purposes other than heating swimming pools and hot tubs. The credit is equal to 30 percent of qualifying expenditures, with a maximum credit for each of these systems of property of $2,000. IRC section 25D also provides a 30 percent credit for the purchase of qualified fuel cell power plants. The credit for any fuel cell may not exceed $500 for each 0.5 kilowatt of capacity.

Qualifying solar water heating property means an expenditure for property to heat water for use in a dwelling unit located in the United States and used as a residence if at least half of the energy used by such property for such purpose is derived from the sun. Qualified solar electric property is property that uses solar energy to generate electricity for use in a dwelling unit. A qualified fuel cell power plant is an integrated system comprised of a fuel cell stack assembly and associated balance of plant components that: (1) converts a fuel into electricity using electrochemical means, (2) has an electricity-only generation efficiency of greater than 30 percent. The qualified fuel cell power plant must be installed on or in connection with a dwelling unit located in the United States and used by the taxpayer as a principal residence.

The credit is nonrefundable, and the depreciable basis of the property is reduced by the amount of the credit. Expenditures for labor costs allocable to onsite preparation, assembly, or original installation of property eligible for the credit are eligible expenditures.

Certain equipment safety requirements need to be met to qualify for the credit. Special proration rules apply in the case of jointly owned property, condominiums, and tenant-stockholders in cooperative housing corporations. If less than 80 percent of the property is used for nonbusiness purposes, only that portion of expenditures that is used for nonbusiness purposes is taken into account.

The credit applies to property placed in service prior to January 1, 2009.

<u>New Federal Law (IRC section 25D)</u>

The provision extends the credit for eight years (through December 31, 2016) and allows the credit to be claimed against the alternative minimum tax. Additionally, the credit cap (currently $2,000) for solar electric property is eliminated.
The provision provides a new 30 percent credit for qualified small wind energy property expenses made by the taxpayer during the taxable year. The credit is limited to $500 with respect to each half kilowatt of capacity, not to exceed $4,000. The credit for qualified small wind energy property is allowed for expenditures after December 31, 2007, for property placed in service prior to January 1, 2017.
Qualified small wind energy property expenditures are expenditures for property that uses a wind turbine to generate electricity for use in a dwelling unit located in the U.S. and used as a residence by the taxpayer.

The provision also provides a 30 percent credit for qualified geothermal heat pump property expenditures, not to exceed $2,000. The term "qualified geothermal heat pump property expenditure" means an expenditure for qualified geothermal heat pump property installed on or in connection with a dwelling unit located in the United States and used as a residence by the taxpayer. Qualified geothermal heat pump property means any equipment that: (1) uses the ground or ground water as a thermal energy source to heat the dwelling unit or as a thermal energy sink to cool such dwelling unit, and (2) meets the requirements of the Energy Star program which are in effect at the time that the expenditure for such equipment is made.

The credit for qualified geothermal heat pump property is allowed for expenditures after December 31, 2007, for property placed in service prior to January 1, 2017.

Effective Date

Generally, the provision is effective for taxable years beginning after December 31, 2007, for property placed in service prior to January 1, 2017. The removal of the solar electric credit cap is effective for property placed in service after December 31, 2008.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
107	New Clean Renewable Energy Bonds

Background

Tax credit bonds generally

Tax credit bonds are not interest-bearing obligations. Instead, a taxpayer holding a tax credit bond on one or more allowance dates during a tax year is allowed a credit against federal income tax equivalent to the interest that the bond would otherwise pay. In effect, the existence of the credit allows the issuer to borrow interest free. The bondholder must include the amount of the credit in his or her gross income and treat it as interest income.

The IRC provisions authorizing the issuance of tax credit bonds for various purposes include mechanical provisions, relating to the credit and the application of tax-exempt bond rules, and substantive provisions, which vary depending on what the bond proceeds are to be used to finance. Prior to 2008, tax credit bond provisions for clean renewable energy tax bonds and for qualified zone academy bonds had been added to the IRC separately, each with their own substantive provisions and each with similar but not identical mechanical provisions. The Heartland, Habitat, Harvest, and Horticulture Act of 2008 (P.L. 110-246) added a new Subpart I to Part IV of the IRC (regarding credits against tax) where common mechanical provisions for such bonds were placed, in new IRC section 54A, with room for substantive provisions relating to the various types of tax credit bonds to follow in succeeding IRC sections. However, the existing provisions for CREBs and qualified zone academy bonds were not moved into the new Subpart.

The common mechanical requirements for tax credit bonds include requirements that the proceeds of the bonds be spent for specified purposes within three years, that the issuer meet certain reporting and arbitrage requirements generally applicable to tax-exempt bonds, that the maturity of the bonds not exceed a maximum term to be set each month by the IRS, and that any applicable conflict-of-interest rules are satisfied.[218]
Clean renewable energy bonds

The Energy Tax Incentives Act of 2005 (ETIA) (P.L. 109-58) authorized the issuance of up to $800 million of CREBs during 2006 and 2007 to finance capital expenditures by tax-exempt electricity producers to increase their capacity to produce electricity from clean renewable sources.[219] Governmental bodies, cooperative electricity companies, and cooperative lenders owned by cooperative electricity companies are eligible to issue such bonds. The bonds provide a federal subsidy to allow nonprofit electricity providers to compete more evenly with for-profit companies that can take advantage of the existing tax credit under IRC section 45. The $800 million national limit was to be allocated among qualified projects at the discretion of the IRS, except that not more than $500 million could be allocated to governmental projects.[220]

An additional $400 million of CREBs, raising the national limitation on the amount of bonds to $1.2 billion, was authorized under the Tax Relief and Health Care Act of 2006 (TRHCA).[221] At the same time, the maximum amount of CREBs that could be allocated to finance qualified projects by qualified governmental bodies was increased by $250 million, raising that limitation to $750 million.[222] The authority to issue CREBs was also extended through December 31, 2008.[223]

<u>New Federal Law (IRC sections 54, 54A and 54C)</u>

The authorization for non-profit electricity producers to issue clean renewable energy bonds (CREBs) under IRC section 54 has been extended for an additional year, through the end of 2009.[224] There is no provision for any additional dollar amount of CREBs to be issued. Instead, EESA authorizes the issuance of $800 million worth of a similar but new category of tax credit bonds called "new clean renewable energy bonds" (New CREBS).[225] These tax credit bonds provide a federal subsidy to allow nonprofit electricity producers, including

[218] IRC section 54A(d).
[219] IRC section 54.
[220] IRC section 54(f).
[221] IRC section 54(f)(1).
[222] IRC section 54(f)(2).
[223] IRC section 54(m).
[224] IRC section 54(m).
[225] IRC section 54C.

cooperatives and government-owned utilities, to compete more evenly with for-profit companies that can take advantage of the production tax credit under IRC section 45.

Holders of tax credit bonds are generally entitled to an annual tax credit calculated by multiplying the outstanding face amount of the bonds held by the applicable credit rate, which is set by the IRS. The credit rate is set so that the bonds can be issued at face value with no interest. For New CREBs, however, the annual tax credit is limited to 70 percent of the face amount times the applicable credit rate (IRC section 54C(b), as added by EESA).

Effective Date

The provisions apply to obligations issued after October 3, 2008.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
108	Credit for Steel Industry Fuel

Background

An income tax credit is allowed for the production of electricity from qualified energy resources at qualified facilities.[226] Qualified energy resources include wind, closed-loop biomass, open-loop biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, refined coal, and qualified hydropower production.[227]

Qualified facilities are generally facilities that generate electricity using qualified energy resources. To be eligible for the credit, electricity produced from qualified energy resources at qualified facilities must be sold by the taxpayer to an unrelated person. The base amount of the electricity production credit is 1.5 cents per kilowatt-hour (indexed annually for inflation) of electricity produced.[228] The credit rate is reduced by one-half for electricity produced from open-loop biomass, small irrigation power, landfill gas, trash combustion and qualified

[226] IRC section 45.
[227] IRC section 45(c).
[228] IRC section 45(a).

hydropower facilities.[229] The base amount of the credit is 2.1 cents per kilowatt-hour for 2008, and the reduced amount is one cent per hour.[230]

A taxpayer may generally claim a credit during the 10-year period commencing with the date the qualified facility is placed in service. The credit is reduced for grants, tax-exempt bonds, subsidized energy financing, and other credits. The amount of credit a taxpayer may claim is phased out as the market price of electricity exceeds certain threshold levels. No reduction applies to the credit for 2008.[231]

In order to be eligible for the credit, the electricity must be produced at qualified facilities.[232]

New Federal Law (IRC section 45)

The provision extends the placed-in-service date for purposes of the renewable electricity production tax credit in the case of refined coal production facilities through December 31, 2009.

The provision additionally adds steel industry fuel to the definition of refined coal for purposes of the credit. Steel industry fuel is fuel that is (1) produced through a process of liquefying coal waste sludge and distributing it on coal, and (2) used as a feedstock for the manufacture of coke. Coal waste sludge is the tar decanter sludge and related byproducts of the coking process, including such materials that have been stored in ground, in tanks and in lagoons that have been treated as hazardous wastes under applicable federal environmental rules absent liquefaction and processing with coal into a feedstock for the manufacture of coke.[233]

There are modifications that apply to the credit for steel industry fuel. The credit is increased by an amount equal to $2 (as adjusted for inflation) per barrel of oil equivalent (5,800,000 BTUs) instead of $4.375 per ton of qualified refined coal. Also, the normal 10-year credit period for refined coal is replaced. The new credit period begins on the later of: (1) the date the facility is originally placed in service, or (2) the placed-in-service date of modifications to an existing facility that allow it to produce steel industry fuel, on October 1, 2008. The credit period ends on the later of: (1) December 1, 2009, or (2) one year after the date the facility or modifications were placed in service. There is no phase out of this credit amount.[234]

Effective Date

The provision is effective for fuel produced and sold after September 30, 2008.

[229] IRC section 45(b).
[230] IRS Notice 2008-48 I.R.B. 2008-21, 1008.
[231] IRS Notice 2008-48 I.R.B. 2008-21, 1008.
[232] IRC section 45(d).
[233] IRC section 45(c)(7)(C).
[234] IRC section 45(e)(8)(D)(ii).

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
109	Special Rule to Implement FERC and State Electric Restructuring Policy

Background

Generally, a taxpayer selling property recognizes gain to the extent the sales price (and any other consideration received) exceeds the seller's basis in the property. The recognized gain is subject to current income tax unless the gain is deferred or not recognized under a special tax provision.

One such special tax provision permits taxpayers to elect to recognize gain from qualifying electric transmission transactions ratably over an eight-year period beginning in the year of sale if the amount realized from such sale is used to purchase exempt utility property within the applicable period[235] (the "reinvestment property"). If the amount realized exceeds the amount used to purchase reinvestment property, any realized gain is recognized to the extent of such excess in the year of the qualifying electric transmission transaction.

A qualifying electric transmission transaction is the sale or other disposition of property used by the taxpayer in the trade or business of providing electric transmission services, or an ownership interest in such an entity, to an independent transmission company prior to January 1, 2008. In general, an independent transmission company is defined as: (1) an independent transmission provider[236] approved by the FERC; (2) a person (i) who the FERC determines under section 203 of the Federal Power Act (or by declaratory order) is not a "market participant" and (ii) whose transmission facilities are placed under the operational control of a FERC-approved independent transmission provider before the close of the period specified in such authorization, but not later than December 31, 2007; or (3) in the case of facilities subject to the jurisdiction of the Public Utility Commission of Texas, (i) a person which is approved by that Commission as consistent with Texas state law regarding an

[235] The applicable period for a taxpayer to reinvest the proceeds is four years after the close of the taxable year in which the qualifying electric transmission transaction occurs.
[236] For example: a regional transmission organization, an independent system operator, or an independent transmission company.

independent transmission organization, or (ii) a political subdivision, or affiliate thereof, whose transmission facilities are under the operational control of an organization described in (i).

Exempt utility property is defined as: (1) property used in the trade or business of generating, transmitting, distributing, or selling electricity or producing, transmitting, distributing, or selling natural gas, or (2) stock in a controlled corporation whose principal trade or business consists of the activities described in (1).

If a taxpayer is a member of an affiliated group of corporations filing a consolidated return, the reinvestment property may be purchased by any member of the affiliated group (in lieu of the taxpayer).

New Federal Law (IRC section 451)

The provision extends the treatment under the present-law deferral provision to sales or dispositions by a qualified electric utility prior to January 1, 2010. A qualified electric utility is defined as an electric utility, which as of the date of the qualifying electric transmission transaction, is vertically integrated in that it is both: (1) a transmitting utility (as defined in the Federal Power Act)[237] with respect to the transmission facilities to which the election applies, and (2) an electric utility (as defined in the Federal Power Act).[238]

The definition of an independent transmission company is modified for taxpayers whose transmission facilities are placed under the operational control of a FERC-approved independent transmission provider, which under the provision must take place no later than four years after the close of the taxable year in which the transaction occurs.

The provision also changes the definition of exempt utility property to exclude property that is located outside the United States.

Effective Date

The extension provision applies to transactions after December 31, 2007. The change in the definition of an independent transmission company is effective as if included in section 909 of the American Jobs Creation Act of 2004. The exclusion for property located outside the United States applies to transactions after October 3, 2008.

[237] Section 16 U.S.C. 796, defines "transmitting utility" as any electric utility, qualifying cogeneration facility, qualifying small power production facility, or federal power marketing agency which owns or operates electric power transmission facilities which are used for the sale of electric energy at wholesale.
[238] Section 3(22), 16 U.S.C. 796, defines "electric utility" as any person or State agency (including any municipality) which sells electric energy; such term includes the Tennessee Valley Authority, but does not include any federal power marketing agency.

California Law (R&TC sections 17551 and 24661.6)

California specifically does not conform to IRC section 451(i), relating to sales or dispositions to implement Federal Energy Regulatory Commission or state electric restructuring policy.

Impact on California Revenue

Not applicable.

SUBTITLE B – CARBON MITIGATION AND COAL PROVISIONS

Section	Section Title
111	Expansion and Modification of Advanced Coal Project Investment Credit

Background

An investment tax credit is available for power generation projects that use integrated gasification combined cycle ("IGCC") or other advanced coal-based electricity generation technologies. The credit amount is 20 percent for investments in qualifying IGCC projects and 15 percent for investments in qualifying projects that use other advanced coal-based electricity generation technologies.

To qualify, an advanced coal project must be located in the United States and use an advanced coal-based generation technology to power a new electric generation unit or to retrofit or repower an existing unit. Generally, an electric generation unit using an advanced coal-based technology must be designed to achieve a 99 percent reduction in sulfur dioxide and a 90 percent reduction in mercury, as well as to limit emissions of nitrous oxide and particulate matter.[239]

The fuel input for a qualifying project, when completed, must use at least 75 percent coal. The project, consisting of one or more electric generation units at one site, must have a nameplate generating capacity of at least 400 megawatts, and the taxpayer must provide evidence that a majority of the output of the project is reasonably expected to be acquired or utilized.

[239] For advanced coal project certification applications submitted after October 2, 2006, an electric generation unit using advanced coal-based generation technology designed to use subbituminous coal can meet the performance requirement relating to the removal of sulfur dioxide if it is designed either to remove 99 percent of the sulfur dioxide or to achieve an emission limit of 0.04 pounds of sulfur dioxide per million British thermal units on a 30-day average.

Credits are available only for projects certified by the Secretary of Treasury, in consultation with the Secretary of Energy. Certifications are issued using a competitive bidding process. The Secretary of Treasury must establish a certification program no later than 180 days after August 8, 2005,[240] and each project application must be submitted during the three-year period beginning on the date such certification program is established. An applicant for certification has two years from the date the Secretary accepts the application to provide the Secretary with evidence that the requirements for certification have been met. Upon certification, the applicant has five years from the date of issuance of the certification to place the project in service.

The Secretary of Treasury may allocate $800 million of credits to IGCC projects and $500 million to projects using other advanced coal-based electricity generation technologies. Qualified projects must be economically feasible and use the appropriate clean coal technologies. With respect to IGCC projects, credit-eligible investments include only investments in property associated with the gasification of coal, including any coal handling and gas separation equipment. Thus, investments in equipment that could operate by drawing fuel directly from a natural gas pipeline do not qualify for the credit.

In determining which projects to certify that use IGCC technology, the Secretary must allocate power generation capacity in relatively equal amounts to projects that use bituminous coal, subbituminous coal, and lignite as primary feedstock. In addition, the Secretary must give high priority to projects that include greenhouse gas capture capability, increased by-product utilization, and other benefits.

New Federal Law (IRC section 48A)

The provision increases to 30 percent the credit rate for IGCC and other advanced coal projects. In addition, the provision permits the Secretary to allocate an additional $1.25 billion of credits to qualifying projects.

The provision modifies the definition of qualifying projects to require that projects include equipment which separates and sequesters at least 65 percent of the project's total carbon dioxide emissions. This percentage increases to 70 percent if the credits are later reallocated by the Secretary. The Secretary is required to recapture the benefit of any allocated credit if a project fails to attain or maintain these carbon dioxide separation and sequestration requirements.

In selecting projects, the provision requires the Secretary to give high priority to applicants who have a research partnership with an eligible educational institution. In addition, the Secretary must give the highest priority to projects with the greatest separation and sequestration percentage of total carbon dioxide emissions. The provision also requires that

[240] The Secretary issued guidance establishing the certification program on February 21, 2006 (IRS Notice 2006-24).

the Secretary disclose which projects receive credit allocations, including the identity of the taxpayer and the amount of the credit awarded.

Effective Date

The provision authorizing the Secretary to allocate additional credits is effective on October 3, 2008. The increased credit rate along with the carbon dioxide sequestration and other rules are effective with respect to these additional credit allocations.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
112	Expansion and Modification of Coal Gasification Investment Credit

Background

A 20 percent investment tax credit is available for investments in certain qualifying coal gasification projects. Only property which is part of a qualifying gasification project and necessary for the gasification technology of such project is eligible for the gasification credit.

Qualified gasification projects convert coal, petroleum residue, biomass, or other materials recovered for their energy or feedstock value into a synthesis gas composed primarily of carbon monoxide and hydrogen for direct use or subsequent chemical or physical conversion. Qualified projects must be carried out by an eligible entity, defined as any person whose application for certification is principally intended for use in a domestic project that employs domestic gasification applications related to: (1) chemicals, (2) fertilizers, (3) glass, (4) steel, (5) petroleum residues, (6) forest products, and (7) agriculture, including feedlots and dairy operations.

Credits are available only for projects certified by the Secretary of Treasury, in consultation with the Secretary of Energy. Certifications are issued using a competitive bidding process. The Secretary of Treasury must establish a certification program no later than 180 days after August 8, 2005,[241] and each project application must be submitted during the 3-year period beginning on the date such certification program is established. The Secretary of Treasury

[241] The Secretary issued guidance establishing the certification program on February 21, 2006 (IRS Notice 2006-25).

may not allocate more than $350 million in credits. In addition, the Secretary may certify a maximum of $650 million in qualified investment as eligible for credit with respect to any single project.

New Federal Law (IRC section 48B)

The provision expands and modifies the coal gasification investment credit. The provision increases gasification project credit rate to 30 percent and permits the Secretary to allocate an additional $250 million of credits to qualified projects that separate and sequester at least 75 percent of total carbon dioxide emissions. The Secretary is required to recapture the benefit of any allocated credit if a project fails to attain or maintain these carbon dioxide separation and sequestration requirements.
In selecting projects, the provision requires the Secretary to give high priority to applicants who have a research partnership with an eligible educational institution. In addition, the Secretary must give the highest priority to projects with the greatest separation and sequestration percentage of total carbon dioxide emissions. The provision also requires that the Secretary disclose which projects receive credit allocations, including the identity of the taxpayer and the amount of the credit awarded.

Effective Date

The provision authorizing the Secretary to allocate additional credits is effective on October 3, 2008. The increased credit rate along with the carbon dioxide sequestration and other rules are effective with respect to these additional credit allocations.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA)
(PL 110-343, OCTOBER 3, 2008)

Section	Section Title
113	Temporary Increase in Coal Excise Tax; Funding of Black Lung Disability Fund

Background

A $1.10 per ton excise tax is imposed on coal sold by the producer from underground mines in the United States. The rate is 55 cents per ton on coal sold by the producer from surface mining operations. In either case, the tax cannot exceed 4.4 percent of the coal producer's selling price. No tax is imposed on lignite.

Gross receipts from the excise tax are dedicated to the Black Lung Disability Trust Fund to finance benefits under the Federal Black Lung Benefits Act. Currently, the Black Lung Disability Trust Fund is in a deficit position because previous spending was financed with interest-bearing advances from the General Fund.

The coal excise tax rates are scheduled to decline to 50 cents per ton for underground-mined coal and 25 cents per ton for surface-mined coal (and the cap is scheduled to decline to two percent of the selling price) for sales after January 1, 2014, or after any earlier January 1 on which there is no balance of repayable advances from the Black Lung Disability Trust Fund to the General Fund and no unpaid interest on such advances.

New Federal Law (IRC section 4121)

The provision retains the excise tax on coal at the current rates until the earlier of the following dates: (1) January 1, 2019, and (2) the day after the first December 31 after 2007 on which the Black Lung Disability Trust Fund has repaid, with interest, all amounts borrowed from the General Fund. On and after that date, the reduced rates of $.50 per ton for coal from underground mines and $.25 per ton for coal from surface mines will apply and the tax per ton of coal will be capped at two percent of the amount for which it is sold by the producer.

Effective Date

The provision is effective on October 3, 2008.

California Law

The Franchise Tax Board does not administer excise taxes. Defer to the State Board of Equalization (BOE).

Impact on California Revenue

Defer to the BOE.

Section	Section Title
114	Special Rules for Refund of the Coal Excise Tax to Certain Coal Producers and Exporters

Background

In general

Excise tax is imposed on coal, except lignite, produced from mines located in the United States.[242] The producer of the coal is liable for paying the tax to the IRS. Producers generally recover the tax from their purchasers.

The Export Clause of the U.S. Constitution provides that "no Tax or Duty shall be laid on Articles exported from any state."[243] Courts have determined that the Export Clause applies to excise tax on exported coal, and therefore such taxes are subject to a claim for refund.[244] The Supreme Court has ruled that taxpayers seeking a refund of such taxes must proceed under the rules of the IRC.[245]

Claims under the IRC

To obtain a refund of taxes on exported coal, a claimant must satisfy the following requirements of the IRC and case law:

1. A claim for refund must be filed within three years from the time the return was filed, or within two years from the time the tax was paid, whichever period expires later;[246]
2. The person must establish that the goods were in the stream of export when the excise tax was imposed;[247]

[242] IRC section 4121(a). Throughout the relevant period, the rate of tax on coal from underground mines has been $1.10 per ton and the rate of tax on coal from surface mines has been $0.55 per ton. These rates are subject to a limitation of 4.4 percent of the producer's sale price. IRC section 4121(b).
[243] U.S. Const., art. I, sec. 9, cl. 5.
[244] See *Ranger Fuel Corp. v. United States*, 33 F. Supp. 2d 466 (E.D. Va. 1998). The IRS subsequently provided guidance regarding how taxpayers may assure that exported coal would not be subject to excise tax. Notice 2000-28, 2000-1 C.B. 1116.
[245] *United States v. Clintwood Elkhorn Mining Co.*, 128 S. Ct. 1511 (April 15, 2008). Prior to the Supreme Court's decision, some courts had allowed taxpayers to bring claims under the Tucker Act, 28 U.S.C. sec. 1491(a), which confers jurisdiction upon the Court of Federal Claims "to render judgment upon any claim against the United States founded either upon the Constitution, or any Act of Congress or any regulation of an executive department ...." Lower courts had held that such a Tucker Act claim was subject to the Tucker Act's six-year statute of limitations and was not subject to the requirements of the Code. *Venture Coal Sales Co. v. U.S.*, 93 AFTR 2d 2004-2495 (Fed. Cir. 2004); *Cyprus Amax Coal Co. v. U.S.*, 205 F.3d 1369 (Fed. Cir. 2000). The Supreme Court held that the stricter Code rules apply to these refund claims.
[246] IRC section 6511(a).

3. The claimant must establish that it has borne the tax. More specifically, the claimant must establish that the tax was neither included in the price of the article nor collected from the purchaser (or if so, that the claimant has repaid the amount of tax to the ultimate purchaser), that the claimant has repaid or agreed to repay the tax to the ultimate vendor or has obtained the written consent of such ultimate vendor to the allowance of the claim, or that the claimant has filed the written consent of the ultimate purchaser to the allowance of the claim;[248]
4. In the case of an exporter or shipper of an article exported to a foreign country or shipped to a possession, the amount of tax may be refunded to the exporter or shipper if the person who paid the tax waives its claim to such amount;[249] and
5. A civil action for refund must not be begun before the expiration of six months from the date of filing the claim (unless the claim has been disallowed during that time), nor after the expiration of two years from the date of mailing the notice of claim disallowance.[250]

In 2000, the IRS issued Notice 2000-28,[251] which summarizes the IRS position regarding claims for credits or refunds of excise taxes on exported coal and sets forth procedural rules relating to such claims. Under Notice 2000-28, a coal producer or exporter must provide the following information as part of its claim:

1. A statement by the person that paid the tax to the government that provides the quarter and the year for which the tax was reported on federal Form 720, the line number on such Form, the amount of tax paid on the coal, and the date of payment;
2. In the case of an exporter, a statement by the person that paid the tax to the government that such person has waived the right to claim a refund;
3. A statement that the claimant has evidence that the coal was in the stream of export when sold by the producer;
4. In the case of an exporter, proof of exportation;
5. In the case of a coal producer, a statement that the coal actually was exported; and
6. A statement that the claimant:
    a. has neither included the tax in the price of the coal nor collected the amount of the tax from its buyer,
    b. has repaid the amount of the tax to the ultimate purchaser of the coal, or

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[247] See *Ranger Fuel Corp. v. United States*, 33 F. Supp. 2d 466 (E.D. Va. 1998). See also *United States v. International Business Machines Corp.*, 517 U.S. 843 (1996); *Joy Oil, Ltd. v. State Tax Commission*, 337 U.S. 286 (1949).
[248] IRC section 6416(a)(1).
[249] IRC section 6416(c).
[250] IRC section 6532(a).
[251] Notice 2000-28, 2001-1 C.B. 1116.

c. has obtained the written consent of the ultimate purchaser of the coal to the allowance of the claim.

If the IRS disallows the claim, the claimant may proceed in a federal district court or the Court of Federal Claims under 28 U.S.C. sec. 1346(a)(1), which grants these courts concurrent jurisdiction over "[a]ny civil action against the United States for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected or any sum alleged to have been excessive or in any manner wrongfully collected under the internal-revenue laws."

With respect to claims under the IRC allowed by the IRS or by a court, prejudgment interest is generally allowed.[252]

New Federal Law (Act section 114 relating to IRC section 4121)

This uncodified provision creates a new procedure under which certain coal producers and exporters may claim a refund of excise taxes imposed on coal exported from the United States. Coal producers or exporters that exported coal during the period beginning on or after October 1, 1990, and ending on or before October 3, 2008, with respect to which a return was filed on or after October 1, 1990, and on or before October 3, 2008, and that file a claim for refund not later than the close of the 30-day period beginning on October 3, 2008, may obtain a refund from the Secretary of the Treasury of excise taxes paid on such exported coal and any interest accrued from the date of overpayment. Interest on such claims is computed under the IRC.[253] The Secretary of the Treasury is required to determine whether to approve the claim within 180 days after such claim is filed, and to pay such claim not later than 180 days after making such determination.

In order to qualify for a refund under the provision, a coal producer must establish that it, or a party related to such coal producer, exported coal produced by such coal producer to a foreign country or shipped coal produced by such coal producer to a U.S. possession, the export or shipment of which was other than through an exporter that has filed a valid and timely claim for refund under the provision. An exporter must establish that it exported coal to a foreign country, shipped coal to a U.S. possession, or caused such coal to be so exported or shipped. Refunds to producers are to be made in an amount equal to the tax paid on exported coal. Exporters are to receive a payment equal to $0.825 per ton of exported coal.

Special rules apply if a court has rendered a judgment. If a coal producer or a party related to a coal producer has received, from a court of competent jurisdiction in the United States, a judgment in favor of such coal producer (or party related to such coal producer) that relates to the constitutionality of federal excise tax paid on exported coal, then such coal producer is deemed to have established the export of coal to a foreign country or shipment of coal to a possession of the United States. If such coal producer is entitled to a payment under this

[252] See IRC section 6611; 28 U.S.C. section 2411.
[253] See IRC section 6621.

provision, the amount of such payment is reduced by any amount awarded under such court judgment. Subject to the rules below, a coal exporter may file a claim notwithstanding that a coal producer or a party related to a coal producer has received a court judgment relating to the same coal.

Under the provision, the term "coal producer" means the person that owns the coal immediately after the coal is severed from the ground, without regard to the existence of any contractual arrangement for the sale or other disposition of the coal or the payment of any royalties between the producer and third parties. The term also includes any person who extracts coal from coal waste refuse piles or from the silt waste product which results from the wet washing or similar processing of coal. The term "exporter" means a person, other than a coal producer, that does not have an agreement with a producer or seller of such coal to sell or export such coal to a third party on behalf of such producer or seller, and that is indicated as the exporter of record in the shipper's export declaration or other documentation, or actually exported such coal to a foreign country, shipped such coal to a U.S. possession, or caused such coal to be so exported or shipped. The term "a party related to such coal producer" means a person that is related to such coal producer through any degree of common management, stock ownership, or voting control, is related, within the meaning of IRC section 144(a)(3), to such coal producer, or has a contract, fee arrangement, or any other agreement with such coal producer to sell such coal to a third party on behalf of such coal producer.

The provision does not apply with respect to excise tax on exported coal if a credit or refund of such tax has been allowed or made, or if a "settlement with the federal government" has been made with and accepted by the coal producer, a party related to such coal producer, or the exporter of such coal, as of the date that the claim is filed under the provision. The term "settlement with the federal government" does not include a settlement or stipulation entered into as of the date of enactment, if such settlement or stipulation contemplates a judgment with respect to which any party has filed an appeal or has reserved the right to file an appeal. In addition, the provision does not apply to the extent that a credit or refund of tax on exported coal has been paid to any person, regardless of whether such credit or refund occurs prior to, or after, the date of enactment.

The provision is not intended to create any inference that an exporter has standing to commence, or intervene in, any judicial or administrative proceeding concerning a claim for refund by a coal producer of any federal or state tax, fee, or royalty paid by the coal producer. Similarly, the provision is not intended to create any inference that a coal producer has standing to commence, or intervene in, any judicial or administrative proceeding concerning a claim for refund by an exporter of any federal or state tax, fee, or royalty paid by the producer and alleged to have been passed on to an exporter.

Effective Date

The provision applies to claims on coal exported on or after October 1, 1990, through October 3, 2008, with respect to amounts of tax for which a return was filed on or after October 1, 1990, and on or before October 3, 2008, and for which a claim for refund is filed not later than the close of the 30-day period beginning on October 3, 2008.

California Law (None)

The Franchise Tax Board does not administer excise taxes. Defer to the State Board of Equalization (BOE).

Impact on California Revenue

Defer to the BOE.

Section	Section Title
115	Tax Credit for Carbon Dioxide Sequestration

Background

The general business credit under IRC section 38 is a limited nonrefundable credit against income tax that is claimed after all other nonrefundable credits. The general business tax credit includes many credits, including the investment credit, work opportunity credit, alcohol fuels credit, enhanced oil recovery credit, renewable electricity production credit, and marginal oil and gas well production credit.

Present law does not provide a credit for carbon dioxide sequestration.

Carbon dioxide sequestration technology helps to capture, purify and store carbon dioxide in order to reduce greenhouse gas emissions.

New Federal Law (IRC sections 38 and 45Q)

The provision provides a credit for the capture and transport of carbon dioxide from an industrial source for use in enhanced oil recovery or for permanent storage in a geologic formation.

The credit is $20 per metric ton of qualified carbon dioxide that is captured by the taxpayer at a qualified facility and disposed of in secure geological storage, and $10 per metric ton of qualified carbon dioxide that is captured by the taxpayer at a qualified facility and used as a tertiary injectant in a qualified enhanced oil or natural gas recovery project.

The credit is attributable to the person that captures and physically or contractually ensures the disposal, or the use as a tertiary injectant, of the qualified carbon dioxide, except to the extent provided by regulations.

The Secretary shall provide regulations for recapturing the credit with respect to any qualified carbon dioxide that ceases to be captured, disposed or, or used as a tertiary injectant.

The $10 and $20 credit amounts will be adjusted for inflation in tax years beginning after 2009. The credit will apply with respect to qualified carbon dioxide before the end of the calendar year in which the IRS, in consultation with the Environmental Protection Agency, certifies that 75 million metric tons of qualified carbon dioxide have been captured or disposed of or used as a tertiary injectant.

Effective Date

The provision shall apply to carbon dioxide recaptured after October 3, 2008.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
116	Certain Income and Gains Relating to Industrial Source Carbon Dioxide Treated as Qualifying Income for Publicly Traded Partnerships

Background

Present law provides that a publicly traded partnership means a partnership, interests in which are traded on an established securities market, or are readily tradable on a secondary market (or the substantial equivalent thereof). In general, a publicly traded partnership is treated as a corporation, but an exception to corporate treatment is provided if 90 percent or more of its gross income is “qualifying income.”

"Qualifying income" includes interest, dividends, and gains from the disposition of a capital asset (or of property described in IRC section 1231(b)) that is held for the production of income that is qualifying income. Qualifying income also includes rents from real property, gains from the sale or other disposition of real property, and income and gains from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber). It also includes income and gains from commodities (not described in IRC section 1221(a)(1)) or futures, options, or forward contracts with respect to such commodities (including foreign currency transactions of a commodity pool) in the case of partnership, a principal activity of which is the buying and selling of such commodities, futures, options or forward contracts.

New Federal Law (IRC section 7704)

The provision provides that qualifying income of a publicly traded partnership includes income or gains derived from the exploration, development, mining or production, processing, refining, transporting or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, timber, or industrial source carbon dioxide).

Effective Date

The provision is effective for taxable years beginning after October 3, 2008.

California Law (R&TC sections 17008.5 and 23038.5)

California conforms by reference to IRC section 7704 as of the "specified date" of January 1, 2005, with modifications. Because this federal change was made after the "specified date" of January 1, 2005, California is not conformed.

Impact on California Revenue

Estimated Revenue Impact of Certain Income and Gains Relating to Industrial Source Carbon Dioxide Treated as Qualifying Income for Publicly Traded Partnerships For Tax Years Beginning On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$40,000	-$30,000	-$50,000

Estimates are based on a proration of federal projections developed for the Emergency Economic Stabilization Act of 2008.

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA) (PL 110-343, OCTOBER 3, 2008)

TITLE II – TRANSPORTATION AND DOMESTIC FUEL SECURITY PROVISIONS

Section	Section Title
201	Inclusion of Cellulosic Biofuel in Bonus Depreciation for Biomass Ethanol Plant Property

Background

IRC section 168(l) allows an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified cellulosic biomass ethanol plant property. To qualify, the property generally must be placed in service before January 1, 2013. Qualified cellulosic biomass ethanol plant property means property used in the U.S. solely to produce cellulosic biomass ethanol. For this purpose, cellulosic biomass ethanol means ethanol derived from any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis. For example, lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis includes bagasse (from sugar cane), corn stalks, and switchgrass.

The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service. The additional first-year depreciation deduction is subject to the general rules regarding whether an item is deductible under IRC section 162 or subject to capitalization under IRC section 263 or IRC section 263A. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction.

In addition, there is no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

For property to qualify for the additional first-year depreciation deduction, it must meet the following requirements. The original use of the property must commence with the taxpayer on or after December 20, 2006. The property must be acquired by purchase (as defined under IRC section 179(d)) by the taxpayer after December 20, 2006, and placed in service before January 1, 2013. Property does not qualify if a binding written contract for the acquisition of such property was in effect on or before December 20, 2006.

Property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer qualifies if the taxpayer begins the manufacture, construction, or production of the property after December 20, 2006, and the property is placed in service before January 1, 2013 (and all other requirements are met). Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.

Property any portion of which is financed with the proceeds of a tax-exempt obligation under IRC section 103 is not eligible for the additional first-year depreciation deduction. Recapture rules apply if the property ceases to be qualified cellulosic biomass ethanol plant property.

Property with respect to which the taxpayer has elected 50-percent expensing under IRC section 179C is not eligible for the additional first-year depreciation deduction.

New Federal Law (IRC section 168)

The provision changes the definition of qualified property. Under the provision, qualified property includes cellulosic biofuel, which is defined as any liquid fuel which is produced from any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis.

Effective Date

The provision is effective for property placed in service after October 3, 2008, in taxable years ending after such date.

California Law (R&TC sections 17201, 17250, 24349, 24355.3, and 24355.4)

Modified accelerated cost recovery system (MACRS)

Under the PITL, California law, as it relates to MACRS, in general conforms to the federal rules as of the “specified date” of January 1, 2005, with certain modifications. California specifically does not conform to IRC section 168(k), which allows 30 percent and 50 percent bonus depreciation for certain property. Additionally, IRC section 168(l), relating to the special allowance for cellulosic biomass ethanol plant property, was enacted in 2006 by Public Law 109-432, after the “specified date” and thus California is not conformed.

Under current California law, S corporations (and their shareholders) are allowed to use MACRS under the PITL.

Under the Corporation Tax Law (CTL), California did not conform to the pre-1986 federal ACRS depreciation deduction and currently does not conform to the federal law MACRS depreciation. Instead, the CTL is in substantial conformity to the pre-1981 federal asset depreciation range (ADR) deduction. The ADR is based on the “useful life” of depreciable property.

IRC section 179 expensing deduction

The PITL is conformed to the IRC section 179 expensing provisions, with modifications. For taxable years beginning on or after January 1, 2005, the CTL is conformed to the IRC section 179 expensing provisions, with the same modifications under the PITL. The CTL continues to allow "additional first-year depreciation" of up to $2,000 per year. However, the CTL allows taxpayers to elect the IRC section 179 expensing deduction in lieu of "additional first-year depreciation." Property qualifying for "additional first-year depreciation" is similar to property qualifying under IRC section 179. However, a corporation is allowed only one or the other of the expensing deductions, not both.

Currently a corporate or non-corporate taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

Under current California law, S corporations (and their shareholders) are allowed to use MACRS and an IRC section 179 deduction under the PITL. For taxable years beginning on or after January 1, 2002, an S corporation may elect to expense up to $25,000 in the computation of the S corporation's measured tax (presently the S corporation tax rate for non-financial corporations is 1.5 percent).

Impact on California Revenue

Estimated Revenue Impact of Inclusion of Cellulosic Biofuel in Bonus Depreciation for Biomass Ethanol Plant Property For Tax Years Beginning On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$110,000	-$60,000	-$20,000

Estimates are based on a proration of federal projections developed for the Energy Improvement and Extension Act of 2008. Estimates are adjusted to reflect California/federal differences in depreciation methods for corporation taxpayers.

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA)
(PL 110-343, OCTOBER 3, 2008)

Section	Section Title
202	Credits for Biodiesel and Renewable Diesel

Background

Income tax credit

Overview

The IRC provides an income tax credit for biodiesel fuels (the "biodiesel fuels credit").[254] The biodiesel fuels credit is the sum of three credits: (1) the biodiesel mixture credit, (2) the biodiesel credit, and (3) the small agri-biodiesel producer credit. The biodiesel fuels credit is treated as a general business credit. The amount of the biodiesel fuels credit is includable in gross income. The biodiesel fuels credit is coordinated to take into account benefits from the biodiesel excise tax credit and payment provisions discussed below. The credit does not apply to fuel sold or used after December 31, 2008.
Biodiesel is monoalkyl esters of long chain fatty acids derived from plant or animal matter that meet: (1) the registration requirements established by the Environmental Protection Agency under section 211 of the Clean Air Act, and (2) the requirements of the American Society of Testing and Materials ("ASTM") D6751. Agri-biodiesel is biodiesel derived solely from virgin oils including oils from corn, soybeans, sunflower seeds, cottonseeds, canola, crambe, rapeseeds, safflowers, flaxseeds, rice bran, mustard seeds, or animal fats.

Biodiesel may be taken into account for purposes of the credit only if the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer or importer of the biodiesel that identifies the product produced and the percentage of biodiesel and agri-biodiesel in the product.

Biodiesel mixture credit

The biodiesel mixture credit is 50 cents for each gallon of biodiesel (other than agribiodiesel) used by the taxpayer in the production of a qualified biodiesel mixture. For agribiodiesel, the credit is $1.00 per gallon. A qualified biodiesel mixture is a mixture of biodiesel and diesel fuel that is: (1) sold by the taxpayer producing such mixture to any person for use as a fuel, or (2) used as a fuel by the taxpayer producing such mixture. The sale or use must be in the trade or business of the taxpayer and is to be taken into account for the taxable year in which such sale or use occurs. No credit is allowed with respect to any casual off-farm production of a qualified biodiesel mixture.

[254] IRC section 40A.

Biodiesel credit

The biodiesel credit is 50 cents for each gallon of biodiesel that is not in a mixture with diesel fuel (100 percent biodiesel or B-100) and which during the taxable year is: (1) used by the taxpayer as a fuel in a trade or business, or (2) sold by the taxpayer at retail to a person and placed in the fuel tank of such person's vehicle. For agri-biodiesel, the credit is $1.00 per gallon.

Small agri-biodiesel producer credit

The IRC provides a small agri-biodiesel producer income tax credit, in addition to the biodiesel and biodiesel fuel mixture credits. The credit is a 10-cents-per-gallon credit for up to 15 million gallons of agri-biodiesel produced by small producers, defined generally as persons whose agri-biodiesel production capacity does not exceed 60 million gallons per year. The agribiodiesel must be: (1) sold by such producer to another person (a) for use by such other person in the production of a qualified biodiesel mixture in such person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or, (c) who sells such agri-biodiesel at retail to another person and places such agri-biodiesel in the fuel tank of such other person; or (2) used by the producer for any purpose described in (a), (b), or (c).

Biodiesel mixture excise tax credit

The IRC also provides an excise tax credit for biodiesel mixtures.[255] The credit is 50 cents for each gallon of biodiesel used by the taxpayer in producing a biodiesel mixture for sale or use in a trade or business of the taxpayer. In the case of agri-biodiesel, the credit is $1.00 per gallon. A biodiesel mixture is a mixture of biodiesel and diesel fuel that: (1) is sold by the taxpayer producing such mixture to any person for use as a fuel, or (2) is used as a fuel by the taxpayer producing such mixture. No credit is allowed unless the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer of the biodiesel that identifies the product produced and the percentage of biodiesel and agri-biodiesel in the product.[256]

The credit is not available for any sale or use for any period after December 31, 2008. This excise tax credit is coordinated with the income tax credit for biodiesel such that credit for the same biodiesel cannot be claimed for both income and excise tax purposes.

[255] IRC section 6426(c).
[256] IRC section 6426(c)(4).

Payments with respect to biodiesel fuel mixtures

If any person produces a biodiesel fuel mixture in such person's trade or business, the Secretary is to pay such person an amount equal to the biodiesel mixture credit.[257] To the extent the biodiesel fuel mixture credit exceeds the IRC section 4081 liability of a person, the Secretary is to pay such person an amount equal to the biodiesel fuel mixture credit with respect to such mixture.[258] Thus, if the person has no IRC section 4081 liability, the credit is refundable. The Secretary is not required to make payments with respect to biodiesel fuel mixtures sold or used after December 31, 2008.

Renewable diesel

"Renewable diesel" is diesel fuel that: (1) is derived from biomass (as defined in IRC section 45K(c)(3)) using a thermal depolymerization process; (2) meets the registration requirements for fuels and fuel additives established by the Environmental Protection Agency ("EPA") under section 211 of the Clean Air Act (42 U.S.C. sec. 7545); and (3) meets the requirements of the ASTM D975 or D396. ASTM D975 provides standards for diesel fuel suitable for use in diesel engines. ASTM D396 provides standards for fuel oil intended for use in fuel-oil burning equipment, such as furnaces.

For purposes of the IRC, renewable diesel is generally treated the same as biodiesel. Like biodiesel, the incentive may be taken as an income tax credit, an excise tax credit, or as a payment from the Secretary.[259] The incentive for renewable diesel is $1.00 per gallon. There is no small producer credit for renewable diesel. The incentives for renewable diesel expire after December 31, 2008.

Pursuant to IRS Notice 2007-37, the Secretary provided that fuel produced as a result of co-processing biomass and petroleum feedstock ("co-produced fuel") qualifies for the renewable diesel incentives to the extent of the fuel attributable to the biomass in the mixture. In co-produced fuel, the fuel attributable to the biomass does not exist as a distinct separate quantity prior to mixing.

New Federal Law (IRC sections 40A, 6426 and 6427)

The provision extends an additional year (through December 31, 2009) the income tax credit, excise tax credit, and payment provisions for biodiesel (including agri-biodiesel) and renewable diesel. The provision provides that both biodiesel and agri-biodiesel are entitled to a credit of $1.00 per gallon.

[257] IRC section 6427(e).
[258] IRC sections 6427(e)(1) and 6427(e)(3).
[259] IRC sections 40A(f), 6426(c), and 6427(e).

The provision modifies the definition of renewable diesel. The provision eliminates the requirement that the fuel be made using a thermal depolymerization process. The provision also permits the Secretary to identify standards equivalent to ASTM D975 and ASTM D396 for renewable diesel. Thus, under the provision, renewable diesel is liquid fuel derived from biomass which meets (a) the registration requirements for fuels and fuel additives established by the EPA under section 211 of the Clean Air Act, and (b) the requirements of the ASTM D975, ASTM D396, or other equivalent standard approved by the Secretary. The provision also provides that renewable diesel includes biomass fuel that meets a Department of Defense military specification for jet fuel or an ASTM for aviation turbine fuel ("renewable jet fuel"). For purposes of the mixture credit, kerosene is treated as diesel fuel when in a mixture with renewable jet fuel.

The provision also overrides IRS Notice 2007-37 with respect to co-produced fuel, providing that renewable diesel does not include any fuel derived from co-processing biomass with a feedstock that is not biomass. The de minimis use of catalysts, such as hydrogen, is permitted under the provision.

Effective Date

The provision is generally effective for fuel produced, and sold or used, after December 31, 2008. The provision making co-produced fuel ineligible for the renewable diesel incentives is effective for fuel produced, and sold or used, after October 3, 2008.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
203	Clarification that Credits for Fuel are Designed to Provide an Incentive for United States Production

Background

The IRC provides per-gallon incentives relating to the following qualified fuels: alcohol (including ethanol), biodiesel (including agri-biodiesel), renewable diesel, and certain alternative fuels.[260] The incentives may be taken as an income tax credit, excise tax credit or payment. The provisions are coordinated so that a gallon of qualified fuel is only taken into account once. If the qualified fuel is part of a qualified fuel mixture, the incentives apply only to the amount of qualified fuel in the mixture. The IRC also provides an income tax credit for cellulosic biofuel.

That credit is limited to fuel produced and sold in the United States. The cellulosic biofuel credit does not apply after December 31, 2012. Other than for cellulosic biofuel, the IRC is silent as to the geographic limitations on where the fuel must be produced, used, or sold.

For alcohol, other than ethanol, the amount of the credit is 60 cents per gallon. For ethanol, the credit is 51 cents per gallon for calendar year 2008. An extra 10 cents per gallon is available for small ethanol producers. The alcohol incentives generally are available through December 31, 2010.

The amount of the credit for biodiesel is 50 cents. For agri-biodiesel and renewable diesel, the credit amount is $1.00 per gallon. An extra 10 cents per gallon is available for small producers of agri-biodiesel. The biodiesel, agri-biodiesel and renewable diesel incentives do not apply after December 31, 2008.

The credit amount for alternative fuels is 50 cents per gallon. The incentives for alternative fuels do not apply after September 30, 2009 (after September 30, 2014, in the case of liquefied hydrogen).

New Federal Law (IRC sections 40, 6426 and 6427)

The provision provides that fuel that is produced outside the United States for use as a fuel outside the United States is ineligible for the per-gallon tax incentives relating to alcohol, biodiesel, renewable diesel, and alternative fuel. For example, fuel in the following situations is ineligible for incentives: (1) biodiesel, which is not in a mixture, that is both produced and used outside the United States, (2) foreign-produced biodiesel that is used to make a qualified mixture outside of the United States for foreign use, and (3) foreign-produced biodiesel that is used to make a qualified mixture in the United States that is then exported for foreign use.

Effective Date

The provision is effective for claims for credit or payment made on or after May 15, 2008.

California Law (None)

California has no comparable credit.

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[260] See IRC sections 40, 40A, 6426, and 6427(e).

Impact on California Revenue

Not applicable.

Section	Section Title
204	Extension and Modification of Alternative Fuel Credit

Background

The alternative fuel tax credit is a credit against the excise tax imposed under IRC section 4041 on the retail sale or use of alternative fuels. The alternative fuel credit is 50 cents per gallon of alternative fuel sold by the taxpayer for use as fuel in a motor vehicle or motorboat, or so used by the taxpayer. Alternative fuels include liquefied petroleum gas, compressed or liquefied natural gas, liquefied hydrogen, any liquid derived from coal (including peat) through the Fischer-Tropsch process, liquid fuels derived from biomass, and P series fuels (as defined by the Secretary of Energy).[261]

The alternative fuel *mixture* credit is a credit against the excise tax on certain removals, entries, and sales imposed under IRC section 4081. The alternative fuel mixture credit is 50 cents per gallon of alternative fuel used by the taxpayer in producing any alternative fuel mixture for sale or use in a trade or business of the taxpayer.[262]

Both the alternative fuel credit and the alternative fuel mixture credit, along with the related payment provision under IRC section 6427(e), are scheduled to terminate with respect to any sale or use for any period after September 30, 2009. For liquefied hydrogen, however, the credits are in effect until after September 30, 2014 (IRC section 6426(d)(4) and (e)(3), and IRC section 6427(e)(5)(C)).

New Federal Law (IRC sections 6426 and 6427)

The alternative fuel credit and the alternative fuel mixture credit, along with the related payment provision under IRC section 6427(e), are extended to December 31, 2009. The expiration date for liquefied hydrogen incentives remains September 30, 2014.

In addition, compressed or liquefied gas derived from biomass, as defined in IRC section 45(c)(3), has been added to the list of alternative fuels that may qualify for the per-gallon incentives under IRC sections 6426(d) and (e) and IRC section 6426(d)(2)(F). And, the uses

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[261] IRC section 6426(d).
[262] IRC section 6426(e).

of alternative fuel that may give rise to an alternative fuel credit now includes use as a fuel in aviation, in addition to use as a fuel in a motor vehicle or motorboat.[263]

Beginning on October 1, 2009, for liquid fuel derived from coal through the Fischer-Tropsch process to qualify for the per-gallon alternative fuel incentives, it must be produced at a facility that separates and sequesters at least 50 percent of its carbon dioxide emissions. Then, starting on December 31, 2009, this requirement increases to 75 percent of carbon dioxide emissions.[264]

Effective Date

The provision is effective to fuel sold or used after October 3, 2008.

California Law

The Franchise Tax Board does not administer excise taxes. Defer to the State Board of Equalization (BOE).

Impact on California Revenue

Defer to the BOE.

Section	Section Title
205	Credit for New Qualified Plug-In Electric Drive Motor Vehicles

Background

In general

A credit is available for each new qualified fuel cell vehicle, hybrid vehicle, advanced lean burn technology vehicle, and alternative fuel vehicle placed in service by the taxpayer during the taxable year.[265] In general, the credit amount varies depending upon the type of technology used, the weight class of the vehicle, the amount by which the vehicle exceeds certain fuel economy standards, and, for some vehicles, the estimated lifetime fuel savings. The credit generally is available for vehicles purchased after 2005. The credit terminates after 2009, 2010, or 2014, depending on the type of vehicle.

[263] IRC section 6426(d)(1).
[264] IRC section 6426(d)(4).
[265] IRC section 30B.

In general, the credit is allowed to the vehicle owner, including the lessor of a vehicle subject to a lease. If the use of the vehicle is described in paragraphs (3) or (4) of section 50(b) (relating to use by tax-exempt organizations, governments, and foreign persons) and is not subject to a lease, the seller of the vehicle may claim the credit so long as the seller clearly discloses to the user in a document the amount that is allowable as a credit. A vehicle must be used predominantly in the United States to qualify for the credit.

Fuel cell vehicles

A qualified fuel cell vehicle is a motor vehicle that is propelled by power derived from one or more cells that convert chemical energy directly into electricity by combining oxygen with hydrogen fuel that is stored on board the vehicle and may or may not require reformation prior to use. A qualified fuel cell vehicle must be purchased before January 1, 2015. The amount of credit for the purchase of a fuel cell vehicle is determined by a base credit amount that depends upon the weight class of the vehicle and, in the case of automobiles or light trucks, an additional credit amount that depends upon the rated fuel economy of the vehicle compared to a base fuel economy. For these purposes the base fuel economy is the 2002 model year city fuel economy rating for vehicles of various weight classes.[266] Table 2, shows the base credit amounts.

Table 2 - Base Credit Amount for Fuel Cell Vehicles

Vehicle Gross Weight Rating (pounds)	Credit Amount
Vehicle ≤ 8,500	$8,000
8,500 < vehicle ≤ 14,000	$10,000
14,000 < vehicle ≤ 26,000	$20,000
26,000 < vehicle	$40,000

[266] See discussion surrounding Table 7, below.

In the case of a fuel cell vehicle weighing less than 8,500 pounds and placed in service after December 31, 2009, the $8,000 amount in Table 2, above is reduced to $4,000.

Table 3, shows the additional credits for passenger automobiles or light trucks:

Table 3 - Credit for Qualified Fuel Cell Vehicles

Credit	**If Fuel Economy of the Fuel Cell Vehicle Is:**	
	at least	but less than
$1,000	150% of base fuel economy	175% of base fuel economy
$1,500	175% of base fuel economy	200% of base fuel economy
$2,000	200% of base fuel economy	225% of base fuel economy
$2,500	225% of base fuel economy	250% of base fuel economy
$3,000	250% of base fuel economy	275% of base fuel economy
$3,500	275% of base fuel economy	300% of base fuel economy
$4,000	300% of base fuel economy	

Hybrid vehicles and advanced lean burn technology vehicles

Qualified hybrid vehicle

A qualified hybrid vehicle is a motor vehicle that draws propulsion energy from on-board sources of stored energy that include both an internal combustion engine or heat engine using combustible fuel and a rechargeable energy storage system (e.g., batteries). A qualified hybrid vehicle must be placed in service before January 1, 2011 (January 1, 2010 in the case of a hybrid vehicle weighing more than 8,500 pounds).

Hybrid vehicles that are automobiles and light trucks

In the case of an automobile or light truck (vehicles weighing 8,500 pounds or less), the amount of credit for the purchase of a hybrid vehicle is the sum of two components: (1) a fuel economy credit amount that varies with the rated fuel economy of the vehicle compared to a 2002 model year standard, and (2) a conservation credit based on the estimated lifetime fuel savings of the qualified vehicle compared to a comparable 2002 model year vehicle that is powered solely by a gasoline or diesel internal combustion engine. A qualified hybrid automobile or light truck must have a maximum available power[267] from the rechargeable energy storage system of at least four percent. In addition, the vehicle must meet or exceed certain Environmental Protection Agency ("EPA") emissions standards. For a vehicle with a gross vehicle weight rating of 6,000 pounds or less the applicable emissions standards are the Bin 5 Tier II emissions standards. For a vehicle with a gross vehicle weight rating greater

[267] For hybrid passenger vehicles and light trucks, the term "maximum available power" means the maximum power available from the rechargeable energy storage system, during a standard 10 second pulse power or equivalent test, divided by such maximum power and the SAE net power of the heat engine. Sec. IRC section 30B(d)(3)(C)(i).

than 6,000 pounds and less than or equal to 8,500 pounds, the applicable emissions standards are the Bin 8 Tier II emissions standards.

Table 4, below, shows the fuel economy credit available to a hybrid passenger automobile or light truck whose fuel economy (on a gasoline gallon equivalent basis) exceeds that of a base fuel economy:

Table 4 - Fuel Economy Credit		
Credit	**If Fuel Economy of the Hybrid Vehicle is:**	
	at least	but less than
$400	125% of base fuel economy	150% of base fuel economy
$800	150% of base fuel economy	175% of base fuel economy
$1,200	175% of base fuel economy	200% of base fuel economy
$1,600	200% of base fuel economy	225% of base fuel economy
$2,000	225% of base fuel economy	250% of base fuel economy
$2,400	250% of base fuel economy	

Table 5, below, shows the conservation credit.

Table 5 - Conservation Credit	
Estimate Lifetime Fuel Saving (gallons of gasoline)	**Conservation Amount**
At least 1,200 but less than 1,800	$250
At least 1,800 but less than 1,800	$500
At least 2,400 but less than 1,800	$750
At least 3,000	$1,000

Advanced lean burn technology vehicles

The amount of credit for the purchase of an advanced lean burn technology vehicle is the sum of two components: (1) a fuel economy credit amount that varies with the rated fuel economy of the vehicle compared to a 2002 model year standard as described in Table 4, above, and (2) a conservation credit based on the estimated lifetime fuel savings of a qualified vehicle compared to a comparable 2002 model year vehicle as described in Table 5, above. The amounts of the credits are determined after an adjustment is made to account for the different BTU content of gasoline and the fuel utilized by the lean burn technology vehicle.

A qualified advanced lean burn technology vehicle is a passenger automobile or a light truck that incorporates direct injection, achieves at least 125 percent of the 2002 model year city fuel economy, and for 2004 and later model vehicles meets or exceeds certain Environmental Protection Agency emissions standards. For a vehicle with a gross vehicle weight rating of 6,000 pounds or less, the applicable emissions standards are the Bin 5 Tier II emissions standards. For a vehicle with a gross vehicle weight rating greater than 6,000 pounds and less than or equal to 8,500 pounds, the applicable emissions standards are the Bin 8 Tier II emissions standards. A qualified advanced lean burn technology vehicle must be placed in service before January 1, 2011.

Limitation on number of qualified hybrid and advanced lean burn technology vehicles eligible for the credit.

There is a limitation on the number of qualified hybrid vehicles and advanced lean burn technology vehicles sold by each manufacturer of such vehicles that are eligible for the credit. Taxpayers may claim the full amount of the allowable credit up to the end of the first calendar quarter after the quarter in which the manufacturer records the 60,000th hybrid and advanced lean burn technology vehicle sale occurring after December 31, 2005. Taxpayers may claim one half of the otherwise allowable credit during the two calendar quarters subsequent to the first quarter after the manufacturer has recorded its 60,000th such sale. In the third and fourth calendar quarters subsequent to the first quarter after the manufacturer has recorded its 60,000th such sale, the taxpayer may claim one quarter of the otherwise allowable credit.

Thus, for example, summing the sales of qualified hybrid vehicles of all weight classes and all sales of qualified advanced lean burn technology vehicles, if a manufacturer records the sale of its 60,000th qualified vehicle in February of 2007, taxpayers purchasing such vehicles from the manufacturer may claim the full amount of the credit on their purchases of qualified vehicles through June 30, 2007. For the period July 1, 2007, through December 31, 2007, taxpayers may claim one half of the otherwise allowable credit on purchases of qualified vehicles of the manufacturer. For the period January 1, 2008, through June 30, 2008, taxpayers may claim one quarter of the otherwise allowable credit on the purchases of qualified vehicles of the manufacturer. After June 30, 2008, no credit may be claimed for purchases of hybrid vehicles or advanced lean burn technology vehicles sold by the manufacturer.

Hybrid vehicles that are medium and heavy trucks

In the case of a qualified hybrid vehicle weighing more than 8,500 pounds, the amount of credit is determined by the estimated increase in fuel economy and the incremental cost of the hybrid vehicle compared to a comparable vehicle powered solely by a gasoline or diesel internal combustion engine and that is comparable in weight, size, and use of the vehicle. For a vehicle that achieves a fuel economy increase of at least 30 percent but less than 40 percent, the credit is equal to 20 percent of the incremental cost of the hybrid vehicle. For a vehicle that achieves a fuel economy increase of at least 40 percent but less than 50 percent, the credit is equal to 30 percent of the incremental cost of the hybrid vehicle. For a vehicle that achieves a fuel economy increase of 50 percent or more, the credit is equal to 40 percent of the incremental cost of the hybrid vehicle.

The credit is subject to certain maximum applicable incremental cost amounts. For a qualified hybrid vehicle weighing more than 8,500 pounds but not more than 14,000 pounds, the maximum allowable incremental cost amount is $7,500. For a qualified hybrid vehicle weighing more than 14,000 pounds but not more than 26,000 pounds, the maximum allowable incremental cost amount is $15,000. For a qualified hybrid vehicle weighing more than 26,000 pounds, the maximum allowable incremental cost amount is $30,000.

A qualified hybrid vehicle weighing more than 8,500 pounds but not more than 14,000 pounds must have a maximum available power from the rechargeable energy storage system of at least 10 percent. A qualified hybrid vehicle weighing more than 14,000 pounds must have a maximum available power from the rechargeable energy storage system of at least 15 percent.[268]

Alternative fuel vehicle

The credit for the purchase of a new alternative fuel vehicle is 50 percent of the incremental cost of such vehicle, plus an additional 30 percent if the vehicle meets certain emissions standards. The incremental cost of any new qualified alternative fuel vehicle is the excess of the manufacturer's suggested retail price for such vehicle over the price for a gasoline or diesel fuel vehicle of the same model. To be eligible for the credit, a qualified alternative fuel vehicle must be purchased before January 1, 2011.

The amount of the credit varies depending on the weight of the qualified vehicle. The credit is subject to certain maximum applicable incremental cost amounts. Table 6, below, shows the maximum permitted incremental cost for the purpose of calculating the credit for alternative fuel vehicles by vehicle weight class as well as the maximum credit amount for such vehicles.

Table 6 - Maximum Allowable Incremental Cost for Calculation of Alternative Fuel Vehicle Credit

Vehicle Gross Weight Rating (pounds)	Maximum Allowable Incremental Cost	Maximum Allowable Creti
Vehicle ≤ 8,500	$5,000	$4,000
8,500 < vehicle ≤ 14,000	$10,000	$8,000
14,000 < vehicle ≤ 26,000	$25,000	$20,000
26,000 < vehicle	$40,000	$32,000

[268] In the case of such heavy-duty hybrid motor vehicles, the percentage of maximum available power is computed by dividing the maximum power available from the rechargeable energy storage system during a standard 10-second pulse power test, divided by the vehicle's total traction power. A vehicle's total traction power is the sum of the peak power from the rechargeable energy storage system and the heat (e.g., internal combustion or diesel) engine's peak power. If the rechargeable energy storage system is the sole means by which the vehicle can be driven, then the total traction power is the peak power of the rechargeable energy storage system.

Alternative fuels comprise compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, and any liquid fuel that is at least 85 percent methanol. Qualified alternative fuel vehicles are vehicles that operate only on qualified alternative fuels and are incapable of operating on gasoline or diesel (except to the extent gasoline or diesel fuel is part of a qualified mixed fuel, described below).

Certain mixed fuel vehicles, that is vehicles that use a combination of an alternative fuel and a petroleum-based fuel, are eligible for a reduced credit. If the vehicle operates on a mixed fuel that is at least 75 percent alternative fuel, the vehicle is eligible for 70 percent of the otherwise allowable alternative fuel vehicle credit. If the vehicle operates on a mixed fuel that is at least 90 percent alternative fuel, the vehicle is eligible for 90 percent of the otherwise allowable alternative fuel vehicle credit.

Base fuel economy

The base fuel economy is the 2002 model year city fuel economy by vehicle type and vehicle inertia weight class. For this purpose, "vehicle inertia weight class" has the same meaning as when defined in regulations prescribed by the EPA for purposes of Title II of the Clean Air Act. Table 7, below, shows the 2002 model year city fuel economy for vehicles by type and by inertia weight class

Table 7 - 2002 Model Year City Fuel Economy

Vehicle Inertia Weight Class (pounds)	Passenger Automobile (miles per gallon)	Light Truck (miles per gallon)
1,500	45.2	39.4
1,750	45.2	39.4
2,000	39.6	35.2
2,250	35.2	31.8
2,500	31.7	29.0
2,750	28.8	26.8
3,000	26.4	24.9
3,500	22.6	21.8
4,000	19.8	19.4
4,500	17.6	17.6
5,000	15.9	16.1
5,500	14.4	14.8
6,000	13.2	13.7
6,500	12.2	12.8
7,000	11.3	12.1
8,500	11.3	12.1

Other rules

The portion of the credit attributable to vehicles of a character subject to an allowance for depreciation is treated as a portion of the general business credit; the remainder of the credit is allowable to the extent of the excess of the regular tax (reduced by certain other credits) over the alternative minimum tax for the taxable year.

New Federal Law (IRC section 30D)

In general

A new credit against tax applies for qualified plug-in electric drive motor vehicles placed in service in 2009 through 2014. The credit is equal to the applicable amount for each new qualified plug-in electric drive motor vehicle placed in service by the taxpayer during the tax year. The applicable amount is the sum of $2,500, plus an additional $417 for each kilowatt hour of traction battery capacity in excess of four kilowatt hours.

In order for a motor vehicle to qualify as a new plug-in electric drive vehicle, the vehicle must be made by a manufacturer, acquired for use or lease, but not resale, the original use must begin with the taxpayer, and the motor vehicle must have:

1. A traction battery (high power battery for electric vehicle traction) propulsion source with at least four kilowatt hours of capacity;
2. An offboard source of energy to recharge the battery;
3. A certificate of conformity under the Clean Air Act, and meet or exceed the equivalent qualifying California low emission vehicle standard (section 243(e)(2) of the Clean Air Act) for that make and model year, in the case of a passenger vehicle or light truck with a gross vehicle weight rating of not more than 8,500 pounds, and
    a. if the vehicle weight rating is 6,000 pounds or less, meet the Bin 5 Tier II emission standard established in the regulations prescribed by the Administrator of the Environmental Protection Agency (section 202(i) of the Clean Air Act) for that make and model year, and
    b. if the vehicle weight rating is more than 6,000 but not more than 8,500 pounds, meet the Bin 8 Tier II emission standards established in the regulations prescribed by the Administrator of the Environmental Protection Agency (section 202(i) of the Clean Air Act) for that make and model year.

The term motor vehicle means any vehicle that has at least four wheels and is manufactured primarily for use on public streets, roads, and highways.[269] The terms passenger automobile, light truck, and manufacturer are given the same meanings given such terms in regulations prescribed by the Administrator of the Environmental Protection Agency for purposes of the

[269] IRC section 30D(e)(1).

administration of title II of the Clean Air Act.[270] A traction battery capacity is measured in kilowatt hours from 100 percent state of charge to a zero percent state of charge. A motor vehicle will not be eligible for the new qualified plug-in electric drive motor vehicle credit unless it is in compliance with the applicable provisions of the Clean Air Act (or equivalent State law) for the applicable make and model year, and the motor vehicle safety provisions of sections 30101 through 30169 of title 49 of the United States Code.

Limitations on credit amount

The plug-in electric drive motor vehicle credit amount is limited based on the weight of the vehicle and the number of vehicles sold. The maximum credit amount that may be claimed for a new qualified plug-in electric drive motor vehicle is:

- $7,500 for a vehicle with a gross vehicle weight rating of not more than 10,000 pounds;
- $10,000 for a vehicle with a gross vehicle weight rating of more than 10,000 pounds but not more than 14,000 pounds;
- $12,500 for a vehicle with a gross vehicle weight rating of more than 14,000 pounds but not more than 26,000 pounds; and
- $15,000 for a vehicle with a gross vehicle weight rating of more than 26,000 pounds.

The limitation based on vehicles sold operates in much the same way as the phaseout of the alternative motor vehicle credit for hybrid vehicles. When 250,000 new qualified plug-in electric drive motor vehicles have been sold for use in the United States, the phaseout will be triggered. The phaseout period begins with the second calendar quarter following the calendar quarter in which the 250,000th unit is sold. For the first two quarters of the phaseout period, the credit is cut to 50 percent of the full credit amount. The credit is cut to 25 percent for the third and fourth quarters of the phaseout period. Thereafter, there is no credit allowed.

Business versus personal use

If the plug-in electric drive motor vehicle is used in a trade or business and, is therefore, subject to depreciation, the credit allowed for the business use portion is treated as part of the general business credit and that portion is not allowed to calculate the new qualified plug-in electric drive vehicle credit. If the plug-in electric drive motor vehicle is considered personal property the credit will be treated as if it is part of the nonrefundable personal credits under subpart A of the IRC. This treatment allows the credit to be claimed against both a taxpayer's regular tax and minimum tax liabilities in years that IRC section 26(a)(2) applies. In the years that IRC section 26(a)(2) does not apply, the claimed credit amount for the qualified plug-in electric drive motor vehicle credit cannot exceed the excess of the sum of the regular tax liability plus the minimum tax liability over the sum of the nonrefundable

[270] IRC section 30D(e)(2).

personal credits less this credit, the child tax credit, the residential energy efficient property credit and the foreign tax credit.[271]

Property used by tax-exempt entity

If the plug-in electric drive motor vehicle will be used by a tax-exempt organization or governmental unit, the seller of the vehicle may claim the credit provided the seller clearly discloses in writing to the entity the amount of any credit allowable with respect to the vehicle.[272]

Basis

The basis of a new qualified plug-in electric drive motor vehicle will be reduced by the amount of any credit claimed.[273]

Disqualified property

No new qualified plug-in electric drive motor vehicle credit is allowed for property used predominately outside of the United States or for any portion of the cost of such vehicle taken into account as a deduction for clean-fuel vehicles under IRC section 179. Additionally, a new qualified plug-in electric drive motor vehicle that is used to claim the plug-in electric drive motor vehicle credit may not be used to claim an alternative motor vehicle credit.[274]

Termination

The credit does not apply to the purchase of new qualified plug-in electric drive motor vehicles after December 31, 2014.[275]

Effective Date

The provision is effective for taxable years beginning after December 31, 2008.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

[271] IRC section 30D(d)(2)(B).
[272] IRC section 30D(6).
[273] IRC section 30D(e)(4).
[274] IRC section 30B(d)(3)(D)
[275] IRC section 30D(g).

Section	Section Title
206	Exclusion from Heavy Truck Tax for Idling Reduction Units and Advanced Insulation

Background

A 12 percent excise tax (the "heavy vehicle excise tax") is imposed on the first retail sale of automobile truck chassis and bodies, truck trailer and semitrailer chassis and bodies, and tractors of the kind chiefly used for highway transportation in combination with a trailer or semitrailer.[276] The heavy vehicle excise tax does not apply to automobile truck chassis and bodies suitable for use with a vehicle which has a gross vehicle weight of 33,000 pounds or less. The tax also does not apply to truck trailer and semitrailer chassis and bodies suitable for use with a trailer or semitrailer which has a gross vehicle weight of 26,000 pounds or less, or to tractors having a gross vehicle weight of 19,500 pounds or less if such tractor in combination with a trailer or semitrailer has a gross combined weight of 33,000 pounds or less.

If the owner, lessee, or operator of a taxable article installs any part or accessory within six months after the date such vehicle was first placed in service, a 12 percent tax applies on the price of such part or accessory and its installation.

New Federal Law (IRC section 4053)

The provision provides an exemption from the heavy vehicle excise tax for the cost of qualifying idling reduction devices. A qualifying idling reduction device means any device or system of devices that: (1) is designed to provide to a vehicle those services (such as heat, air conditioning, or electricity), which would otherwise require the operation of the main drive engine while the vehicle is temporarily parked or remains stationary, by using one or more devices affixed to a tractor or truck, and (2) is certified by the Secretary of Energy, in consultation with the Administrator of the Environmental Protection Agency and the Secretary of Transportation, to reduce idling of such vehicle at a motor vehicle rest stop or other location where such vehicles are temporarily parked or remain stationary.

The provision also provides an exemption for the installation of "advanced insulation" in a commercial refrigerated truck or trailer that is subject to the heavy vehicle excise tax. Advanced insulation means insulation that has an R value of not less than R35 per inch.

Both exemptions apply regardless of whether the device or insulation is factory installed or later added as an accessory.

Effective Date

The provision is effective for retail sales or installations made after October 3, 2008.

[276] IRC section 4051.

California Law

The Franchise Tax Board does not administer excise taxes; instead, excise taxes are administered by the State Board of Equalization (BOE).

Impact on California Revenue

Defer to the BOE.

Section	Section Title
207	Alternative Fuel Vehicle Refueling Property Credit

Background

Taxpayers may claim a 30-percent credit for the cost of installing qualified clean-fuel vehicle refueling property to be used in a trade or business of the taxpayer or installed at the principal residence of the taxpayer.[277] The credit may not exceed $30,000 per taxable year, per location, in the case of qualified refueling property used in a trade or business and $1,000 per taxable year per location in the case of qualified refueling property installed on property that is used as a principal residence.

Qualified refueling property is property (not including a building or its structural components) for the storage or dispensing of a clean-burning fuel into the fuel tank of a motor vehicle propelled by such fuel, but only if the storage or dispensing of the fuel is at the point where such fuel is delivered into the fuel tank of the motor vehicle. The use of such property must begin with the taxpayer.

Clean-burning fuels are any fuel at least 85 percent of the volume of which consists of ethanol, natural gas, compressed natural gas, liquefied natural gas, liquefied petroleum gas, or hydrogen. In addition, any mixture of biodiesel and diesel fuel, determined without regard to any use of kerosene and containing at least 20 percent biodiesel, qualifies as a clean fuel.

Credits for qualified refueling property used in a trade or business are part of the general business credit and may be carried back for one year and forward for 20 years. Credits for residential qualified refueling property cannot exceed for any taxable year the difference between the taxpayer's regular tax (reduced by certain other credits) and the taxpayer's tentative minimum tax. Generally, in the case of qualified refueling property sold to a tax-exempt entity, the taxpayer selling the property may claim the credit.

[277] IRC section 30C.

A taxpayer's basis in qualified refueling property is reduced by the amount of the credit. In addition, no credit is available for property used outside the United States or for which an election to expense has been made under IRC section 179.

The credit is available for property placed in service after December 31, 2005, and (except in the case of hydrogen refueling property) before January 1, 2010. In the case of hydrogen refueling property, the property must be placed in service before January 1, 2015.

New Federal Law (IRC section 30C)

The provision extends the alternative fuel vehicle refueling property credit to apply to refueling property (other than property relating to hydrogen) placed in service through December 31, 2010. Additionally, the definition of a clean-burning fuel for purposes of the credit is modified to include electricity.[278]

Effective Date

The provision is effective for property placed in service after October 3, 2008, in taxable years ending after October 3, 2008.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
208	Certain Income and Gains Relating to Alcohol Fuels and Mixtures, Biodiesel Fuels and Mixtures, and Alternative Fuels and Mixtures Treated as Qualifying Income for Publicly Traded Partnerships

Background

Present law provides that a publicly traded partnership means a partnership, interests in which are traded on an established securities market, or are readily tradable on a secondary market (or the substantial equivalent thereof). In general, a publicly traded partnership is

[278] IRC section 30C(c)(2)(c).

treated as a corporation, but an exception to corporate treatment is provided if 90 percent or more of its gross income is "qualifying income."

"Qualifying income" includes interest, dividends, and gains from the disposition of a capital asset (or of property described in IRC section 1231(b)) that is held for the production of income that is qualifying income. Qualifying income also includes rents from real property, gains from the sale or other disposition of real property, and income and gains from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber). It also includes income and gains from commodities (not described in IRC section 1221(a)(1)) or futures, options, or forward contracts with respect to such commodities (including foreign currency transactions of a commodity pool) in the case of partnership, a principal activity of which is the buying and selling of such commodities, futures, options or forward contracts.

<u>New Federal Law (IRC section 7704)</u>

The provision provides that qualifying income of a publicly traded partnership includes income or gains from the transportation or storage of certain fuels. Specifically, the fuels are: (1) any fuel described in subsection (b), (c), (d) or (e) of IRC section 6426, namely, alcohol fuel mixtures, biodiesel mixtures, alternative fuels (which include liquefied petroleum gas, P Series Fuels, compressed or liquefied natural gas, liquefied hydrogen, liquid fuel derived from coal through the Fischer-Tropsch process, and liquid fuel derived from biomass), and alternative fuel mixtures; (2) neat alcohol other than alcohol derived from petroleum, natural gas, or coal, or having a proof of less than 190 (as defined in IRC section 6426(b)(4)(A)), and (3) neat biodiesel (as defined in IRC section 40A(d)(1)).

<u>Effective Date</u>

The provision is effective on October 3, 2008, for taxable years beginning after October 3, 2008.

<u>California Law (R&TC sections 17008.5 and 23038.5)</u>

California conforms by reference to IRC section 7704 as of the "specified date" of January 1, 2005, with modifications. Because this federal change was made after the "specified date" of January 1, 2005, California is not conformed.

Impact on California Revenue

Estimated Revenue Impact of Certain Income and Gains Relating to Alcohol Fuels and Mixtures, Biodiesel Fuels and Mixtures, and Alternative Fuels and Mixtures Treated as Qualifying Income for Publicly Traded Partnerships For Tax Years Beginning On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$300,000	-$200,000	-$250,000

Estimates are based on a proration of federal projections developed for the Energy Improvement and Extension Act of 2008.

Section	Section Title
209	Extension and Modification of Election to Expense Certain Refineries

Background

Current law allows a taxpayer to make an election to expense 50 percent of the cost of eligible qualified refinery property placed in service by the taxpayer.[279] A taxpayer who makes an IRC section 179C election to expense 50 percent of the cost of qualified refinery property may still recover the remaining 50 percent of such qualifying expenditures under IRC section 168 and IRC section 179B, if applicable.

Qualified refinery property is any portion of a qualified refinery ("property") which meets certain placed in service requirements and also meets certain construction and written binding contract requirements. In addition, other requirements regarding original use, production capacity, and compliance with environmental laws must be met. The property must be placed in service by the taxpayer after August 8, 2005, and before January 1, 2012, and there can be no written binding contract for the construction of the property in effect on or before June 14, 2005.[280] Also:

- The construction of the property must be subject to a written binding construction contract entered into before January 1, 2008;
- The property must be placed in service before January 1, 2008; or
- In the case of self-constructed property, the construction of the property must begin after June 14, 2005, and before January 1, 2008.[281]

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[279] IRC section 179C(a) and (f).
[280] IRC section 179C(c)(1)(B) and (E).
[281] IRC section 179C(c)(1)(F).

For purposes of the IRC section 179C election, a "qualified refinery" means any refinery located in the United States that is designed to serve the primary purpose of processing liquid fuel from crude oil or qualified fuels. Qualified fuels include oil produced from shale and tar sands; gas produced from geopressured brine, Devonian shale, coal seams, or a tight formation or biomass; and liquid, gaseous, or solid synthetic fuels produced from coal (including lignite), including such fuels when used as feedstocks.[282]

No deduction is allowed for any qualified refinery property, however, which is built solely to comply with consent decrees or projects mandated by federal, state, or local governments, or if the primary purpose of the property is for use as a topping plant, asphalt plant, lube oil facility, crude or product terminal, or blending facility.

For qualified refinery property other than a qualified refinery which is separate from an existing refinery (e.g., expansion of an existing refinery), production capacity requirements apply. These requirements are met if the property enables the existing qualified refinery to (1) increase total volume output, determined without regard to asphalt or lube oil, by five percent or more on an average daily basis, or (2) process qualified fuels at a rate which is equal to or greater than 25 percent of the total throughput of the qualified refinery on an average daily basis.[283]

Temporary and proposed regulations have been issued and providing guidance with respect to the election to expense qualified refinery property.[284] The temporary regulations restate many of the statutory elements of the expense election, including the definition of eligible property, the description of a qualified refinery, compliance with applicable environmental laws, and the written binding contract requirement. They generally interpret the statute in a manner consistent with existing statutory and regulatory principles, and recognize that taxpayers have had to address issues related to the expense election for prior tax years in the absence of regulations.

<u>New Federal Law (IRC section 179C)</u>

Placed-in-service and construction requirements for the IRC section 179C election to expense 50 percent of the cost of eligible qualified refinery property have been extended by two years.

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[282] IRC section 45K(c)).
[283] IRC section 179(c)(1)(C) and (e).
[284] T.D. 9412, I.R.B. 2008-37, 687.

Qualified refinery property is now any portion of a qualified refinery ("property") placed in service by the taxpayer after August 8, 2005, and before January 1, 2014. With respect to construction and written binding contract requirements, one of the following three requirements must be met:

- The construction of the property is subject to a written binding construction contract entered into before January 1, 2010;
- The property was placed in service before January 1, 2010; or
- In the case of self-constructed property, the construction of the property began after June 14, 2005, and before January 1, 2010.[285]

The definition of a "qualified refinery" for purposes of the IRC section 179C election has also been modified and now includes a refinery located in the United States that is designed to serve the primary purpose of processing liquid fuel from crude oil or qualified fuels, or directly from shale or tar sands. Thus, for qualified refinery property other than a qualified refinery which is separate from an existing refinery (e.g., expansion of an existing refinery), production capacity requirements are met if the property enables the existing qualified refinery to: (1) increase total volume output, determined without regard to asphalt or lube oil, by five percent or more on an average daily basis, or (2) process shale, tar sands, or qualified fuels at a rate which is equal to or greater than 25 percent of the total throughput of the qualified refinery on an average daily basis.

Effective Date

The provision applies to property placed in service after October 3, 2008.

California Law (R&TC sections 17201, 17250, 24349, 24355.3, and 24355.4)

Modified Accelerated Cost Recovery System

Under the PITL, California law, as it relates to MACRS, in general conforms to the federal rules with certain modifications as of the “specified date” of January 1, 2005. California specifically does not conform to IRC section 168(k), which allows 30% and 50% bonus depreciation for certain property. Additionally, IRC section 179C, relating to the election to expense certain refineries, was enacted in 2005 by Public Law 109-58, after the “specified date” and thus California is not conformed.

Under current California law, S corporations (and their shareholders) are allowed to use MACRS under the PITL.

[285] IRC section 179C(c)(1)(F).

Under the Corporation Tax Law (CTL), California did not conform to the pre-1986 federal ACRS depreciation deduction and currently does not conform to the federal law MACRS depreciation. Instead, the CTL is in substantial conformity to the pre-1981 federal asset depreciation range (ADR) deduction. The ADR is based on the "useful life" of depreciable property.

IRC section 179 expensing deduction

The PITL is conformed to the IRC section 179 expensing provisions, with modifications. For taxable years beginning on or after January 1, 2005, the CTL is conformed to the IRC section 179 expensing provisions, with the same modifications under the PITL. The CTL continues to allow "additional first-year depreciation" of up to $2,000 per year. However, the CTL allows taxpayers to elect the IRC section 179 expensing deduction in lieu of "additional first-year depreciation." Property qualifying for "additional first-year depreciation" is similar to property qualifying under IRC section 179. However, a corporation is allowed only one or the other of the expensing deductions, not both.

Currently a corporate or non-corporate taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

Under current California law, S corporations (and their shareholders) are allowed to use MACRS and an IRC section 179 deduction under the PITL. For taxable years beginning on or after January 1, 2002, an S corporation may elect to expense up to $25,000 in the computation of the S corporation's measured tax (presently the S corporation tax rate for non-financial corporations is 1.5 percent).

Impact on California Revenue

Estimated Revenue Impact of Extension and Modification of Election to Expense Certain Refineries Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$6,000,000	-$9,000,000	-$34,000,000

Estimates are based on a proration of federal projections developed for the Energy Improvement and Extension Act of 2008. Estimates are adjusted to reflect California/federal differences in depreciation methods for the corporation taxpayers.

Section	Section Title
210	Extension of Suspension of Taxable Income Limit on Percentage Depletion for Oil and Natural Gas Produced from Marginal Properties

Background

The IRC permits taxpayers to recover their investments in oil and gas wells through depletion deductions. Two methods of depletion are currently allowable under the IRC: (1) the cost depletion method, and (2) the percentage depletion method. Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the depletable property which is equal to the ratio of units sold from that property during the taxable year to the number of units remaining as of the end of taxable year plus the number of units sold during the taxable year. Thus, the amount recovered under cost depletion may never exceed the taxpayer's basis in the property.

The IRC generally limits the percentage depletion method for oil and gas properties to independent producers and royalty owners. Generally, under the percentage depletion method, 15% of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year. The amount deducted generally may not exceed 100% of the taxable income from that property in any year. For marginal production, the 100% taxable income limitation has been suspended for taxable years beginning after December 31, 1997, and before January 1, 2008.

Marginal production is defined as domestic crude oil and natural gas production from stripper well property or from property substantially all of the production from which 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 (IRC section 613A)

The temporary suspension of the taxable income limit on the percentage-depletion allowance for oil and gas produced from marginal wells has been extended to include tax years beginning after December 31, 2008, and before January 1, 2010. As a result, the limitation on the amount of a percentage-depletion deduction to 100 percent of the net income from an oil or gas producing property does not apply to domestic oil and gas produced from marginal properties during tax years beginning in 2009, but applies for tax years beginning in 2008.

Effective Date

The provision is effective October 3, 2008.

California Law (R&TC sections 17681, 17681.6, 24831 and 24831.6)

California conforms by reference to IRC section 613A as of the "specified date" of January 1, 2005, but does not conform to the extension of the temporary suspension of the taxable income limit with respect to percentage depletion of certain oil or gas wells in IRC section 613A. Thus, the 100-percent net-income limitation for marginal wells is suspended only for taxable years beginning after December 31, 1997, and before January 1, 2002, for California purposes.

Impact on California Revenue

Not applicable.

Section	Section Title
211	Transportation Fringe Benefit to Bicycle Commuters

Background

Qualified transportation fringe benefits provided by an employer are excluded from an employee's gross income.[286] Qualified transportation fringe benefits include parking, transit passes, and vanpool benefits. In addition, no amount is includible in income of an employee merely because the employer offers the employee a choice between cash and qualified transportation fringe benefits. Up to $220 (for 2008) per month of employer-provided parking is excludable from income. Up to $115 (for 2008) per month of employer-provided transit and vanpool benefits are excludable from gross income. These amounts are indexed annually for inflation, rounded to the nearest multiple of $5.

Under present law, qualified transportation fringe benefits include a cash reimbursement by an employer to an employee. However, in the case of transit passes, a cash reimbursement is considered a qualified transportation fringe benefit only if a voucher or similar item which may be exchanged only for a transit pass is not readily available for direct distribution by the employer to the employee.

[286] IRC section 132(f).

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA)
(PL 110-343, OCTOBER 3, 2008)

New Federal Law (IRC section 132)

The provision adds a qualified bicycle commuting reimbursement fringe benefit as a qualified transportation fringe benefit. A qualified bicycle commuting reimbursement fringe benefit means, with respect to a calendar year, any employer reimbursement during the 15-month period beginning with the first day of such calendar year of an employee for reasonable expenses incurred by the employee during the calendar year for the purchase and repair of a bicycle, bicycle improvements, and bicycle storage, provided that the bicycle is regularly used for travel between the employee's residence and place of employment.

The maximum amount that can be excluded from an employee's gross income for a calendar year on account of a bicycle commuting reimbursement fringe benefit is the applicable annual limitation for the employee for that calendar year. The applicable annual limitation for an employee for a calendar year is equal to the product of $20 multiplied by the number of the employee's qualified bicycle commuting months for the year. The $20 amount is not indexed for inflation. A qualified bicycle commuting month means with respect to an employee any month for which the employee does not receive any other qualified transportation fringe benefit and during which the employee regularly uses a bicycle for a substantial portion of travel between the employee's residence and place of employment. Thus, no amount is credited towards an employee's applicable annual limitation for any month in which an employee's usage of a bicycle is infrequent or constitutes an insubstantial portion of the employee's commute.

A bicycle commuting reimbursement fringe benefit cannot be funded by an elective salary contribution on the part of an employee.

Effective Date

The provision is effective for taxable years beginning after December 31, 2008.

California Law (R&TC sections 17131 and 17149)

California conforms by reference to Part III of Subchapter B of Chapter 1 of Subtitle A of the Internal Revenue Code as of the "specified date" of January 1, 2005, with modifications. Because this federal change was made after the "specified date" of January 1, 2005, California is not conformed to the federal change to IRC section 132.

However, current California law additionally provides an exclusion from gross income for any compensation or the fair market value of any other benefit, except salary or wages, received by an employee from an employer for participation in any ridesharing arrangement in California, including an employee's bicycling to or from his or her place of work. This enhanced exclusion is not subject to any limitation.

Thus, California law already excludes from gross income any compensation or the fair market value of any other benefit, except salary or wages, received by an employee from an employer for participation in any ridesharing arrangement in California, including an employee's bicycling to or from his or her place of work.

Impact on California Revenue

Baseline. Although California currently allows an exclusion of income for qualified bicycling commuter reimbursements for employees, it is likely that taxpayers will follow the new federal exclusion. If California conforms to the federal law, there will be a minor baseline revenue impact.

TITLE III – ENERGY CONSERVATION AND EFFICIENCY PROVISIONS

Section	Section Title
301	Qualified Energy Conservation Bonds

Background

Tax credit bonds generally

A new method of subsidizing state and local governments was introduced with the authorization of tax credit bonds, first exemplified in the form of qualified zone academy bonds, in the Taxpayer Relief Act of 1997.[287] Tax credit bonds are not interest-bearing obligations. Instead, a taxpayer holding a tax credit bond on one or more allowance dates during a tax year is allowed a credit against federal income tax equivalent to the interest that the bond would otherwise pay. The bondholder must include the amount of the credit in his or her gross income and treat it as interest income. In effect, the federal government pays the interest, allowing the issuer to borrow interest free. In return, the issuer must follow certain requirements with regard to the form of the bonds and the use of the proceeds. The IRC provisions authorizing the issuance of tax credit bonds for various financing purposes include *mechanical* provisions, relating to the credit and the application of tax-exempt bond rules, and *substantive* provisions, which vary depending on what the bond proceeds are to be used to finance. Prior to 2008, tax credit bonds for clean renewable energy purposes and for qualified zone academy purposes had been added to the IRC separately, each with their own separate substantive and mechanical provisions.

[287] Public Law 105-34.

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA)
(PL 110-343, OCTOBER 3, 2008)

The Heartland, Habitat, Harvest, and Horticulture Act of 2008[288] added a new Subpart I to Part IV of the IRC (regarding credits against tax), placing common mechanical provisions for tax credit bonds in new IRC section 54A, with room for substantive provisions relating to various types of tax credit bonds to follow in succeeding IRC sections.

The common mechanical requirements for tax credit bonds include requirements that:

- The available project proceeds of the bonds be spent for the specified purposes within three years;
- The issuer meet certain reporting and arbitrage requirements generally applicable to tax-exempt bonds;
- The maturity of the bonds not exceed a maximum term to be set each month by the IRS; and
- Any applicable conflict-of-interest rules are satisfied (IRC section 54A(d)).

New Federal Law (IRC section 54D)

The provision authorizes the issuance of $800 million worth of a new type of tax credit bond called "qualified energy conservation bonds."[289] These tax credit bonds provide a federal subsidy to assist state and local governments in financing the expenses of many energy conservation projects, including capital expenditures, research expenditures, expenses for mass commuting facilities, demonstration projects, and public education campaigns.

Holders of tax credit bonds are generally entitled to an annual tax credit calculated by multiplying the outstanding face amount of the bonds held by the applicable credit rate, which is set by the IRS. The credit rate is set so that the bonds can be issued at face value with no interest. For qualified energy conservation bonds, however, the annual tax credit is limited to 70 percent of the face amount times the applicable credit rate.

Qualified energy conservation bonds

A qualified energy conservation bond is a bond issued as part of an issue if:

- 100 percent of the available project proceeds of the issue are to be used for one or more qualified conservation purposes;
- The bond is issued by a state or local government; and
- The issuer designates the bond as a qualified energy conservation bond.

[288] Public Law 110-246.
[289] IRC section 54D.

The $800 million national limit for qualified energy conservation bonds is to be allocated among the states in proportion to their populations. Any municipality or county with a population of 100,000 or more, known as a large local government, will get a direct allocation from its state's allocation, in an amount that bears the same ratio to the state's allocation as the locality's population bears to the state population. A large local government may choose to reallocate its direct allocation to its state. Each state and each large local government must then allocate its own allocation to issuers within the state.

Although each issuer can designate an amount of its eligible bonds not exceeding the limitation amount allocated to it as qualified energy conservation bonds, each state and each large local government must ensure that no less than 70 percent of its allocation is used to designate bonds that are not private activity bonds. For purposes of the allocation, an Indian tribal government will be treated as located within a state to the extent that its population resides within the state, so that an Indian tribal government that straddles state lines will receive a direct allocation from each state's allocated limitation.

Indian tribal governments are generally treated as large local governments for energy conservation bond purposes even if their population is not 100,000 or more. As a result, they are entitled to their own direct allocations based on their proportion their population bears to the state's population. However, a bond issued by an Indian tribal government will be treated as a qualified energy conservation bond only if the available project proceeds of its issue are used for purposes for which the tribal government could issue tax-exempt bonds.

The population of any location for a calendar year is determined by reference to the most recent census estimate of the location's population that is issued before the beginning of the year in question. If a municipality is a large local government (i.e., it has 100,000 or more residents), that municipality's population is not counted in determining the population of its county.

Qualified conservation purposes

To be a qualified energy conservation bond, a bond must be part of an issue for which 100 percent of the available project proceeds are to be used for one or more qualified conservation purposes. Qualified conservation purposes include:

1. Capital expenditures incurred for purposes of: (a) reducing energy consumption in publicly owned buildings by at least 20 percent; (b) implementing green community programs; (c) rural development involving the production of electricity from renewable energy resources; or (d) any qualified facility for purposes of the renewable electricity production credit under IRC section 45 (excluding refined coal production facilities and Indian coal production facilities, without taking into account the placed in service date restrictions in IRC section 45);
2. Expenditures with respect to research facilities and research grants to support research in: (a) development of cellulosic ethanol and other nonfossil fuels; (b) technologies for the capture and sequestration of carbon dioxide produced from the

use of fossil fuels; (c) increasing the efficiency of existing technologies for producing nonfossil fuels; (d) auto battery technologies and other technologies to reduce fossil fuel consumption in transportation; or (e) technologies to reduce energy use in buildings;

3. Mass commuting facilities and related facilities that reduce the consumption of energy, including expenditures to reduce pollution from vehicles used for mass commuting;
4. Demonstration projects designed to promote the commercialization of: (a) green building technology; (b) the conversion of agricultural waste for use in the production of fuel or otherwise; (c) advanced battery manufacturing technologies; (d) technologies to reduce peak use of electricity; or (e) technologies for the capture and sequestration of carbon dioxide emitted from burning fossil fuels to produce electricity; and
5. Public education campaigns to promote energy efficiency.

If the bond in question is a private activity bond, any expenditure that is not a capital expenditure is not a qualified conservation purpose.

Interaction with IRC section 54A

The provisions of IRC section 54A, which provide mechanical rules for multiple types of tax credit bonds, apply to qualified energy conservation bonds.290

Effective Date

The provisions apply to obligations issued after October 3, 2008.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

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[290] IRC section 54A(d)(1), (d)(2)(C).

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA) (PL 110-343, OCTOBER 3, 2008)

Section	Section Title
302	Credit for Nonbusiness Energy Property

Background

Credit for the purchase of qualified energy efficiency improvements to existing homes

The Energy Tax Incentives Act (ETIA) of 2005 (P.L. 109-58) provided a 10-percent credit for the purchase of qualified energy efficiency improvements to existing homes. A qualified energy efficiency improvement is any energy efficiency building envelope component that meets or exceeds the prescriptive criteria for such a component established by the 2000 International Energy Conservation Code as supplemented and as in effect on August 8, 2005 (or, in the case of metal roofs with appropriate pigmented coatings, meets the Energy Star program requirements), and (1) that is installed in or on a dwelling located in the United States; (2) owned and used by the taxpayer as the taxpayer's principal residence; (3) the original use of which commences with the taxpayer; and (4) such component reasonably can be expected to remain in use for at least five years. The credit is nonrefundable.

Building envelope components are: (1) insulation materials or systems which are specifically and primarily designed to reduce the heat loss or gain for a dwelling; (2) exterior windows (including skylights) and doors; and (3) metal roofs with appropriate pigmented coatings which are specifically and primarily designed to reduce the heat loss or gain for a dwelling. The taxpayer's basis in the property is reduced by the amount of the credit. Special rules apply in the case of condominiums and tenant-stockholders in cooperative housing corporations.

Credit for the purchase of certain property

The ETIA also provided a personal tax credit equal to the total of the allowable credits for the purchase of certain property. The allowable credit for the purchase of certain property is (1) $50 for each advanced main air circulating fan, (2) $150 for each qualified natural gas, propane, or oil furnace or hot water boiler, and (3) $300 for each item of qualified energy efficient property.

An advanced main air circulating fan is a fan used in a natural gas, propane, or oil furnace originally placed in service by the taxpayer during the taxable year, and which has an annual electricity use of no more than two percent of the total annual energy use of the furnace (as determined in the standard Department of Energy test procedures).

A qualified natural gas, propane, or oil furnace or hot water boiler is a natural gas, propane, or oil furnace or hot water boiler with an annual fuel utilization efficiency rate of at least 95.

Qualified energy-efficient property is: (1) an electric heat pump water heater which yields an energy factor of at least 2.0 in the standard Department of Energy test procedure; (2) an electric heat pump which has a heating seasonal performance factor (HSPF) of at least 9, a seasonal energy efficiency ratio (SEER) of at least 15, and an energy efficiency ratio (EER) of at least 13; (3) a geothermal heat pump which (i) in the case of a closed loop product, has an energy efficiency ratio (EER) of at least 14.1 and a heating coefficient of performance (COP) of at least 3.3, (ii) in the case of an open loop product, has an energy efficiency ratio (EER) of at least 16.2 and a heating coefficient of performance (COP) of at least 3.6, and (iii) in the case of a direct expansion (DX) product, has an energy efficiency ratio (EER) of at least 15 and a heating coefficient of performance (COP) of at least 3.5; (4) a central air conditioner which has a seasonal energy efficiency ratio (SEER) of at least 15 and an energy efficiency ratio (EER) of at least 13; and (5) a natural gas, propane, or oil water heater which has an energy factor of at least 0.80.

Overall limitations on credit

The credit allowed under this section may not exceed $500 in total across all taxable years, and no more than $200 dollars of such credit may be attributable to expenditures on windows.

The credit applies to property placed in service after December 31, 2005, and prior to January 1, 2008.

<u>New Federal Law (IRC section 25C)</u>

The provision reestablishes the credit for one year, for property placed in service after December 31, 2008, and before January 1, 2010.

The provision also adds biomass fuel property to the list of qualified energy efficient building property eligible for a $300 credit. Biomass fuel property is a stove that burns biomass fuel to heat a dwelling unit located in the United States and used as a principal residence by the taxpayer, or to heat water for such dwelling unit, and that has a thermal efficiency rating of at least 75 percent. Biomass fuel is any plant-derived fuel available on a renewable or recurring basis, including agricultural crops and trees, wood and wood waste and residues (including wood pellets), plants (including aquatic plants, grasses, residues, and fibers.

The credit for geothermal heat pumps is eliminated to conform with the establishment of a residential geothermal heat pump credit under IRC section 25D, as provided in section 105 of EESA.

<u>Effective Date</u>

The provision is effective for expenditures after December 31, 2008, for property placed in service after December 31, 2008, and prior to January 1, 2010.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
303	Energy Efficient Commercial Buildings Deduction

Background

In general

Current federal law[291] provides a deduction equal to energy-efficient commercial building property expenditures made by the taxpayer. Energy-efficient commercial building property expenditures is defined as property: (1) which is installed on or in any building located in the United States that is within the scope of Standard 90.1-2001 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America (“ASHRAE/IESNA”), (2) which is installed as part of (i) the interior lighting systems, (ii) the heating, cooling, ventilation, and hot water systems, or (iii) the building envelope, and (3) which is certified as being installed as part of a plan designed to reduce the total annual energy and power costs with respect to the interior lighting systems, heating, cooling, ventilation, and hot water systems of the building by 50 percent or more in comparison to a reference building which meets the minimum requirements of Standard 90.1-2001 (as in effect on April 2, 2003). The deduction is limited to an amount equal to $1.80 per square foot of the property for which such expenditures are made. The deduction is allowed in the year in which the property is placed in service. Certain certification requirements must be met in order to qualify for the deduction. The Secretary, in consultation with the Secretary of Energy, will promulgate regulations that describe methods of calculating and verifying energy and power costs using qualified computer software based on the provisions of the 2005 California Nonresidential Alternative Calculation Method Approval Manual or, in the case of residential property, the 2005 California Residential Alternative Calculation Method Approval Manual.

The Secretary shall prescribe procedures for the inspection and testing for compliance of buildings that are comparable, given the difference between commercial and residential buildings, to the requirements in the Mortgage Industry National Accreditation procedures for

[291] IRC section 179D.

Home Energy Rating Systems. Individuals qualified to determine compliance shall only be those recognized by one or more organizations certified by the Secretary for such purposes.

For energy-efficient commercial building property expenditures made by a public entity, such as public schools, the Secretary shall promulgate regulations that allow the deduction to be allocated to the person primarily responsible for designing the property in lieu of the public entity.

If a deduction is allowed under this section, the basis of the property shall be reduced by the amount of the deduction.

The deduction is effective for property placed in service after December 31, 2005, and prior to January 1, 2009.

Partial allowance of deduction

In the case of a building that does not meet the overall building requirement of a 50-percent energy savings, a partial deduction is allowed with respect to each separate building system that comprises energy efficient property and which is certified by a qualified professional as meeting or exceeding the applicable system-specific savings targets established by the Secretary of the Treasury. The applicable system-specific savings targets to be established by the Secretary are those that would result in a total annual energy savings with respect to the whole building of 50 percent, if each of the separate systems met the system specific target. The separate building systems are: (1) the interior lighting system, (2) the heating, cooling, ventilation and hot water systems, and (3) the building envelope. The maximum allowable deduction is $0.60 per square foot for each separate system.

Interim rules for lighting systems

In the case of system-specific partial deductions, in general no deduction is allowed until the Secretary establishes system-specific targets.[292] However, in the case of lighting system retrofits, until such time as the Secretary issues final regulations, the system-specific energy savings target for the lighting system is deemed to be met by a reduction in Lighting Power Density of 40 percent (50 percent in the case of a warehouse) of the minimum requirements in Table 9.3.1.1 or Table 9.3.1.2 of ASHRAE/IESNA Standard 90.1-2001. Also, in the case of a lighting system that reduces lighting power density by 25 percent, a partial deduction of 30 cents per square foot is allowed. A pro-rated partial deduction is allowed in the case of a lighting system that reduces lighting power density between 25 percent and 40 percent. Certain lighting level and lighting control requirements must also be met in order to qualify for the partial lighting deductions under the interim rule.

[292] IRS Notice 2008-40 has set a target of a 10 percent reduction in total energy and power costs with respect to the building envelope, and 20 percent each with respect to the interior lighting system and the heating, cooling, ventilation and hot water systems.

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA) (PL 110-343, OCTOBER 3, 2008)

New Federal Law (IRC section 179D)

The provision extends the energy efficient commercial buildings deduction for five years, through December 31, 2013.

Effective Date

The provision is effective on October 3, 2008.

California Law (R&TC sections 17201 and 17255)

IRC section 179 expensing deduction

The PITL is conformed to the IRC section 179 expensing provisions, with modifications as of the “specified date” of January 1, 2005. For taxable years beginning on or after January 1, 2005, the CTL is conformed to the IRC section 179 expensing provisions, with the same modifications under the PITL. The CTL continues to allow “additional first-year depreciation” of up to $2,000 per year. However, the CTL allows taxpayers to elect the IRC section 179 expensing deduction in lieu of “additional first-year depreciation.” Property qualifying for “additional first-year depreciation” is similar to property qualifying under IRC section 179. However, a corporation is allowed only one or the other of the expensing deductions, not both.

Currently a corporate or non-corporate taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

Under current California law, S corporations (and their shareholders) are allowed to use MACRS and an IRC section 179 deduction under the PITL. For taxable years beginning on or after January 1, 2002, an S corporation may elect to expense up to $25,000 in the computation of the S corporation’s measured tax (presently the S corporation tax rate for non-financial corporations is 1.5 percent).

Energy efficient commercial buildings deduction

California conforms to IRC section 179 as of the specified date of January 1, 2005, with modifications. As this federal deduction[293] was enacted after January 1, 2005, California does not conform to this provision.

Impact on California Revenue

Estimated Revenue Impact of Energy Efficient Commercial Buildings Deduction For Tax Years Beginning On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$9,500,000	-$8,000,000	-$8,200,000

Estimates are based on a proration of federal projections developed for the Emergency Economic Stabilization Act of 2008. The provision would sunset on December 31, 2013.

Section	Section Title
304	New Energy Efficient Home Credit

Background

A credit is allowed to an eligible contractor for the construction of a qualified new energy-efficient home under IRC section 45L. To qualify as an energy-efficient new home, the home must be: (1) a dwelling located in the United States, (2) substantially completed after August 8, 2005, and (3) certified in accordance with guidance prescribed by the Secretary to have a projected level of annual heating and cooling energy consumption that meets the standards for either a 30-percent or 50-percent reduction in energy usage, compared to a comparable dwelling constructed in accordance with the standards of chapter 4 of the 2003 International Energy Conservation Code as in effect (including supplements) on August 8, 2005, and any applicable federal minimum efficiency standards for equipment. With respect to homes that meet the 30-percent standard, one-third of such 30 percent savings must come from the building envelope, and with respect to homes that meet the 50-percent standard, one-fifth of such 50 percent savings must come from the building envelope.

The credit equals $1,000 in the case of a new home that meets the 30 percent standard and $2,000 in the case of a new home that meets the 50 percent standard. The credit related to homes meeting the 30-percent efficiency standard applies only to manufactured homes.

[293] IRC section 179D.

The eligible contractor is the person who constructed the home, or in the case of a manufactured home, the producer of such home. The conference committee report specifically states that the Committee intends that the building envelope component means insulation materials or system specifically and primarily designed to reduce heat loss or gain, exterior windows (including skylights), doors, and any duct sealing and infiltration reduction measures.

Manufactured homes that conform to federal manufactured home construction and safety standards are eligible for the credit provided all the criteria for the credit are met. Manufactured homes certified by a method prescribed by the Administrator of the Environmental Protection Agency under the Energy Star Labeled Homes program are eligible for the $1,000 credit provided criteria (1) and (2), above, are met.

The credit is part of the general business credit. No credits attributable to energy efficient homes can be carried back to any taxable year ending on or before the effective date of the credit.

The credit applies to homes whose construction is substantially completed after December 31, 2005, and which are purchased after December 31, 2005, and prior to January 1, 2008.

New Federal Law (IRC section 45L)

The provision extends the credit through December 31, 2009.

Effective Date

The provision is effective October 3, 2008.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
305	Modification of Energy Efficient Appliance Credit for Appliances Produced After 2007

Background

A credit is allowed under IRC section 45M for the eligible production of certain energy-efficient dishwashers, clothes washers, and refrigerators.

The credit for dishwashers applies to dishwashers produced in 2006 and 2007 that meet the Energy Star standards for 2007, and equals $32.31 per eligible dishwasher.[294]

The credit for clothes washers equals $100 for clothes washers manufactured in 2006-2007 that meet the requirements of the Energy Star program that are in effect for clothes washers in 2007.

The credit for refrigerators is based on energy savings and year of manufacture. The energy savings are determined relative to the energy conservation standards promulgated by the Department of Energy that took effect on July 1, 2001. Refrigerators that achieve a 15 to 20 percent energy saving and that are manufactured in 2006 receive a $75 credit. Refrigerators that achieve a 20 to 25 percent energy saving receive a $125 credit if manufactured in 2006-2007. Refrigerators that achieve at least a 25 percent energy saving receive a $175 credit if manufactured in 2006-2007.

Appliances eligible for the credit include only those produced in the United States and that exceed the average amount of U.S. production from the three prior calendar years for each category of appliance. In the case of refrigerators, eligible production is U.S. production that exceeds 110 percent of the average amount of U.S. production from the three prior calendar years.

A dishwasher is any a residential dishwasher subject to the energy conservation standards established by the Department of Energy. A refrigerator must be an automatic defrost refrigerator-freezer with an internal volume of at least 16.5 cubic feet to qualify for the credit. A clothes washer is any residential clothes washer, including a residential style coin operated washer, that satisfies the relevant efficiency standard.

[294] The credit amount equals $3 multiplied by 100 times the "energy savings percentage," but may not exceed $100 per dishwasher. The energy saving percentage is defined as the change in the energy factor (EF) required by the Energy Star program between 2007 and 2005 divided by the EF requirement for 2007. The EF required for the Energy Star program was 0.58 in 2005 and 0.65 in 2007, for a change of 0.07. The energy saving percentage is thus 0.07 / 0.65, which when multiplied by 100 times $3 equals $32.31 per refrigerator.

The taxpayer may not claim credits in excess of $75 million for all taxable years, and may not claim credits in excess of $20 million with respect to clothes washers eligible for the $50 credit and refrigerators eligible for the $75 credit. A taxpayer may elect to increase the $20 million limitation described above to $25 million provided that the aggregate amount of credits with respect to such appliances, plus refrigerators eligible for the $100 and $125 credits, is limited to $50 million for all taxable years.

Additionally, the credit allowed in a taxable year for all appliances may not exceed two percent of the average annual gross receipts of the taxpayer for the three taxable years preceding the taxable year in which the credit is determined. The credit is part of the general business credit.

New Federal Law (IRC section 45M)

The provision extends and modifies the energy efficient appliance credit. The provision provides modified credits for eligible production as follows:

Dishwashers

1. $45 in the case of a dishwasher that is manufactured in calendar year 2008 or 2009 that uses no more than 324 kilowatt hours per year and 5.8 gallons per cycle, and
2. $75 in the case of a dishwasher that is manufactured in calendar year 2008, 2009, or 2010 and that uses no more than 307 kilowatt hours per year and 5.0 gallons per cycle (5.5 gallons per cycle for dishwashers designed for greater than 12 place settings).

Clothes washers

1. $75 in the case of a residential top-loading clothes washer manufactured in calendar year 2008 that meets or exceeds a 1.72 modified energy factor and does not exceed a 8.0 water consumption factor, and
2. $125 in the case of a residential top-loading clothes washer manufactured in calendar year 2008 or 2009 that meets or exceeds a 1.8 modified energy factor and does not exceed a 7.5 water consumption factor,
3. $150 in the case of a residential or commercial clothes washer manufactured in calendar year 2008, 2009 or 2010 that meets or exceeds a 2.0 modified energy factor and does not exceed a 6.0 water consumption factor, and
4. $250 in the case of a residential or commercial clothes washer manufactured in calendar year 2008, 2009, or 2010 that meets or exceeds a 2.2 modified energy factor and does not exceed a 4.5 water consumption factor.

Refrigerators

1. $50 in the case of a refrigerator manufactured in calendar year 2008 that consumes at least 20 percent but not more than 22.9 percent less kilowatt hours per year than the 2001 energy conservation standards,

2. $75 in the case of a refrigerator that is manufactured in calendar year 2008 or 2009 that consumes at least 23 percent but no more than 24.9 percent less kilowatt hours per year than the 2001 energy conservation standards,
3. $100 in the case of a refrigerator that is manufactured in calendar year 2008, 2009 or 2010 that consumes at least 25 percent but not more than 29.9 percent less kilowatt hours per year than the 2001 energy conservation standards, and
4. $200 in the case of a refrigerator manufactured in calendar year 2008, 2009 or 2010 that consumes at least 30 percent less energy than the 2001 energy conservation standards.

Appliances eligible for the credit include only those that exceed the average amount of production from the two prior calendar years for each category of appliance, rather than the present law three prior calendar years. Additionally, the special rule with respect to refrigerators is eliminated.

The aggregate credit amount allowed with respect to a taxpayer for all taxable years beginning after December 31, 2007, may not exceed $75 million, with the exception that the $200 refrigerator credit and the $250 clothes washer credit are not limited.

The term "modified energy factor" means the modified energy factor established by the Department of Energy for compliance with the Federal energy conservation standard.

The term "gallons per cycle" means, with respect to a dishwasher, the amount of water, expressed in gallons, required to complete a normal cycle of a dishwasher.

The term "water consumption factor" means, with respect to a clothes washer, the quotient of the total weighted per-cycle water consumption divided by the cubic foot (or liter) capacity of the clothes washer.

<u>Effective Date</u>

The provision applies to appliances produced after December 31, 2007.

<u>California Law (None)</u>

California has no comparable credit.

<u>Impact on California Revenue</u>

Not applicable.

Section	Section Title
306	Accelerated Recovery Period for Depreciation of Smart Meters and Smart Grid Systems

Background

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.[295] The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[296] Assets included in class 49.14, describing assets used in the transmission and distribution of electricity for sale and related land improvements, are assigned a class life of 30 years and a recovery period of 20 years.

New Federal Law (IRC section 168)

The provision provides a 10-year recovery period and 150 percent declining balance method for any qualified smart electric meter and any qualified smart electric grid system.[297] For purposes of the provision, a qualified smart electric meter means any time-based meter and related communication equipment which is placed in service by a taxpayer who is a supplier of electric energy or a provider of electric energy services and which is capable of being used by the taxpayer as part of a system that: (1) measures and records electricity usage data on a time differentiated basis in at least 24 separate time segments per day; (2) provides for the exchange of information between the supplier or provider and the customer's smart electric meter in support of time-based rates or other forms of demand response; and (3) provides data to such supplier or provider so that the supplier or provider can provide energy usage information to customers electronically; and (4) provides net metering.

For purposes of the provision, a qualified smart electric grid system means any smart grid property used as part of a system for electric distribution grid communications, monitoring, and management placed in service by a taxpayer who is a supplier of electric energy or a provider of electric energy services. Smart grid property includes electronics and related equipment that is capable of: (1) sensing, collecting, and monitoring data of or from all portions of a utility's electric distribution grid; (2) providing real-time, two-way communications to monitor or manage such grid; and (3) providing real-time analysis of and event prediction based upon collected data that can be used to improve electric distribution system reliability, quality, and performance.

[295] IRC section 168.
[296] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).
[297] To the extent property otherwise qualified for a shorter recover period, such shorter recovery period shall apply.

Effective Date

The provision is effective for property placed in service after October 3, 2008.

California Law (R&TC sections 17201, 17250, 24349, 24355.3 and 24355.4)

Modified accelerated cost recovery system (MACRS)

Personal Income Tax Law (PITL), as it relates to MACRS, in general conforms to the federal rules with certain modifications as of the "specified date" of January 1, 2005. Because this federal change was made after the "specified date" of January 1, 2005, California is not conformed.

Under the Corporation Tax Law (CTL), California did not conform to the pre-1986 federal ACRS depreciation deduction and currently does not conform to the federal law MACRS depreciation. Instead, the CTL is in substantial conformity to the pre-1981 federal asset depreciation range (ADR) deduction. The ADR is based on the "useful life" of depreciable property.

Impact on California Revenue

Estimated Revenue Impact of Accelerated Recovery Period for Depreciation of Smart Meters and Smart Grid Systems Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$1,000,000	-$1,400,000	-$2,200,000

Estimates are based on a proration of federal projections developed by the Joint Committee on Taxation for the Emergency Economic Stabilization Act of 2008.

Section	Section Title
307	Qualified Green Building and Sustainable Design Projects

Background

In general

Private activity bonds are bonds that nominally are issued by states or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such private person. The exclusion from income for state and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds"). The definition of a qualified private activity bond includes exempt facility bonds.

In most cases, the aggregate volume of tax-exempt qualified private activity bonds, including most exempt facility bonds, is restricted by annual aggregate volume limits imposed on bonds issued by issuers within each state. For calendar year 2008, the state volume cap, which is indexed for inflation, equals $85 per resident of the state, or $262.09 million, if greater.

Qualified green building and sustainable design project bonds

The definition of exempt facility bond includes qualified green building and sustainable design project bonds ("qualified green bond"). A qualified green bond is defined as any bond issued as part of an issue that finances a project designated by the Secretary, after consultation with the Administrator of the Environmental Protection Agency (the "Administrator") as a green building and sustainable design project that meets the following eligibility requirements: (1) at least 75 percent of the square footage of the commercial buildings that are part of the project is registered for the U.S. Green Building Council's LEED[298] certification and is reasonably expected (at the time of designation) to meet such certification; (2) the project includes a brownfield site;[299] (3) the project receives at least $5 million dollars in specific state or local resources; and (4) the project includes at least one million square feet of building or at least 20 acres of land.

Qualified green bonds are not subject to the state bond volume limitations. Rather, there is a national limitation of $2 billion of qualified green bonds that the Secretary may allocate, in the aggregate, to qualified green building and sustainable design projects. Qualified green bonds may be currently refunded if certain conditions are met, but cannot be advance refunded. The authority to issue qualified green bonds terminates after September 30, 2009.

Under present law, each green building and sustainable design project must certify to the Secretary, no later than 30 days after the completion of the project, that the net benefit of the tax exempt financing was used for the purposes described in the project application. Issuers are required to maintain, on behalf of each project, an interest bearing reserve account equal to one percent of the net proceeds of any qualified green bond issued for such project. Not

[298] The LEED (Leadership in Energy and Environmental Design) Green Building Rating System is a voluntary, consensus-based national standard for developing high-performance sustainable buildings. Registration is the first step toward LEED certification. Actual certification requires that the applicant project satisfy a number of requirements. Commercial buildings, as defined by standard building codes are eligible for certification. Commercial occupancies include, but are not limited to, offices, retail and service establishments, institutional buildings (e.g. libraries, schools, museums, churches, etc.), hotels, and residential buildings of four or more habitable stories.

[299] For this purpose, a brownfield site is defined by IRC section 101(39) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (42 U.S.C. sec. 9601), including a site described in subparagraph (D)(ii)(II)(aa) thereof (relating to a site that is contaminated by petroleum or a petroleum product excluded from the definition of 'hazardous substance' under IRC section 101).

later than five years after the date of issuance of bonds with respect to the project, the Secretary, after consultation with the Administrator, shall determine whether the project financed with the proceeds of qualified green bonds has substantially complied with the requirements and goals of the project. If the Secretary, after such consultation, certifies that the project has substantially complied with the requirements and goals, amounts in the reserve account, including all interest, shall be released to the project. If the Secretary determines that the project has not substantially complied with such requirements and goals, amounts in the reserve account, including all interest, shall be paid to the United States Treasury.

New Federal Law (IRC section 142)

The provision extends the authority to issue qualified green bonds through September 30, 2012. The provision also clarifies that the date for determining whether amounts in a reserve account may be released to a green building and sustainable design project is the date that is five years after the date of issuance of the last bond issue issued with respect to such project.

Effective Date

The provision is effective October 3, 2008.

California Law (R&TC sections 17133 and 17143)

California law specifically does not conform to IRC sections 103 and 141 through 150, inclusive, relating to exempting the interest earned on state or municipal bonds. In addition, the federal “private-activity-bond” rules have not been adopted by California.

The California exemption from income taxation of interest on bonds of the state and its political subdivisions is contained in the California Constitution (Art. XIII, Sec. 26(b)). The Revenue and Taxation Code further provides, by statute, that the federal “private-activity-bond” analysis shall not be made in determining whether interest on bonds issued by the state or a political subdivision thereof shall be exempt from California income tax. Thus, in California, if the use of the bond proceeds of a state or local California issue is for private business use or is secured by property used for a private business use, the interest on that bond is still treated for California income tax purposes as tax exempt, even though the interest on the bond may well be taxable for federal income tax purposes.

Impact on California Revenue

Not applicable.

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA)
(PL 110-343, OCTOBER 3, 2008)

Section	Section Title
308	Special Depreciation Allowance for Certain Reuse and Recycling Property

Background

The cost of depreciable property placed in service after 1986 is generally recovered using the Modified Accelerated Cost Recovery System (MACRS). Each type of property is assigned to a property class in accordance with the property class table issued by the IRS in Rev. Proc. 87-56, 1987-2 CB 674. The property classes for personal property are: three-year property, five-year property, seven-year property, 10-year property, 15-year property, and 20-year property. The depreciation periods are three years for three-year property, five years for five-year property, seven years for seven-year property, 10 years for 10-year property, etc. Longer recovery periods apply if the MACRS alternative depreciation system (ADS) is used. In the case of 3-, 5-, 7-, and 10-year property, the applicable depreciation method is the 200-percent declining balance method. The 150-percent declining balance method applies to 15- and 20-year property. The half-year or mid-quarter convention applies to personal property. Under these conventions, an asset is considered placed in service or disposed of on the midpoint of the year or quarter, respectively, in which it is placed in service or disposed of.

Subject to certain limitations, a taxpayer may claim a current deduction under IRC section 179 for the cost of tangible personal property acquired for use in the active conduct of a trade or business. For 2008, the maximum deduction is $250,000. The basis of any property expensed under IRC section 179 is reduced for purposes of computing depreciation.

Taxpayers who place qualifying property in service in the 2008 calendar year may claim 50-percent additional depreciation allowance (bonus depreciation) on such property (IRC section 168(k)). Generally, to be eligible to claim bonus depreciation, property must be: eligible for MACRS, with a depreciation period of 20 years or less; water utility property; off-the-shelf computer software; or qualified leasehold property. The property generally must be purchased and placed in service during 2008. In other words, the original use of the property must begin with the taxpayer and must occur after December 31, 2007, and before January 1, 2009. There cannot be a binding written contract before January 1, 2008, to acquire the property. Property qualifies only if it is acquired under a binding written contract entered into during 2008. In the case of self-constructed property, the taxpayer must begin the manufacture, construction or production of qualifying property for its own use during 2008. Bonus depreciation is claimed for both regular tax and alternative minimum tax (AMT) liability unless the taxpayer makes an election out of bonus depreciation.

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA)
(PL 110-343, OCTOBER 3, 2008)

New Federal Law (IRC section 168)

The provision provides that a 50-percent additional depreciation allowance (bonus depreciation) may be claimed on the adjusted basis of qualified reuse and recycling property acquired and placed in service after August 31, 2008. The additional depreciation is claimed in the tax year the property is placed in service. The original use of the property must begin with the taxpayer after August 31, 2008 (i.e., the property must be new) (IRC section 168(m)). Regular MACRS depreciation deductions are computed on the adjusted basis of the property beginning in the tax year the property is placed in service after reduction by the 50-percent allowance.

Effective Date

This provision applies to property placed in service after August 31, 2008.

California Law (R&TC sections 17201, 17250, 24349, 24355.3, and 24355.4)

Modified Accelerated Cost Recovery System

Under the PITL, California law, as it relates to MACRS, in general conforms to the federal rules as of the “specified date” of January 1, 2005, with certain modifications. California specifically does not conform to IRC section 168(k), which allows 30 percent and 50 percent bonus depreciation for certain property. IRC section 168(m), relating to special depreciation allowance for certain reuse and recycling property, was enacted after the “specified date” and thus, California is not conformed.

Under current California law, S corporations (and their shareholders) are allowed to use MACRS under the PITL.

Under the Corporation Tax Law (CTL), California did not conform to the pre-1986 federal ACRS depreciation deduction and currently does not conform to the federal law MACRS depreciation. Instead, the CTL is in substantial conformity to the pre-1981 federal asset depreciation range (ADR) deduction. The ADR is based on the “useful life” of depreciable property.

IRC section 179 expensing deduction

The PITL is conformed to the IRC section 179 expensing provisions, with modifications. For taxable years beginning on or after January 1, 2005, the CTL is conformed to the IRC section 179 expensing provisions, with the same modifications under the PITL. The CTL continues to allow “additional first-year depreciation” of up to $2,000 per year. However, the CTL allows taxpayers to elect the IRC section 179 expensing deduction in lieu of “additional first-year depreciation.” Property qualifying for “additional first-year depreciation” is similar to property qualifying under IRC section 179. However, a corporation is allowed only one or the other of the expensing deductions, not both.

Currently a corporate or non-corporate taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

Under current California law, S corporations (and their shareholders) are allowed to use MACRS and an IRC section 179 deduction under the PITL. For taxable years beginning on or after January 1, 2002, an S corporation may elect to expense up to $25,000 in the computation of the S corporation's measured tax (presently the S corporation tax rate for non-financial corporations is 1.5 percent).

Impact on California Revenue

Estimated Revenue Impact of Special Depreciation Allowance for Certain Reuse and Recycling Property Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$2,300,000	-$1,500,000	-$1,200,000

Estimates are based on a proration of federal projections developed by the Joint Committee on Taxation for the Energy Improvement and Extension Act of 2008. The estimates are adjusted to reflect California/federal differences in depreciation methods for corporation taxpayers.

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA) (PL 110-343, OCTOBER 3, 2008)

TITLE IV – REVENUE PROVISIONS

Section	Section Title
401	Limitation of Deduction for Income Attributable to Domestic Production of Oil, Gas, or Primary Products Thereof

Background

In general

IRC section 199 provides a deduction equal to a portion of the taxpayer's qualified production activities income. For taxable years beginning after 2009, the deduction is nine percent of such income. For taxable years beginning in 2008 and 2009, the deduction is six percent of income. However, the deduction for a taxable year is limited to 50 percent of the wages properly allocable to domestic production gross receipts paid by the taxpayer during the calendar year that ends in such taxable year.[300]

Qualified production activities income

In general, "qualified production activities income" is equal to domestic production gross receipts (defined by IRC section 199(c)(4)), reduced by the sum of: (1) the costs of goods sold that are allocable to such receipts; (2) other expenses, losses, or deductions which are properly allocable to such receipts.

Domestic production gross receipts

"Domestic production gross receipts" generally are gross receipts of a taxpayer that are derived from: (1) any sale, exchange or other disposition, or any lease, rental or license, of qualifying production property ("QPP") that was manufactured, produced, grown or extracted ("MPGE") by the taxpayer in whole or in significant part within the United States; (2) any sale, exchange or other disposition, or any lease, rental or license, of qualified film produced by the taxpayer; (3) any sale, exchange or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) construction activities performed in the United States;[301] or (5) engineering or architectural services performed in the United States for construction projects located in the United States.

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[300] For this purpose, "wages" include the sum of the amounts of wages as defined in IRC section 3401(a) and elective deferrals that the taxpayer properly reports to the Social Security Administration with respect to the employment of employees of the taxpayer during the calendar year ending during the taxpayer's taxable year. Elective deferrals include elective deferrals as defined in IRC section 402(g)(3), amounts deferred under IRC section 457, and designated Roth contributions (as defined in IRC section 402A).

[301] For this purpose, construction activities include activities that are directly related to the erection or substantial renovation of residential and commercial buildings and infrastructure. Substantial renovation would include structural improvements, but not mere cosmetic changes, such as painting, that is not performed in connection with activities that otherwise constitute substantial renovation.

Congress granted Treasury broad authority to "prescribe such regulations as are necessary to carry out the purposes" of section 199.[302] In defining MPGE for purposes of section 199, Treasury described the following as MPGE activities: manufacturing, producing, growing, extracting, installing, developing, improving, and creating QPP; making QPP out of scrap, salvage, or junk material as well as from new or raw material by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles; cultivating soil, raising livestock, fishing, and mining minerals.[303]

The regulations specifically cite an example of oil refining activities in describing the "in whole or in significant part" test in determining domestic production gross receipts. QPP is generally considered to be MPGE in significant part by the taxpayer within the United States if such activities are substantial in nature taking into account all of the facts and circumstances, including the relative value added by, and relative cost of, the taxpayer's MPGE activity within the United States, the nature of the QPP, and the nature of the MPGE activity that the taxpayer performs within the United States.[304]

The following example is provided in the regulations to illustrate this "substantial in nature" standard:

X purchases from Y, an unrelated person, unrefined oil extracted outside the United States. X refines the oil in the United States. The refining of the oil by X is an MPGE activity that is substantial in nature.[305]

Natural gas transmission or distribution

Domestic production gross receipts include gross receipts from the production in the United States of natural gas, but exclude gross receipts from the transmission or distribution of natural gas.[306] Production activities generally include all activities involved in extracting natural gas from the ground and processing the gas into pipeline quality gas. However, gross receipts of a taxpayer attributable to transmission of pipeline quality gas from a natural gas field (or from a natural gas processing plant) to a local distribution company's citygate (or to another customer) are not qualified domestic production gross receipts. Likewise, gas purchased by a local gas distribution company and distributed from the citygate to the local customers does not give rise to domestic production gross receipts.

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[302] IRC section 199(d)(9).
[303] Treas. Reg. sec. 1.199-3(e)(1).
[304] Treas. Reg. sec. 1.199-3(g)(2).
[305] Treas. Reg. sec. 1.199-3(g)(5), Example 1.
[306] H.R. Rep. No. 108-755 (conference report for the American Jobs Creation Act of 2004), footnote 28 at 272.

Drilling oil or gas wells

The Treasury regulations provide that qualifying construction activities performed in the United States include activities relating to drilling an oil or gas well.[307] Under the regulations, activities the cost of which are intangible drilling and development costs within the meaning of Treas. Reg. section 1.612-4 are considered to be activities constituting construction for purposes of determining domestic production gross receipts.[308]

Qualifying in-kind partnerships

In general, an owner of a pass-thru entity is not treated as conducting the qualified production activities of the pass-thru entity, and vice versa. However, the Treasury regulations provide a special rule for “qualifying in-kind partnerships,” which are defined as partnerships engaged solely in the extraction, refining, or processing of oil, natural gas, petrochemicals, or products derived from oil, natural gas, or petrochemicals in whole or in significant part within the United States, or the production or generation of electricity in the United States.[309] In the case of a qualifying in-kind partnership, each partner is treated as MPGE or producing the property MPGE or produced by the partnership that is distributed to that partner.[310] If a partner of a qualifying in-kind partnership derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of the property that was MPGE or produced by the qualifying in-kind partnership, then, provided such partner is a partner of the qualifying in-kind partnership at the time the partner disposes of the property, the partner is treated as conducting the MPGE or production activities previously conducted by the qualifying in-kind partnership with respect to that property.

Alternative minimum tax

The deduction for domestic production activities is allowed for purposes of computing alternative minimum taxable income (including adjusted current earnings). The deduction in computing alternative minimum taxable income is determined by reference to the lesser of the qualified production activities income (as determined for the regular tax) or the alternative minimum taxable income (in the case of an individual, adjusted gross income as determined for the regular tax) without regard to this deduction.

New Federal Law (IRC section 199)

The provision reduces the IRC section 199 deduction for taxpayers with oil related qualified production activities income for any taxable year beginning after 2009 by three percent of the least of: (1) oil related qualified production activities income of the taxpayer for the taxable year; (2) qualified production activities income of the taxpayer for the taxable year; or (3)

[307] Treas. Reg. sec. 1.199-3(m)(1)(i).
[308] Treas. Reg. sec. 1.199-3(m)(2)(iii).
[309] Treas. Reg. sec. 1.199-9(i)(2).
[310] Treas. Reg. sec. 1.199-9(i)(1).

taxable income (determined without regard to the IRC section 199 deduction). For purposes of this provision, the term “oil related qualified production activities income” means qualified production activities income for any taxable year which is attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof during such taxable year.

The term “primary product” has the same meaning as when used in IRC section 927(a)(2)(C), as in effect before its repeal. The Treasury regulations define the term “primary product from oil” to mean crude oil and all products derived from the destructive distillation of crude oil, including volatile products, light oils such as motor fuel and kerosene, distillates such as naphtha, lubricating oils, greases and waxes, and residues such as fuel oil.[311] Additionally, a product or commodity derived from shale oil which would be a primary product from oil if derived from crude oil is considered a primary product from oil. The term “primary product from gas” is defined as all gas and associated hydrocarbon components from gas wells or oil wells, whether recovered at the lease or upon further processing, including natural gas, condensates, liquefied petroleum gases such as ethane, propane, and butane, and liquid products such as natural gasoline.[312] These primary products and processes are not intended to represent either the only primary products from oil or gas or the only processes from which primary products may be derived under existing and future technologies.[313] Examples of non-primary products include, but are not limited to, petrochemicals, medicinal products, insecticides, and alcohols.[314]

Effective Date

The provision is effective for taxable years beginning after December 31, 2008.

California Law (R&TC section 17201.6)

Under the PITL, California specifically does not conform to IRC section 199, relating to the deduction for income attributable to domestic production activities. Additionally, under the CTL, California has no provision allowing a deduction for income attributable to domestic production activities.

Impact on California Revenue

Not applicable.

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[311] Treas. Reg. sec. 1.927(a)-1T(g)(2)(i).
[312] Treas. Reg. sec. 1.927(a)-1T(g)(2)(ii).
[313] Treas. Reg. sec. 1.927(a)-1T(g)(2)(iii).
[314] Treas. Reg. sec. 1.927(a)-1T(g)(2)(iv).

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA) (PL 110-343, OCTOBER 3, 2008)

Section	Section Title
402	Elimination of the Different Treatment of Foreign Oil and Gas Extraction Income and Foreign Oil Related Income for Purposes of the Foreign Tax Credit

Background

In general

Foreign tax credit

The United States taxes its citizens and residents (including U.S. corporations) on their worldwide income. Because the countries in which income is earned also may assert their jurisdiction to tax the same income on the basis of source, foreign-source income earned by U.S. persons may be subject to double taxation. In order to mitigate this possibility, the United States generally provides a credit against U.S. tax liability for foreign income taxes paid or accrued.[315] In the case of foreign income taxes paid or accrued by a foreign subsidiary, a U.S. parent corporation is generally entitled to an indirect (also referred to as a deemed paid) credit for those taxes when it receives an actual or deemed distribution of the underlying earnings from the foreign subsidiary.[316]

Foreign tax credit limitations

The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source income. This general limitation is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting the U.S. tax on U.S.-source income.[317]

In addition, this limitation is calculated separately for various categories of income, generally referred to as "separate limitation categories." The total amount of the foreign tax credit used to offset the U.S. tax on income in each separate limitation category may not exceed the proportion of the taxpayer's U.S. tax which the taxpayer's foreign-source taxable income in that category bears to its worldwide taxable income in that category. The separate limitation rules are intended to reduce the extent to which excess foreign taxes paid in a high-tax foreign jurisdiction can be "cross-credited" against the residual U.S. tax on low-taxed foreign-source income.[318]

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[315] IRC section 901.
[316] IRC sections 902, 960.
[317] IRC section 904(a).
[318] IRC section 904(d). For taxable years beginning prior to January 1, 2007, IRC section 904(d) provides eight separate baskets as a general matter, and effectively many more in situations in which various special rules apply. The American Jobs Creation Act of 2004 reduced the number of baskets from nine to eight for taxable years beginning after December 31, 2002, and further reduced the number of baskets to two (i.e., "general" and "passive") for taxable years beginning after December 31, 2006. P.L.. 108-357, section 404 (2004).

Special limitation on credits for foreign extraction taxes and taxes on foreign oil related income

In addition to the foreign tax credit limitations that apply to all foreign tax credits, a special limitation is placed on foreign income taxes on foreign oil and gas extraction income ("FOGEI").[319] Under this special limitation, amounts claimed as taxes paid on FOGEI of a U.S. corporation qualify as creditable taxes (if they otherwise so qualify) only to the extent they do not exceed the product of the highest marginal U.S. tax rate on corporations (presently 35 percent) multiplied by such extraction income. Foreign taxes paid in excess of that amount on such income are, in general, neither creditable nor deductible. The amount of any such taxes paid or accrued (or deemed paid) in any taxable year which exceeds the FOGEI limitation may be carried back to the immediately preceding taxable year and carried forward 10 taxable years and credited (not deducted) to the extent that the taxpayer otherwise has excess FOGEI limitation for those years.[320]

A similar special limitation applies, in theory, to foreign taxes paid on foreign oil related income ("FORI") in certain cases where the foreign law imposing such amount of tax is structured, or in fact operates, so that the amount of tax imposed with respect to foreign oil related income will generally be "materially greater," over a "reasonable period of time," than the amount generally imposed on income that is neither FORI nor FOGEI.[321] Under the FORI rules, if this theoretical limitation were to apply, then the portion of the foreign taxes on FORI so disallowed would be recharacterized as a (non-creditable) deductible expense.[322]

As a general matter, the FOGEI and FORI rules of section 907 are informed by two related but distinct concerns. First, as described by the Staff of the Joint Committee on Taxation in 1982, the rules were designed to address the perceived problem of "disguised royalties" being improperly treated as creditable foreign taxes:

When U.S. oil companies began operations in a number of major oil exporting countries, they paid only a royalty for the oil extracted since there was generally no applicable income tax in those countries. However, in part because of the benefit to the oil companies of imposing an income tax, as opposed to a royalty, those countries have adopted taxes applicable to extraction income and have labeled them income taxes. Moreover, because of this relative advantage to the oil companies of paying income taxes rather than royalties, many oil-producing nations in the post-World II era have tended to increase their revenues from oil extraction by increasing their taxes on U.S. oil companies.[323]

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[319] IRC section 907(a).
[320] IRC section 907(f). These carryback and carryforward rules are similar to the general foreign tax credit carryback and carryforward rules of IRC section 904(c).
[321] IRC section 907(b).
[322] Treas. Reg. sec. 1.907(a)-0(d).
[323] Joint Committee on Taxation, *Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982*, (JCS-38-82), December 31, 1982, sec. IV.A.7.a, footnote 63.

In addition, the IRC section 907 rules have also been described as intended to prevent the crediting of high foreign taxes on FOGEI and FORI against the residual U.S. tax on other types of lower-taxed foreign source income.[324] Consistent with this concern, between 1975 and 1982 the foreign tax credit rules provided a separate limitation category (or "basket") under the general IRC section 904 limitation for foreign oil income (broadly defined to include both FORI and FOGEI within the meaning of present law IRC section 907); this separate basket for foreign oil income was eliminated when the present law FORI rules were added and other changes were made by the Tax Equity and Reform Act of 1982.[325]

Determination of FOGEI and FORI

In general

Determination of a taxpayer's FOGEI and FORI is highly specific to the taxpayer's relevant facts and circumstances. Under IRC section 907(c)(1), FOGEI is defined as taxable income derived from sources outside the United States and its possessions from the extraction (by the taxpayer or any other person) of minerals from oil or gas wells located outside the United States and its possessions or from the sale or exchange of assets used by the taxpayer in the trade or business of extracting those minerals.[326] The regulations provide that "gross income from extraction is determined by reference to the fair market value of the minerals in the immediate vicinity of the well."[327]

The regulations do not provide specific methods for determining the fair market value of the extracted oil or gas in the immediate vicinity of the well, but simply provide that all the facts and circumstances that exist in the particular case must be considered, including (but not limited to) facts and circumstances pertaining to the independent market value (if any) in the immediate vicinity of the well, the fair market value at the port of the foreign county, and the relationships between the taxpayer and the foreign government.[328]

IRC section 907(c)(2) defines FORI to include taxable income from the processing of oil and gas into their primary products, from the transportation or distribution and sale of oil and gas and their primary products, from the disposition of assets used in these activities, and from the performance of any other related service.[329]

As a result of these separate rules governing FOGEI and FORI and the interaction between them, a taxpayer's determination of the amounts of FOGEI and FORI, as well as the allocation of foreign taxes to each class of income, can have a significant impact on the taxpayer's overall U.S. tax liability.

[324] H.R. Conf. Rep. No. 103-213, at 646 (1993).
[325] P.L. 97-248, sec. 211(c) (1982).
[326] IRC section 907(c)(1).
[327] Treas. Reg. sec. 1.907(c)-1(b)(2).
[328] Treas. Reg. sec. 1.907(c)-1(b)(6).
[329] Sec. 907(c)(1); Treas. Reg. sec. 1.907(c)-1(d).

IRS field directive

An October 12, 2004, IRS field directive (the "2004 Field Directive") sets forth guidance to international examiners and specialists on the application of what it describes as the two most commonly used methods for determining FOGEI and FORI when there is no ascertainable market price for the oil and gas in the immediate vicinity of the well, namely the residual (rate of return) method and the proportionate profits method.[330]

Under the residual (rate of return) method, the taxpayer first calculates FORI by applying an assumed after-tax rate of return to the cost of its fixed "FORI assets." Then, because income from the production and sale of oil and gas product is equal to the sum of FORI and FOGEI, FOGEI is determined by subtracting FORI (as calculated) from the taxpayer's total foreign income from the production and sale of oil and gas product.

Under the proportionate profits method, the taxpayer allocates total income from the production and sale of the oil or gas product between FOGEI and FORI based on the relative costs of the FOGEI and FORI activities.

Under either method, the taxpayer must determine its total income from the production and sale of oil and gas product, and must distinguish between costs and assets classified as relating to FOGEI and those relating to FORI. Under the residual (rate of return) method, the taxpayer must also determine appropriate rates of return for FORI assets. The 2004 Field Directive sets forth examples of FOGEI assets[331] and FORI assets,[332] and further provides that assets that support both FOGEI and FORI may be allocated by any reasonable method.

New Federal Law (IRC section 907)

Under the provision, the scope of the present-law FOGEI rules is expanded to apply to all foreign income from production and other activity related to the sale of oil and gas product (i.e., the sum of FORI and FOGEI as classified under present law). Thus, amounts claimed as taxes paid on such amount of (combined) foreign oil and gas income are creditable in a given taxable year (if they otherwise so qualify) only to the extent they do not exceed the product of the highest marginal U.S. tax rate on corporations (in the case of corporations)

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[330] Memorandum for Industry Directors ("Field Directive on IRC §907 Evaluating Taxpayer Methods of Determining Foreign Oil and Gas Extraction Income (FOGEI) and Foreign Oil Related Income (FORI)"), October 12, 2004 (Tax Analysts Doc 2004-23010; 2004 TNT 233-8). By its terms, the 2004 Field Directive "is not an official pronouncement of the law or the Service's position and cannot be used, cited, or relied upon as such."

[331] Examples of FOGEI assets include wells, wellheads, and pumping equipment; slug catchers, separators, treaters, emulsion breakers and stock tanks needed to obtain marketable crude (for oil production); primary separation and dehydration equipment needed to arrive at a gaseous stream in which hydrocarbons may be recovered (for gas production); lines interconnecting the above; the infrastructure-type equipment to provide for the operation of the above; and structures to physically support the above (such as offshore platforms).

[332] Examples of FORI assets include lines that carry natural gas beyond the primary separator and dehydration equipment and towards its sales point, and compressors needed to transport through these lines; lines that carry marketable crude oil from the premises, as well as pumps needed to transport crude oil through these lines; and assets used to process crude oil and natural gas.

multiplied by such combined foreign oil and gas income for such taxable year. As under the present-law FOGEI rules, excess foreign taxes may be carried back to the immediately preceding taxable year and carried forward 10 taxable years and credited (not deducted) to the extent that the taxpayer otherwise has excess limitation with regard to combined foreign oil and gas income in a carryover year. Under a transition rule, pre-2009 credits carried forward to post-2008 years will continue to governed by present law for purposes of determining the amount of carryforward credits eligible to be claimed in a post-2008 year; similarly, solely for purposes of determining whether excess credits generated in 2009 and carried back can be claimed to offset 2008 tax liability, the new rules will be deemed to apply in determining overall (combined FOGEI-FORI) limitation for the carryback year.

The provision repeals the present-law IRC section 907(b) FORI limitation.

Effective Date

The provision is effective for taxable years beginning after December 31, 2008.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
403	Broker Reporting of Customer's Basis in Securities Transactions

Background

In general

Gain or loss generally is recognized for federal income tax purposes on realization of that gain or loss (for example, through the sale of property giving rise to the gain or loss). The taxpayer's gain or loss on a disposition of property is the difference between the amount realized and the adjusted basis.[333]

[333] IRC section 1001.

To compute adjusted basis, a taxpayer must first determine the property's unadjusted or original basis and then make adjustments prescribed by the IRC.[334] The original basis of property is its cost, except as otherwise prescribed by the IRC (for example, in the case of property acquired by gift or bequest or in a tax-free exchange). Once determined, the taxpayer's original basis generally is adjusted downward to take account of depreciation or amortization, and generally is adjusted upward to reflect income and gain inclusions or capital outlays with respect to the property.

Basis computation rules

If a taxpayer has acquired stock in a corporation on different dates or at different prices and sells or transfers some of the shares of that stock, and the lot from which the stock is sold or transferred is not adequately identified, the shares deemed sold are the earliest acquired shares (the "first-in-first-out rule").[335] If a taxpayer makes an adequate identification of shares of stock that it sells, the shares of stock treated as sold are the shares that have been identified.[336] A taxpayer who owns shares in a regulated investment company ("RIC") generally is permitted to elect, in lieu of the specific identification or first-in-first-out methods, to determine the basis of RIC shares sold under one of two average-cost-basis methods described in Treasury regulations.[337]

Information reporting

Present law imposes information reporting requirements on participants in certain transactions. Under these requirements, information is generally reported to the IRS and furnished to taxpayers. These requirements are intended to assist taxpayers in preparing their income tax returns and to help the IRS determine whether taxpayers' tax returns are correct and complete. For example, every person engaged in a trade or business generally is required to file information returns for each calendar year for payments of $600 or more made in the course of the payor's trade or business.[338]

IRC section 6045(a) requires brokers to file with the IRS annual information returns showing the gross proceeds realized by customers from various sale transactions. The Secretary is authorized to require brokers to report additional information related to customers.[339] Brokers are required to furnish, to every customer, information statements with the same gross proceeds information that is included in the returns filed with the IRS for that customer.[340] These information statements are required to be furnished by January 31 of the year following the calendar year for which the return under IRC section 6045(a) is required to be filed.

[334] IRC section 1016.
[335] Treas. Reg. sec. 1.1012-1(c)(1).
[336] Treas. Reg. sec. 1.1012-1(c).
[337] Treas. Reg. sec. 1.1012-1(e).
[338] IRC section 6041(a).
[339] IRC section 6045(a).
[340] IRC section 6045(b).

A person who is required to file information returns but who fails to do so by the due date for the returns, includes on the returns incorrect information, or files incomplete returns generally is subject to a penalty of $50 for each return with respect to which such a failure occurs, up to a maximum of $250,000 in any calendar year.[341] Similar penalties, with a $100,000 calendar year maximum, apply to failures to furnish correct information statements to recipients of payments for which information reporting is required.[342] Present law does not require broker information reporting with respect to a customer's basis in property but does impose an obligation to keep records, as described below.

Basis recordkeeping requirements

Taxpayers are required to "keep such records as the Secretary may from time to time prescribe."[343] Treasury regulations impose recordkeeping requirements on any person required to file information returns.[344]

Treasury regulations provide that donors and donees should keep records that are relevant in determining a donee's basis in property.[345] IRS Publication 552 states that a taxpayer should keep basis records for property until the period of limitations expires for the year in which the taxpayer disposes of the property.

<u>New Federal Law (IRC sections 1012, 6041, 6045, 6045B and 6724)</u>

In general

Under the provision, every broker that is required to file a return under IRC section 6045(a) reporting the gross proceeds from the sale of a covered security must include in the return: (1) the customer's adjusted basis in the security, and (2) whether any gain or loss with respect to the security is long-term or short-term (within the meaning of IRC section 1222).

Covered securities

A covered security is any specified security acquired on or after an applicable date if the security was: (1) acquired through a transaction in the account in which the security is held, or (2) was transferred to that account from an account in which the security was a covered security, but only if the transferee broker received a statement under IRC section 6045A (described below) with respect to the transfer. Under this rule, certain securities acquired by gift or inheritance are not covered securities.

[341] IRC section 6721.
[342] IRC section 6722.
[343] IRC section 6001.
[344] Treas. Reg. sec. 1.6001-1(a).
[345] Treas. Reg. sec. 1.1015-1(g).

A specified security is any share of stock in a corporation (including stock of a regulated investment company); any note, bond, debenture, or other evidence of indebtedness; any commodity or a contract or a derivative with respect to the commodity if the Secretary determines that adjusted basis reporting is appropriate; and any other financial instrument with respect to which the Secretary determines that adjusted basis reporting is appropriate.

For stock in a corporation (other than stock for which an average basis method is permissible under IRC section 1012), the applicable date is January 1, 2011. For any stock for which an average basis method is permissible under IRC section 1012, the applicable date is January 1, 2012. Consequently, the applicable date for certain stock acquired through a periodic stock investment plan (for which stock additional rules are described below) and for stock in a regulated investment company is January 1, 2012. A regulated investment company is permitted to elect to treat as a covered security any stock in the company acquired before January 1, 2012.

This election is described below. For any specified security other than stock in a corporation or stock for which an average basis method is permitted, the applicable date is January 1, 2013, or a later date determined by the Secretary.

Computation of adjusted basis

The customer's adjusted basis required to be reported to the IRS is determined under the following rules. The adjusted basis of any security other than stock for which an average basis method is permissible under IRC section 1012 is determined under the first-in, first-out method unless the customer notifies the broker by means of making an adequate identification (under the rules of IRC section 1012 for specific identification) of the stock sold or transferred. The adjusted basis of stock for which an average basis method is permissible under IRC section 1012 is determined in accordance with the broker's default method under IRC section 1012 (that is, the first-in, first-out method, the average-cost method, or the specific-identification method) unless the customer notifies the broker that the customer elects another permitted method. This notification is made separately for each account in which stock for which the average cost method is permissible is held and, once made, applies to all stock held in that account. As a result of this rule, a broker's basis computation method used for stock held in one account with that broker may differ from the basis computation method used for stock held in another account with that broker.

For any sale, exchange, or other disposition of a specified security after the applicable date (defined previously), the provision modifies IRC section 1012 so that the conventions prescribed by regulations under that section for determining adjusted basis (the first-in, first-out, specific identification, and average basis conventions) apply on an account-by-account basis. Under this rule, for example, if a customer holds shares of the same specified security in accounts with different brokers, each broker makes its adjusted basis determinations by reference only to the shares held in the account with that broker, and only shares in the account from which the sale is made may be identified as the shares sold. Unless the election described next applies, any stock for which an average basis method is permissible under IRC section 1012 which is acquired before January 1, 2012, is treated as a separate account from any such stock acquired on or after that date. A consequence of this rule is that if adjusted basis is being determined using an average basis method, average basis is computed without regard to any stock acquired before January 1, 2012. A regulated investment company, however, may elect (at the time and in the form and manner prescribed by the Secretary), on a stockholder-by-stockholder basis, to treat as covered securities all stock in the company held by the stockholder without regard to when the stock was acquired. When this election applies, the average basis of a customer's regulated investment company stock is determined by taking into account shares of stock acquired before, on, and after January 1, 2012. A similar election is allowed for any broker holding stock in a regulated investment company as a nominee of the beneficial owner of the stock.

If stock is acquired on or after January 1, 2011, in connection with a periodic stock investment plan, the basis of that stock is determined under one of the basis computation methods permissible for stock in a regulated investment company. Accordingly, an average-cost method may be used for determining the basis of stock acquired under a periodic stock investment plan. In determining basis under this rule, the account-by-account rules described previously, including the election available to regulated investment companies, apply. The special rule for stock acquired through a periodic stock investment plan, however, applies only while the stock is held as part of the plan. If stock to which this rule applies is transferred to another account, the stock will have a cost basis in that other account equal to its basis in the periodic stock investment plan immediately before the transfer (with any proper adjustment for charges incurred in connection with the transfer). After the transfer, however, the transferee broker may use the otherwise applicable convention (that is, the first-in, first-out method or the specific identification method) for determining which shares are sold when a sale is made of some but not all shares of a particular security. It is expected that when stock acquired through a periodic stock investment plan is transferred to another account, the broker executing the transfer will provide information necessary in applying an allowable convention for determining which shares are sold. Accordingly, the transferor broker will be expected to state that shares transferred have a long-term holding period or, for shares that have a short-term holding period, the dates on which the shares were acquired.

A periodic stock investment plan is any stock purchase plan and any dividend reinvestment plan. A stock purchase plan is any arrangement under which identical stock is periodically purchased pursuant to a written plan. A dividend reinvestment plan is any arrangement under which dividends on stock are reinvested in stock identical to the stock with respect to which the dividends are paid. Stock is treated as acquired in connection with a dividend reinvestment plan if the stock is acquired pursuant to the plan or if the dividends paid on the stock are subject to the plan.

Exception for wash sales

Unless the Secretary provides otherwise, a customer's adjusted basis in a covered security generally is determined without taking into account the effect on basis of the wash sale rules of IRC section 1091. If, however, the acquisition and sale transactions resulting in a wash sale under IRC section 1091 occur in the same account and are in identical securities, adjusted basis is determined by taking into account the effect of the wash sale rules. Securities are identical for this purpose only if they have the same Committee on Uniform Security Identification Procedures number.

Special rules for short sales

The provision provides that in the case of a short sale, gross proceeds and basis reporting under IRC section 6045 generally is required in the year in which the short sale is closed (rather than, as under the present law rule for gross proceeds reporting, the year in which the short sale is entered into).

Reporting requirements for options

The provision generally eliminates the present-law regulatory exception from IRC section 6045(a) reporting for certain options. If a covered security is acquired or disposed of by reason of the exercise of an option that was granted or acquired in the same account as the covered security, the amount of the premium received or paid with respect to the acquisition of the option is treated as an adjustment to the gross proceeds from the subsequent sale of the covered security or as an adjustment to the customer's adjusted basis in that security. Gross proceeds and basis reporting also is required when there is a lapse of, or a closing transaction with respect to, an option on a specified security or an exercise of a cash-settled option. Reporting is required for the calendar year that includes the date of the lapse, closing transaction, or exercise. For example, if a taxpayer acquires for $5 a cash settlement stock option with a strike price of $100 and settles the option when the stock trades at $120, a broker through which the acquisition and cash settlement are executed is required to report gross proceeds of $20 from the cash settlement and a basis in the option of $5. For purposes of the reporting requirement for closing transactions, a closing transaction includes a mark-to-market under IRC section 1256. It is intended that a specified security for purposes of the reporting rules described in this paragraph includes a stock index such as the S&P 500. The reporting rules related to options transactions apply only to options granted or acquired on or after January 1, 2013.

Treatment of S corporations

The provision provides that for purposes of IRC section 6045, an S corporation (other than a financial institution) is treated in the same manner as a partnership. This rule applies to any sale of a covered security acquired by an S corporation (other than a financial institution) after December 31, 2011. When this rule takes effect, brokers generally will be required to report gross proceeds and basis information to customers that are S corporations.

Time for providing statements to customers

The provision changes to February 15 the present-law January 31 deadline for furnishing certain information statements to customers. The statements to which the new February 15 deadline applies are: (1) statements showing gross proceeds (under IRC section 6045(b)) or substitute payments (under IRC section 6045(d)), and (2) statements with respect to reportable items (including, but not limited to, interest, dividends, and royalties) that are furnished with consolidated reporting statements (as defined in regulations). The term "consolidated reporting statement" is intended to refer to annual account information statements that brokerage firms customarily provide to their customers and that include tax-related information. It is intended that the February 15 deadline for consolidated reporting statements apply in the same manner to statements furnished for any account or accounts, taxable and retirement, held by a customer with a mutual fund or other broker.

Broker-to-broker and issuer reporting

Every broker (as defined in IRC section 6045(c)(1)), and any other person specified in Treasury regulations, that transfers to a broker (as defined in IRC section 6045(c)(1)) a security that is a covered security when held by that broker or other person must, under new IRC section 6045A, furnish to the transferee broker a written statement that allows the transferee broker to satisfy the provision's basis and holding period reporting requirements. The Secretary may provide regulations that prescribe the content of this statement and the manner in which it must be furnished. It is contemplated that the Secretary will permit this broker-to-broker reporting requirement to be satisfied electronically rather than by paper. Unless the Secretary provides otherwise, the statement required by this rule must be furnished not later than 15 days after the date of the transfer of the covered security.

Present law penalties for failure to furnish correct payee statements apply to failures to furnish correct statements in connection with the transfer of covered securities. New IRC section 6045B requires, according to forms or regulations prescribed by the Secretary, any issuer of a specified security to file a return setting forth a description of any organizational action (such as a stock split or a merger or acquisition) that affects the basis of the specified security, the quantitative effect on the basis of that specified security, and any other information required by the Secretary. This return must be filed within 45 days after the date of the organizational action or, if earlier, by January 15 of the year following the calendar year during which the action occurred. Every person required to file this return for a specified security also must furnish, according to forms or regulations prescribed by the Secretary, to the nominee with respect to that security (or to a certificate holder if there is no nominee) a written statement showing the name, address, and phone number of the information contact of the person required to file the return, the information required to be included on the return with respect to the security, and any other information required by the Secretary. This statement must be furnished to the nominee or certificate holder on or before January 15 of the year following the calendar year in which the organizational action took place. No return or information statement is required to be provided under new IRC section 6045B for any action with respect to a specified security if the action occurs before the applicable date (as defined previously) for that security.

The Secretary may waive the return filing and information statement requirements if the person to which the requirements apply makes publicly available, in the form and manner determined by the Secretary, the name, address, phone number, and email address of the information contact of that person, and the information about the organizational action and its effect on basis otherwise required to be included in the return.

The present-law penalties for failure to file correct information returns apply to failures to file correct returns in connection with organizational actions. Similarly, the present-law penalties for failure to furnish correct payee statements apply to a failure under new IRC section 6045B to furnish correct statements to nominees or holders or to provide required publicly available information in lieu of returns and written statements.

Effective Date

The provision generally takes effect on January 1, 2011. The change to February 15 of the present-law January 31 deadline for furnishing certain information statements to customers applies to statements required to be furnished after December 31, 2008.

California Law (R&TC sections 18031 and 18631)

California conforms by reference to IRC section 1012, relating to basis of property-cost, in R&TC section 18031 as of the “specified date” of January 1, 2005.

California does not conform by reference to IRC section 6045, relating to returns of brokers, but instead provides in R&TC section 18631 that a copy of the federal information return is required to be filed with the FTB upon request. More specifically, R&TC section 18631(c)(7), requires the filing of a copy of the federal information return filed under IRC section 6045, relating to returns of brokers, upon request of the FTB. Because R&TC section 18631(c)(7), requires the filing of a copy of the federal information return filed under IRC section 6045, the return received by the FTB will contain the information mandated by the EESA change. Thus, California has effectively pre-conformed to federal changes in information reporting under those IRC sections enumerated in R&TC section 18631.

California does not have any provisions relating to the newly-created IRC sections 6045A and 6045B.

Impact on California Revenue

Baseline. There will be a baseline gain whether or not California conforms to this provision. The baseline revenue gain is estimated to begin in 2011-12, generating $2.5 million in that year and increasing amounts in future years.

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA) (PL 110-343, OCTOBER 3, 2008)

Section	Section Title
404	0.2 percent FUTA Surtax

Background

The Federal Unemployment Tax Act ("FUTA") imposes a 6.2 percent 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 percent tax rate, making the minimum, net federal unemployment tax rate 0.8 percent. Since all states have approved programs, 0.8 percent is the federal tax rate that generally applies. This federal revenue finances administration of the unemployment system, half of the federal-state extended benefits program, and a federal account for state loans. The states use the revenue turned back to them by the 5.4 percent credit to finance their regular state programs and half of the federal-state extended benefits program.

In 1976, Congress passed a temporary surtax of 0.2 percent of taxable wages to be added to the permanent FUTA tax rate. Thus, the current 0.8 percent FUTA tax rate has two components: a permanent tax rate of 0.6 percent, and a temporary surtax rate of 0.2 percent. The temporary surtax subsequently has been extended through 2008.

New Federal Law (IRC section 3301)

The provision extends the temporary surtax rate (for one year) through December 31, 2009.

Effective Date

The provision is effective for wages paid after December 31, 2008.

California Law

The Franchise Tax Board does not administer Unemployment Insurance provisions; instead, those provisions are administered by the Employment Development Department (EDD).

Impact on California Revenue

Defer to EDD.

Section	Section Title
405	Increase and Extension of Oil Spill Liability Trust Fund

Background

The Oil Spill Liability Trust Fund financing rate ("oil spill tax") was reinstated effective April 1, 2006.[346] The oil spill tax rate is five cents per barrel and generally applies to crude oil received at a U.S. refinery and to petroleum products entered into the United States for consumption, use, or warehousing.[347]

The oil spill tax also applies to certain uses and the exportation of domestic crude oil.[348] If any domestic crude oil is used in or exported from the United States, and before such use or exportation no oil spill tax was imposed on such crude oil, then the oil spill tax is imposed on such crude oil. The tax does not apply to any use of crude oil for extracting oil or natural gas on the premises where such crude oil was produced.

For crude oil received at a refinery, the operator of the U.S. refinery is liable for the tax. For imported petroleum products, the person entering the product for consumption, use, or warehousing is liable for the tax. For certain uses and exports, the person using or exporting the crude oil is liable for the tax. No tax is imposed with respect to any petroleum product if the person who would be liable for such tax establishes that a prior oil spill tax has been imposed with respect to such product.

The imposition of the tax is dependent in part on the balance of the Oil Spill Liability Trust Fund. The oil spill tax does not apply during a calendar quarter if the Secretary estimates that, as of the close of the preceding calendar quarter, the un-obligated balance of the Oil Spill Liability Trust Fund exceeds $2.7 billion. If the Secretary estimates that the un-obligated balance in the Oil Spill Liability Trust Fund is less than $2 billion at close of any calendar quarter, the oil spill tax will apply on the date that is 30 days from the last day of that quarter. The tax does not apply to any periods after December 31, 2014.

New Federal Law (IRC section 4611)

The provision extends the oil spill tax through December 31, 2017. The provision increases the tax rate from five cents to eight cents per barrel for the first quarter that is more than 60 days after the date of enactment through December 31, 2016, and then increases the rate to nine cents per barrel for calendar year 2017. The tax does not apply after December 31, 2017. The provision also repeals the requirement that the tax be suspended when the un-obligated balance exceeds $2.7 billion.

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[346] IRC section 4611(f).
[347] The term "crude oil" includes crude oil condensates and natural gasoline. The term "petroleum product" includes crude oil.
[348] The term "domestic crude oil" means any crude oil produced from a well located in the United States.

Effective Date

The provision increasing the tax rate is effective beginning the first quarter that is more than 60 days after October 3, 2008. The remaining provisions are effective October 3, 2008.

California Law (None)

The Franchise Tax Board does not administer excise taxes; instead, those taxes are administered by the Board of Equalization (BOE).

Impact on California Revenue

Defer to BOE.

DIVISION C – TAX EXTENDERS AND ALTERNATIVE MINIMUM TAX RELIEF
TITLE I – ALTERNATIVE MINIMUM TAX RELIEF

Sections	Section Title
101 & 102	Extension of Alternative Minimum Tax Relief for Nonrefundable Personal Credits / Extension of Increased Alternative Minimum Tax Exemption Amount

Background

Present law imposes an alternative minimum tax ("AMT") on individuals. The AMT is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed $175,000 ($87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The taxable excess is so much of the alternative minimum taxable income ("AMTI") as exceeds the exemption amount. The maximum tax rates on net capital gain and dividends used in computing the regular tax are used in computing the tentative minimum tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments.

The present exemption amount is: (1) $66,250 ($45,000 in taxable years beginning after 2007) in the case of married individuals filing a joint return and surviving spouses; (2) $44,350 ($33,750 in taxable years beginning after 2007) in the case of other unmarried individuals; (3) $33,125 ($22,500 in taxable years beginning after 2007) in the case of married individuals filing separate returns; and (4) $22,500 in the case of an estate or trust. The exemption amount is phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds: (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child credit,[349] the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, the credit for savers, the credit for certain nonbusiness energy property, the credit for residential energy efficient property, and the D.C. first-time homebuyer credit).

For taxable years beginning before 2008, the nonrefundable personal credits are allowed to the extent of the full amount of the individual's regular tax and alternative minimum tax. For taxable years beginning after 2007, the nonrefundable personal credits (other than the adoption credit, child credit and saver's credit) are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit. The adoption credit, child credit, and saver's credit are allowed to the full extent of the individual's regular tax and alternative minimum tax.[350]

New Federal Law (IRC sections 26 and 55)

The provision provides that the individual AMT exemption amount for taxable years beginning in 2008 is: (1) $69,950, in the case of married individuals filing a joint return and surviving spouses; (2) $46,200 in the case of other unmarried individuals; and (3) $34,975 in the case of married individuals filing separate returns.

For taxable years beginning in 2008, the bill allows individuals to offset their entire regular tax liability and alternative minimum tax liability by the nonrefundable personal credits.

Effective Date

The provision is effective for taxable years beginning in 2008.

California Law (R&TC sections 17062 and 17062.3)

California law imposes an AMT. The AMT is the amount by which the tentative minimum tax (TMT) exceeds the regular income tax. An individual's TMT is 7 percent of the amount that AMTI exceeds the exemption amount. California conforms by reference to IRC sections 55 thru 59, relating to the computation of TMT, as of the "specified date" of January 1, 2005, with significant modifications.

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[349] The child credit may be refundable in whole or in part to a taxpayer.
[350] The rule applicable to the adoption credit and child credit is subject to the EGTRRA sunset.

For taxable years beginning in 1998 and later, California specifically modifies IRC section 55(d)(1), relating to exemption amount, to provide its own AMT exemption and phase-out amounts that are indexed annually. For the 2008 taxable year the exemption amount and phase-out amounts by filing status are as follows:

Filing Status	Exemption Amount	Phase-out Amount
Married/RDP filing jointly or qualifying window(er)	$80,017	$300,065
Single or head of household	$60,014	$225,050
Married/RDP filing separately, estate or trust	$40,007	$150,031

Impact on California Revenue

Not applicable.

Section	Section Title
103	Increase of AMT Refundable Credit Amount for Individuals with Long-Term Unused Credits for Prior Year Minimum Tax Liability, etc

Background

In general

Present law imposes an alternative minimum tax on an individual taxpayer to the extent the taxpayer's tentative minimum tax liability exceeds his or her regular income tax liability. An individual's tentative minimum tax is the sum of: (1) 26 percent of so much of the taxable excess as does not exceed $175,000 ($87,500 in the case of a married individual filing a separate return), and (2) 28 percent of the remaining taxable excess. The taxable excess is the amount by which the alternative minimum taxable income exceeds an exemption amount.

An individual's 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.

The individual AMT attributable to deferral adjustments generates a minimum tax credit that is allowable to the extent the regular tax (reduced by other nonrefundable credits) exceeds the tentative minimum tax in a future taxable year. Unused minimum tax credits are carried forward indefinitely.

AMT treatment of incentive stock options

One of the adjustments in computing AMTI is the tax treatment of the exercise of an incentive stock option. An incentive stock option is an option granted by a corporation in connection with an individual's employment, so long as the option meets certain specified requirements.[351]

Under the regular tax, the exercise of an incentive stock option is tax-free if the stock is not disposed of within one year of exercise of the option or within two years of the grant of the option.[352] When the stock is sold, the individual's long-term capital gain or loss is determined using the amount paid for the stock as the cost basis. If the holding period requirements are not satisfied, the individual generally takes into account at the exercise of the option an amount of ordinary income equal to the excess of the fair market value of the stock on the date of exercise over the amount paid for the stock. The cost basis of the stock is increased by the amount taken into account.[353]

Allowance of long-term unused credits

Under present law, an individual's minimum tax credit allowable for any taxable year beginning after December 31, 2006, and beginning before January 1, 2013, is not less than the "AMT refundable credit amount." The "AMT refundable credit amount" is the amount (not in excess of the long-term unused minimum tax credit) equal to the greatest of: (1) $5,000, (2) 20 percent of the long-term unused minimum tax credit for the taxable year, or (3) the amount (if any) of the AMT refundable credit amount for the preceding taxable year before any reduction by reason of the reduction for adjusted gross income described below. The long-term unused minimum tax credit for any taxable year means the portion of the minimum tax credit attributable to the adjusted net minimum tax for taxable years before the 3rd taxable year immediately preceding the taxable year (assuming the credits are used on a first-in, first-out basis).

In the case of an individual whose adjusted gross income for a taxable year exceeds the threshold amount (within the meaning of IRC section 151(d)(3)(C)), the AMT refundable credit amount is reduced by the applicable percentage (within the meaning of IRC section 151(d)(3)(B)). The additional credit allowable by reason of this provision is refundable.

[351] IRC section 422.
[352] IRC section 421.
[353] If the stock is sold at a loss before the required holding periods are met, the amount taken into account may not exceed the amount realized on the sale over the adjusted basis of the stock. If the stock is sold after the taxable year in which the option was exercised but before the required holding periods are met, the required inclusion is made in the year the stock is sold.

New Federal Law (IRC section 53)

The provision generally allows the long-term unused minimum tax credit to be claimed over a two-year period (rather than five years) and eliminates the AGI phase-out. The provision provides that any underpayment of tax outstanding on the date of enactment which is attributable to the application of the minimum tax adjustment for incentive stock options (including any interest or penalty relating thereto) is abated. No tax which is abated is taken into account in determining the minimum tax credit.

The provision provides that the AMT refundable credit amount and the AMT credit for each of the first two taxable years beginning after December 31, 2007, are increased by one-half of the amount of any interest and penalty paid before the date of enactment on account of the application of the minimum adjustment for incentive stock options.

Effective Date

The provision generally applies to taxable years beginning after December 31, 2007.

California Law (R&TC section 17063)

California generally conforms to the minimum tax credit, but does not conform to the special rule for individuals with long-term unused credits.

Impact on California Revenue

Not applicable.

TITLE II – EXTENSION OF INDIVIDUAL TAX PROVISIONS

Section	Section Title
201	Deduction for State and Local Sales Taxes

Background

Present law

For purposes of determining regular tax liability, an itemized deduction is permitted for certain state and local taxes paid, including individual income taxes, real property taxes, and personal property taxes. The itemized deduction is not permitted for purposes of determining a taxpayer's alternative minimum taxable income. For taxable years beginning in 2004 and 2005, at the election of the taxpayer, an itemized deduction may be taken for state and local general sales taxes in lieu of the itemized deduction provided under present law for state and local income taxes. As is the case for state and local income taxes, the itemized deduction for State and local general sales taxes is not permitted for purposes of determining a taxpayer's alternative minimum taxable income. Taxpayers have two options with respect to the determination of the sales tax deduction amount. Taxpayers may deduct the total amount of general state and local sales taxes paid by accumulating receipts showing general sales taxes paid. Alternatively, taxpayers may use tables created by the Secretary of the Treasury that show the allowable deduction. The tables are based on average consumption by taxpayers on a state-by-state basis taking into account number of dependents, modified adjusted gross income and rates of state and local general sales taxation. Taxpayers who live in more than one jurisdiction during the tax year are required to pro-rate the table amounts based on the time they live in each jurisdiction. Taxpayers who use the tables created by the Secretary may, in addition to the table amounts, deduct eligible general sales taxes paid with respect to the purchase of motor vehicles, boats and other items specified by the Secretary. Sales taxes for items that may be added to the tables are not reflected in the tables themselves.

The term "general sales tax" means a tax imposed at one rate with respect to the sale at retail of a broad range of classes of items. However, in the case of items of food, clothing, medical supplies, and motor vehicles, the fact that the tax does not apply with respect to some or all of such items is not taken into account in determining whether the tax applies with respect to a broad range of classes of items, and the fact that the rate of tax applicable with respect to some or all of such items is lower than the general rate of tax is not taken into account in determining whether the tax is imposed at one rate. Except in the case of a lower rate of tax applicable with respect to food, clothing, medical supplies, or motor vehicles, no deduction is allowed for any general sales tax imposed with respect to an item at a rate other than the general rate of tax. However, in the case of motor vehicles, if the rate of tax exceeds the general rate, such excess shall be disregarded and the general rate is treated as the rate of tax.

A compensating use tax with respect to an item is treated as a general sales tax, provided such tax is complementary to a general sales tax and a deduction for sales taxes is allowable with respect to items sold at retail in the taxing jurisdiction that are similar to such item.

New Federal Law (IRC section 164)

The present-law provision allowing taxpayers to elect to deduct state and local sales taxes in lieu of state and local income taxes is extended for two years (through December 31, 2009).

Effective Date

The provision applies to taxable years beginning after December 31, 2007.

California Law (R&TC section 17220)

California specifically does not conform to IRC section 164(b)(5), relating to the election to deduct state and local general sales taxes.

Impact on California Revenue

Not applicable.

Section	Section Title
202	Deduction of Qualified Tuition and Related Expenses

Background

An individual is allowed an above-the-line deduction for qualified tuition and related expenses for higher education paid by the individual during the taxable year.[354] Qualified tuition and related expenses are defined in the same manner as for the Hope and Lifetime Learning credits, and includes tuition and fees required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer with respect to whom the taxpayer may claim a personal exemption, at an eligible institution of higher education for courses of instruction of such individual at such institution.[355] The expenses must be in connection with enrollment at an institution of higher education during the taxable year, or with an academic period beginning during the taxable year or during the first three months of the next taxable year.

The deduction is not available for tuition and related expenses paid for elementary or secondary education. The maximum deduction is $4,000 for an individual whose adjusted gross income for the taxable year does not exceed $65,000 ($130,000 in the case of a joint return), or $2,000 for other individuals whose adjusted gross income does not exceed $80,000 ($160,000 in the case of a joint return). No deduction is allowed for an individual whose adjusted gross income exceeds the relevant adjusted gross income limitations, for a married individual who does not file a joint return, or for an individual with respect to whom a personal exemption deduction may be claimed by another taxpayer for the taxable year. The deduction is not available for taxable years beginning after December 31, 2007.

[354] IRC section 222.
[355] The deduction generally is not available for expenses with respect to a course or education involving sports, games, or hobbies, and is not available for student activity fees, athletic fees, insurance expenses, or other expenses unrelated to an individual's academic course of instruction.

The amount of qualified tuition and related expenses must be reduced by certain scholarships, educational assistance allowances, and other amounts paid for the benefit of such individual,[356] and by the amount of such expenses taken into account for purposes of determining any exclusion from gross income of: (1) income from certain U.S. savings bonds used to pay higher education tuition and fees; and (2) income from a Coverdell education savings account.[357] Additionally, such expenses must be reduced by the earnings portion (but not the return of principal) of distributions from a qualified tuition program if an exclusion under IRC section 529 is claimed with respect to expenses eligible for the qualified tuition deduction. No deduction is allowed for any expense for which a deduction is otherwise allowed or with respect to an individual for whom a Hope or Lifetime Learning credit is elected for such taxable year.

New Federal Law (IRC section 222)

The provision extends the qualified tuition deduction for two years so that it is generally available for taxable years beginning before January 1, 2010. However, the provision also modifies the qualified tuition deduction so that it is unavailable to any taxpayer for any taxable year beginning in 2008 or 2009 if the taxpayer would, in the absence of the alternative minimum tax, have a lower tax liability for that year if he or she elected the Hope or Lifetime Learning credit with respect to an eligible individual instead of the qualified tuition deduction.

Effective Date

The provision is effective for taxable years beginning after December 31, 2007.

California Law (R&TC section 17204.7)

California specifically does not conform to IRC section 222, relating to a deduction for qualified tuition and related expenses.

Impact on California Revenue

Not applicable.

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[356] IRC sections 222(d)(1) and 25A(g)(2).
[357] IRC section 222(c). These reductions are the same as those that apply to the Hope and Lifetime Learning credits.

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA)
(PL 110-343, OCTOBER 3, 2008)

Section	Section Title
203	Deduction for Certain Expenses of Elementary and Secondary School Teachers

Background

In general, ordinary and necessary business expenses are deductible. However, unreimbursed employee business expenses generally are deductible only as an itemized deduction and only to the extent that the individual's total miscellaneous deductions (including employee business expenses) exceed two percent of adjusted gross income. An individual's otherwise allowable itemized deductions may be further limited by the overall limitation on itemized deductions, which reduces itemized deductions for taxpayers with adjusted gross income in excess of $159,950 (for 2008).[358] In addition, miscellaneous itemized deductions are not allowable under the alternative minimum tax.

Eligible educators are allowed an above-the-line deduction for certain expenses.[359] Specifically, for taxable years beginning after December 31, 2001, and prior to January 1, 2008, an above-the-line deduction is allowed for up to $250 annually of expenses paid or incurred by an eligible educator for books, supplies (other than non-athletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom. To be eligible for this deduction, the expenses must be otherwise deductible under IRC section 162 as a trade or business expense. A deduction is allowed only to the extent the amount of expenses exceeds the amount excludable from income under IRC sections 135 (relating to education savings bonds), IRC 529(c)(1) (relating to qualified tuition programs), and IRC section 530(d)(2) (relating to Coverdell education savings accounts).

An eligible educator is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during a school year. A school means any school that provides elementary education or secondary education, as determined under State law.

New Federal Law (IRC section 62)

The provision extends the deduction for eligible educator expenses for two years so that it is available for taxable years beginning before January 1, 2010.

Effective Date

The provision applies to taxable years beginning after December 31, 2007.

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[358] The adjusted gross income threshold is $79,975 in the case of a married individual filing a separate return (for 2008).
[359] IRC section 62(a)(2)(D).

California Law (R&TC section 17072(b))

California specifically does not conform to IRC section 62(a)(2)(D), relating to an above-the-line deduction for eligible educators.

Impact on California Revenue

Not applicable.

Section	Section Title
204	Additional Standard Deduction for Real Property Taxes for Nonitemizers

Background

In general

An individual taxpayer's taxable income is computed by reducing adjusted gross income either by a standard deduction or, if the taxpayer elects, by the taxpayer's itemized deductions. The deduction for certain taxes, including income taxes, real property taxes, and personal property taxes, generally is an itemized deduction.[360]

Additional standard deduction for state and local property taxes

An individual taxpayer's standard deduction for a taxable year beginning in 2008 is increased by the lesser of: (1) the amount allowable[361] to the taxpayer as a deduction for state and local taxes described in IRC section 164(a)(1) (relating to real property taxes), or (2) $500 ($1,000 in the case of a married individual filing jointly). The increased standard deduction is determined by taking into account real estate taxes for which a deduction is allowable to the taxpayer under IRC section 164 and, in the case of a tenant-stockholder in a cooperative housing corporation, real estate taxes for which a deduction is allowable to the taxpayer under IRC section 216. No taxes deductible in computing adjusted gross income are taken into account in computing the increased standard deduction.

[360] If the deduction for State and local taxes is attributable to business or rental income, the deduction is allowed in computing adjusted gross income and therefore is not an itemized deduction.
[361] In the case of an individual taxpayer who does not elect to itemize deductions, although no itemized deductions are allowed to the taxpayer, itemized deductions are nevertheless treated as "allowable." See section 63(e).

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA)
(PL 110-343, OCTOBER 3, 2008)

New Federal Law (IRC section 63)

The provision extends the additional standard deduction for State and local real property taxes for one year.

Effective Date

The provision applies to taxable years beginning in 2009.

California Law (R&TC sections 17073 and 17073.5)

California conforms to IRC section 63 as of the "specified date" of January 1, 2005, with significant modifications. Because these changes were made after the "specified date" California is not conformed. Additionally, California specifically does not conform to IRC sections 63(c)(1) relating to the standard deduction. Instead, California provides its own stand-alone standard deduction amounts and rules.

Impact on California Revenue

Estimated Revenue Impact of Additional Standard Deduction for Real Property Taxes for Nonitemizers For Tax Years Beginning On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$31,000,000	No impact	No impact

Estimates are based on a proration of federal projections developed for the Emergency Economic Stabilization Act of 2008 and adjusted to reflect California differences.

Section	Section Title
205	Tax-Free Distributions from Individual Retirement Plans for Charitable Purposes

Background

In general

If an amount withdrawn from a traditional individual retirement arrangement ("IRA") or a Roth IRA is donated to a charitable organization, the rules relating to the tax treatment of withdrawals from IRAs apply to the amount withdrawn and the charitable contribution is subject to the normally applicable limitations on deductibility of such contributions. An exception applies in the case of a qualified charitable distribution.

Charitable contributions

In computing taxable income, an individual taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and up to the fair market value of property contributed to a charity described in section 501(c)(3), to certain veterans' organizations, fraternal societies, and cemetery companies,[362] or to a federal, state, or local governmental entity for exclusively public purposes.[363] The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property 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.[364]

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.[365]

A payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate, among other things, that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of $250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.[366] In addition, present law requires that any charity that receives a contribution exceeding $75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a "quid pro quo" contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services may be deductible as a charitable contribution.[367]

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base, which is the taxpayer's adjusted gross income for a taxable year (disregarding any net operating loss carryback). To the extent a

[362] IRC sections 170(c)(3)-(5).
[363] IRC section 170(c)(1).
[364] IRC sections 170(b) and (e).
[365] IRC section 170(a).
[366] IRC section 170(f)(8).
[367] IRC section 6115.

taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's contribution base, (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.

Contributions by individuals in excess of the 50-percent, 30-percent, and 20-percent limits may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 2008 is $159,950 ($79,975 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, the overall limitation on itemized deductions phases-out for all taxpayers. The overall limitation on itemized deductions was reduced by one-third in taxable years beginning in 2006 and 2007, and is reduced by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however, this elimination of the limitation sunsets on December 31, 2010.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity (e.g., a remainder) 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.[368] Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, and present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property.[369] For such interests, a charitable deduction is allowed to the extent of the present value of the interest designated for a charitable organization.

IRA rules

Within limits, individuals may make deductible and nondeductible contributions to a traditional IRA. Amounts in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal represents a return of nondeductible contributions). Individuals also may make nondeductible contributions to a Roth IRA. Qualified withdrawals from a Roth IRA

[368] IRC sections 170(f), 2055(e)(2), and 2522(c)(2).
[369] IRC section 170(f)(2).

are excludable from gross income. Withdrawals from a Roth IRA that are not qualified withdrawals are includible in gross income to the extent attributable to earnings. Includible amounts withdrawn from a traditional IRA or a Roth IRA before attainment of age 59-1/2 are subject to an additional 10-percent early withdrawal tax, unless an exception applies. Under present law, minimum distributions are required to be made from tax-favored retirement arrangements, including IRAs. Minimum required distributions from a traditional IRA must generally begin by the April 1 of the calendar year following the year in which the IRA owner attains age 70½.[370]

If an individual has made nondeductible contributions to a traditional IRA, a portion of each distribution from an IRA is nontaxable until the total amount of nondeductible contributions has been received. In general, the amount of a distribution that is nontaxable is determined by multiplying the amount of the distribution by the ratio of the remaining nondeductible contributions to the account balance. In making the calculation, all traditional IRAs of an individual are treated as a single IRA, all distributions during any taxable year are treated as a single distribution, and the value of the contract, income on the contract, and investment in the contract are computed as of the close of the calendar year.

In the case of a distribution from a Roth IRA that is not a qualified distribution, in determining the portion of the distribution attributable to earnings, contributions and distributions are deemed to be distributed in the following order: (1) regular Roth IRA contributions; (2) taxable conversion contributions;[371] (3) nontaxable conversion contributions; and (4) earnings. In determining the amount of taxable distributions from a Roth IRA, all Roth IRA distributions in the same taxable year are treated as a single distribution, all regular Roth IRA contributions for a year are treated as a single contribution, and all conversion contributions during the year are treated as a single contribution.

Distributions from an IRA (other than a Roth IRA) are generally subject to withholding unless the individual elects not to have withholding apply.[372] Elections not to have withholding apply are to be made in the time and manner prescribed by the Secretary.

Qualified charitable distributions

Present law provides an exclusion from gross income for otherwise taxable IRA distributions from a traditional or a Roth IRA in the case of qualified charitable distributions.[373] The exclusion may not exceed $100,000 per taxpayer per taxable year. Special rules apply in determining the amount of an IRA distribution that is otherwise taxable. The otherwise applicable rules regarding taxation of IRA distributions and the deduction of charitable contributions continue to apply to distributions from an IRA that are not qualified charitable

[370] Minimum distribution rules also apply in the case of distributions after the death of a traditional or Roth IRA owner.
[371] Conversion contributions refer to conversions of amounts in a traditional IRA to a Roth IRA.
[372] IRC section 3405.
[373] The exclusion does not apply to distributions from employer-sponsored retirements plans, including SIMPLE IRAs and simplified employee pensions ("SEPs").

distributions. Qualified charitable distributions are taken into account for purposes of the minimum distribution rules applicable to traditional IRAs to the same extent the distribution would have been taken into account under such rules had the distribution not been directly distributed under the qualified charitable distribution provision. An IRA does not fail to qualify as an IRA merely because qualified charitable distributions have been made from the IRA.

A qualified charitable distribution is any distribution from an IRA directly by the IRA trustee to an organization described in IRC section 170(b)(1)(A) (other than an organization described in IRC section 509(a)(3) or a donor advised fund (as defined in IRC section 4966(d)(2)). Distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70½.

The exclusion applies only if a charitable contribution deduction for the entire distribution otherwise would be allowable (under present law), determined without regard to the generally applicable percentage limitations. Thus, for example, if the deductible amount is reduced because of a benefit received in exchange, or if a deduction is not allowable because the donor did not obtain sufficient substantiation, the exclusion is not available with respect to any part of the IRA distribution.

If the IRA owner has any IRA that includes nondeductible contributions, a special rule applies in determining the portion of a distribution that is includible in gross income (but for the qualified charitable distribution provision) and thus is eligible for qualified charitable distribution treatment. Under the special rule, the distribution is treated as consisting of income first, up to the aggregate amount that would be includible in gross income (but for the qualified charitable distribution provision) if the aggregate balance of all IRAs having the same owner were distributed during the same year. In determining the amount of subsequent IRA distributions includible in income, proper adjustments are to be made to reflect the amount treated as a qualified charitable distribution under the special rule. Distributions that are excluded from gross income by reason of the qualified charitable distribution provision are not taken into account in determining the deduction for charitable contributions under IRC section 170.
The exclusion for qualified charitable distributions applies to distributions made in taxable years beginning after December 31, 2005. Under present law, the exclusion does not apply to distributions made in taxable years beginning after December 31, 2007.
New Federal Law (IRC section 408)

The provision would extend the exclusion for qualified charitable distributions to distributions made in taxable years beginning after December 31, 2007, and before January 1, 2009.

Effective Date

The provision is effective for distributions made in taxable years beginning after December 31, 2007.

California Law (R&TC sections 17501 and 17551)

California conforms by reference to Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of IRC sections 401 through 424, inclusive, in R&TC section 17501. Additionally, California conforms by reference to IRC 457, relating to deferred compensation plans of state and local governments and tax-exempt organizations, in R&TC section 17551. However, except for increases in the maximum amount of elective deferrals, R&TC sections 17501(b) and 17551(c) specifically provide that federal changes to Part I of Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of IRC sections 401 through 420, inclusive, and IRC section 457, relating to deferred compensation plans of state and local governments and tax-exempt organizations, automatically apply without regard to taxable year to the same extent as applicable for federal income tax purposes and thus adopt all changes made to those IRC sections without regard to the “specified date” contained in R&TC section 17024.5. The federal changes to IRC sections 408 that extend the exclusion for qualified charitable distributions to distributions made in taxable years beginning after December 31, 2007, and before January 1, 2009, automatically apply under California law without regard to taxable year to the same extent as applicable for federal income tax purposes.

Impact on California Revenue

No conformity revenue impact because California automatically conforms to this federal change. Any revenue impact would be considered baseline.

Section	Section Title
206	Treatment of Certain Dividends of Regulated Investment Companies

Background

In general

A regulated investment company (RIC), commonly known as a mutual fund, is a domestic corporation or common trust fund that invests in stocks and securities. RICs must satisfy a number of complex tests relating to income, assets, and other matters (IRC sections 851 and 852). A RIC passes through the character of its long-term capital gains to its shareholders, by designating a dividend paid as a capital gain dividend to the extent that the RIC has net capital gains available. Shareholders treat these gains as long-term capital gains (IRC section 852(b)(3)).

Generally, U.S. source income received by a nonresident alien or foreign corporation that is not "effectively connected with a U.S. trade or business" is subject to a flat 30-percent tax, collected through withholding (or, if applicable, a lower treaty tax rate) (IRC sections 871(a) and 881). U.S. source net income that is "effectively connected" to a trade or business is subject to the regular graduated tax rates (IRC sections 871(b) and 882).

The following items received by a nonresident alien or foreign corporation are exempt from the 30-percent tax:

1. Interest from certain bank deposits;[374]
2. Original issue discount obligations that mature within 183 days or less from the original issue date;[375] and
3. Interest paid on portfolio obligations.[376]

Foreign persons are generally not subject to tax on gain realized when they dispose of stock or securities issued by a U.S. entity, unless the gain is effectively connected with the conduct of a U.S. trade or business. This exception does not apply, however, in the case of a nonresident alien who is present in the United States for more than 183 aggregated days in a tax year.[377] A RIC may elect to withhold tax on a distribution, representing a capital gain dividend, to a foreign person.[378]

Interest-related dividend

For dividends with respect to tax years of RICs beginning after December 31, 2004, but before January 1, 2008, a RIC can designate all or a portion of a dividend paid to a nonresident alien or foreign corporation as an interest-related dividend. The RIC must designate the dividend as an interest-dividend by written notice mailed to its shareholders no later than 60 days after the close of its tax year. As a result of the designation, and with some exceptions, the dividend is exempt from the 30-percent tax, collected through withholding. The provision applies to amounts that would be exempt if paid to a nonresident alien or foreign corporation directly.[379] An interest-related dividend is limited to the RIC's qualified net interest income. Qualified interest income is the sum of the RIC's U.S. source income with respect to:

1. Bank deposit interest;
2. Short-term original issue discount that is currently exempt from tax under IRC section 871;

[374] IRC sections 871(i)(2)(A) and 881(d).
[375] IRC section 871(g).
[376] IRC sections 871(h) and 881(c).
[377] IRC section 871(a)(2).
[378] Treas. Reg. sec. 1.1441-3(c)(2)(i)(D).
[379] IRC sections 871(k)(1)(C), 881(e)(1), 1441(c)(12) and 1442(a).

3. Any interest (including amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount, and any other such amounts that may be prescribed by regulations) on an obligation that is in registered form (unless the interest was earned on an obligation issued by a corporation or partnership in which the RIC is a 10-percent shareholder or is contingent interest not treated as portfolio interest under IRC section 871(h)(4)); and
4. Any interest-related dividend from another RIC.[380]

If the exemption is inapplicable because the interest is on certain debt of the recipient or any corporation or partnership for which the recipient is a 10-percent shareholder, the RIC remains exempt from its withholding obligation unless it knows the dividend is subject to the exception.[381] A similar rule applies in the case of dividends received by controlled foreign corporations where the interest is attributable to a related person.[382]

Short-term capital gain dividend

For dividends with respect to tax years of a RIC beginning after December 31, 2004, but before January 1, 2008, a RIC can designate all or a portion of a dividend paid to a nonresident alien or foreign corporation as a short-term capital gain dividend. The RIC must designate the dividend as a short-term capital gains dividend by written notice mailed to its shareholders no later than 60 days after the close of its tax year. As a result of the designation, the short-term capital gain dividend is exempt from the 30-percent tax, collected through withholding.[383] This exemption does not apply when the nonresident alien is present in the United States for 183 days or more during the tax year. If the exemption is inapplicable, the RIC, nevertheless, remains exempt from its withholding obligation, unless it knows that the dividend recipient has been present in the United States for such period.

The amount designated as a short-term capital gain dividend cannot exceed the qualified short-term capital gain for the tax year. The amount qualified to be designated as a short-term capital gain dividend for the RIC's tax year is equal to the excess of the RIC's net short-term capital gain over its net long-term capital losses. Short-term capital gain includes short-term capital gain dividends from another RIC. Net short-term capital gain is determined without regard to any net capital loss or net short-term capital loss attributable to transactions occurring after October 31 of the tax year. The loss is treated as arising on the first day of the next tax year. To the extent provided in regulations, this rule will apply for purposes of computing the RIC's taxable income.[384]

[380] IRC section 871(k)(1)(E).
[381] IRC sections 871(k)(1)(B)(i) and 1441(c)(12)(B).
[382] IRC sections 881(e)(1)(B)(ii) and 1442(a).
[383] IRC sections 871(k)(2)(C), 881(e)(1)(C), 1441(c)(12) and 1442(a)).
[384] IRC section 871(k)(2)(D)).

New Federal Law (IRC section 871)

The provision that allows a regulated investment company (RIC) to designate dividends paid to nonresident aliens or foreign corporations as interest-related dividends or short-term capital gains dividends is extended for two years. Dividends that are so designated are generally exempt from the 30-percent tax, collected through withholding. Specifically, interest-related dividends and short-term capital gain dividends do not include dividends with respect to any tax year of a RIC beginning after December 31, 2009.

Effective Date

The amendments made by this provision apply to dividends with respect to tax years of RICs beginning after December 31, 2007.

California Law (None)

California has no comparable provision.

Impact on California Revenue

Not applicable.

Section	Section Title
207	Stock in RIC for Purposes of Determining Estates of Nonresidents Not Citizens

Background

The value of the gross estate of a nonresident decedent who was not a citizen of the United States includes only the portion of the gross estate located in the United States.[385] A portion of stock in a regulated investment company (RIC), commonly known as a mutual fund, that is owned by a nonresident, non-U.S. citizen, is treated as property located outside of the United States and is not includible in the estate of the person for federal estate tax purposes.

[385] IRC section 2103.

The exempt amount is the proportion of the RIC's assets that were "qualifying assets" in relation to the total assets of the RIC. Qualifying assets are assets that, if owned directly by the decedent, would have been:

1. bank deposits that are exempt from income tax;
2. portfolio debt obligations;
3. certain original issue discount obligations;
4. debt obligations of a U.S. corporation that are treated as giving rise to foreign source income; and
5. other property not within the United States.[386]

The favorable estate tax treatment applies to estates of decedents dying after December 31, 2004, and before January 1, 2008.

New Federal Law (IRC section 2105)

The favorable estate tax treatment afforded a portion of stock in a RIC that is owned by a nonresident, non-U.S. citizen, is extended for two years.

Effective Date

This provision applies to the estates of decedents dying after December 31, 2007.

California Law (R&TC Sections 17024.5, 17041, 17952, and 25110)

While California does impose an estate tax, the tax (also known as a “pick-up” tax) is limited to the amount of credit available under federal law for state inheritance or death taxes. California’s estate tax is administered by the State Controller.

Impact on California Revenue

Defer to the State Controller.

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[386] IRC section 2105(d)(2)).

Section	Section Title
208	Qualified Investment Entities

Background

Special U.S. tax rules apply to capital gains of foreign persons that are attributable to dispositions of interests in U.S. real property. In general, a foreign person (a foreign corporation or a nonresident alien individual) is not generally taxed on U.S. source capital gains unless certain personal presence or effectively connected business requirements are met. However, under the Foreign Investment in Real Property Tax Act ("FIRPTA") provisions codified in IRC section 897, a foreign person who sells a U.S. real property interest (USRPI) is treated as if the gain from such a sale is effectively connected with a U.S. business, and is subject to tax at the same rates as a U.S. person. Withholding tax is also imposed under IRC section 1445.

A USPRI, the sale of which is subject to FIRPTA tax, includes stock or a beneficial interest in any U.S. real property holding corporation (as defined), unless the stock is regularly traded on an established securities market and the selling foreign corporation or nonresident alien individual held no more than 5 percent of that stock within the 5-year period ending on date of disposition (or, if shorter, during the period in which the entity was in existence). There is an exception, however, for stock of a domestically controlled "qualified investment entity." However, if stock of a domestically controlled qualified investment entity is disposed of within the 30 days preceding a dividend distribution in an "applicable wash sale transaction," in which an amount that would have been a taxable distribution (as described below) is instead treated as nontaxable sales proceeds, but substantially similar stock is reacquired (or an option to obtain it is acquired) within a 61 day period, then the amount that would have been a taxable distribution continues to be taxed.
A distribution from a "qualified investment entity" that is attributable to the sale of a USRPI is subject to tax under FIRPTA unless the distribution is with respect to an interest that is regularly traded on an established securities market located in the United Sates and the recipient foreign corporation or nonresident alien individual held no more than 5 percent of that class of stock or beneficial interest within the 1-year period ending on the date of distribution. Special rules apply to situations involving tiers of qualified investment entities.

The term "qualified investment entity" includes a regulated investment company ("RIC") that meets certain requirements, although the inclusion of a RIC in that definition is scheduled to have expired, for certain purposes, on December 31, 2007.[387] The definition does not expire for purposes of taxing distributions from the RIC that are attributable directly or indirectly to a distribution to the entity from a real estate investment trust, nor for purposes of the applicable wash sale rules.

[387] IRC section 897(h).

New Federal Law (IRC section 897)

The provision extends the inclusion of a regulated investment company ("RIC") within the definition of a "qualified investment entity" under IRC section 897 through December 31, 2009, for those situations in which that that inclusion would otherwise expire at the end of 2007.

Effective Date

The provision takes effect on January 1, 2008.

California Law (R&TC sections 25110 and 25116)

California does not generally conform to the federal rules for sourcing the income for 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 sourcing rules, such as those set forth in Sections 861 through 865 and Sections 897(g) and (h), as applicable for federal purposes, to determine United States source income, including rules for foreign corporations. In other words, California is already conformed to these changes for water's-edge purposes.

Impact on California Revenue

Baseline.

TITLE III – EXTENSION OF BUSINESS TAX PROVISIONS

Section	Section Title
301	Extension and Modification of Research Credit

Background

General rule

A taxpayer may claim a research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a taxable year exceed its base amount for that year.[388] Thus, the research credit is generally available with respect to incremental increases in qualified research.

[388] IRC section 41.

A 20-percent research tax credit is also available with respect to the excess of: (1) 100 percent of corporate cash expenses (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.[389]

Energy research credit

A research credit is available for a taxpayer's expenditures on research undertaken by an energy research consortium. This separate credit computation is commonly referred to as the energy research credit. Unlike the other research credits, the energy research credit applies to all qualified expenditures, not just those in excess of a base amount.

Credit expiration

The research credit, including the university basic research credit and the energy research credit, has expired and does not apply to amounts paid or incurred after December 31, 2007.[390]

Computation of allowable credit

Except for energy research payments and certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenses 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 expenses and had gross receipts during each of at has been subsequently extended and modified numerous times.

If a taxpayer both incurred qualified research expenses 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 expenses for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum fixed-base percentage of 16 percent). All other taxpayers (so-called start-up firms) are assigned a fixed-base percentage of three percent.[391]

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[389] IRC section 41(e).

[390] The research tax credit was initially enacted in the Economic Recovery Tax Act of 1981. It has been subsequently extended and modified numerous times. Most recently, the Tax Relief and Health Care Act of 2006 extended the research credit through December 31, 2007, modified the alternative incremental research credit, and added an election to claim an alternative simplified credit.

[391] 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. A special rule (enacted in 1993) is designed to gradually re-compute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up

In computing the credit, a taxpayer's base amount cannot be less than 50 percent of its current-year qualified research expenses.

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.[392] Under regulations prescribed by the Secretary, special rules apply for computing the credit when a major portion of a trade or business (or unit thereof) changes hands, under which qualified research expenses 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 expenses and receipts for purposes of re-computing a taxpayer's fixed-base percentage.[393]

Alternative incremental research credit regime

Taxpayers are allowed to elect an alternative incremental research credit regime.[394] If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced.

Generally, for amounts paid or incurred prior to 2007, under the alternative incremental credit regime, a credit rate of 2.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of one percent (i.e., the base amount equals one percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 3.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of two percent. A credit rate of 3.75 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of two percent. Generally, for amounts paid or incurred after 2006, the credit rates listed above are increased to three percent, four percent, and five percent, respectively.[395]

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firm is assigned a fixed-base percentage of three percent for each of its first five taxable years after 1993 in which it incurs qualified research expenses. A start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenses is a phased-in ratio based on the firm's actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage is its actual ratio of qualified research expenses to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993. IRC section 41(c)(3)(B).

[392] IRC section 41(f)(1).

[393] IRC section 41(f)(3).

[394] IRC section 41(c)(4).

[395] A special transition rule applies for fiscal year 2006-2007 taxpayers.

An election to be subject to this alternative incremental credit regime can be made for any taxable year beginning after June 30, 1996, and such an election applies to that taxable year and all subsequent years unless revoked with the consent of the Secretary of the Treasury.

Alternative simplified credit

Generally, for amounts paid or incurred after 2006, taxpayers may elect to claim an alternative simplified credit for qualified research expenses.[396] The alternative simplified research credit is equal to 12 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. The rate is reduced to six percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years.

An election to use the alternative simplified credit applies to all succeeding taxable years unless revoked with the consent of the Secretary. An election to use the alternative simplified credit may not be made for any taxable year for which an election to use the alternative incremental credit is in effect. A transition rule applies which permits a taxpayer to elect to use the alternative simplified credit in lieu of the alternative incremental credit if such election is made during the taxable year which includes January 1, 2007. The transition rule applies only to the taxable year which includes that date.

Eligible expenses

Qualified research expenses 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 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).[397] Notwithstanding the limitation for contract research expenses, qualified research expenses include 100 percent of amounts paid or incurred by the taxpayer to an eligible small business, university, or federal laboratory for qualified energy research.

To be eligible for the credit, the research does not only have to satisfy the requirements of present-law IRC section 174 but also 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 substantially all of the activities of which constitute elements of a process of experimentation for functional

[396] A special transition rule applies for fiscal year 2006-2007 taxpayers.
[397] Under a special rule, 75 percent of amounts paid to a research consortium for qualified research are treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under IRC section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in IRC section 501(c)(3) (other than a private foundation) or IRC 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. IRC section 41(b)(3)(C).

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.[398] In addition, research does not qualify for the credit: (1) if conducted after the beginning of commercial production of the business component; (2) if related to the adaptation of an existing business component to a particular customer's requirements; (3) if related to the duplication of an existing business component from a physical examination of the component itself or certain other information; or (4) if related to certain efficiency surveys, management function or technique, market research, market testing, or market development, routine data collection or routine quality control.[399] Research does not qualify for the credit if it is conducted outside the United States, Puerto Rico, or any U.S. possession.

Relation to deduction

Under IRC section 174, taxpayers may elect to deduct currently the amount of certain research or experimental expenditures paid or incurred in connection with a trade or business, notwithstanding the general rule that business expenses to develop or create an asset that has a useful life extending beyond the current year must be capitalized.[400] However, deductions allowed to a taxpayer under IRC section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year.[401] Taxpayers may alternatively elect to claim a reduced research tax credit amount under IRC section 41 in lieu of reducing deductions otherwise allowed.[402]

New Federal Law (IRC section 41)

The provision extends the research credit for two years, through December 31, 2009. The provision also increases the alternative simplified credit for taxable years beginning after 2008, provides that no election to use the alternative incremental credit will be allowed for taxable years beginning after December 31, 2008, and clarifies the computation of the alternative incremental research credit and the alternative simplified credit for the taxable year in which the credit terminates.

Effective Date

The provision is effective for amounts paid or incurred after December 31, 2007.

[398] IRC section 41(d)(3).
[399] IRC section 41(d)(4).
[400] Taxpayers may elect 10-year amortization of certain research expenditures allowable as a deduction under IRC section 174(a). IRC sections 174(f)(2) and 59(e).
[401] IRC section 280C(c).
[402] IRC section 280C(c)(3).

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA) (PL 110-343, OCTOBER 3, 2008)

California Law (R&TC sections 17052.12 and 23609)

In general

California conforms by reference to IRC section 41, relating to the research credit, as of the "specified date" of January 1, 2005, in R&TC sections 17052.5 and 23609 with modifications, including modifications to the credit percentage amounts

The California credit percentage is 15 percent (20 percent federal) for "qualified research" and 24 percent (20 percent federal) for "basic research."

As under federal law, only corporations qualify for the credit for "basic research." The terms "qualified research" and "basic research" include only research conducted in California. In computing gross receipts under IRC section 41(c)(5), only gross receipts from the sale of property held for sale in the ordinary course or business, that is delivered or shipped to a purchaser within California, will be included. Qualified research expense is modified to exclude any amount paid or incurred for tangible personal property that is eligible for the exemption from sales or use tax under R&TC section 6378.

Under California law, "basic research" is modified to include any basic or applied research including scientific inquiry or original investigation for advancement of scientific or engineering knowledge or the improved effectiveness of commercial products, except the term does not include any of the following:

1. Basic research conducted outside California.
2. Basic research in social sciences, arts or humanities.
3. Basic research for purposes of improving a commercial product if the improvements relate to style, taste, cosmetic, or seasonal design factors.
4. Any expenditure paid or incurred to ascertain existence, location, extent, or quality of any deposit of ore or other mineral, including oil or gas.

California law also provides special treatment for taxpayers engaged in biopharmaceutical research activities or other biotechnology research and development activities. For these taxpayers, payments to qualifying organizations that qualify for the credit include payments to research hospitals that are owned by institutions of higher education and certain charitable research hospitals designated as a "specialized laboratory cancer center" that has received Clinical Cancer Research Center status from the National Cancer Institute.

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA) (PL 110-343, OCTOBER 3, 2008)

Recent federal credit modifications

1. *Energy Research Credit*. The Energy Tax Incentives Act (ETIA) of 2005 (PL 109-58), enacted on August 8, 2005, provides an energy research credit. The energy research credit was enacted after the "specified date" of January 1, 2005. Thus, California has not conformed to this provision.
2. *Alternative Simplified Credit*. The Tax Relief and Health Care Act (TRHCA) of 2006 (P.L. 109-432), enacted on December 20, 2006, provides an alternative simplified credit. The alternative simplified credit was enacted after the "specified date" of January 1, 2005. Thus, California has not conformed to the alternative simplified credit or the increase to the credit provided in EESA.
3. *Alternative incremental credit.* California conforms to the alternative incremental credit as of the "specified date" of January 1, 2005, with modifications. The federal alternative incremental research expense credit rates of 2.65 percent, 3.2 percent and 3.75 percent are modified for California purposes to be 1.49 percent, 1.98 percent, and 2.48 percent, respectively.

   The EESA clarifications for the year in which the credit terminates do not apply because California specifically does not conform to the federal termination provisions.[403] As a result, while no federal election for the alternative incremental credit will be allowed for taxable years ending after January 1, 2009, an election to use the alternative incremental credit will be allowable unless California conforms to the federal termination provision.

4. *Extension of federal credit.* Because the California credit is permanent, the extension of the federal credit is not applicable.

Impact on California Revenue

Estimated Revenue Impact of Extension and Modification of Research Credit Effective On or after January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$39,000,000	-$39,000,000	-$40,000,000

This provision extends the regular research credit program, eliminates the alternative incremental research credit program, and raises the rate of the alternative simplified credit (ASC) program from 12 percent to 14 percent. If California were to conform to the last two provisions of this federal section, annual revenue losses are estimated at approximately $40 million. Estimates are based on simulations of the 2005 sample of corporate tax returns.

[403] R&TC sections 17052.12(h) and 23609(i).

The simulation result was extrapolated into future years based on Department of Finance projections of corporate tax liabilities.

Section	Section Title
302	New Markets Tax Credit

Background

IRC section 45D provides a new markets tax credit for qualified equity investments made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity ("CDE").[404] The amount of the credit allowable to the investor (either the original purchaser or a subsequent holder) is: (1) a five-percent credit for the year in which the equity interest is purchased from the CDE and for each of the following two years, and (2) a six-percent credit for each of the following four years. The credit is determined by applying the applicable percentage (five or six percent) to the amount paid to the CDE for the investment at its original issue, and is available for a taxable year to the taxpayer who holds the qualified equity investment on the date of the initial investment or on the respective anniversary date that occurs during the taxable year. The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity ceases to be a qualified CDE, the proceeds of the investment cease to be used as required, or the equity investment is redeemed.

A qualified CDE is any domestic corporation or partnership: (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons; (2) that maintains accountability to residents of low-income communities by their representation on any governing board of or any advisory board to the CDE; and (3) that is certified by the Secretary as being a qualified CDE. A qualified equity investment means stock (other than nonqualified preferred stock) in a corporation or a capital interest in a partnership that is acquired directly from a CDE for cash, and includes an investment of a subsequent purchaser if such investment was a qualified equity investment in the hands of the prior holder. Substantially all of the investment proceeds must be used by the CDE to make qualified low-income community investments. For this purpose, qualified low-income community investments include: (1) capital or equity investments in, or loans to, qualified active low-income community businesses; (2) certain financial counseling and other services to businesses and residents in low-income communities; (3) the purchase from another CDE of any loan made by such entity that is a qualified low-income community investment; or (4) an equity investment in, or loan to, another CDE.

[404] IRC section 45D was added by section 121(a) of the Community Renewal Tax Relief Act of 2000, Public Law 106-554 (December 21, 2000).

A "low-income community" is a population census tract with either: (1) a poverty rate of at least 20 percent, or (2) median family income which does not exceed 80 percent of the greater of metropolitan area median family income or statewide median family income (for a non-metropolitan census tract, does not exceed 80 percent of statewide median family income). In the case of a population census tract located within a high migration rural county, low-income is defined by reference to 85 percent (rather than 80 percent) of statewide median family income. For this purpose, a high migration rural county is any county that, during the 20-year period ending with the year in which the most recent census was conducted, has a net out-migration of inhabitants from the county of at least 10 percent of the population of the county at the beginning of such period.

The Secretary has the authority to designate "targeted populations" as low-income communities for purposes of the new markets tax credit. For this purpose, a "targeted population" is defined by reference to section 103(20) of the Riegle Community Development and Regulatory Improvement Act of 1994 (12 U.S.C. 4702(20)) to mean individuals, or an identifiable group of individuals, including an Indian tribe, who (A) are low-income persons; or (B) otherwise lack adequate access to loans or equity investments. Under such Act, "low-income" means: (1) for a targeted population within a metropolitan area, less than 80 percent of the area median family income; and (2) for a targeted population within a non-metropolitan area, less than the greater of 80 percent of the area median family income or 80 percent of the statewide non-metropolitan area median family income.[405] Under such Act, a targeted population is not required to be within any census tract. In addition, a population census tract with a population of less than 2,000 is treated as a low-income community for purposes of the credit if such tract is within an empowerment zone, the designation of which is in effect under IRC section 1391, and is contiguous to one or more low-income communities.

A qualified active low-income community business is defined as a business that satisfies, with respect to a taxable year, the following requirements: (1) at least 50 percent of the total gross income of the business is derived from the active conduct of trade or business activities in any low-income community; (2) a substantial portion of the tangible property of such business is used in a low-income community; (3) a substantial portion of the services performed for such business by its employees is performed in a low-income community; and (4) less than five percent of the average of the aggregate unadjusted bases of the property of such business is attributable to certain financial property or to certain collectibles.

The maximum annual amount of qualified equity investments is capped at $2.0 billion per year for calendar years 2004 and 2005, and at $3.5 billion per year for calendar years 2006, 2007, and 2008.

<u>New Federal Law (IRC section 45)</u>

The provision extends the new markets tax credit for one year, through 2009, permitting up to $3.5 billion in qualified equity investments for that calendar year.

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[405] 12 U.S.C. 4702(17) (defines "low-income" for purposes of 12 U.S.C. 4702(20)).

Effective Date

The provision is effective on October 3, 2008.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
303	Subpart F Exception for Active Financing Income

Background

Under the subpart F rules,[406] 10-percent-or-greater U.S. shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, insurance income and foreign base company income. Foreign base company income includes, among other things, foreign personal holding company income and foreign base company services income (i.e., income derived from services performed for or on behalf of a related person outside the country in which the CFC is organized).

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities transactions; (4) net gains from certain foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; (7) payments in lieu of dividends; and (8) amounts received under personal service contracts.

[406] IRC sections 951-964.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income.[407]

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, as a securities dealer, or in the conduct of an insurance business (so-called "active financing income").[408] With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the active financing exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit ("QBU") of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met. Additional exceptions from foreign personal holding company income apply for certain income derived by a securities dealer within the meaning of IRC section 475 and for gain from the sale of active financing assets.

In the case of a securities dealer, the temporary exception from foreign personal holding company income applies to certain income. The income covered by the exception is any interest or dividend (or certain equivalent amounts) from any transaction, including a hedging transaction or a transaction consisting of a deposit of collateral or margin, entered into in the ordinary course of the dealer's trade or business as a dealer in securities within the meaning of IRC section 475. In the case of a QBU of the dealer, the income is required to be attributable to activities of the QBU in the country of incorporation, or to a QBU in the country

[407] Prop. Treas. Reg. 1.953-1(a).

[408] Temporary exceptions from the subpart F provisions for certain active financing income applied only for taxable years beginning in 1998 (Taxpayer Relief Act of 1997, Public Law 105-34). Those exceptions were modified and extended for one year, applicable only for taxable years beginning in 1999 (the Tax and Trade Relief Extension Act of 1998, Public Law 105-277). The Tax Relief Extension Act of 1999 (Public Law 106-170) clarified and extended the temporary exceptions for two years, applicable only for taxable years beginning after 1999 and before 2002. The Job Creation and Worker Assistance Act of 2002 (Public Law 107-147) modified and extended the temporary exceptions for five years, for taxable years beginning after 2001 and before 2007. The Tax Increase Prevention and Reconciliation Act of 2005 (Public Law 109-222) extended the temporary provisions for two years, for taxable years beginning after 2006 and before 2009.

in which the QBU both maintains its principal office and conducts substantial business activity. A coordination rule provides that this exception generally takes precedence over the exception for income of a banking, financing or similar business, in the case of a securities dealer.

In the case of insurance, a temporary exception from foreign personal holding company income applies for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization. In the case of insurance, temporary exceptions from insurance income and from foreign personal holding company income also apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met. In the case of a life insurance or annuity contract, reserves for such contracts are determined under rules specific to the temporary exceptions. Present law also permits a taxpayer in certain circumstances, subject to approval by the IRS through the ruling process or in published guidance, to establish that the reserve of a life insurance company for life insurance and annuity contracts is the amount taken into account in determining the foreign statement reserve for the contract (reduced by catastrophe, equalization, or deficiency reserve or any similar reserve). IRS approval is to be based on whether the method, the interest rate, the mortality and morbidity assumptions, and any other factors taken into account in determining foreign statement reserves (taken together or separately) provide an appropriate means of measuring income for federal income tax purposes.

New Federal Law (IRC section 953)

The provision extends for one year (for taxable years beginning before 2010) the present-law temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business.

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 2008, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

California Law (R&TC section 25110)

California does not conform by reference to IRC sections 951 through 971. However, R&TC section 25110, relating to the water's-edge election, specifically provides that the amount of a CFC's income and apportionment factors included in California taxable income when the CFC has federal subpart F income is determined by multiplying these items by the ratio, the numerator of which is the CFC's federal subpart F income for the current year, and the denominator of which is the CFC's current year earnings and profits, as defined by IRC section 964. Subpart F income, as defined in IRC section 952, includes:

- International Boycott Income (IRC sections 952(a)(3) and 999)
- Income From Illegal Bribes and Kickbacks (IRC section 952)
- Insurance Income (IRC section 953)
- Foreign Base Company Income (FBCI) (IRC section 954)
- IRC section 901(j) Foreign Country Income (IRC section 952(a)(5))

R&TC section 25116 provides that when applying provisions of the IRC in connection with a water-s edge election which are not otherwise applicable, such as subpart F rules, the federal rules as applicable for federal purposes shall apply for water's edge purposes. Therefore, under California water's-edge rules, the EESA changes to federal subpart F income automatically apply.

Impact on California Revenue

Baseline.

Section	Section Title
304	Extension of Look-Thru Rule for Related Controlled Foreign Corporations

Background

In general

In general, the rules of subpart F require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation ("CFC") to include certain income of the CFC (referred to as "subpart F income") on a current basis for U.S. tax purposes, regardless of whether the income is distributed to the shareholders.[409]

[409] IRC sections 951-964.

Subpart F income includes foreign base company income. One category of foreign base company income is foreign personal holding company income. For subpart F purposes, foreign personal holding company income generally includes dividends, interest, rents, and royalties, among other types of income. There are several exceptions to these rules. For example, foreign personal holding company income does not include dividends and interest received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized, or rents and royalties received by a CFC from a related corporation for the use of property within the country in which the CFC is organized. Interest, rent, and royalty payments do not qualify for this exclusion to the extent that such payments reduce the subpart F income of the payor. In addition, subpart F income of a CFC does not include any item of income from sources within the United States which is effectively connected with the conduct by such CFC of a trade or business within the United States ("ECI") unless such item is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a tax treaty.

The "look-through rule"[410]

Under the "look-through rule,"[411] dividends, interest (including factoring income, which is treated as equivalent to interest under IRC section 954(c)(1)(E)), rents, and royalties received by one CFC from a related CFC, are not treated as foreign personal holding company income to the extent attributable or properly allocable to income of the payor that is neither subpart F nor treated as ECI. For this purpose, a related CFC is a CFC that controls or is controlled by the other CFC, or a CFC that is controlled by the same person or persons that control the other CFC. Ownership of more than 50 percent of the CFC's stock (by vote or value) constitutes control for these purposes.

The Secretary is authorized to prescribe regulations that are necessary or appropriate to carry out the look-through rule, including such regulations as are appropriate to prevent the abuse of the purposes of such rule.

The look-through rule is effective for taxable years of foreign corporations beginning after December 31, 2005, but before January 1, 2009, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

New Federal Law (IRC section 954)

The provision extends for one year the application of the look-through rule, to taxable years of foreign corporations beginning before January 1, 2010, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

[410] The look-through rule was enacted by the Tax Increase Prevention and Reconciliation Act of 2005 (Public Law 109-222).
[411] IRC section 954(c)(6).

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 2008, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

California Law (R&TC section 25110)

California does not conform by reference to IRC sections 951 through 971. However, R&TC section 25110, relating to the water's-edge election, specifically provides that the amount of a CFC's income and apportionment factors included in California taxable income when the CFC has federal subpart F income is determined by multiplying these items by the ratio, the numerator of which is the CFC's federal subpart F income for the current year, and the denominator of which is the CFC's current year earnings and profits, as defined by IRC section 964. Subpart F income, as defined in IRC section 952, includes:

- International Boycott Income (IRC sections 952(a)(3) and 999)
- Income From Illegal Bribes and Kickbacks (IRC section 952)
- Insurance Income (IRC section 953)
- Foreign Base Company Income (FBCI) (IRC section 954)
- IRC section 901(j) Foreign Country Income (IRC section 952(a)(5))

R&TC section 25116 provides that when applying provisions of the IRC in connection with a water-s edge election which are not otherwise applicable, such as subpart F rules, the federal rules as applicable for federal purposes shall apply for water's edge purposes. Therefore, under California water's-edge rules, the EESA changes to federal subpart F income automatically apply.

Impact on California Revenue

Baseline.

Section	Section Title
305	Extension of 15-Year Straight-Line Cost Recovery for Qualified Leasehold Improvements and Qualified Restaurant Improvements; 15-Year Straight Line Cost Recovery for Certain Improvements to Retail Space

A. Fifteen-year straight-line cost recovery for qualified leasehold improvements and qualified restaurant property

Background

In general

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.[412] The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month.

Depreciation of leasehold improvements

Generally, depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease. This rule applies regardless of whether the lessor or the lessee places the leasehold improvements in service. If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement generally is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service. However, exceptions exist for certain qualified leasehold improvements and qualified restaurant property.

Qualified leasehold improvement property

IRC section 168(e)(3)(E)(iv) provides a statutory 15-year recovery period for qualified leasehold improvement property placed in service before January 1, 2008. Qualified leasehold improvement property is recovered using the straight-line method and a half-year convention. Leasehold improvements placed in service in 2008 and later will be subject to the general rules described above.

[412] IRC section 168.

Qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease either by the lessee (or sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service. Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building.

If a lessor makes an improvement that qualifies as qualified leasehold improvement property, such improvement does not qualify as qualified leasehold improvement property to any subsequent owner of such improvement. An exception to the rule applies in the case of death and certain transfers of property that qualify for non-recognition treatment.

Qualified restaurant property

IRC Section 168(e)(3)(E)(v) provides a statutory 15-year recovery period for qualified restaurant property placed in service before January 1, 2008. For purposes of the provision, qualified restaurant property means any improvement to a building if such improvement is placed in service more than three years after the date such building was first placed in service and more than 50 percent of the building's square footage is devoted to the preparation of, and seating for on-premises consumption of, prepared meals. Qualified restaurant property is recovered using the straight-line method and a half-year convention. Restaurant property placed in service in 2008 and later will be subject to the general rules described above.

<u>New Federal Law (IRC section 168)</u>

The present-law provisions for qualified leasehold improvement property and qualified restaurant property are extended for two years through December 31, 2009.

<u>Effective Date</u>

The provision applies to property placed in service after December 31, 2007.

<u>California Law (R&TC sections 17250(a)(6-7) and 24349)</u>

California specifically does not conform to the federal statutory 15-year recovery period for qualified leasehold improvements and qualified restaurant property contained in IRC section 168.

Impact on California Revenue

Not applicable.

B. 15-Year MACRS Recovery Period Qualified Retail Improvement Property

Background

Additions and improvements to a building are generally depreciated in the same manner that the building would be depreciated if the building was placed in service when the addition or improvement was placed in service.[413]

New Federal Law (IRC section 168)

A new category of MACRS property --"qualified retail improvement property" --is created.[414] This property is treated as MACRS 15-year property and, accordingly, has a 15-year recovery period. A 39-year MACRS alternative depreciation system (ADS) recovery period applies if ADS is elected or required. The straight-line method must be used to depreciate qualified retail improvement property.[415] The half-year convention applies unless the mid-quarter convention is applicable because the taxpayer placed more than 40 percent of the total basis of its depreciable property (other than residential rental and nonresidential real property) in service in the last quarter of its tax year.

Effective Date

The provision applies to property placed in service after December 31, 2008.

California Law (R&TC sections 17201, 17250, 24349, 24355.3 and 24355.4)

Under the Personal Income Tax Law (PITL), California law, as it relates to MACRS, in general conforms to the federal rules with certain modifications. For example, California did not conform to the American Jobs Creation Act (AJCA) of 2004 changes to IRC section 168 that specifically provided the recovery period for depreciation of certain leasehold improvements and restaurant property.

Under current California law, S corporations (and their shareholders) are allowed to use MACRS under the PITL.

Under the Corporation Tax Law (CTL), California did not conform to the pre-1986 federal ACRS depreciation deduction and currently does not conform to the federal law MACRS depreciation.

[413] IRC section 168(i)(6).
[414] IRC sections 168(e)(3)(E)(ix) and 168(e)(9).
[415] IRC section 168(b)(3)(I).

The CTL is in substantial conformity to the pre-1981 federal asset depreciation range (ADR) deduction. The ADR is based on the "useful life" of depreciable property. The CTL has specified a useful life of seven years for certain motorsport entertainment complexes and natural gas pipelines located in Alaska. For California purposes, assets used in the transmission and distribution of electricity for sale and related land improvements have a "useful life" of 30 years.

Prior to the adoption of ACRS by the Economic Recovery Tax Act (ERTA) of 1981, taxpayers were allowed to depreciate (under the ADR) the various components of a building as separate assets with separate useful lives.

The CTL has not conformed to the repeal of the use of component depreciation, as ACRS, originally enacted by ERTA, was never adopted in the CTL. Similarly, the CTL did not adopt the MACRS depreciation rules for corporations that were enacted in the Tax Reform Act of 1986, which also denied the use of component depreciation under MACRS. Thus, the CTL still allows the use of component depreciation.

Impact on California Revenue

Estimated Revenue Impact of 15-Year MARCS Recovery Period Qualified Retail Improvement Property For Tax Years Beginning On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009-10	2010-11	2011-12
-$39,000,000	-$19,000,000	-$13,000,000

Estimates are based on a proration of federal projections developed for the Emergency Economic Stabilization Act of 2008, adjusted to reflect California differences, including differences in California's depreciation rules.

Section	Section Title
306	Modification of Tax Treatment of Certain Payments to Controlling Exempt Organizations

Background

In general, organizations exempt from federal income tax are subject to the unrelated business income tax on income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization's tax-exempt functions.[416] In general, interest, rents, royalties, and annuities are excluded from the unrelated business income of tax-exempt organizations.[417]

IRC section 512(b)(13) provides special rules regarding income derived by an exempt organization from a controlled subsidiary. In general, IRC section 512(b)(13) treats otherwise excluded rent, royalty, annuity, and interest income as unrelated business income if such income is received from a taxable or tax-exempt subsidiary that is 50-percent controlled by the parent tax-exempt organization to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity (determined as if the entity were tax exempt). However, a special rule enacted as part of the Pension Protection Act of 2006 provides that, for payments made pursuant to a binding written contract in effect on August 17, 2006 (or renewal of such a contract on substantially similar terms), the general rule of IRC section 512(b)(13) applies only to the portion of payments received or accrued (before January 1, 2008) in a taxable year that exceeds the amount of the payment that would have been paid or accrued if the amount of such payment had been determined under the principles of IRC section 482.[418] In addition, the special rule imposes a 20-percent penalty on the larger of such excess determined without regard to any amendment or supplement to a return of tax, or such excess determined with regard to all such amendments and supplements.

In the case of a stock subsidiary, "control" means ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, "control" means ownership of more than 50 percent of the profits, capital, or beneficial interests. In addition, present law applies the constructive ownership rules of IRC section 318 for purposes of IRC section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50 percent 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-tier subsidiary).

[416] IRC section 511.
[417] IRC section 512(b).
[418] IRC section 512(b)(13)(E).

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA) (PL 110-343, OCTOBER 3, 2008)

New Federal Law (IRC section 512)

The provision extends the special rule of the Pension Protection Act of 2006 to payments received or accrued before January 1, 2010. Thus, payments of rent, royalties, annuities, or interest income by a controlled organization to a controlling organization pursuant to a binding written contract in effect on August 17, 2006 (or renewal of such a contract on substantially similar terms), may be includible in the unrelated business taxable income of the controlling organization only to the extent the payment exceeds the amount of the payment determined under the principles of IRC section 482. Any such excess is subject to a 20-percent penalty on the larger of such excess determined without regard to any amendment or supplement to a return of tax, or such excess determined with regard to all such amendments and supplements.

Effective Date

The provision is effective for payments received or accrued after December 31, 2007.

California Law (R&TC sections 17651, 23731, 23732, and 23772)

California imposes a tax on the “unrelated business income” of organizations and trusts exempt from tax in R&TC sections 17561 and 23732. California conforms by reference to IRC section 512, relating to unrelated business taxable income, in R&TC section 23732, as of the “specified date” of January 1, 2005, with modifications. Therefore, because the special rule enacted in the Pension Protection Act of 2006 and the EESA changes were made after the “specified date,” this EESA change to IRC section 512 does not apply.

Impact on California Revenue

Estimated Revenue Impact of Modification of Tax Treatment of Certain Payments to Controlling Exempt Organizations Effective for Payments Received or Accrued After December 31, 2008		
2009 -10	2010 -11	2011 -12
-$800,000	No impact	No impact

Estimates are based on a proration of federal projections developed for the Emergency Economic Stabilization Act of 2008.

Section	Section Title
307	Basis Adjustment to Stock of S Corporations Making Charitable Contributions of Property

Background

Under present law, if an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the contribution in determining its own income tax liability.[419] A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.[420]

In the case of contributions made in taxable years beginning after December 31, 2005, and before January 1, 2008, the amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation is equal to the shareholder's pro rata share of the adjusted basis of the contributed property. For contributions made in taxable years beginning after December 31, 2007, the amount of the reduction is the shareholder's pro-rata share of the fair market value of the contributed property.

New Federal Law (IRC section 1367)

The bill extends the rule relating to the basis reduction on account of charitable contributions of property for two years to contributions made in taxable years beginning before January 1, 2010.

Effective Date

The provision applies to contributions made in taxable years beginning after December 31, 2007.

California Law (R&TC sections 23800 and 23804)

California conforms by reference to IRC section 1367, relating to adjustments to basis of stock of shareholders, in R&TC section 23800, as of the “specified date” of January 1, 2005, with modifications in 23804. Therefore, because the PPA changes were made after the “specified date,” this EESA change to IRC section 1367 does not apply.

[419] IRC section 1366(a)(1)(A).
[420] IRC section 1367(a)(2)(B).

Impact on California Revenue

Estimated Revenue Impact of Basis Adjustment to Stock of S Corporations Making Charitable Contributions of Property For Tax Years Beginning On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$1,000,000	-$400,000	-$250,000

Estimates are based on a proration of federal projections developed for the Emergency Economic Stabilization Act of 2008. The provision would sunset on December 31, 2009.

Section	Section Title
308	Increase in Limit on Cover Over of Rum Excise Tax to Puerto Rico and the Virgin Islands

Background

A $13.50 per proof gallon[421] excise tax is imposed on distilled spirits produced in or imported (or brought) into the United States.[422] The excise tax does not apply to distilled spirits that are exported from the United States, including exports to U.S. possessions (e.g., Puerto Rico and the Virgin Islands).[423]

The IRC provides for cover over (payment) to Puerto Rico and the Virgin Islands of the excise tax imposed on rum imported (or brought) into the United States, without regard to the country of origin.[424] The amount of the cover over is limited under IRC section 7652(f) to $10.50 per proof gallon ($13.25 per proof gallon during the period July 1, 1999, through December 31, 2007).

Tax amounts attributable to shipments to the United States of rum produced in Puerto Rico are covered over to Puerto Rico. Tax amounts attributable to shipments to the United States of rum produced in the Virgin Islands are covered over to the Virgin Islands. Tax amounts attributable to shipments to the United States of rum produced in neither Puerto Rico nor the

[421] A proof gallon is a liquid gallon consisting of 50 percent alcohol. *See* IRC sections 5002(a)(10) and (11).
[422] IRC sections 5001(a)(1).
[423] IRC sections 5062(b), 7653(b) and (c).
[424] IRC sections 7652(a)(3), (b)(3), and (e)(1). One percent of the amount of excise tax collected from imports into the United States of articles produced in the Virgin Islands is retained by the United States under IRC section 7652(b)(3).

Virgin Islands are divided and covered over to the two possessions under a formula.[425] Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.[426] All of the amounts covered over are subject to the limitation.

New Federal Law (IRC section 7652)

The provision suspends for two years the $10.50 per proof gallon limitation on the amount of excise taxes on rum covered over to Puerto Rico and the Virgin Islands. Under the provision, the cover over amount of $13.25 per proof gallon is extended for rum brought into the United States after December 31, 2007 and before January 1, 2010. After December 31, 2009, the cover over amount reverts to $10.50 per proof gallon.

Effective Date

The change in the cover over rate is effective for articles brought into the United States after December 31, 2007.

California Law

The Franchise Tax Board does not administer excise taxes; instead, excise taxes are administered by the State Board of Equalization (BOE).

Impact on California Revenue

Defer to BOE.

Section	Section Title
309	Extension of Economic Development Credit for American Samoa

Background

In general

For taxable years beginning before January 1, 2006, certain domestic corporations with business operations in the U.S. possessions were eligible for the possession tax credit.[427] This credit offset the U.S. tax imposed on certain income related to operations in the U.S.

[425] IRC section 7652(e)(2).
[426] IRC sections 7652(a)(3), (b)(3), and (e)(1).
[427] IRC sections 27(b), 936.

possessions.[428] For purposes of the credit, possessions included, among other places, American Samoa. Subject to certain limitations described below, the amount of the possession tax credit allowed to any domestic corporation equaled the portion of that corporation's U.S. tax that was attributable to the corporation's non-U.S. source taxable income from: (1) the active conduct of a trade or business within a U.S. possession, (2) the sale or exchange of substantially all of the assets that were used in such a trade or business, or (3) certain possessions investment.[429] No deduction or foreign tax credit was allowed for any possessions or foreign tax paid or accrued with respect to taxable income that was taken into account in computing the credit under IRC section 936.[430] The IRC section 936 credit generally expired for taxable years beginning after December 31, 2005, but a special credit, described below, was allowed with respect to American Samoa.

To qualify for the possession tax credit for a taxable year, a domestic corporation was required to satisfy two conditions. First, the corporation was required to derive at least 80 percent of its gross income for the three-year period immediately preceding the close of the taxable year from sources within a possession. Second, the corporation was required to derive at least 75 percent of its gross income for that same period from the active conduct of a possession business.

The possession tax credit was available only to a corporation that qualified as an existing credit claimant. The determination of whether a corporation was an existing credit claimant was made separately for each possession. The possession tax credit was computed separately for each possession with respect to which the corporation was an existing credit claimant, and the credit was subject to either an economic activity-based limitation or an income-based limitation.

Qualification as existing credit claimant

A corporation was an existing credit claimant with respect to a possession if: (1) the corporation was engaged in the active conduct of a trade or business within the possession on October 13, 1995, and (2) the corporation elected the benefits of the possession tax credit in an election in effect for its taxable year that included October 13, 1995.[431] A corporation that added a substantial new line of business (other than in a qualifying acquisition of all the assets of a trade or business of an existing credit claimant) ceased to be an existing credit

[428] Domestic corporations with activities in Puerto Rico are eligible for the IRC section 30A economic activity credit. That credit is calculated under the rules set forth in IRC section 936.
[429] Under phase-out rules described below, investment only in Guam, American Samoa, and the Northern Mariana Islands (and not in other possessions) now may give rise to income eligible for the IRC section 936 credit.
[430] IRC section 936(c).
[431] A corporation will qualify as an existing credit claimant if it acquired all the assets of a trade or business of a corporation that (1) actively conducted that trade or business in a possession on October 13, 1995, and (2) had elected the benefits of the possession tax credit in an election in effect for the taxable year that included October 13, 1995.

claimant as of the close of the taxable year ending before the date on which that new line of business was added.

Economic activity-based limit

Under the economic activity-based limit, the amount of the credit determined under the rules described above was not permitted to exceed an amount equal to the sum of: (1) 60 percent of the taxpayer's qualified possession wages and allocable employee fringe benefit expenses; (2) 15 percent of depreciation allowances with respect to short-life qualified tangible property, plus 40 percent of depreciation allowances with respect to medium-life qualified tangible property, plus 65 percent of depreciation allowances with respect to long-life qualified tangible property; and (3) in certain cases, a portion of the taxpayer's possession income taxes.

Income-based limit

As an alternative to the economic activity-based limit, a taxpayer was permitted elect to apply a limit equal to the applicable percentage of the credit that otherwise would have been allowable with respect to possession business income; in taxable years beginning in 1998 and subsequent years, the applicable percentage was 40 percent.

Repeal and phase out

In 1996, the IRC section 936 credit was repealed for new claimants for taxable years beginning after 1995 and was phased out for existing credit claimants over a period including taxable years beginning before 2006. The amount of the available credit during the phase-out period generally was reduced by special limitation rules. These phase-out period limitation rules did not apply to the credit available to existing credit claimants for income from activities in Guam, American Samoa, and the Northern Mariana Islands. As described previously, the IRC section 936 credit generally was repealed for all possessions, including Guam, American Samoa, and the Northern Mariana Islands, for all taxable years beginning after 2005, but a modified credit was allowed for activities in American Samoa.

American Samoa economic development credit

A domestic corporation that was an existing credit claimant with respect to American Samoa and that elected the application of IRC section 936 for its last taxable year beginning before January 1, 2006, is allowed a credit based on the economic activity-based limitation rules described above. The credit is not part of the IRC but is computed based on the rules IRC sections 30A and 936. The credit is allowed for the first two taxable years of a corporation that begin after December 31, 2005, and before January 1, 2008.

The amount of the credit allowed to a qualifying domestic corporation under the provision is equal to the sum of the amounts used in computing the corporation's economic activity-based limitation (described previously) with respect to American Samoa, except that no credit is allowed for the amount of any American Samoa income taxes. Thus, for any qualifying corporation the amount of the credit equals the sum of: (1) 60 percent of the corporation's qualified American Samoa wages and allocable employee fringe benefit expenses; and (2) 15 percent of the corporation's depreciation allowances with respect to short-life qualified American Samoa tangible property, plus 40 percent of the corporation's depreciation allowances with respect to medium-life qualified American Samoa tangible property, plus 65 percent of the corporation's depreciation allowances with respect to long-life qualified American Samoa tangible property.

The IRC section 936(c) rule denying a credit or deduction for any possessions or foreign tax paid with respect to taxable income taken into account in computing the credit under section 936 does not apply with respect to the credit allowed by the provision.

The credit is not available for taxable years beginning after December 31, 2007.

New Federal Law (Act section 309)

This uncodified provision allows the American Samoa economic development credit to apply for the first four taxable years of a corporation that begin after December 31, 2005, and before January 1, 2010.

Effective Date

The provision is effective for taxable years beginning after December 31, 2007.

California Law (None)

California does not conform to IRC section 936, relating to the possessions tax credit, or any credit available in connection with economic activity in American Samoa.

Impact on California Revenue

Not applicable.

Section	Section Title
310	Extension of Mine Rescue Team Training Credit

Background

As part of the general business credit under IRC section 38, a taxpayer that is an eligible employer may claim a credit with respect to each qualified mine rescue team employee equal to the lesser of (1) 20% of the amount paid or incurred by the taxpayer during the taxable year with respect to the training program costs of such qualified mine rescue team employee (including wages of the employee while attending the program), or (2) $10,000. For purposes of the provision, “wages” has the meaning given to such term by IRC section 3306(b) (determined without regard to any dollar limitation contained in that section). An eligible employer is any taxpayer which employs individuals as miners in underground mines in the United States. No deduction is allowed for the amount of the expenses otherwise deductible which is equal to the amount of the credit.

A qualified mine rescue team employee is any full-time employee of the taxpayer who is a miner eligible for more than six months of a taxable year to serve as a mine rescue team member by virtue of either having completed the initial 20-hour course of instruction prescribed by the Mine Safety and Health Administration’s Office of Educational Policy and Development, or receiving at least 40 hours of refresher training in such instruction.

The credit is effective for taxable years beginning after December 31, 2005, and before January 1, 2009.

New Federal Law (IRC section 45N)

The provision extends the mine rescue team training credit for one year. The credit now terminates for tax years beginning after December 31, 2009

Effective Date

The provision is effective on October 3, 2008.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA)
(PL 110-343, OCTOBER 3, 2008)

Section	Section Title
311	Extension of Election to Expense Advanced Safety Mine Equipment

Background

In general

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the Modified Accelerated Cost Recovery System (MACRS), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.[432]

Personal property is classified under MACRS based on the property's class life unless a different classification is specifically provided in IRC section 168. The class life applicable for personal property is the asset guideline period (midpoint class life as of January 1, 1986). Based on the property's classification, a recovery period is prescribed under MACRS. In general, there are six classes of recovery periods to which personal property can be assigned. For example, personal property that has a class life of four years or less has a recovery period of three years, whereas personal property with a class life greater than four years but less than 10 years has a recovery period of five years. The class lives and recovery periods for most property are contained in Revenue Procedure 87-56.

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct (or "expense") such costs. Present law provides that the maximum amount a taxpayer may expense, for taxable years beginning in 2003 through 2009, is $100,000 of the cost of qualifying property placed in service for the taxable year. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $400,000.

Election to expense advanced mine safety equipment

A taxpayer may elect to treat 50% of the cost of any qualified advanced mine safety equipment property as a deduction in the taxable year in which the equipment is placed in service.

[432] IRC section 168.

Advanced mine safety equipment property means any of the following: (1) emergency communication technology or devices used to allow a miner to maintain constant communication with an individual who is not in the mine; (2) electronic identification and location devices that allow individuals not in the mine to track at all times the movements and location of miners working in or at the mine; (3) emergency oxygen-generating, self-rescue devices that provide oxygen for at least 90 minutes; (4) pre-positioned supplies of oxygen providing each miner on a shift the ability to survive for at least 48 hours; and (5) comprehensive atmospheric monitoring systems that monitor the levels of carbon monoxide, methane and oxygen that are present in all areas of the mine and that can detect smoke in the case of a fire in a mine.

To be treated as qualified advanced mine safety equipment property under the provision, the original use of the property must have commenced with the taxpayer, and the taxpayer must have placed the property in service after December 20, 2006.

The portion of the cost of any property with respect to which an expensing election under IRC section 179 is made may not be taken into account for purposes of the 50% deduction allowed under this provision. For federal tax purposes, the basis of property is reduced by the portion of its cost that is taken into account for purposes of the 50% deduction allowed under the provision.

The provision requires the taxpayer to report information required by the Treasury Secretary with respect to the operation of mines of the taxpayer, in order for the deduction to be allowed for the taxable year.

An election made by the taxpayer under the provision may not be revoked except with the consent of the Secretary.

The provision:

- Includes a termination rule providing that it does not apply to property placed in service after December 31, 2008; and
- Applies to costs paid or incurred after December 20, 2006, with regard to property placed in service on or before December 31, 2008.

New Federal Law (IRC section 179E)

The election to expense 50 percent of the cost of advanced mine safety equipment is extended for one year to new property placed in service before January 1, 2010.

Effective Date

The provision is effective on October 3, 2008.

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA) (PL 110-343, OCTOBER 3, 2008)

California Law (R&TC sections 17201, 17250, and 24349 - 24366)

Under the Personal Income Tax Law (PITL), California law conforms to IRC section 168, relating to MACRS, as of the "specified date" of January 1, 2005, with certain modifications. California has not conformed to the GO Zone Act (PL 109-135) provision that allows an additional first-year depreciation deduction equal to 50% of the adjusted basis of qualified Gulf Opportunity Zone property. Also, California specifically does not conform to IRC section 168(k), which allows 30% and 50% bonus depreciation for certain property. California did not conform to the American Jobs Creation Act (AJCA) of 2004 changes to IRC section 168 that specifically provided a statutory recovery period for depreciation of certain restaurant property and leasehold improvements.

Under the Corporation Tax Law (CTL), California does not conform to IRC section 168, relating to MACRS depreciation. Instead, the CTL is in substantial conformity to the pre-1981 federal asset depreciation range (ADR) deduction. The ADR is based on the "useful life" of depreciable property. The CTL has specified a useful life of seven years for certain motorsport entertainment complexes and natural gas pipelines located in Alaska. For California purposes, natural gas pipelines have a "useful life" of 22 years.

Prior to the adoption of the accelerated cost recovery system (ACRS) by the Economic Recovery Tax Act (ERTA) of 1981, taxpayers were allowed to depreciate (under the ADR) the various components of a building as separate assets with separate useful lives. The CTL has not conformed to the repeal of the use of component depreciation, as ACRS, originally enacted by ERTA, was never adopted in the CTL. Similarly, the CTL did not adopt the MACRS depreciation rules for corporations that were enacted in the Tax Reform Act of 1986, which also denied the use of component depreciation under MACRS.

Thus, the CTL still allows the use of component depreciation.

California law, as it relates to the IRC section 179 deduction, conforms to federal law as of the "specified date" of January 1, 2005, with significant exceptions. California specifically does not conform to the increased small business expensing enacted in the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003 and extended in the American Jobs Creation Act of 2004 (AJCA). Thus, under California law, both corporate and non-corporate taxpayers with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

Because IRC section 179E was enacted after the “specified date” California is not conformed.

Impact on California Revenue

Estimated Revenue Impact of Extension of Election to Expense Advanced Safety Mine Equipment For Taxable Years Beginning On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$1,000,000	$200,000	$200,000

Estimates are based on a proration of federal projections developed by the Joint Committee on Taxation for the Emergency Economic Stabilization Act of 2008.

Section	Section Title
312	Deduction Allowable with Respect to Income Attributable to Domestic Production Activities in Puerto Rico

Background

In general

Present law provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to a portion of the taxpayer's qualified production activities income. For taxable years beginning after 2009, the deduction is nine percent of that income. For taxable years beginning in 2005 and 2006, the deduction is three percent of qualified production activities income and for taxable years beginning in 2007, 2008, and 2009, the deduction is six percent of qualified production activities income. For taxpayers subject to the 35-percent corporate income tax rate, the nine-percent deduction effectively reduces the corporate income tax rate to just under 32 percent on qualified production activities income.

Qualified production activities income

In general, qualified production activities income is equal to domestic production gross receipts (defined by IRC section 199(c)(4)), reduced by the sum of: (1) the costs of goods sold that are allocable to those receipts; and (2) other expenses, losses, or deductions which are properly allocable to those receipts.

Domestic production gross receipts

Domestic production gross receipts generally are gross receipts of a taxpayer that are derived from: (1) any sale, exchange, or other disposition, or any lease, rental, or license, of qualifying production property[433] that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States; (2) any sale, exchange, or other disposition, or any lease, rental, or license, of qualified film[434] produced by the taxpayer; (3) any lease, rental, license, sale, exchange, or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) construction of real property performed in the United States by a taxpayer in the ordinary course of a construction trade or business; or (5) engineering or architectural services performed in the United States for the construction of real property located in the United States.

Wage limitation

For taxable years beginning after May 17, 2006, the amount of the deduction for a taxable year is limited to 50 percent of the wages paid by the taxpayer, and properly allocable to domestic production gross receipts, during the calendar year that ends in such taxable year.[435] Wages paid to bona fide residents of Puerto Rico generally are not included in the wage limitation amount.[436]

Rules for Puerto Rico

When used in the IRC in a geographical sense, the term "United States" generally includes only the states and the District of Columbia.[437] A special rule for determining domestic production gross receipts, however, provides that in the case of any taxpayer with gross receipts from sources within the Commonwealth of Puerto Rico, the term "United States" includes the Commonwealth of Puerto Rico, but only if all of the taxpayer's gross receipts are taxable under the federal income tax for individuals or corporations.[438] In computing the

[433] Qualifying production property generally includes any tangible personal property, computer software, and sound recordings.
[434] Qualified film includes any motion picture film or videotape (including live or delayed television programming, but not including certain sexually explicit productions) if 50 percent or more of the total compensation relating to the production of the film (including compensation in the form of residuals and participations) constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers.
[435] For purposes of the provision, "wages" include the sum of the amounts of wages as defined in IRC section 3401(a) and elective deferrals that the taxpayer properly reports to the Social Security Administration with respect to the employment of employees of the taxpayer during the calendar year ending during the taxpayer's taxable year. For taxable years beginning before May 18, 2006, the limitation is based upon all wages paid by the taxpayer, rather than only wages properly allocable to domestic production gross receipts.
[436] IRC section 3401(a)(8)(C).
[437] IRC section 7701(a)(9).
[438] IRC section 199(d)(8)(A).

50-percent wage limitation, that taxpayer is permitted to take into account wages paid to bona fide residents of Puerto Rico for services performed in Puerto Rico.[439]

The special rules for Puerto Rico apply only with respect to the first two taxable years of a taxpayer beginning after December 31, 2005 and before January 1, 2008.

New Federal Law (IRC section 199)

The provision allows the special domestic production activities rules for Puerto Rico to apply for the first four taxable years of a taxpayer beginning after December 31, 2005, and before January 1, 2010.

Effective Date

The provision is effective for taxable years beginning after December 31, 2007.

California Law (R&TC sections 17201 and 17201.6)

California conforms by reference to Part VI of Subchapter B of Chapter 1 of Subtitle A of the IRC in the PITL in R&TC section 17201 as of the "specified date" of January 1, 2005, but specifically does not conform to IRC section 199. Additionally, California does not conform by reference to Part VI of Subchapter B of Chapter 1 of Subtitle A of the IRC in the CTL but instead has stand-alone provisions allowing deductions under California law and the deduction under IRC section 199 has not been adopted. Thus, California law does not conform to IRC section 199, relating to the deduction for qualified production activities income.

Impact on California Revenue

Not applicable.

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[439] IRC section 199(d)(8)(B).

Section	Section Title
313	Qualified Zone Academy Bonds

Background

Tax-exempt bonds

Interest on state and local governmental bonds generally is excluded from gross income for federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units. Activities that can be financed with these tax-exempt bonds include the financing of public schools.[440] An issuer must file with the IRS certain information about the bonds issued by them in order for that bond issue to be tax-exempt.[441] Generally, this information return is required to be filed no later the 15th day of the second month after the close of the calendar quarter in which the bonds were issued.

The tax exemption for state and local bonds does not apply to any arbitrage bond.[442] An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments.[443] In general, arbitrage profits may be earned only during specified periods (e.g., defined "temporary periods") before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., "reasonably required reserve or replacement funds"). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the federal government.

Qualified zone academy bonds

As an alternative to traditional tax-exempt bonds, states and local governments were given the authority to issue "qualified zone academy bonds."[444] A total of $400 million of qualified zone academy bonds is authorized to be issued annually in calendar years 1998 through 2007. The $400 million aggregate bond cap is allocated each year to the states according to their respective populations of individuals below the poverty line. Each state, in turn, allocates the credit authority to qualified zone academies within such state.

Financial institutions that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate multiplied by the face amount of the bond. A taxpayer holding a qualified zone academy bond on the credit allowance date is entitled to a credit. The credit is includable in gross income (as if it were a taxable interest payment on

[440] IRC section 103.
[441] IRC section 149(e).
[442] IRC section 103(a) and (b)(2).
[443] IRC section 148.
[444] IRC section 1397E.

the bond), and may be claimed against regular income tax and alternative minimum tax liability.

The Treasury Department sets the credit rate at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The maximum term of the bond is determined by the Treasury Department, so that the present value of the obligation to repay the bond was 50 percent of the face value of the bond.

"Qualified zone academy bonds" are defined as any bond issued by a state or local government, provided that: (1) at least 95 percent 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 percent 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 designated under the Code, or (b) it is reasonably expected that at least 35 percent 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.

The Tax Relief and Health Care Act of 2006 ("TRHCA")[445] imposed the arbitrage requirements that generally apply to interest-bearing tax-exempt bonds to qualified zone academy bonds. In addition, an issuer of qualified zone academy bonds must reasonably expect to and actually spend 95 percent or more of the proceeds of such bonds on qualified zone academy property within the five-year period that begins on the date of issuance. To the extent less than 95 percent of the proceeds are used to finance qualified zone academy property during the five-year spending period, bonds will continue to qualify as qualified zone academy bonds if unspent proceeds are used within 90 days from the end of such five-year period to redeem any nonqualified bonds. The five-year spending period may be extended by the Secretary if the issuer establishes that the failure to meet the spending requirement is due to reasonable cause and the related purposes for issuing the bonds will continue to proceed with due diligence. Issuers of qualified zone academy bonds are required to report issuance to the IRS in a manner similar to the information returns required for tax-exempt bonds.

[445] Public Law 109-432.

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA)
(PL 110-343, OCTOBER 3, 2008)

New Federal Law (IRC section 54E)

The provision extends and modifies the present-law qualified zone academy bond program. The provision authorizes issuance of up to $400 million of qualified zone academy bonds annually through 2009.

For bonds issued after October 3, 2008, the provision also modifies the spending and arbitrage rules that apply to qualified zone academy bonds. The provision modifies the spending rule by requiring 100 percent of available project proceeds to be spent on qualified zone academy property. In addition, the provision modifies the arbitrage rules by providing that available project proceeds invested during the five-year period beginning on the date of issue are not subject to the arbitrage restrictions (i.e., yield restriction and rebate requirements). The provision defines "available project proceeds" as proceeds from the sale of an issue of qualified zone academy bonds, less issuance costs (not to exceed two percent) and any investment earnings on such proceeds. Thus, available project proceeds invested during the five-year spending period may be invested at unrestricted yields, but the earnings on such investments must be spent on qualified zone academy property.

The provision provides that amounts invested in a reserve fund are not subject to the arbitrage restrictions to the extent: (1) such fund is funded at a rate not more rapid than equal annual installments; (2) such fund is funded in a manner reasonably expected to result in an amount not greater than an amount necessary to repay the issue; and (3) the yield on such fund is not greater than the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified zone academy bonds are issued.

Effective Date

The provision applies to bonds issued after October 3, 2008.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
314	Indian Employment Credit

Background

In general, a credit against income tax liability is allowed to employers for the first $20,000 of qualified wages and qualified employee health insurance costs paid or incurred by the employer with respect to certain employees (IRC section 45A). The credit is equal to 20 percent of the excess of eligible employee qualified wages and health insurance costs during the current year over the amount of such wages and costs incurred by the employer during 1993. The credit is an incremental credit, such that an employer's current-year qualified wages and qualified employee health insurance costs (up to $20,000 per employee) are eligible for the credit only to the extent that the sum of such costs exceeds the sum of comparable costs paid during 1993. No deduction is allowed for the portion of the wages equal to the amount of the credit.

Qualified wages means wages paid or incurred by an employer for services performed by a qualified employee. A qualified employee means any employee who is an enrolled member of an Indian tribe or the spouse of an enrolled member of an Indian tribe, who performs substantially all of the services within an Indian reservation, and whose principal place of abode while performing such services is on or near the reservation in which the services are performed. An "Indian reservation" is a reservation as defined in section 3(d) of the Indian Financing Act of 1974 or section 4(1) of the Indian Child Welfare Act of 1978. For purposes of the preceding sentence, section 3(d) is applied by treating "former Indian reservations in Oklahoma" as including only lands that are (1) within the jurisdictional area of an Oklahoma Indian tribe as determined by the Secretary of the Interior, and (2) recognized by such Secretary as an area eligible for trust land status under 25 C.F.R. Part 151 (as in effect on August 5, 1997).

An employee is not treated as a qualified employee for any taxable year of the employer if the total amount of wages paid or incurred by the employer with respect to such employee during the taxable year exceeds an amount determined at an annual rate of $30,000 (which after adjustment for inflation is currently $40,000).[446] In addition, an employee will not be treated as a qualified employee under certain specific circumstances, such as where the employee is related to the employer (in the case of an individual employer) or to one of the employer's shareholders, partners, or grantors. Similarly, an employee will not be treated as a qualified employee where the employee has more than a 5 percent ownership interest in the employer. Finally, an employee will not be considered a qualified employee to the extent the employee's services relate to gaming activities or are performed in a building housing such activities.

The Indian employment tax credit is not available for taxable years beginning after December 31, 2007.

[446] See federal Form 8845, Indian Employment Credit (Rev. December 2006).

New Federal Law (IRC section 45A)

The provision extends for two years the present-law employment credit provision (through taxable years beginning on or before December 31, 2009).

Effective Date

The provision is effective for taxable years beginning after December 31, 2007.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
315	Accelerated Depreciation for Business Property on Indian Reservations

Background

With respect to certain property used in connection with the conduct of a trade or business within an Indian reservation, depreciation deductions under IRC section 168(j) are determined using the following recovery periods:

3-year property	2 years
5-year property	3 years
7-year property	4 years
10-year property	6 years
15-year property	9 years
20-year property	12 years
Nonresidential real property	22 years

"Qualified Indian reservation property" eligible for accelerated depreciation includes property described in the table above which is: (1) used by the taxpayer predominantly in the active conduct of a trade or business within an Indian reservation; (2) not used or located outside the reservation on a regular basis; (3) not acquired (directly or indirectly) by the taxpayer from a person who is related to the taxpayer;[447] and (4) is not property placed in service for purposes of conducting gaming activities.[448] Certain "qualified infrastructure property" may be eligible for the accelerated depreciation even if located outside an Indian reservation, provided that the purpose of such property is to connect with qualified infrastructure property located within the reservation (e.g., roads, power lines, water systems, railroad spurs, and communications facilities).[449]

An "Indian reservation" means a reservation as defined in section 3(d) of the Indian Financing Act of 1974 or section 4(10) of the Indian Child Welfare Act of 1978. For purposes of the preceding sentence, section 3(d) is applied by treating "former Indian reservations in Oklahoma" as including only lands that are (1) within the jurisdictional area of an Oklahoma Indian tribe as determined by the Secretary of the Interior, and (2) recognized by such Secretary as an area eligible for trust land status under 25 C.F.R. Part 151 (as in effect on August 5, 1997).

The depreciation deduction allowed for regular tax purposes is also allowed for purposes of the alternative minimum tax. The accelerated depreciation for Indian reservations is available with respect to property placed in service on or after January 1, 1994, and before January 1, 2008.

<u>New Federal Law (IRC section 168)</u>

The provision extends for two years the present-law incentive relating to depreciation of qualified Indian reservation property (to apply to property placed in service through December 31, 2009).

<u>Effective Date</u>

The provision applies to property placed in service after December 31, 2007.

<u>California Law (R&TC sections 17250(a)(3) and 24349)</u>

California specifically does not conform to the federal special accelerated depreciation for business property on an Indian Reservation.

<u>Impact on California Revenue</u>

Not applicable.

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[447] For these purposes, related persons is defined in IRC section 465(b)(3)(C).
[448] IRC section 168(j)(4)(A).
[449] IRC section 168(j)(4)(C).

Section	Section Title
316	Railroad Track Maintenance

Background

Present law provides a 50-percent business tax credit for qualified railroad track maintenance expenditures paid or incurred by an eligible taxpayer during the taxable year.[450] The credit is limited to the product of $3,500 times the number of miles of railroad track: (1) owned or leased by an eligible taxpayer as of the close of its taxable year, and (2) assigned to the eligible taxpayer by a Class II or Class III railroad that owns or leases such track at the close of the taxable year.[451] Each mile of railroad track may be taken into account only once, either by the owner of such mile or by the owner's assignee, in computing the per-mile limitation. Under the provision, the credit is limited in respect of the total number of miles of track: (1) owned or leased by the Class II or Class III railroad, and (2) assigned to the Class II or Class III railroad for purposes of the credit.

Qualified railroad track maintenance expenditures are defined as gross expenditures (whether or not otherwise chargeable to capital account) for maintaining railroad track (including roadbed, bridges, and related track structures) owned or leased as of January 1, 2005, by a Class II or Class III railroad (determined without regard to any consideration for such expenditure given by the Class II or Class III railroad which made the assignment of such track).[452]

An eligible taxpayer means any Class II or Class III railroad, and any person who transports property using the rail facilities of a Class II or Class III railroad or who furnishes railroad-related property or services to a Class II or Class III railroad, but only with respect to miles of railroad track assigned to such person by such railroad under the provision.[453]

The terms Class II or Class III railroad have the meanings given by the Surface Transportation Board.[454]

The provision applies to qualified railroad track maintenance expenditures paid or incurred during taxable years beginning after December 31, 2004, and before January 1, 2008.

New Federal Law (IRC section 45G)

The provision extends the present law provision for two years, for qualified railroad track maintenance expenditures paid or incurred before January 1, 2010.

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[450] IRC section 45G(a).
[451] IRC section 45G(b)(1).
[452] IRC section 45G(d).
[453] IRC section 45G(c).
[454] IRC section 45G(e)(1).

Effective Date

The provision is effective for expenditures paid or incurred during taxable years beginning after December 31, 2007.

California Law

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
317	Seven-Year Cost Recovery Period for Motorsports Racing Track Facility

Background

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.[455] The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month. Land improvements (such as roads and fences) are recovered over 15 years. An exception exists for the theme and amusement park industry, whose assets are assigned a recovery period of seven years. Additionally, a motorsports entertainment complex placed in service before December 31, 2007, is assigned a recovery period of seven years.[456] For these purposes, a motorsports entertainment complex means a racing track facility which is permanently situated on land that during the 36 month period following its placed in service date it hosts a racing event.[457] The term motorsports entertainment complex also includes ancillary facilities, land improvements (e.g., parking lots, sidewalks, fences), support facilities (e.g., food and beverage retailing, souvenir vending), and appurtenances associated with such facilities (e.g., ticket booths, grandstands).

[455] IRC section 168.
[456] IRC section 168(e)(3)(C)(ii).
[457] IRC section 168(i)(15).

New Federal Law (IRC section 168)

The provision extends the present law seven-year cost recovery period for two years through December 31, 2009.

Effective Date

The provision is effective for property placed in service after December 31, 2007.

California Law (R&TC sections 17250, 24349, and 24355.3)

California conforms to the 7-year life of motor sport entertainment complex defined in IRC section 168(i)(15), in both the PITL and the CTL as of the “specified date” of January 1, 2005. Because this change was made after the “specified date” California is not conformed.

Impact on California Revenue

Estimated Revenue Impact of Seven-Year Cost Recovery Period for Motorsports Racing Track Facility For Property Placed in Service After December 31, 2008 and Before January 1, 2010 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$3,700,000	-$500,000	-$200,000

Estimates are based on a proration of federal projections developed by the Joint Committee on Taxation for the Emergency Economic Stabilization Act of 2008.

Section	Section Title
318	Expensing of Environmental Remediation Costs

Background

Present law allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business.[458] Treasury regulations provide that the cost of incidental repairs that 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"

[458] IRC section 162.

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.

Taxpayers may elect to treat certain environmental remediation expenditures paid or incurred before January 1, 2008, that would otherwise be chargeable to capital account as deductible in the year paid or incurred.[459] 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, which would otherwise be allocated to the site under the principles set forth in Commissioner v. Idaho Power Co.[460] and IRC section 263A, are treated as qualified environmental remediation expenditures.

A "qualified contaminated site" (a so-called "brownfield") generally is any property that is held for use in a trade or business, for the production of income, or as inventory and is certified by the appropriate state environmental agency to be an area at or on which there has been a release (or threat of release) or disposal of a hazardous substance. Both urban and rural property may qualify. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA")[461] cannot qualify as targeted areas. 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, as well as petroleum products defined in IRC section 4612(a)(3).

In the case of property to which a qualified environmental remediation expenditure otherwise would have been capitalized, any deduction allowed under IRC section 198 is treated as a depreciation deduction and the property is treated as IRC section 1245 property. Thus, deductions for qualified environmental remediation expenditures are subject to recapture as ordinary income upon a sale or other disposition of the property. In addition, IRC sections 280B, relating to demolition of structures, and IRC section 468, relating to special rules for mining and solid waste reclamation and closing costs, do not apply to amounts that are treated as expenses under this provision.

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[459] IRC section 198.
[460] 418 U.S. 1 (1974).
[461] Public Law 96-510 (1980).

IRC section 1400N(g) permits the expensing of environmental remediation expenditures paid or incurred on or after August 28, 2005, and before January 1, 2008, to abate contamination at qualified contaminated sites located in the Gulf Opportunity Zone.

New Federal Law (IRC section 198)

The provision extends the present law expensing provision under IRC section 198 for two years through December 31, 2009.

Effective Date

The provision is effective for expenditures paid or incurred after December 31, 2007.

California Law (R&TC sections 17279.4 and 24369.4)

California specifically does not conform to the deduction under IRC section 198, relating to expensing of environmental remediation costs, for expenditures paid or incurred after December 31, 2003.

Impact on California Revenue

Not applicable.

Section	Section Title
320	Extension of Increased Rehabilitation Credit for Structures in the Gulf Opportunity Zone

Background

In general

Present law provides a two-tier tax credit for rehabilitation expenditures. A 20-percent credit is provided for qualified rehabilitation expenditures with respect to a certified historic structure. For this purpose, a certified historic structure means any building that is listed in the National Register, or that is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.

A 10-percent credit is provided for qualified rehabilitation expenditures with respect to a qualified rehabilitated building, which generally means a building that was first placed in service before 1936. The pre-1936 building must meet requirements with respect to retention of existing external walls and internal structural framework of the building in order for expenditures with respect to it to qualify for the 10-percent credit. A building is treated as having met the substantial rehabilitation requirement under the 10-percent credit only if the rehabilitation expenditures during the 24-month period selected by the taxpayer and ending within the taxable year exceed the greater of: (1) the adjusted basis of the building (and its structural components), or (2) $5,000.

The provision requires the use of straight-line depreciation or the alternative depreciation system in order for rehabilitation expenditures to be treated as qualified under the provision.

Increased Rehabilitation Credit for Structures in the Gulf Opportunity Zone

The Gulf Opportunity (GO) Zone Act of 2005[462] increased from 20 to 26 percent, and from 10 to 13 percent, respectively, the credit under IRC section 47 with respect to any certified historic structure or qualified rehabilitated building located in the Gulf Opportunity Zone, provided the qualified rehabilitation expenditures with respect to such buildings or structures are incurred on or after August 28, 2005, and before January 1, 2009.

New Federal Law (IRC section 1400N)

The 13 and 26 percent rehabilitation tax credit for qualified expenditures on, respectively, qualifying rehabilitated buildings and certified historic structures in the GO Zone has been extended for one year or until December 31, 2009.

Effective Date

The provision is effective for taxable years beginning after December 31, 2007.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

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[462] Public Law 109-135.

Section	Section Title
321	Enhanced Deduction for Qualified Computer Contributions

Background

In the case of a charitable contribution of inventory or other ordinary-income or short-term capital gain property, the amount of the charitable deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. 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.[463] Under present law, a taxpayer's deduction for charitable contributions of computer technology and equipment generally is limited to the taxpayer's basis (typically, cost) in the property. However, certain corporations may claim a deduction in excess of basis for a "qualified computer contribution."[464] This enhanced deduction is equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis. The enhanced deduction for qualified computer contributions expires for any contribution made during any taxable year beginning after December 31, 2007.

A qualified computer contribution means a charitable contribution of any computer technology or equipment, which meets standards of functionality and suitability as established by the Secretary of the Treasury. The contribution must be to certain educational organizations or public libraries and made not later than three years after the taxpayer acquired the property or, if the taxpayer constructed or assembled the property, not later than the date construction or assembly of the property is substantially completed.[465] The original use of the property must be by the donor or the donee,[466] and in the case of the donee, must be used substantially for educational purposes related to the function or purpose of the donee. The property must fit productively into the donee's education plan. The donee may not transfer the property in exchange for money, other property, or services, except for shipping, installation, and transfer costs. To determine whether property is constructed or assembled by the taxpayer, the rules applicable to qualified research contributions apply. Contributions may be made to private foundations under certain conditions.[467]

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[463] IRC section 170(e)(1).
[464] IRC sections 170(e)(4) and 170(e)(6).
[465] If the taxpayer constructed the property and reacquired such property, the contribution must be within three years of the date the original construction was substantially completed. IRC section 170(e)(6)(D)(i).
[466] This requirement does not apply if the property was reacquired by the manufacturer and contributed. IRC section 170(e)(6)(D)(ii).
[467] IRC section 170(e)(6)(C).

New Federal Law (IRC section 170)

The provision extends the enhanced deduction for computer technology and equipment for one year to apply to contributions made during any taxable year beginning after December 31, 2007, and before January 1, 2010.

Effective Date

The provision is effective for taxable years beginning after December 31, 2007.

California Law (R&TC section 24357.9)

Under California law, for taxable years beginning after December 31, 2003, a deduction by a corporation for charitable contributions of computer technology and equipment generally is limited to the corporation's basis in the property. For taxable years beginning after January 1, 2002, and before December 31, 2003, certain corporations were allowed a deduction in excess of basis for a qualified computer contribution. California did not conform to the Working Families Tax Relief Act of 2004 (PL 108-311) two-year extension of the federal deduction in excess of basis for a "qualified research contribution" or a "qualified computer contribution."

Impact on California Revenue

Not applicable.

Section	Section Title
322	Tax Incentives for Investment in the District of Columbia

Background

In general

The Taxpayer Relief Act of 1997 designated certain economically depressed census tracts within the District of Columbia as the District of Columbia Enterprise Zone (the "D.C. Zone"), within which businesses and individual residents are eligible for special tax incentives. The census tracts that compose the D.C. Zone are: (1) all census tracts that presently are part of the D.C. enterprise community designated under IRC section 1391 (i.e., portions of Anacostia, Mt. Pleasant, Chinatown, and the easternmost part of the District); and (2) all additional census tracts within the District of Columbia where the poverty rate is not less than 20 percent. The D.C. Zone designation remained in effect for the period from January 1, 1998, through December 31, 2007.

In general, the tax incentives available in connection with the D.C. Zone are a 20-percent wage credit, an additional $35,000 of IRC section 179 expensing for qualified zone property, expanded tax-exempt financing for certain zone facilities, and a zero-percent capital gains rate from the sale of certain qualified D.C. zone assets.

Wage credit

A 20-percent wage credit is available to employers for the first $15,000 of qualified wages paid to each employee (i.e., a maximum credit of $3,000 with respect to each qualified employee) who: (1) is a resident of the D.C. Zone, and (2) performs substantially all employment services within the D.C. Zone in a trade or business of the employer.

Wages paid to a qualified employee who earns more than $15,000 are eligible for the wage credit (although only the first $15,000 of wages is eligible for the credit). The wage credit is available with respect to a qualified full-time or part-time employee (employed for at least 90 days), regardless of the number of other employees who work for the employer. In general, any taxable business carrying out activities in the D.C. Zone may claim the wage credit, regardless of whether the employer meets the definition of a "D.C. Zone business."[468]

An employer's deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year.[469] Wages are not to be taken into account for purposes of the wage credit if taken into account in determining the employer's work opportunity tax credit under IRC section 51 or the welfare-to-work credit under IRC section 51A.[470] In addition, the $15,000 cap is reduced by any wages taken into account in computing the work opportunity tax credit or the welfare-to-work credit.[471] The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.[472]

IRC section 179 expensing

In general, a D.C. Zone business is allowed an additional $35,000 of IRC section 179 expensing for qualifying property placed in service by a D.C. Zone business.[473] The IRC section 179 expensing allowed to a taxpayer is phased out by the amount by which 50 percent of the cost of qualified zone property placed in service during the year by the taxpayer exceeds $200,000 ($500,000 for taxable years beginning after 2006 and before 2011).

[468] However, the wage credit is not available for wages paid in connection with certain business activities described in IRC section 144(c)(6)(B) or certain farming activities. In addition, wages are not eligible for the wage credit if paid to (1) a person who owns more than five percent of the stock (or capital or profits interests) of the employer, (2) certain relatives of the employer, or (3) if the employer is a corporation or partnership, certain relatives of a person who owns more than 50 percent of the business.
[469] IRC section 280C(a).
[470] IRC sections 1400H(a), 1396(c)(3)(A) and 51A(d)(2).
[471] IRC sections 1400H(a), 1396(c)(3)(B) and 51A(d)(2).
[472] IRC section 38(c)(2).
[473] IRC section 1397A.

The term "qualified zone property" is defined as depreciable tangible property (including buildings), provided that: (1) the property is acquired by the taxpayer (from an unrelated party) after the designation took effect, (2) the original use of the property in the D.C. Zone commences with the taxpayer, and (3) substantially all of the use of the property is in the D.C. Zone in the active conduct of a trade or business by the taxpayer.[474] Special rules are provided in the case of property that is substantially renovated by the taxpayer.

Tax-exempt financing

A qualified D.C. Zone business is permitted to borrow proceeds from tax-exempt qualified enterprise zone facility bonds (as defined in IRC section 1394) issued by the District of Columbia.[475] Such bonds are subject to the District of Columbia's annual private-activity-bond volume limitation. Generally, qualified enterprise zone facility bonds for the District of Columbia are bonds 95 percent or more of the net proceeds of which are used to finance certain facilities within the D.C. Zone. The aggregate face amount of all outstanding qualified enterprise zone facility bonds per qualified D.C. Zone business may not exceed $15 million and may be issued only while the D.C. Zone designation is in effect.

Zero-percent capital gains

A zero-percent capital gains rate applies to capital gains from the sale of certain qualified D.C. Zone assets held for more than five years.[476] In general, a qualified "D.C. Zone asset" means stock or partnership interests held in, or tangible property held by, a D.C. Zone business. 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 percent.
In general, gain eligible for the zero-percent tax rate means gain from the sale or exchange of a qualified D.C. Zone asset that is (1) a capital asset or property used in the trade or business as defined in IRC section 1231(b), and (2) acquired before January 1, 2008. Gain that is attributable to real property, or to intangible assets, qualifies for the zero-percent rate, provided that such real property or intangible asset is an integral part of a qualified D.C. Zone business.[477] However, no gain attributable to periods before January 1, 1998, and after December 31, 2012, is qualified capital gain.

District of Columbia homebuyer tax credit

First-time homebuyers of a principal residence in the District of Columbia are eligible for a nonrefundable tax credit of up to $5,000 of the amount of the purchase price. The $5,000 maximum credit applies both to individuals and married couples. Married individuals filing separately can claim a maximum credit of $2,500 each.

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[474] IRC section 1397D.
[475] IRC section 1400A.
[476] IRC section 1400B.
[477] However, sole proprietorships and other taxpayers selling assets directly cannot claim the zero-percent rate on capital gain from the sale of any intangible property (i.e., the integrally-related test does not apply).

The credit phases out for individual taxpayers with adjusted gross income between $70,000 and $90,000 ($110,000-$130,000 for joint filers). For purposes of eligibility, "first-time homebuyer" means any individual if such individual did not have a present ownership interest in a principal residence in the District of Columbia in the one-year period ending on the date of the purchase of the residence to which the credit applies. The credit expired for purchases after December 31, 2007.[478]

New Federal Law (IRC section 1400, 1400A, 1400B, 1400C, and 1400F)

The provision extends the designation of the D.C. Zone for two years (through December 31, 2009), thus extending the wage credit and IRC section 179 expensing for two years.

The provision extends the tax-exempt financing authority for two years, applying to bonds issued during the period beginning on January 1, 1998, and ending on December 31, 2009.

The provision extends the zero-percent capital gains rate applicable to capital gains from the sale of certain qualified D.C. Zone assets for two years.

Effective Date

The provision is effective for periods beginning after, bonds issued after, acquisitions after, and property purchased after December 31, 2007.

California Law (None)

California does not conform to the D.C. Zone special tax incentives.

Impact on California Revenue

Not applicable.

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[478] IRC section 1400C(i).

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA) (PL 110-343, OCTOBER 3, 2008)

Section	Section Title
323	Enhanced Charitable Deductions for Contributions of Food Inventory

Background

General rules regarding contributions of food inventory

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory, or if less the fair market value of the inventory.

For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of: (1) basis plus one-half of the item's appreciation (i.e., basis plus one-half of fair market value in excess of basis), or (2) two times basis.[479] In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income.[480] To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in IRC section 501(c)(3) (except for private nonoperating foundations), and the donee must: (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants; (2) not transfer the property in exchange for money, other property, or services; and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements. In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inventory.[481] Accordingly, if the allowable charitable deduction for inventory is the fair market value of the inventory, the donor reduces its cost of goods sold by such value, with the result that the difference between the fair market value and the donor's basis may still be recovered by the donor other than as a charitable contribution.

To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis. The valuation of food inventory has been the subject of disputes between taxpayers and the IRS.[482]

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[479] IRC section 170(e)(3).
[480] IRC section 170(b)(2).
[481] Treas. Reg. sec. 1.170A-4A(c)(3).
[482] *Lucky Stores Inc. v. Commissioner,* 105 T.C. 420 (1995) (holding that the value of surplus bread inventory donated to charity was the full retail price of the bread rather than half the retail price, as the IRS asserted).

Temporary rule expanding and modifying the enhanced deduction for contributions of food inventory

Under a temporary provision enacted as part of the Katrina Emergency Tax Relief Act of 2005 (KETRA) and extended by the Pension Protection Act of 2006 (PPA), any taxpayer, whether or not a C corporation, engaged in a trade or business is eligible to claim the enhanced deduction for donations of food inventory.[483] For taxpayers other than C corporations, the total deduction for donations of food inventory in a taxable year generally may not exceed 10 percent of the taxpayer's net income for such taxable year from all sole proprietorships, S corporations, or partnerships (or other non C corporation) from which contributions of apparently wholesome food are made. For example, if a taxpayer is a sole proprietor, a shareholder in an S corporation, and a partner in a partnership, and each business makes charitable contributions of food inventory, the taxpayer's deduction for donations of food inventory is limited to 10 percent of the taxpayer's net income from the sole proprietorship and the taxpayer's interests in the S corporation and partnership. However, if only the sole proprietorship and the S corporation made charitable contributions of food inventory, the taxpayer's deduction would be limited to 10 percent of the net income from the trade or business of the sole proprietorship and the taxpayer's interest in the S corporation, but not the taxpayer's interest in the partnership.[484]

Under the temporary provision, the enhanced deduction for food is available only for food that qualifies as "apparently wholesome food." "Apparently wholesome food" is defined as food intended for human consumption that meets all quality and labeling standards imposed by federal, state, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions.

The temporary provision does not apply to contributions made after December 31, 2007.

New Federal Law (IRC section 170)

The provision extends the expansion of, and modifications to, the enhanced deduction for charitable contributions of food inventory to contributions made before January 1, 2010.

Effective Date

The provision is effective for contributions made after December 31, 2007.

[483] IRC section 170(e)(3)(C).
[484] The 10-percent limitation does not affect the application of the generally applicable percentage limitations. For example, if 10 percent of a sole proprietor's net income from the proprietor's trade or business was greater than 50 percent of the proprietor's contribution base, the available deduction for the taxable year (with respect to contributions to public charities) would be 50 percent of the proprietor's contribution base. Consistent with present law, such contributions may be carried forward because they exceed the 50-percent limitation. Contributions of food inventory by a taxpayer that is not a C corporation that exceed the 10-percent limitation but not the 50-percent limitation could not be carried forward.

California Law (R&TC sections 17201, 17275.5, and 24357 – 24357.9)

The PITL conforms by reference to IRC section 170, relating to charitable contributions, in R&TC section 17201, as of the "specified date" of January 1, 2005, with modifications in 17275.5. Under the CTL, California has stand alone law in R&TC sections 24357 – 24357.9 providing for charitable contributions for corporations, with two instances where specific rules contained in IRC section 170 are specifically made applicable, as of the "specified date" of January 1, 2005. Under the CTL, R&TC section 24357.1 provides that a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory. California has not conformed to the charitable contribution provisions contained in KETRA or the PPA in either the PITL or the CTL.

Impact on California Revenue

Estimated Revenue Impact of Enhanced Charitable Deduction for Contributions of Food Inventory For Taxable Years Beginning On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$2,700,000	$0	$0

Estimates are based on a proration of federal projections for the Emergency Economic Stabilization Act of 2008, with modifications.

Section	Section Title
324	Extension of Enhanced Charitable Deduction for Contributions of Book Inventory

Background

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory, or, if less, the fair market value of the inventory.

In general, for certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one-half of fair market value in excess of basis) or (2) two times basis.[485]

[485] IRC section 170(e)(3).

In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income.[486] To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer contributed to a charitable organization described in IRC section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements. In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inventory.[487] Accordingly, if the allowable charitable deduction for inventory is the fair market value of the inventory, the donor reduces its cost of goods sold by such value, with the result that the difference between the fair market value and the donor's basis may still be recovered by the donor other than as a charitable contribution.

To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis.

The Katrina Emergency Tax Relief Act of 2005 expanded the generally applicable enhanced deduction for C corporations to certain qualified book contributions made after August 28, 2005, and before January 1, 2006. The Pension Protection Act of 2006 extended the deduction for qualified book contributions to contributions made before January 1, 2008. A qualified book contribution means a charitable contribution of books to a public school that provides elementary education or secondary education (kindergarten through grade 12) and that is an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The enhanced deduction for qualified book contributions is not allowed unless the donee organization certifies in writing that the contributed books are suitable, in terms of currency, content, and quantity, for use in the donee's educational programs and that the donee will use the books in such educational programs. The donee also must make the certifications required for the generally applicable enhanced deduction, i.e., the donee will: (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants; (2) not transfer the property in exchange for money, other property, or services; and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements.

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486 IRC section 170(b)(2).
487 Treas. Reg. sec. 1.170A-4A(c)(3).

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA)
(PL 110-343, OCTOBER 3, 2008)

New Federal Law (IRC section 170)

The provision extends the enhanced deduction for contributions of book inventory to contributions made before January 1, 2010.

Effective Date

The provision is effective for contributions made after December 31, 2007.

California Law (R&TC sections 24357-24359)

The CTL is not conformed by reference to the federal percentage limitations in IRC section 170, but instead has stand-alone law in R&TC sections 24357 through 24359, inclusive. The CTL specifically provides that the charitable contribution deduction may not exceed ten percent of the corporation's net income, and any excess may be carried forward for up to five years.

In addition, the CTL does not conform to the federal enhanced deduction for contributions of certain inventory items. Instead, under the CTL contributions of property other than cash, such as inventory items, are limited to the taxpayer's adjusted basis in that property, generally its cost. California has not conformed to the charitable contribution provisions contained in KETRA or the PPA in either the PITL or the CTL.

Impact on California Revenue

Estimated Revenue Impact of Extension of Enhanced Charitable Deduction for Contributions of Book Inventory For Taxable Years Beginning On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$1,000,000	$0	$0

Estimates are based on a proration of federal projections developed for the Emergency Economic Stabilization Act of 2008. The provision would sunset on December 31, 2009.

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA)
(PL 110-343, OCTOBER 3, 2008)

TITLE IV – EXTENSION OF TAX ADMINISTRATION PROVISIONS

Section	Section Title
401	Permanent Authority for Undercover Operations

Background

IRS undercover operations are statutorily[488] exempt from the generally applicable restrictions controlling the use of government funds (which generally provide that all receipts must be deposited in the general fund of the Treasury and all expenses be paid out of appropriated funds). In general, the IRC permits the IRS to use proceeds from an undercover operation to pay additional expenses incurred in the undercover operation, through 2007. The IRS is required to conduct a detailed financial audit of large undercover operations in which the IRS is churning funds and to provide an annual audit report to the Congress on all such large undercover operations.

New Federal Law (IRC section 7608)

The provision makes permanent the IRS's authority to use proceeds from an undercover operation to pay additional expenses incurred in the undercover operation.

Effective Date

The provision shall take effect on January 1, 2008.

California Law

California does not conform to this administrative provision.

Impact on California Revenue

Not applicable.

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[488] IRC section 7608(c).

Section	Section Title
402	Permanent Authority for Disclosure of Information Relating to Terrorists Activities

Background

In general

IRC section 6103 provides that returns and return information may not be disclosed by the IRS, other federal employees, state employees, and certain others having access to the information except as provided in the IRC. IRC section 6103 contains a number of exceptions to this general rule of nondisclosure that authorize disclosure in specifically identified circumstances (including nontax criminal investigations) when certain conditions are satisfied.

Disclosure provisions relating to emergency circumstance

The IRS is authorized to disclose return information to apprise federal law enforcement agencies of danger of death or physical injury to an individual or to apprise federal law enforcement agencies of imminent flight of an individual from federal prosecution.[489] This authority has been used in connection with the investigation of terrorist activity.[490]

Disclosure provisions relating specifically to terrorist activity

Also among the disclosures permitted under the IRC is disclosure of returns and return information for purposes of investigating terrorist incidents, threats, or activities, and for analyzing intelligence concerning terrorist incidents, threats, or activities. The term "terrorist incident, threat, or activity" is statutorily defined to mean an incident, threat, or activity involving an act of domestic terrorism or international terrorism.[491]

The term "international terrorism" means activities that involve violent acts or acts dangerous to human life that are a violation of the criminal laws of the United States or of any state, or that would be a criminal violation if committed within the jurisdiction of the United States or of any state; appear to be intended to intimidate or coerce a civilian population, to influence the policy of a government by intimidation or coercion, or to affect the conduct of a government by mass destruction, assassination, or kidnapping; and occur primarily outside the territorial jurisdiction of the United States, or transcend national boundaries in terms of the means by which they are accomplished, the persons they appear intended to intimidate or coerce, or the locale in which their perpetrators operate or seek asylum.

[489] IRC section 6103(i)(3)(B).
[490] See, Joint Committee on Taxation, *Disclosure Report for Public Inspection Pursuant to Internal Revenue Code Section 6103(p)(3)(C) for Calendar Year 2002 (JCX-29-04)* April 6, 2004.
[491] IRC section 6103(b)(11). For this purpose, "domestic terrorism" is defined in 18 U.S.C. section 2331(5) and "international terrorism" is defined in 18 U.S.C. section 2331(1).

The term "domestic terrorism" means activities that involve acts dangerous to human life that are a violation of the criminal laws of the United States or of any state; appear to be intended to intimidate or coerce a civilian population, to influence the policy of a government by intimidation or coercion or to affect the conduct of a government by mass destruction, assassination, or kidnapping; and occur primarily within the territorial jurisdiction of the United States.

In general, returns and taxpayer return information must be obtained pursuant to an ex parte court order. Return information, other than taxpayer return information, generally is available upon a written request meeting specific requirements. The IRS also is permitted to make limited disclosures of such information on its own initiative to the appropriate federal law enforcement agency.

No disclosures may be made under these provisions after December 31, 2007. The procedures applicable to these provisions are described in detail below.

Disclosure of returns and return information - by ex parte court order

Ex parte court orders sought by federal law enforcement and federal intelligence agencies

The IRC permits, pursuant to an ex parte court order, the disclosure of returns and return information (including taxpayer return information) to certain officers and employees of a federal law enforcement agency or federal intelligence agency. These officers and employees are required to be personally and directly engaged in any investigation of, response to, or analysis of intelligence and counterintelligence information concerning any terrorist incident, threat, or activity. These officers and employees are permitted to use this information solely for their use in the investigation, response, or analysis, and in any judicial, administrative, or grand jury proceeding, pertaining to any such terrorist incident, threat, or activity.

The Attorney General, Deputy Attorney General, Associate Attorney General, an Assistant Attorney General, or a United States attorney, may authorize the application for the ex parte court order to be submitted to a federal district court judge or magistrate. The federal district court judge or magistrate would grant the order if based on the facts submitted he or she determines that: (1) there is reasonable cause to believe, based upon information believed to be reliable, that the return or return information may be relevant to a matter relating to such terrorist incident, threat, or activity; and (2) the return or return information is sought exclusively for the use in a federal investigation, analysis, or proceeding concerning any terrorist incident, threat, or activity.

Special rule for ex parte court ordered disclosure initiated by the IRS

If the Secretary of the Treasury (or his delegate) possesses returns or return information that may be related to a terrorist incident, threat, or activity, the Secretary may, on his own initiative, authorize an application for an ex parte court order to permit disclosure to federal law enforcement. In order to grant the order, the federal district court judge or magistrate must determine that there is reasonable cause to believe, based upon information believed to be reliable, that the return or return information may be relevant to a matter relating to such terrorist incident, threat, or activity. The information may be disclosed only to the extent necessary to apprise the appropriate federal law enforcement agency responsible for investigating or responding to a terrorist incident, threat, or activity and for officers and employees of that agency to investigate or respond to such terrorist incident, threat, or activity. Further, use of the information is limited to use in a federal investigation, analysis, or proceeding concerning a terrorist incident, threat, or activity. Because the Department of Justice represents the Secretary in federal district court, the Secretary is permitted to disclose returns and return information to the Department of Justice as necessary and solely for the purpose of obtaining the special IRS ex parte court order.

Disclosure of return information other than by ex parte court order

Disclosure by the IRS without a request

The IRC permits the IRS to disclose return information, other than taxpayer return information, related to a terrorist incident, threat, or activity to the extent necessary to apprise the head of the appropriate federal law enforcement agency responsible for investigating or responding to such terrorist incident, threat, or activity. The IRS on its own initiative and without a written request may make this disclosure. The head of the federal law enforcement agency may disclose information to officers and employees of such agency to the extent necessary to investigate or respond to such terrorist incident, threat, or activity. A taxpayer's identity is not treated as return information supplied by the taxpayer or his or her representative.

Disclosure upon written request of a federal law enforcement agency

The IRC permits the IRS to disclose return information, other than taxpayer return information, to officers and employees of federal law enforcement upon a written request satisfying certain requirements. The request must: (1) be made by the head of the federal law enforcement agency (or his delegate) involved in the response to or investigation of terrorist incidents, threats, or activities, and (2) set forth the specific reason or reasons why such disclosure may be relevant to a terrorist incident, threat, or activity. The information is to be disclosed to officers and employees of the federal law enforcement agency who would be personally and directly involved in the response to or investigation of terrorist incidents, threats, or activities. The information is to be used by such officers and employees solely for such response or investigation.

The IRC permits the re-disclosure by a federal law enforcement agency to officers and employees of state and local law enforcement personally and directly engaged in the response to or investigation of the terrorist incident, threat, or activity. The state or local law enforcement agency must be part of an investigative or response team with the federal law enforcement agency for these disclosures to be made.

Disclosure upon request from the Departments of Justice or the Treasury for intelligence analysis of terrorist activity

Upon written request satisfying certain requirements discussed below, the IRS is to disclose return information (other than taxpayer return information) to officers and employees of the Department of Justice, Department of the Treasury, and other federal intelligence agencies, who are personally and directly engaged in the collection or analysis of intelligence and counterintelligence or investigation concerning terrorist incidents, threats, or activities. Use of the information is limited to use by such officers and employees in such investigation, collection, or analysis.

The written request is to set forth the specific reasons why the information to be disclosed is relevant to a terrorist incident, threat, or activity. The request is to be made by an individual who is: (1) an officer or employee of the Department of Justice or the Department of the Treasury, (2) appointed by the President with the advice and consent of the Senate, and (3) responsible for the collection, and analysis of intelligence and counterintelligence information concerning terrorist incidents, threats, or activities. The Director of the United States Secret Service also is an authorized requester.

New Federal Law (IRC section 6103)

The provision makes permanent the present-law disclosure authority relating to terrorist activities.

Effective Date

The provision is effective for disclosures made on or after October 3, 2008.

California Law (R&TC sections 19542 and 19559)

In general, California does not conform by reference to IRC section 6103, relating to confidentiality and disclosure of returns and return information, but has stand alone law in R&TC sections 19542 – 19570 providing the California rules for disclosure of returns and return information. California conforms by reference to IRC section 6103(i), relating to disclosure of return information regarding terrorist activities, as of the “specified date” of January 1, 2005, in R&TC section 19559, but contains a stand-alone sunset date in R&TC section 19559(b). No disclosures may be made under this provision after December 31, 2005.

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA) (PL 110-343, OCTOBER 3, 2008)

Under R&TC section 19542, except as otherwise provided, it is a misdemeanor for a member of the Franchise Tax Board or any employee of the state, or former officer or employee or other individual, to disclose any information as to the amount of income or other information included in the tax returns filed with the state. Specific exceptions are provided to allow disclosure of certain information in specified circumstances.

Impact on California Revenue

Estimated Revenue Impact of Permanent Authority for Disclosure of Information Relating to Terrorists Activities For Distributions After October 3, 2008 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
No Impact	No Impact	No Impact

This provision has no revenue effect according to the Joint Committee on Taxation.

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA)
(PL 110-343, OCTOBER 3, 2008)

TITLE V – ADDITIONAL TAX RELIEF AND OTHER PROVISIONS
SUBTITLE A – GENERAL PROVISIONS

Section	Section Title
501	$8,500 Income Threshold Used to Calculate Refundable Portion of Child Tax Credit

Background

An individual may claim a tax credit for each qualifying child under the age of 17. The amount of the credit per child is $1,000 through 2010, and $500 thereafter. A child who is not a citizen, national, or resident of the United States cannot be a qualifying child.

The credit is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable child tax credit is reduced by $50 for each $1,000 (or fraction thereof) of modified adjusted gross income over $75,000 for single individuals or heads of households, $110,000 for married individuals filing joint returns, and $55,000 for married individuals filing separate returns. For purposes of this limitation, modified adjusted gross income includes certain otherwise excludable income earned by U.S. citizens or residents living abroad or in certain U.S. territories.

The credit is allowable against the regular tax and the alternative minimum tax. To the extent the child credit exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit (the additional child tax credit) equal to 15 percent of earned income in excess of a threshold dollar amount (the "earned income" formula). The threshold dollar amount is $12,050 (2008), and is indexed for inflation.

Families with three or more children may determine the additional child tax credit using the "alternative formula," if this results in a larger credit than determined under the earned income formula. Under the alternative formula, the additional child tax credit equals the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit ("EIC").

Earned income is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings. Unlike the EIC, which also includes the preceding items in its definition of earned income, the additional child tax credit is based only on earned income to the extent it is included in computing taxable income. For example, some ministers' parsonage allowances are considered self-employment income, and thus are considered earned income for purposes of computing the EIC, but the allowances are excluded from gross income for individual income tax purposes, and thus are not considered earned income for purposes of the additional child tax credit since the income is not included in taxable income.

New Federal Law (IRC section 24)

The provision modifies the earned income formula for the determination of the refundable child credit to apply to 15 percent of earned income in excess of $8,500 for taxable years beginning in 2009.

Effective Date

The provision is effective for taxable years beginning in 2009.

California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
502	Provisions Related to Film and Television Productions

Background

The modified Accelerated Cost Recovery System ("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 properly applies a unit-of-production method or other method of depreciation not expressed in a term of years. IRC section 197 does not apply to certain intangible property, including property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property not acquired in a transaction (or a series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. Thus, the recovery of the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be determined under either the MACRS depreciation provisions or under the IRC section 197 amortization provisions. The cost recovery of such property may be determined under IRC section 167, which allows a depreciation deduction for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the property. A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. IRC section 167(g) provides that the cost of motion picture films, sound recordings, copyrights, books, and patents are eligible to be recovered using the income forecast method of depreciation.

Under IRC section 181, taxpayers may elect[492] to deduct the cost of any qualifying film and television production, commencing prior to January 1, 2009, in the year the expenditure is incurred in lieu of capitalizing the cost and recovering it through depreciation allowances.[493] A qualified film or television production is one in which the aggregate cost is $15 million or less.[494] The threshold is increased to $20 million if a significant amount of the production expenditures are incurred in areas eligible for designation as a low-income community or eligible for designation by the Delta Regional Authority as a distressed county or isolated area of distress.[495]

A qualified film or television production means any production of a motion picture (whether released theatrically or directly to video cassette or any other format) or television program if at least 75 percent of the total compensation expended on the production is for services performed in the United States by actors, directors, producers, and other relevant production personnel.[496] The term "compensation" does not include participations and residuals (as defined in IRC section 167(g)(7)(B)).[497] With respect to property which is one or more episodes in a television series, each episode is treated as a separate production and only the first 44 episodes qualify under the provision.[498] Qualified property does not include sexually explicit productions as defined by section 2257 of title 18 of the U.S. Code.[499]

For purposes of recapture under IRC section 1245, any deduction allowed under IRC section 181 is treated as if it were a deduction allowable for amortization.[500]

New Federal Law (IRC section 181)

The provision modifies the dollar limitation so that the first $15 million ($20 million for productions in low income communities or distressed area or isolated area of distress) of an otherwise qualified film or television production may be treated as an expense in cases where the aggregate cost of the production exceeds the dollar limitation. The cost of the production in excess of the dollar limitation is capitalized and recovered under the taxpayer's method of accounting for the recovery of such property.

Effective Date

The provision applies to qualified film and television productions commencing after December 31, 2007.

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[492] See Treas. Reg. section 1.181-2T for rules on making an election under this section.
[493] For this purpose, a production is treated as commencing on the first date of principal photography.
[494] IRC section 181(a)(2)(A). A qualifying film or television production that is co-produced is eligible for the benefits of the provision only if its aggregate cost, regardless of funding source, does not exceed the threshold.
[495] IRC section 181(a)(2)(B).
[496] IRC section 181(d)(3)(A).
[497] IRC section 181(d)(3)(B).
[498] IRC section 181(d)(2)(B).
[499] IRC section 181(d)(2)(C).
[500] IRC section 1245(a)(2)(C).

California Law (R&TC sections 17201.5, 17250.5, and 24349(f))

California specifically does not conform to IRC section 181, relating to treatment of certain qualified film and television productions, under the PITL. Under the CTL California does not adopt IRC section 181. For taxable years beginning on or after January 1, 1997, California conforms under both the PITL and CTL to 1996 federal revisions of the income forecast method. This method may be used on property that can't be depreciated under MACRS or amortized under IRC section 197. It generally applies to determine depreciation of property such as films, videotapes, television, book rights, patents, master sound recordings, video games, and like items.

Impact on California Revenue

Not applicable.

Section	Section Title
503	Exemption from Excise Tax for Certain Wooden Arrows Designed for Use by Children

Background

Under present law, IRC section 4161(b)(2) imposes an excise tax of 39 cents, adjusted for inflation, on the first sale by the manufacturer, producer, or importer of any shaft (whether sold separately or incorporated as part of a finished or unfinished product) used to produce certain types of arrows.[501] These taxes support the Federal Aid to Wildlife Restoration Fund.[502]

New Federal Law (IRC section 4161)

The provision exempts from the excise tax on arrow shafts certain shafts (whether sold separately or incorporated as part of a finished or unfinished product) that are all natural wood. The shaft cannot be in excess of 5/16 of an inch in diameter and cannot have any laminations or artificial means of enhancing the spine of the shaft. The shaft must be of a type used in the manufacture of an arrow which after its assembly is not suitable for use with a bow that has a peak draw weight of 30 pounds or more.

Effective Date

This provision applies to shafts first sold after October 3, 2008.

[501] The tax on arrow shafts is 43 cents per arrow shaft beginning January 1, 2008.
[502] 16 U.S.C. sec. 669b.

California Law

The Franchise Tax Board does not administer excise taxes; instead, excise taxes are administered by the State Board of Equalization (BOE).

Impact on California Revenue

Defer to the BOE.

Section	Section Title
505	Certain Farming Business Machinery and Equipment Treated as 5-Year Property

Background

Present law provides that property, such as machinery or equipment, with a determinable useful life of more than a year that is used in a business or held for the production of income and is placed in service after December 31, 1986, is depreciated under the Modified Accelerated Cost Recovery System (MACRS) over the property's recovery period. MACRS consists of two ways of computing depreciation: the more commonly used General Depreciation System (GDS) and the Alternative Depreciation System (ADS), which generally provides for slower cost recovery over a longer period of time than GDS.

Property that is used in a farming business is depreciated under GDS (unless ADS is required or is elected by the taxpayer) using the 150-percent declining-balance method. The term "farming business" means the trade or business of farming, which also includes the trade or business of operating a nursery or sod farm and the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees. The "trade or business of farming" involves the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity.[503] Farm machinery and equipment generally has a seven-year recovery period under GDS.[504]

Farm machinery and equipment generally has a recovery period of 10 years under ADS and is depreciated using the straight-line method.[505]

[503] IRC section 263A(e)(4); Treas. Reg. section 1.264A-4(a)(4).
[504] IRC section 168; Rev. Proc. 87-57, 1987-2 CB 687.
[505] IRC section 168(g).

New Federal Law (IRC section 168)

The provision provides that any machinery or equipment (other than a grain bin, cotton ginning asset, fence, or land improvement), the original use of which begins with the taxpayer in 2009, and that is placed in service by the taxpayer in a farming business in 2009, has a recovery period of five years under GDS,[506] and a recovery period of 10 years under ADS.[507]

Effective Date

The provision applies to property placed in service after December 31, 2008.

California Law (R&TC sections 17201, 17250, 24349, 24355.3, and 24355.4)

Under the Personal Income Tax Law (PITL), California law, as it relates to MACRS, in general conforms to the federal rules with certain modifications. For example, California did not conform to the American Jobs Creation Act (AJCA) of 2004 changes to IRC section 168 that specifically provided the recovery period for depreciation of certain leasehold improvements and restaurant property.

Under current California law, S corporations (and their shareholders) are allowed to use MACRS under the PITL.

Under the Corporation Tax Law (CTL), California did not conform to the pre-1986 federal ACRS depreciation deduction and currently does not conform to the federal law MACRS depreciation.

The CTL is in substantial conformity to the pre-1981 federal asset depreciation range (ADR) deduction. The ADR is based on the “useful life” of depreciable property. The CTL has specified a useful life of seven years for certain motorsport entertainment complexes and natural gas pipelines located in Alaska. For California purposes, assets used in the transmission and distribution of electricity for sale and related land improvements have a “useful life” of 30 years.

Prior to the adoption of ACRS by the Economic Recovery Tax Act (ERTA) of 1981, taxpayers were allowed to depreciate (under the ADR) the various components of a building as separate assets with separate useful lives.

The CTL has not conformed to the repeal of the use of component depreciation, as ACRS, originally enacted by ERTA, was never adopted in the CTL. Similarly, the CTL did not adopt the MACRS depreciation rules for corporations that were enacted in the Tax Reform Act of 1986, which also denied the use of component depreciation under MACRS. Thus, the CTL still allows the use of component depreciation.

[506] IRC section 168(e)(3)(B)(vii).
[507] IRC section 168(g)(3)(B).

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA)
(PL 110-343, OCTOBER 3, 2008)

Impact on California Revenue

Estimated Revenue Impact of Extension of Certain Farming Business Machinery and Equipment Treated as 5-Year Property For Property Placed in Service On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$14,400,000	-$8,500,000	-$7,400,000

Estimates are based on a proration of federal projections developed by the Joint Committee on Taxation for the Emergency Economic Stabilization Act of 2008. The estimates are adjusted to reflect California/federal differences in depreciation methods for corporate taxpayers.

Section	Section Title
506	Modification of Penalty on Understatement of Taxpayer's Liability by Tax Return Preparer

Background

Prior to enactment of the Small Business and Work Opportunity Tax Act of 2007, an income tax return preparer who prepared a tax return with respect to which there was an understatement of tax that was due to an undisclosed position for which there was not a realistic possibility of being sustained on its merits was liable for a $250 penalty. For a disclosed position, the preparer was liable only if the position was frivolous.

Legislation enacted as part of the Small Business and Work Opportunity Tax Act of 2007 broadened the scope of the preparer penalty by applying it to all tax return preparers and altered the standards of conduct a tax return preparer is required to meet in order to avoid the imposition of penalties for the preparation of a return with respect to which there is an understatement of tax. A tax return preparer now can be penalized for preparing a return on which there is an understatement of tax liability as a result of an "unreasonable position." Any position that a return preparer does not reasonably believe is more likely than not to be sustained on its merits is an "unreasonable position" unless the position is disclosed on the return and there is a reasonable basis for the position.

In general, the term "tax return preparer" is broadly defined as any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax or any claim for refund of tax.[508] Preparation of a substantial portion of a return is treated as if it were the preparation of such return.

New Federal Law (IRC section 6694)

The provision revises the definition of an "unreasonable position" and changes the standards for imposition of the tax return preparer penalty. The preparer standard for undisclosed positions is reduced to "substantial authority," which conforms to the taxpayer standard. The preparer standard for disclosed positions is set at "reasonable basis." The preparer standard for reportable transactions, to which IRC section 6662A applies (i.e., listed transactions and reportable transactions with significant avoidance or evasion purposes), remains unchanged. For reportable transactions, the preparer must have a reasonable belief that the position would more likely than not be sustained on its merits.

Effective Date

The provision generally is effective with respect to returns prepared after May 25, 2007. In the case of reportable transactions, the provision is effective for returns prepared for taxable years beginning after the date of enactment.

California Law (R&TC section 19166)

California conforms by reference to IRC section 6694, relating to understatement of taxpayer's liability by tax preparer, as of the "specified date" of January 1, 2005, with substantial modifications.

California modifies the federal standards of conduct that must be met to avoid imposition of the penalties for preparing a return with respect to which there is an understatement of tax as follows:

- R&TC section 19166(b)(2) replaces the "realistic possibility standard" for undisclosed positions with a requirement that there be a "reasonable belief that the tax treatment in that position was more likely than not the proper treatment."
- R&TC section 19166(b)(3) replaces the "not-frivolous standard" accompanied by disclosure with the requirement that there be a "reasonable basis for the tax treatment of the position" accompanied by disclosure.

[508] IRC section 7701(a)(36)(A).

Additionally, California modifies the federal first-tier and second-tier penalty amounts as follows:

- R&TC section 19166(b)(1) also increases the first-tier penalty for unrealistic positions from $250 to $1,000 for certain reportable transactions, any listed transaction, or a gross misstatement.
- R&TC section 19166(c) increases the second-tier penalty for willful or reckless conduct from $1,000 to $5,000.

Impact on California Revenue

Estimated Revenue Impact for Modification of Penalty on Understatement of Taxpayer's Liability by Tax Return Preparer For Returns Prepared After June 30, 2009 Enactment Assumed After June 30, 2009		
2009-10	2010-11	2011-12
-$125,000	-$250,000	-250,000

The effect of conforming to a lesser standard of compliance for state purposes may contribute to a somewhat higher risk tolerance and potentially lead to more aggressive tax positions. Potential revenue losses from less conservative compliance positions are estimated to be approximately $250,000 annually. Revenue losses would begin to be realized with positions taken on or after June 30, 2009, the assumed enactment date of this provision. The initial fiscal year, 2009-10, reflects a half-year's impact.

SUBTITLE B – PAUL WELLSTONE AND PETE DOMENICI MENTAL HEALTH PARITY AND ADDICTION EQUITY ACT OF 2008

Section	Section Title
512	Mental Health Parity

Background

Under present law, the IRC, the Employee Retirement Income Security Act of 1974 ("ERISA") and the Public Health Service Act ("PHSA") contain provisions under which 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 ("mental health parity requirements"). In the case of a group health plan which provides benefits for mental health, the mental health parity requirements do not affect the terms and conditions (including cost sharing, limits on numbers of visits or days of coverage, and requirements relating to medical necessity) relating to the amount, duration, or scope of mental health benefits under the plan, except as specifically provided in regard to parity in the imposition of aggregate lifetime limits and annual limits.

The mental health parity requirements do not apply to group health plans of small employers nor do they apply if their application results in an increase in the cost under a group health plan of at least one percent. Further, the mental health parity requirements do not require group health plans to provide mental health benefits. The IRC imposes an excise tax on group health plans which fail to meet the mental health parity requirements. The excise tax is equal to $ 100 per day during the period of noncompliance and is generally imposed on the employer sponsoring the plan if the plan fails to meet the requirements.

The IRC, ERISA and PHSA mental health parity requirements expired with respect to benefits for services furnished after December 31, 2007.

New Federal Law (IRC sections 9811 and 9812)

The provision makes permanent the mental health parity requirements under the IRC, ERISA and the Public Health Service Act. The provision also adds financial requirements and treatment limitations to the existing mental health parity provisions and expressly adds substance use disorder to the coverage of the parity provisions.[509]

[509] IRC section 9812(a)(3), section 712(a)(3) of Employment Retirement Income Security Act of 1974 (ERISA), section 2705(a)(3) of the Public Health Service Act (PHSA), as added by Public Law 110-343.

The provision eliminates the express exclusion of treatment of substance abuse or chemical dependency from the term "mental health benefits." Substance use disorder benefits means benefits with respect to services for substance use disorders as defined under the terms of the plan and in accordance with federal and state law.[510]

The provision requires group plans that provide both medical and surgical benefits and mental health or substance use disorder to apply the financial requirements and treatment limitations for both benefits equally.

Effective Date

The provisions apply generally with respect to group health plans for plan years beginning after October 3, 2009, regardless of whether regulations have been issued to carry out such provisions by such effective date.

The provisions making the mental health parity requirements permanent apply on January 1, 2009. In the case of a group health plan maintained pursuant to one or more collective bargaining agreements ratified before October 3, 2008, these provisions will not apply to plan years beginning before the later of the date on which the last of the collective bargaining agreements relating to the plan terminate, determined without regard to any extension agreed to after October 3, 2008, or January 1, 2009.

California Law

ERISA Preemption

Federal ERISA provisions apply to pension plans in California. There are no California law provisions because federal law preempts state laws affecting these plans.

Impact on California Revenue

ERISA changes result in no conformity revenue impact. Any revenue impact would be considered baseline.

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[510] IRC section 9812(e)(5), Section 712(e)(5) of ERISA, Section 2705(e)(5) of PHSA, as amended by Public Law 110-343.

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA) (PL 110-343, OCTOBER 3, 2008)

TITLE VII – DISASTER RELIEF
SUBTITLE A – HEARTLAND AND HURRICANE IKE DISASTER RELIEF

Section	Section Title
702	Temporary Tax Relief for Areas Damaged by 2008 Mid-Western Severe Storms, Tornados, and Flooding

Background

Present law provides a variety of tax relief provisions for victims of the hurricanes that hit the Gulf region in 2005 (i.e. the Katrina Emergency Tax Relief Act of 2005 (KETRA)[511] and the Gulf Opportunity Zone Act of 2005 (GO Zone Act)[512] (IRC sections IRC sections 1400O, 1400P, 1400Q, 1400R, 1400S and 1400T). These provisions include suspending certain limitations on deductions for personal casualty losses under IRC section 165; extending the replacement period for nonrecognition of gain under IRC section 1033; providing an employee retention credit for affected employers; allowing additional first-year depreciation for certain property; increasing the amount that may be expensed under IRC section 179; allowing certain demolition and clean up costs to be expensed; altering the carryback period for net operating losses that result from public utility property disaster losses; extending the carryback period for net operating losses; liberalizing the representation requirements for owners of residential real property financed by private activity bonds; providing tax beneficial rules for distributions to disaster victims from qualified retirement plans; and, allowing certain retirement plan amendments made in light of the disaster to be retroactive.

New Federal Law (Uncodified section 702 of EESA)

This uncodified provision provides similar tax relief to the victims of storms that hit the Midwestern United States in the summer of 2008 by amending the IRC section 1400 series. The area designated for tax relief is the "Midwestern disaster area," which is, generally (1) an area with respect to which a major disaster has been declared by the President under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act[513] by reason of severe storms, tornadoes or flooding on or after May 20, 2008, and before August 1, 2008, in any of the following states: Arkansas, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska and Wisconsin; and (2) determined by the President to warrant individual or individual and public assistance from the federal government under the Act with respect to damages attributable to storms, tornadoes or flooding.

Effective Date

The effective date is October 3, 2008.

[511] Public Law 109-73.
[512] Public Law 109-35.
[513] Public Law 100-707.

California Law (None)

California does not conform to the IRC section 1400 series provisions.

Impact on California Revenue

Not applicable.

Section	Section Title
703	Reporting Requirements Relating to Disaster Relief Contributions

Background

Under current law, exempt organizations under IRC section 501(a) must generally file an annual information return reporting items of gross income, receipts, disbursements and other information required by the IRS.[514] A charitable organization under IRC section 501(c)(3) must include on its annual return the organization's gross income, expenses, disbursements for exempt purposes, fund balances, balance sheet, total contributions, the names and addresses of persons contributing $5,000 or more during the tax year (or substantial contributors, in the case of private foundations), and the names, addresses, and compensation of its officers, directors, trustees, and foundation managers.[515]

In addition, IRC section 501(c)(3) charitable organizations must report information regarding direct or indirect transfers, transactions and relationships with other IRC section 501(c) organizations (other than IRC section 501(c)(3) organizations) and political organizations described in IRC section 527.

An IRC section 501(c)(3) organization is also required to report annually on its federal Form 990 the amounts of certain excise taxes paid by the organization, its managers, or a disqualified person, as well as any reimbursements paid to an organization manager with respect to the taxes.

[514] IRC section 6033(a).
[515] IRC section 6033(b).

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA)
(PL 110-343, OCTOBER 3, 2008)

New Federal Law (IRC section 6033)

The provision provides that the Secretary of the Treasury may require that the annual information return filed by a IRC section 501(c)(3) charitable organization include information regarding the disaster relief activities conducted by the charity.[516] This includes the use of "qualified contributions" made by individuals to the charity which are not subject to the 50-percent contribution base deduction limitation for charitable contributions and the limitation on overall itemized deductions, as well as "qualified contributions" made by corporations to the charity which are not subject to the 10-percent of taxable income deduction limitation.[517]

Effective Date

The provision applies to returns the due date for which (determined without regard to any extensions) occurs after December 31, 2008.

California Law (R&TC section 23772)

California does not conform by reference to IRC section 6033, relating to returns by exempt organizations, but instead has stand alone law in R&TC section 23772, relating to annual information returns of exempt organizations.

Impact on California Revenue

Estimated Revenue Impact of Reporting Requirements Relating to Disaster Relief Contributions For Returns Filed After December 31, 2008 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
$0	$0	$0

Conforming to a change in the way disaster relief contributions are reported on the annual information return filed by California exempt organizations would not impact income tax revenues.

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[516] IRC section 6033(b)(14).
[517] IRC section 1400S(a).

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA)
(PL 110-343, OCTOBER 3, 2008)

SUBTITLE B – NATIONAL DISASTER RELIEF

Section	Section Title
706	Losses Attributable to Federally Declared Disasters

Background

Casualty losses

Under present law, a taxpayer may generally claim a deduction for any loss sustained during the taxable year and not compensated by insurance or otherwise.[518] For individual taxpayers, deductible losses must be incurred in a trade or business or other profit-seeking activity or consist of property losses arising from fire, storm, shipwreck, or other casualty, or from theft. Personal casualty or theft losses for the taxable year are allowable only if they exceed a $100 limitation per casualty or theft. In addition, aggregate net casualty and theft losses are deductible only to the extent they exceed 10 percent of an individual taxpayer's adjusted gross income. If the disaster occurs in a Presidentially declared disaster area, the taxpayer may elect to take into account the casualty loss in the taxable year immediately preceding the taxable year in which the disaster occurs.

Standard deduction

An individual taxpayer's taxable income is computed by reducing adjusted gross income either by a standard deduction or, if the taxpayer elects, by the taxpayer's itemized deductions. Unless an individual elects, no itemized deductions are allowed for the taxable year. The deduction for casualty losses is an itemized deduction.

New Federal Law (IRC sections 56, 63, 139, 165, 172, and 7508A)

Waiver of adjusted gross income limitation for personal casualty losses

The provision waives the 10 percent of adjusted gross income limitation for a "net disaster loss." The term "net disaster loss" means the excess of personal casualty losses attributable to a "federally declared disaster" occurring after December 31, 2007, and before January 1, 2010, occurring in a "disaster area," over personal casualty gains. The term "federally declared disaster" means any disaster subsequently determined by the President of the United States to warrant assistance by the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. The term "disaster area" means the area so determined to warrant assistance.

[518] IRC section 165.

Net disaster losses are deductible without regard to whether aggregate net casualty losses exceed 10 percent of a taxpayer's adjusted gross income. For purposes of applying the 10-percent limitation to other personal casualty or theft losses, losses deductible under this provision are disregarded. As a result, the provision has the effect of treating net disaster losses attributable to federally declared disasters as a deduction separate from all other non-disaster casualty and theft losses.

Increase of standard deduction

The provision increases an individual taxpayer's standard deduction by the "disaster loss deduction." The "disaster loss deduction" is defined as the net disaster loss.

Increase of limitation per casualty

The provision increases the $100 limitation per casualty to $500 for taxable years beginning after December 31, 2008, and before January 1, 2010.

Effective Date

The provision generally applies to taxable years beginning after December 31, 2007.

The provision applies to the taxpayer's last taxable year beginning before January 1, 2008, solely for purposes of determining the amount allowable as a deduction with respect to any net disaster loss for such year by reason of an election under IRC section 165(i).

The portion of the provision increasing the limitation per casualty to $500 applies to taxable years beginning after December 31, 2008, and before January 1, 2010.

California Law (R&TC sections 17072, 17201, 17207, 17276, 24347, 24347.5, and 24416)

Waiver of adjusted gross income limitation for personal casualty losses

California conforms by reference under the PITL and the CTL to IRC section 165(i), relating to losses, as of the “specified date” of January 1, 2005. Thus, aggregate net casualty and theft losses are deductible only to the extent they exceed 10 percent of an individual taxpayer’s adjusted gross income.

Increase of standard deduction

California does not conform to the federal standard deduction amounts, but instead has its own standard-deduction provision.[519] Thus, the standard deduction is not increased by the amount of the “disaster loss deduction.”

[519] R&TC section 17073.5.

Increase of limitation per casualty

California conforms by reference to IRC section 165, relating to losses, as of the "specified date" of January 1, 2005. Thus, under California law, personal casualty or theft losses are deductible to the extent they exceed $100 per casualty or theft.

Impact on California Revenue

Estimated Revenue Impact of Losses Attributable to Federally Declared Disasters For Taxable Years Beginning On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$25,000,000	-$3,600,000	$0

Estimates are based on a proration of federal projections developed for the Emergency Economic Stabilization Act of 2008, adjusted to reflect California's larger share of disaster losses. This provision would sunset on December 31, 2009.

Section	Section Title
707	Expensing of Qualified Disaster Expenses

Background

In general

Present law allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business.[520] 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 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.[521] Amounts paid or incurred for incidental repairs and maintenance of property that neither materially add to the value of the property nor appreciably prolong its life are not considered to be capital expenditures and may be deducted currently.[522] The determination of whether an expense is deductible or capitalizable is based on the facts and circumstances of each case.

[520] IRC section 162.
[521] Treas. Reg. sec. 1.263(a)-1(b).
[522] Treas. Reg. sec.'s 1.162-4 and 1.263(a)-1(b).

Environmental remediation costs

Taxpayers may elect to treat certain environmental remediation expenditures paid or incurred before January 1, 2008, that would otherwise be chargeable to capital account as deductible in the year paid or incurred.[523] 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. Generally, 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 are treated as qualified environmental remediation expenditures.

A "qualified contaminated site" (known as a "brownfield") is generally any property that is held for use in a trade or business, for the production of income, or as inventory and is certified by the appropriate state environmental agency to be an area at or on which there has been a release (or threat of release) or disposal of a hazardous substance. Both urban and rural property may qualify. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA")[524] cannot qualify as targeted areas. 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, as well as petroleum products defined in IRC section 4612(a)(3).

In the case of property to which a qualified environmental remediation expenditure otherwise would have been capitalized, any deduction allowed under IRC section 198 is treated as a depreciation deduction and the property is treated as IRC section 1245 property. Thus, deductions for qualified environmental remediation expenditures are subject to recapture as ordinary income upon a sale or other disposition of the property. Additionally, IRC section 280B and IRC section 468 do not apply to amounts that are treated as expenses under this provision.

IRC section 1400N(g) permits the expensing of environmental remediation expenditures paid or incurred on or after August 28, 2005, and before January 1, 2008, to abate contamination at qualified contaminated sites located in the Gulf Opportunity Zone (GO Zone).

[523] IRC section 198.
[524] Public Law 96-510.

Debris removal and demolition of structures

Under present law, the cost of demolishing a structure is generally capitalized into the taxpayer's basis in the land on which the structure is located.[525] Land is not subject to an allowance for depreciation or amortization.

The treatment of the cost of debris removal depends on the nature of the costs incurred. For example, the cost of debris removal after a storm may in some cases constitute an ordinary and necessary business expense which is deductible in the year paid or incurred. In other cases, debris removal costs may be in the nature of replacement of part of the property that was damaged. In such cases, the costs are capitalized and added to the taxpayer's basis in the property. For example, Revenue Ruling 71-161[526] permits the use of clean-up costs as a measure of casualty loss but requires that such costs be added to the post-casualty basis of the property.

IRC section 1400N(f) provides a special rule for certain demolition and clean-up costs. Under the provision, a taxpayer is permitted a deduction for 50 percent of any qualified GO Zone clean-up cost paid or incurred on or after August 28, 2005, and before January 1, 2008. The remaining 50 percent is capitalized and treated under the general rules. A qualified GO Zone clean-up cost is an amount paid or incurred for the removal of debris from, or the demolition of structures on, real property located in the GO Zone to the extent that the amount would otherwise be capitalized. In order to qualify, the property must be held for use in a trade or business, for the production of income, or as inventory. This special rule also applies to the Kansas disaster area, as added by the Heartland, Habitat, Harvest, and Horticulture Act of 2008.[527]

Repair of business property

The cost of incidental repairs that 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. In the case of repair expenditures incurred subsequent to a casualty event, the IRS ruled in 1999 that the costs of restoring uninsured property damage caused by severe flooding was that the determination of whether the costs are deductible as repairs or capital expenditures "turns on the taxpayer's particular set of facts."[528] That is, the treatment of the costs to restore the property after a casualty is determined based on the general treatment of such costs, regardless of the fact that such costs are incurred as a result of a casualty event.

[525] IRC section 280B.
[526] 1971-1 C.B. 76.
[527] Public Law 110-234, section 15345(a)(3).
[528] CCA 199903030.

In August 2006, Treasury issued proposed regulations providing that amounts paid or incurred to restore property are required to be capitalized to the extent the taxpayer deducts a casualty loss under IRC section 165 with respect to the same property.[529] In an internal legal memorandum issued after the proposed Treasury regulations were issued, the IRS stated that the proposed regulations, which contained a prospective effective date when finalized, were "essentially reflective of current law."[530] In March 2008, Treasury reissued the proposed regulations with the same treatment of restoration expenditures of property destroyed in a casualty.

New Federal Law (IRC section 198A)

The provision provides that a taxpayer may elect to treat any qualified disaster expense that is paid or incurred by the taxpayer as a deduction for the taxable year in which paid or incurred. For purposes of the provision, a qualified disaster expense is any otherwise capitalizable expenditure paid or incurred in connection with a trade or business or with business-related property that is: (1) for the abatement or control of hazardous substances that were released on account of a federally declared disaster; (2) for the removal of debris from, or the demolition of structures on, real property damaged or destroyed as a result of a federally declared disaster; or (3) for the repair of business-related property damaged as a result of a federally declared disaster.

For purposes of this provision, "business-related property" is property held by the taxpayer for use in a trade or business, for the production of income, or as inventory, and a federally declared disaster is any disaster occurring after December 31, 2007, and before January 1, 2012, that is subsequently determined by the President of the United States to warrant assistance by the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

For purposes of recapture as ordinary income, any deduction allowed under this provision is treated as a deduction for depreciation and IRC section 1245 property for purposes or depreciation recapture.

Effective Date

The provision is effective for amounts paid or incurred after December 31, 2007.

[529] Prop. Reg. sec. 1.263(a)-3(f)(3)(iv). 2006-2 C.B. 532.
[530] AM 2006-006, footnote 2.

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA)
(PL 110-343, OCTOBER 3, 2008)

California Law (R&TC sections 17201, 17279.4 and 24369.4)

California does not allow expensing of qualified disaster expenses. Under the PITL, California conforms to Part VI of Subchapter B of Chapter 1 of Subtitle A of the IRC, relating to deductions for individuals and corporations, as of the "specified date" of January 1, 2005, with modifications. And, there is no provision in the CTL to allow expensing of qualified disaster expenses.

Impact on California Revenue

Estimated Revenue Impact of Expensing of Qualified Disaster Expenses For Amounts Paid or Incurred After December 31, 2007 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$600,000	-$400,000	-$200,000

Estimates are based on a proration of federal projections developed for the Emergency Economic Stabilization Act of 2008, adjusted to reflect California's larger share of disaster losses.

Section	Section Title
708	Net Operating Losses Attributable to Federally Declared Disasters

Background

Under present law, a net operating loss ("NOL") is generally the amount by which a taxpayer's business deductions exceed its gross income. In general, an NOL may be carried back two years and carried over 20 years to offset taxable income in such years.531 NOLs offset taxable income in the order of the taxable years to which the NOL may be carried.532

[531] IRC section 172(b)(1)(A).
[532] IRC section 172(b)(2).

Different rules apply with respect to NOLs arising in certain circumstances.

- A three-year carryback applies with respect to NOLs: (1) arising from casualty or theft losses of individuals, or (2) attributable to Presidentially declared disasters for taxpayers engaged in a farming business or a small business.
- A five-year carryback applies to NOLs (1) arising from a farming loss (regardless of whether the loss was incurred in a Presidentially declared disaster area), or (2) certain amounts related to the Gulf Opportunity Zone and Kansas disaster area.
- Special rules also apply to real estate investment trusts (no carryback), specified liability losses (10-year carryback), and excess interest losses (no carryback to any year preceding a corporate equity reduction transaction). Additionally, a special rule applies to certain electric utility companies.

<u>New Federal Law (IRC section 172)</u>

The provision provides a special five-year carryback period for NOLs to the extent of a qualified disaster loss. For purposes of the provision, a qualified disaster loss is the lesser of: (1) the sum of (a) IRC section 165 losses for the taxable year attributable to a federally declared disaster occurring after December 31, 2007, and before January 1, 2012, and occurring in a disaster area, and (b) the deduction for the taxable year for qualified disaster expenses allowable under IRC section 198A(a) or which would be allowable as a deduction under that section if not treated as an expense in another section of the IRC; or (2) the NOL for the taxable year.

The amount of the NOL to which the five-year carryback period applies is limited to the amount of the taxpayer’s overall NOL for the taxable year. Any remaining portion of the taxpayer's NOL is subject to the general two-year carryback period.

Any taxpayer entitled to the five-year carryback under this provision may elect to have the carryback period determined without regard to this provision. In addition, the general rule which limits a taxpayer's NOL deduction to 90 percent of AMTI does not apply to any NOL to which the five-year carryback period applies under the provision. Instead, a taxpayer may apply such NOL carrybacks to offset up to 100 percent of AMTI.

<u>Effective Date</u>

The provision is effective for net operating losses for taxable years beginning after December 31, 2007.

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA)
(PL 110-343, OCTOBER 3, 2008)

California Law (R&TC sections 17201, 17207, 17276-17276.7 and 24416-24416.7)

In general

A California taxpayer generally calculates its NOL in accordance with federal rules, as California conforms by reference under the PITL and the CTL to IRC section 172, relating to net operating loss deducting, with modifications.

Disaster losses

State tax law identifies specific events as disasters and excess disaster losses are allowed special carry forward treatment. That is, 100 percent of the excess disaster loss may be carried over for up to 15 taxable years. In addition, for disasters that were the subject of a Governor's proclamation, but not the subject of a Presidential disaster declaration, enactment of state law identifying a specific event as a disaster for state tax law purposes authorizes the taxpayer to elect to deduct the disaster loss on the return for the prior taxable year.
Taxable years beginning before January 1, 2008

Depending on the type of taxpayer or amount of a taxpayer's income, the amount of NOL that is eligible to be carried forward and the number of years it can be carried forward will vary. Two important differences are that California does not generally allow the carryback of NOLs and limits the carryforward period to 10 years in circumstances where federal law allows 20 years.

The taxpayer must make an election from the following list as to the type of NOL the taxpayer has incurred. Existing state law provides for the following types of NOLs:

Type of NOL and Description	**NOL % Allowed to be Carried Over**
General NOL	100%
New Business NOL	100%
Eligible Small Business	100%
Pierce's Disease	100%
Economic Development Areas	100%

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA)
(PL 110-343, OCTOBER 3, 2008)

Taxable years beginning on or after January 1, 2008

In 2008, the following changes were made: [533]

- NOL deductions are suspended for taxable years 2008 and 2009 for a taxpayer with net business income (PITL) and income subject to tax (CTL) of $500,000 or more. However, deductions for NOL carrybacks from taxable years beginning on or after January 1, 2011, will be allowed.
- For PIT, "net business income" means income from a trade or business, whether conducted by the taxpayer or by a pass-through entity (partnership or S corporation), income from rental activity, and income attributable to a farming business.
- The NOL carryover period is extended by one year for NOLs incurred in taxable year 2008, and two years for NOLs attributable to taxable years beginning before January 1, 2008.
- A 20-year NOL carryover period is allowed for NOLs attributable to taxable years beginning on or after January 1, 2008.
- California conforms to the federal NOL carryback rules for NOLs attributable to taxable years beginning on or after January 1, 2011, with the following modifications:
    - NOLs may only be carried back 2 years. (Federal law has special rules that in some cases, allow an NOL to be carried back for a longer period).
    - The amount of NOL carryback attributable to taxable year 2011 is limited to 50% of the net operating loss.
    - The amount of NOL carryback attributable to taxable year 2012 is limited to 75% of the net operating loss.
- California conforms to the federal carryback period for a Real Estate Investment Trusts (REITS) and a corporate equity reduction interest loss, which is zero.

<u>Impact on California Revenue</u>

Estimated Revenue Impact of Net Operating Losses Attributable to Federally Declared Disasters For Tax Years Beginning On or After January 1, 2009 (sunsets 12/31/09) Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$9,600,000	$800,000	$1,100,000

Estimates are based on a proration of federal projections developed for the Emergency Economic Stabilization Act of 2008. The provision would sunset on December 31, 2009.

[533] Ch. 763, Laws of 2008 (A.B. 1452).

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA) (PL 110-343, OCTOBER 3, 2008)

Section	Section Title
709	Waiver of Certain Mortgage Revenue Bond Requirements Following Federally Declared Disasters

Background

In general

Under present law, gross income does not include interest on state or local bonds.[534] State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds which are primarily used to finance governmental functions or which are repaid with governmental funds. Private activity bonds are bonds with respect to which the state or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). The exclusion from income for state and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds").[535]

Qualified mortgage bonds

Generally

The definition of a qualified private activity bond includes a qualified mortgage bond.[536] Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for the purchase, improvement, or rehabilitation of owner-occupied residences. Rehabilitation loans are eligible for such financing if: (1) the mortgagor receiving the financing is the first resident after the completion of the rehabilitation; (2) at least 20 years have elapsed between the first use of the residence and the start of the physical work of the rehabilitation; (3) certain percentages of internal and external walls are retained after the rehabilitation; and (4) rehabilitation expenditures equal at least 25 percent of the taxpayer's adjusted basis in the residence after such rehabilitation.[537]

The IRC imposes several limitations on qualified mortgage bonds, including purchase price limitations for the home financed with bond proceeds and income limitations for homebuyers. In general, the purchase price limitation is met if the acquisition cost of each residence financed does not exceed 90 percent of the average area purchase applicable to the residence (i.e., the average single-family residence purchase price purchased during the one-

[534] IRC section 103.
[535] IRC sections 103(b)(1) and 141.
[536] IRC section 143.
[537] IRC section 141(k)(5).

year period in the statistical area in which the residence is located).[538] Also, the income limitation generally is met if all the owner-financing provided under the issue is provided to individuals who have family income of 115 percent of the applicable median family income.[539]

First-time homebuyers

In addition to the purchase price and income limitations, qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage (the "first-time homebuyer" requirement).[540] The first-time homebuyer requirement does not apply to targeted area residences (described below).

Special rules for targeted area residences

A targeted area residence is one located in either: (1) a census tract in which at least 70 percent of the families have an income which is 80 percent or less of the state-wide median income; or (2) an area of chronic economic distress.[541]

In addition to the waiver of the first-time homebuyer rule, targeted area residences have special purchase price limitations and income limitations. For targeted area residences, the purchase price limitation is applied by substituting 110 percent for 90 percent. (i.e., the purchase price limitation is met if the acquisition cost of each residence financed does not exceed 110 percent of the average area purchase applicable to the residence). For targeted area residences, the income limitation generally is met if at least two-thirds of all the owner-financing provided under the issue is provided to individuals who have family income of 140 percent of the applicable median family income. The other third is not subject to an income limitation.

Special rules for federally disaster areas

A temporary provision waives the first-time homebuyer requirement for residences located in federally declared disaster areas.[542] Also, under the provision, residences located in federally declared disaster areas are treated as targeted area residences for purposes of the income and purchase price limitations. The special rules for residences located in federally declared disaster areas apply to bonds issued after May 1, 2008, and before January 1, 2010.

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[538] IRC section 141(e).
[539] IRC section 141(f).
[540] IRC section 141(d).
[541] IRC section 141(j).
[542] IRC section 143(k)(11).

New Federal Law (IRC section 143)

The provision replaces the temporary present-law provision for residences located in federally declared disaster areas with: (1) a waiver of the first-time homebuyer requirement; and (2) the purchase price limitation otherwise applicable to targeted area residences (i.e., the purchase price limitation is met if the acquisition cost of each residence financed does not exceed 110 percent of the average area purchase applicable to the residence). The provision applies for the two-year period beginning on the date of the disaster, when the principal residence of a taxpayer is: (1) rendered unsafe for use by reason of a federally declared disaster, or (2) demolished or relocated by reason of an order of the government of a state of political subdivision thereof on account of a federally declared disaster.

Also, the provision expands the definition of rehabilitation loans to include the cost of repair or reconstruction of a taxpayer's principal residence for damage from a federally declared disaster regardless of whether the present-law rehabilitation requirements are satisfied. Such rehabilitation loans are limited to the lesser of $150,000 or the cost of repair or reconstruction.
For purposes of the provision, the term federally declared disaster does not apply to any disaster occurring before January 1, 2008, or after December 31, 2011.

Effective Date

The provision is effective for bonds issued after October 3, 2008.

California Law (R&TC sections 17143 and 24272)

California law does not conform to the federal rules relating to exempting the interest earned on state or municipal bonds and the arbitrage rules. In addition, the federal “private-activity-bond” rules have not been adopted by California. Also, the federal treatment of Indian tribal governments as states has never been adopted by this state.

California state and municipal bonds

The general rule in California is that for income tax purposes all interest received or accrued is fully taxable, except for interest on federal obligations (such as Treasury bills, notes, and bonds, as more fully described below) and tax-exempt bonds issued by this state or a local government in this state.

Unlike federal law, the interest earned on bonds issued by other states and municipalities in other states is fully taxable to a resident of California. The California exemption from income taxation of interest on bonds of the state and its political subdivisions is contained in the California Constitution (Art. XIII, § 26. subd. (b)). The Revenue and Taxation Code further provides, by statute, that the federal “private-activity-bond” analysis shall not be made in determining whether interest on bonds issued by the state or a political subdivision thereof shall be exempt from California income tax. Thus, in California, if the use of the bond proceeds of a state or local California issue is for private business use or is secured by property used for a private business use, the interest on that bond is still treated for California income tax purposes as tax exempt, even though the interest on the bond may well be taxable for federal income tax purposes.

California conduit revenue bonds

Conduit revenue bonds are issued by a governmental (state or municipal) entity for various purposes, including economic development, educational and health facilities construction, and multi-family housing. The funds obtained from the financing are loaned to a nongovernmental borrower who builds and operates the project. The use by a private firm (via expenditure of the bond proceeds) of a governmental agency's authority to issue tax-exempt debt is premised on the fact that the project will provide public benefit. A conduit revenue bond is payable solely from the loan payments received from the non-governmental party (unless the bond is insured by a third party who guarantees payment in the event of a default by the private firm who has pledged the revenue source). The governmental issuer typically has no liability for debt service on the bonds, except for the administration of the bond.

Although the issuer has no actual liability on the bonds, their reputation and standing with respect to future debt financing may be negatively affected in the event of a default on the bonds. More importantly, should the bonds go into default, the governmental entity will likely be drawn into the settlement process. Most conduit revenue bonds are sold at negotiated sales with the interest rate and other terms of the bonds negotiated between the issuer, the non-governmental borrower, and an underwriter. The security for some of these transactions is sufficient to allow the underwriter to act as a pass-through for the bonds and in so doing act as a placement agent rather than an underwriter. Because the public agency's credit is not on the line, many issuers do not participate in any substantive fashion in the sale of the bonds. Rather, they may limit their role to reviewing the bond purchase contract and other legal and disclosure documents to ensure that they are adequately indemnified against liabilities and to accurately describe their role to investors as issuers and not as borrowers or guarantors of the debt.

Because the conduit revenue bonds issued in California are issued by this state or a local government in this state, the interest paid on such bonds is exempt from state income taxation under the California Constitution.

California treatment of federal bond interest

Interest earned on federal bonds is also tax-exempt for California income tax purposes. This results from federal law (31 U.S.C. § 3124(a)) that prohibits all states from imposing an income tax on interest income from direct obligations of the U. S. government. Examples of bonds that are exempt for California income tax purposes include those issued by federal land banks, the Federal Home Loan Bank, and Banks for Cooperatives. Not all federal bonds are direct obligations of the U.S. government and interest on those bonds is taxable.

Examples of federal bonds not exempt are those issued by the Federal National Mortgage Association (Fannie Maes), Government National Mortgage Association (Ginnie Maes), and Federal Loan Home Mortgage Corporation (Freddie Macs).

California franchise tax treatment

Interest received from federal, state, municipal, or other bonds is includable in the gross income of corporations taxable under the franchise tax. The franchise tax is a nondiscriminatory privilege tax for the right to exercise the corporate franchise and is not a tax on the income received but merely uses that income of the year as the measure of the tax for the privilege of exercising the corporate franchise.

Impact on California Revenue

Not applicable.

Section	Section Title
710	Special Depreciation Allowance for Qualified Disaster Property

Background

The cost of depreciable property placed in service after 1986 is generally recovered using the Modified Accelerated Cost Recovery System (MACRS). Each type of property is assigned to a property class in accordance with the property class table issued by the IRS in Rev. Proc. 87-56, 1987-2 CB 674. The property classes for personal property are: three-year property, five-year property, seven-year property, 10-year property, 15-year property, and 20-year property. The depreciation periods are three years for three-year property, five years for five-year property, seven years for seven-year property, 10 years for 10-year property, etc. Longer recovery periods apply if the MACRS alternative depreciation system (ADS) is used. In the case of 3-, 5-, 7-, and 10-year property, the applicable depreciation method is the 200-percent declining balance method. The 150-percent declining balance method applies to 15- and 20-year property. The half-year or mid-quarter convention applies to personal property. Under these conventions, an asset is considered placed in service or disposed of on the midpoint of the year or quarter, respectively, in which it is placed in service or disposed of.

Subject to certain limitations, a taxpayer may claim a current deduction under IRC section 179 for the cost of tangible personal property acquired for use in the active conduct of a trade or business. For 2008, the maximum deduction is $250,000. The basis of any property expensed under IRC section 179 is reduced for purposes of computing depreciation.

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA) (PL 110-343, OCTOBER 3, 2008)

Taxpayers who place qualifying property in service in the 2008 calendar year may claim 50-percent additional depreciation allowance (bonus depreciation) on such property (IRC section 168(k)). Generally, to be eligible to claim bonus depreciation, property must be: eligible for MACRS, with a depreciation period of 20 years or less; water utility property; off-the-shelf computer software; or qualified leasehold property. The property generally must be purchased and placed in service during 2008. In other words, the original use of the property must begin with the taxpayer and must occur after December 31, 2007, and before January 1, 2009. There cannot be a binding written contract before January 1, 2008, to acquire the property. Property qualifies only if it is acquired under a binding written contract entered into during 2008. In the case of self-constructed property, the taxpayer must begin the manufacture, construction or production of qualifying property for its own use during 2008. Bonus depreciation is claimed for both regular tax and alternative minimum tax (AMT) liability unless the taxpayer makes an election out of bonus depreciation.

<u>New Federal Law (IRC section 168)</u>

The provision provides that for property placed in service after December 31, 2007, with respect to disasters declared after that date, an additional depreciation deduction is allowed in the placed-in-service year equal to 50% of the adjusted basis of "qualified disaster assistance property."[543] There is no AMT depreciation adjustment for qualified disaster assistance property recovered under IRC section 168(n).[544]

Qualified disaster assistance property defined

Property is qualified disaster assistance property only if it meets all of the following requirements:

1) Qualifying type of property requirement. The property must be in one of two categories:
2) Property described in IRC section 168(k)(2)(A)(i) . This includes property to which IRC section 168 applies, and which has a recovery period of 20 years or less; computer software for which a deduction is allowable under IRC section 167(a), water utility property (which property defined in IRC section 168(e)(5) and qualified leasehold improvement property (certain improvements to buildings made more than three years after the building is placed in service and that are made under a lease).
3) Nonresidential real property or residential rental property (buildings and structural components of buildings).
4) Active business use in a qualifying disaster area. Substantially all of the use of the property must be in a disaster area with respect to a federally declared disaster occurring before January 1, 2010, and in the active conduct of a trade or business by the taxpayer in that disaster area.

[543] IRC section 168(n).
[544] IRC section 168(n)(2)(D).

5) Rehabilitation or replacement of similar local property*.* The property must:
    a. Rehabilitate property damaged, or replace property destroyed or condemned, as a result of the federally declared disaster, except that, for purposes of this rule, property is treated as replacing property destroyed or condemned, if, as part of an integrated plan, the property replaces property that is included in a continuous area that included property destroyed or condemned; and
    b. Be similar in nature to, and located in the same county as, the property being rehabilitated or replaced.

6) Original use requirement. The original use of the property in the disaster area must begin with an eligible taxpayer on or after the applicable disaster date. An eligible taxpayer is one who has suffered an economic loss attributable to a federally declared disaster. The applicable disaster date is the date on which a federally declared disaster occurs.
7) Timely acquisition requirement. The property must be acquired by the taxpayer on or after the applicable disaster date by purchase (as defined in IRC section 179(d)(2)), and no written binding contract for the acquisition can be in effect before the applicable disaster date.
8) Placed-in-service requirement*.* The property must be placed in service by the eligible taxpayer by the end of the third calendar year (fourth calendar year for nonresidential real property and residential rental property) following the applicable disaster date.

Ineligible property

Property is not treated as qualified disaster assistance property if:[545]

1) It is property to which any of the following applies: IRC section 168(k) (determined without regard to IRC section 168(k)(4), IRC section 168(l), or IRC section 168(m)).
2) It is property to which IRC section 1400N(d) applies (GO Zone property).
3) It is property to which IRC section 1400N(p)(3) applies.
4) It is property to which the alternative depreciation system (ADS) under IRC section 168(g), without regard to IRC section 168(g)(7), applies.
5) It is property any portion of which is financed with the proceeds of any obligation the interest on which is exempt from tax under IRC section 103.

[545] IRC section 168(n)(2)(B).

Finally, qualified disaster assistance property doesn't include any qualified revitalization building (certain nonresidential buildings located in areas designated as renewal communities) for which the taxpayer has elected the application of IRC section 1400I(a)(1) or IRC section 1400I(a)(2).[546]

Effective Date

The provision is effective for property placed in service after December 31, 2007, with respect to disasters declared after that date.

California Law (R&TC sections 17250, 24349, 24355.3, and 24355.4)

Under the Personal Income Tax Law (PITL), California law, as it relates to MACRS, in general conforms to the federal rules with certain modifications. For example, California did not conform to the American Jobs Creation Act (AJCA) of 2004 changes to IRC section 168 that specifically provided the recovery period for depreciation of certain leasehold improvements and restaurant property or the allowance of bonus depreciation.

Under the Corporation Tax Law (CTL), California does not conform to the federal law MACRS depreciation. Instead, the CTL is in substantial conformity to the pre-1981 federal asset depreciation range (ADR) deduction. The ADR is based on the “useful life” of depreciable property. The CTL has specified a useful life of seven years for certain motorsport entertainment complexes and natural gas pipelines located in Alaska.

Prior to the adoption of ACRS by the Economic Recovery Tax Act (ERTA) of 1981, taxpayers were allowed to depreciate (under the ADR) the various components of a building as separate assets with separate useful lives.

The CTL has not conformed to the repeal of the use of component depreciation, as ACRS, originally enacted by ERTA, was never adopted in the CTL. Similarly, the CTL did not adopt the MACRS depreciation rules for corporations that were enacted in the Tax Reform Act of 1986, which also denied the use of component depreciation under MACRS. Thus, the CTL still allows the use of component depreciation.

[546] IRC section 168(n)(2)(B)(iv).

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA) (PL 110-343, OCTOBER 3, 2008)

Impact on California Revenue

Estimated Revenue Impact of Special Depreciation Allowance for Qualified Disaster Property For Tax Years Beginning On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$54,000,000	-$27,000,000	-$3,300,000

This estimate is for conforming only to the provision for bonus depreciation. California currently does not conform to several key federal depreciation rules, including the Modified Accelerated Cost Recovery System (MARCS) under Corporation tax law. This estimate is based on a proration of federal projections developed for the Emergency Economic Stabilization Act of 2008.

Section	Section Title
711	Increased Expensing for Qualified Disaster Assistance Property

Background

The cost of depreciable property placed in service after 1986 is generally recovered using the Modified Accelerated Cost Recovery System (MACRS). Each type of property is assigned to a property class in accordance with the property class table issued by the IRS in Rev. Proc. 87-56, 1987-2 CB 674. The property classes for personal property are: three-year property, five-year property, seven-year property, 10-year property, 15-year property, and 20-year property. The depreciation periods are three years for three-year property, five years for five-year property, seven years for seven-year property, 10 years for 10-year property, etc. Longer recovery periods apply if the MACRS alternative depreciation system (ADS) is used. In the case of 3-, 5-, 7-, and 10-year property, the applicable depreciation method is the 200-percent declining balance method. The 150-percent declining balance method applies to 15- and 20-year property. The half-year or mid-quarter convention applies to personal property. Under these conventions, an asset is considered placed in service or disposed of on the midpoint of the year or quarter, respectively, in which it is placed in service or disposed of.

Subject to certain limitations, a taxpayer may claim a current deduction under IRC section 179 for the cost of tangible personal property acquired for use in the active conduct of a trade or business. For 2008, the maximum deduction is $250,000. The basis of any property expensed under IRC section 179 is reduced for purposes of computing depreciation.

New Federal Law (IRC section 179)

The provision provides that for or property placed in service after December 31, 2007, with respect to disasters declared after that date, the maximum expense amount that can otherwise be deducted under IRC section 179 for the tax year is increased by the lesser of: (1) $100,000, or (2) the cost of qualified IRC section 179 disaster assistance property (defined below) placed in service during the tax year.

Additionally, the beginning-of-phase-out amount otherwise in effect for the tax year is increased by the lesser of $600,000, or the cost of qualified IRC section 179 disaster assistance property placed in service during the tax year.

The term “qualified IRC section 179 disaster assistance property” means section 179 property which is qualified disaster assistance property as defined in IRC section 168(n)(2).

Effective Date

The provision applies to property placed in service after December 31, 2007, with respect to disasters declared after such date.

California Law (R&TC sections 17201, 17255, and 24356)

The PITL is conformed to the IRC section 179 expensing provisions, with modifications. For taxable years beginning on or after January 1, 2005, the CTL is conformed to the IRC section 179 expensing provisions, with the same modifications under the PITL. The CTL continues to allow “additional first-year depreciation” of up to $2,000 per year. However, the CTL allows taxpayers to elect the IRC section 179 expensing deduction in lieu of “additional first-year depreciation.” Property qualifying for the “additional first-year depreciation” is similar to property qualifying under IRC section 179. However, a corporation is allowed only one or the other of the expensing deductions, not both.

Currently a corporate or non-corporate taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

Under current California law, S corporations (and their shareholders) are allowed to use MACRS and an IRC section 179 deduction under the PITL. For taxable years beginning on or after January 1, 2002, an S corporation may elect to expense up to $25,000 in the computation of the S corporation's measured tax (presently the S corporation tax rate for non-financial corporations is 1.5 percent).

Impact on California Revenue

Estimated Revenue Impact of Increased Expensing for Qualified Disaster Assistance Property For Taxable Years Beginning On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
-$1,400,000	-$400,000	-$100,000

Estimates are based on a proration of federal projections developed for the Emergency Economic Stabilization Act of 2008.

For this estimate, it is assumed the maximum IRC section 179 deduction for California of $25,000 would be increased by the lesser of: (1) $100,000 (for a total of $125,000), or (2) the cost of qualified IRC section 179 disaster assistance property. Additionally, the phase-out amount for California would increase from $200,000 to the lesser of $600,000 (for a total of $800,000) or the cost of qualified IRC section 179 disaster assistance property.

TITLE VIII – SPENDING REDUCTIONS AND APPROPRIATE REVENUE RAISERS FOR NEW TAX POLICY RELIEF

Section	Section Title
801	Nonqualified Deferred Compensation from Certain Tax Indifferent Parties

Background

In general

Under present law, the determination of when amounts deferred under a nonqualified deferred compensation arrangement are includible in the gross income of the person earning the compensation depends on the facts and circumstances of the arrangement.

In general, the time for income inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, then the compensation generally is includible in income by a cash-basis taxpayer when it is actually or constructively received. If the arrangement is funded, then income is includible for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture.

An arrangement generally is considered funded if there has been a transfer of property under IRC section 83. Under that section, a transfer of property occurs when a person acquires a beneficial ownership interest in such property. The term "property" is defined very broadly for purposes of IRC section 83.[547] Property includes real and personal property other than money or an unfunded and unsecured promise to pay money in the future. Property also includes a beneficial interest in assets (including money) that are transferred or set aside from claims of the creditors of the transferor; for example, in a trust or escrow account. Accordingly, if, in connection with the performance of services, vested contributions are made to a trust on an individual's behalf and the trust assets may be used solely to provide future payments to the individual, the payment of the contributions to the trust constitutes a transfer of property to the individual that is taxable under IRC section 83. On the other hand, deferred amounts generally are not includible in income if nonqualified deferred compensation is payable from general corporate funds that are subject to the claims of general creditors, as such amounts are treated as unfunded and unsecured promises to pay money or property in the future.

As discussed above, if the arrangement is unfunded, then the compensation generally is includible in income by a cash-basis taxpayer when it is actually or constructively received under IRC section 451.[548] Income is constructively received when it is credited to a person's account, set apart, or otherwise made available so that it may be drawn on at any time. Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. A requirement to relinquish a valuable right in order to make withdrawals is generally treated as a substantial limitation or restriction.

New Federal Law (IRC section 457A)

In general

Under the provision, any compensation of a service provider that is deferred under a nonqualified deferred compensation plan of a nonqualified entity is includible in gross income by the service provider when there is no substantial risk of forfeiture of the service provider's rights to such compensation. The provision applies in addition to the requirements of IRC section 409A (or any other provision of the IRC) with respect to nonqualified deferred compensation. The term service provider has the same meaning as under the regulations

[547] Treas. Reg. sec. 1.83-3(e). This definition, in part, reflects previous IRS rulings on nonqualified deferred compensation.
[548] Treas. Reg. sec's. 1.451-1 and 1.451-2.

under IRC section 409A except that whether a person is a service provider is determined without regard to the person's method of accounting.

Nonqualified deferred compensation

For purposes of the provision, the term nonqualified deferred compensation plan is defined in the same manner as for purposes of IRC section 409A. The term nonqualified deferred compensation includes earnings with respect to previously deferred amounts. Earnings are treated in the same manner as the amount deferred to which the earnings relate.

Under the provision, nonqualified deferred compensation includes any arrangement under which compensation is based on the increase in value of a specified number of equity units of the service recipient. Thus, stock appreciation rights are treated as nonqualified deferred compensation under the provision, regardless of the exercise price of the stock appreciation right. It is not intended that the term nonqualified deferred compensation plan include an arrangement taxable under IRC section 83 providing for the grant of an option on employer stock with an exercise price that is not less than the fair market value of the underlying stock on the date of grant if such arrangement does not include a deferral feature other than the feature that the option holder has the right to exercise the option in the future. The provision is not intended to change the tax treatment of incentive stock options meeting the requirements of IRC section 422 or options granted under an employee stock purchase plan meeting the requirements of IRC section 423. Similarly, nonqualified deferred compensation for purposes of the provision does not include a transfer of property to which IRC section 83 is applicable (such as a transfer of restricted stock), provided that the arrangement does not include a deferral feature. However, it is not intended that the provision be avoided through the use of an instrument (such as an option or a notional principal contract) held or entered into directly or indirectly by a service provider, the value of which is determined in whole or part by reference to the profits or value (or any increase or decrease in the profits or value) of the business of the entity for which the services are effectively provided, particularly when the value of such instrument is not determinable at the time it is granted or received. Similarly, it is not intended that the purposes of the provision be avoided through the use of “springing” partnerships or other entities or rights that come into existence in the future and serve a function similar to a conversion right.

Compensation is not treated as deferred for purposes of the provision if the service provider receives payment of the compensation not later than 12 months after the end of the first taxable year of the service recipient during which the right to the payment of such compensation is no longer subject to a substantial risk of forfeiture.

Nonqualified entity

The term nonqualified entity includes certain foreign corporations and certain partnerships (either domestic or foreign). A foreign corporation is a nonqualified entity unless substantially all of its income is effectively connected with the conduct of a United States trade or business or is subject to a comprehensive foreign income tax. A partnership is a nonqualified entity unless substantially all of its income is, directly or indirectly, allocated to: (1) United States persons (other than persons exempt from U.S. income tax); (2) foreign persons with respect to whom such income is subject to a comprehensive foreign income tax; (3) foreign persons with respect to whom such income is effectively connected with the conduct of a United States trade or business and a withholding tax is paid under IRC section 1446 with respect to such income; or (4) organizations which are exempt from US income tax if such income is unrelated business taxable income (as defined in IRC section 512) with respect to such organization. It is intended that substantially all the income of a partnership —whether allocated directly, or, in the case of tiered partnerships, indirectly —be taxed in the hands of partners under the U.S. income tax, or be subject to a comprehensive foreign income tax, for the partnership not to be treated as a nonqualified entity. It is not intended that tiered partnerships, or intermediate entities, be used to achieve deferral of compensation that would otherwise not be permitted under the provision.

The term comprehensive foreign income tax means with respect to a foreign person, the income tax of a foreign country if: (1) such person is eligible for the benefits of a comprehensive income tax treaty between such foreign county and the United States, or (2) such person demonstrates to the satisfaction of the Secretary of the Treasury that such foreign country has a comprehensive income tax.

The Secretary may provide guidance concerning the case of a corporation resident in a country that has an income tax treaty with the United States but that does not generally tax the foreign-source income of its residents (a “territorial country”). This guidance may address the question whether, or in which circumstances, substantially all the income of such a corporation will be considered to be subject to a comprehensive income tax if the corporation derives income not only from its country of residence but also from one or more countries that may or may not have tax treaties with the United States. For example, it is intended that if a corporation resident in a territorial country that has an income tax treaty with the United States derives a portion of its income from dividends paid by a subsidiary organized in another country that also has an income tax treaty with the United States, and the dividends are paid out of income that is subject to tax by that other treaty country, the Secretary may provide guidance under which the dividend income is considered subject to a comprehensive income tax in determining whether substantially all of the income of the recipient corporation is subject to a comprehensive income tax.

In the case of a foreign corporation with income that is taxable under IRC section 882, the provision does not apply to compensation which, had such compensation been paid in cash on the date that such compensation ceased to be subject to a substantial risk of forfeiture, would have been deductible by such foreign corporation against such income. The provision does not apply to a nonqualified deferred compensation plan of a nonqualified entity if such compensation is payable to an employee of a domestic subsidiary of such entity and such compensation is reasonably expected to be deductible by such subsidiary under IRC section 404(a)(5) when such compensation is includible in income by such employee.

Effective Date

The provision is effective with respect to amounts deferred which are attributable to services performed after December 31, 2008. In the case of an amount deferred which is attributable to services performed on or before December 31, 2008, to the extent such amount is not includible in gross income in a taxable year beginning before 2018, then such amount is includible in gross income in the later of: (1) the last taxable year beginning before 2018, or (2) the taxable year in which there is no substantial risk of forfeiture of the rights to such compensation. Earnings on amounts deferred which are attributable to services performed on or before December 31, 2008, are subject to the provision only to the extent that the amounts to which such earnings relate are subject to the provision.

No later than 120 days after date of enactment, the Secretary shall issue guidance providing a limited period of time during which a nonqualified deferred compensation arrangement attributable to services performed on or before December 31, 2008, may, without violating the requirements of IRC section 409A(a), be amended to conform the date of distribution to the date the amounts are required to be included in income. If the taxpayer is also a service recipient and maintains one or more nonqualified deferred compensation arrangements for its service providers under which any amount is attributable to services performed on or before December 31, 2008, the guidance shall permit such arrangements to be amended to conform the dates of distribution under the arrangement to the date amounts are required to be included in income of the taxpayer under the provision. An amendment made pursuant to the Treasury guidance will not be treated as a material modification of the arrangement for purposes of IRC section 409A. A special transition rule applies to nonqualified deferred compensation that is determined based on gain recognized on the disposition of a specified asset held by a service recipient on the date of enactment. Under this rule, if any portion of compensation payable under a binding written contract entered into on or before December 31, 2007, is determined as a portion of the amount of gain recognized on the disposition during such period of the specified asset, the provision will not apply to the portion of compensation attributable to such disposition even though such portion of compensation may be reduced by realized losses or depreciation in the value of other assets during such period or a prior period or be attributable in part to services performed after December 31, 2008. However, this rule only applies if payment of such portion of compensation is received by the service provider and included in its gross income no later than the earlier of 12 months after the end of the taxable year of the service recipient during which the disposition of the specified asset occurs and the last taxable year of the service provider beginning before January 1, 2018.

California Law (R&TC section 17551)

California conforms by reference to IRC 457, relating to deferred compensation plans of state and local governments and tax-exempt organizations, in R&TC section 17551. Except for increases in the maximum amount of elective deferrals, R&TC section17551(c) specifically provides that federal changes to IRC section 457 automatically apply without regard to taxable year to the same extent as applicable for federal income tax purposes and thus adopts all changes made to IRC section 457 without regard to the "specified date" contained in R&TC section 17024.5.

However, California is not conformed to the newly-created IRC section 457A.

Impact on California Revenue

Estimated Revenue Impact of Nonqualified Deferred Compensation from Certain Tax Indifferent Parties For Tax Years Beginning On or After January 1, 2009 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
$137,000,000	$78,000,000	$88,400,000

Estimates are based on a proration of federal projections developed for the Emergency Economic Stabilization Act of 2008. The provision is for services performed after December 31, 2008.

WORKER, RETIREE, AND EMPLOYER RECOVERY ACT OF 2008 (WRERA) (PL 110-458, DECEMBER 23, 2008)

TITLE I – TECHNICAL CORRECTIONS RELATED TO THE PENSION PROTECTION ACT OF 2006

SUBTITLE A – TECHNICAL CORRECTIONS RELATED TO THE PENSION PROTECTION ACT OF 2006

Sections	Section Titles
101-112	Amendments Related to Titles I-XI

Background

The Pension Protection Act of 2006 (PPA) (P.L. 109-280, August 17, 2006) made substantial changes to the Employee Retirement Income Security Act of 1974 (ERISA) and the IRC.

New Federal Law (IRC sections 401, 409A, 411, 412, 414, 430, 436, and 4971)

1. Amendments relating to Title I of the PPA: Reform of the Funding Rules for Single-Employer Defined Benefit Plans

Minimum funding standards – (Act section 101(a))

Prohibition on increases in benefits while a waiver is in effect

The PPA restates the prior-law provision prohibiting plan amendments that increase benefits while a waiver or amortization extension is in effect or if a retroactive amendment was previously made within a certain period. As under prior law, an exception applies for a plan amendment increasing benefits that only repeals a previously made retroactive amendment. The provision provides that the references to retroactive amendments are limited to those that reduced accrued benefits.

Minimum funding standards

Under the PPA, the Secretary of the Treasury must approve a change in a plan's funding method, valuation date, or a plan year. The provision deletes the reference to valuation date because a change in such date is a change in the plan's funding method.

Funding rules for single-employer defined benefit plans – (Act section 101(b))

Determination of target normal cost

The PPA defines the term "target normal cost" for a plan year as the present value of all benefits which are expected to accrue or be earned under the plan during the plan year.

The provision clarifies that a plan's target normal cost is increased by the amount of plan-related expenses expected to be paid from plan assets during the plan year, and is decreased by the amount of mandatory employee contributions expected to be made to the plan during the plan year. This clarification is effective for plan years beginning after December 31, 2008, and is elective for the preceding plan year.

Determination of at-risk status

Under the PPA, the 80-percent and 70-percent prongs of the at-risk status definition are based on funded status for the preceding plan year. The PPA provides that determination of the 70-percent prong for 2008 may be determined using methods of estimation provided by the Secretary of Treasury. The provision applies this rule also for purposes of the 80-percent prong (as phased in under the PPA).

Quarterly contributions

Under the PPA, quarterly contributions are required if a plan has a funding shortfall for the preceding year. The provision includes a transition rule for the 2008 plan year; under this rule, in the case of plan years beginning in 2008, the funding shortfall for the preceding plan year may be determined using such methods of estimation as the Secretary of the Treasury may provide.

The quarterly installment rules require a higher rate of interest to be charged on required contributions. Small plans are permitted to use a valuation date other than the first day of the plan year. The provision provides that the Secretary of the Treasury is to prescribe rules relating to interest charges and credits in the case of a plan with a valuation date other than the first day of the plan year.

Benefit limitations under single-employer plans – (Act section 101(c))

Definition of prohibited payment

The PPA provides that certain underfunded plans may not make prohibited payments, which include accelerated forms of distribution such as lump sums. Present law provides that if the present value of a participant's vested benefit exceeds $5,000,[549] the benefit may not be distributed without the participant's consent. If the vested benefit is less than or equal to this amount, the consent requirement does not apply. The provision provides that the payment of benefits that may be immediately distributed without the consent of the participant is not a prohibited payment.

[549] The portion of a participant's benefit that is attributable to amounts rolled over from another plan may be disregarded in determining the present value of the participant's vested benefit.

Small plans

The benefit restriction provisions are based upon a plan's adjusted funding target attainment percentage as of the first day of the plan year. This presents issues for small plans, which are allowed to designate any day of the plan year as their valuation date, because a plan's adjusted funding target attainment percentage cannot be determined until valuation date. The provision provides that the Secretary of the Treasury may prescribe rules for the application of the benefit restrictions which are necessary to reflect the alternate valuation date.

Notice requirement

The provision provides that the Secretary of the Treasury, in consultation with the Secretary of Labor, has the authority to prescribe rules applicable to the notice of funding-based limitations on distributions required under section 101(j) of ERISA as added by the PPA.

Definition of single employer plan

The PPA provides rules under ERISA and the IRC that limit the benefits and benefit accruals that can be provided under a single employer plan, depending on the funding level of the plan. The provision adds a definition of the term "single employer plan" for purposes of the limitations in the IRC.

Technical and conforming amendments – (Act section 101(d))

The PPA provides for technical and conforming amendments to reflect the new funding rules. The provision provides that the effective date for the amendments to the excise tax on a failure to satisfy the funding rules is taxable years beginning after 2007 and, for the other technical and conforming amendments, plan years beginning after 2007.

Restrictions on funding of nonqualified deferred compensation plans by employers maintaining underfunded or terminated single-employer plans – (Act section 101(e))

The PPA provides that if, during any restricted period in which a defined benefit pension plan of an employer is in at-risk status, assets are set aside (directly or indirectly) in a trust (or other arrangement as determined by the Secretary of the Treasury), or transferred to such a trust or other arrangement, for purposes of paying deferred compensation of an applicable covered employee, such assets are treated as property transferred in connection with the performance of services (whether or not such assets are available to satisfy the claims of general creditors) under IRC section 83.

The PPA further provides that if a nonqualified deferred compensation plan of an employer provides that assets will be restricted to the provision of benefits under the plan in connection with a restricted period (or other similar financial measure as determined by the Secretary of the Treasury) of any defined benefit pension plan of the employer, or assets are so restricted, such assets are treated as property transferred in connection with the performance of services (whether or not such assets are available to satisfy the claims of general creditors) under IRC section 83. The provision provides that this rule applies with respect to assets that are restricted under the plan with respect to a covered employee.

2. Amendments relating to Title II of the PPA: Funding Rules for Multiemployer Defined Benefit Plans

Funding rules for multiemployer defined benefit plans – (Act section 102(a))

Shortfall funding method

The PPA provides that a multiemployer plan meeting certain criteria may adopt, use or cease using the shortfall funding method and such adoption, use, or cessation of use is deemed to be approved by the Secretary of the Treasury. One of the criteria is that "the plan has not used the shortfall funding method during the 5-year period ending on the day before the date the plan is to use the method" under the PPA. The provision changes this so that the criterion is that "the plan has not adopted or ceased using the shortfall funding method during the 5-year period ending on the day before the date the plan is to use the method" under the PPA.

Funding rules for multiemployer plans in endangered or critical status – (Act section 102(b))

Notice requirements

The PPA requires the plan sponsor of a multiemployer plan to distribute a notice if the plan is in endangered or critical status and if the plan is required to make reductions to adjustable benefits. The provision clarifies that the Secretary of the Treasury, in consultation with the Secretary of Labor, shall provide guidance with respect to the plan sponsor's notice obligations.

Implementation and enforcement of default schedule

Under the PPA, a default schedule applies if a funding improvement plan or rehabilitation plan is not timely adopted. The provision removes the rule that provides that the default schedule is implemented upon the date on which the Department of Labor certifies that the parties are at impasse. Thus, under the provisions, the plan trustees are required to implement the default schedule within 180 days of the expiration date of the collective bargaining agreement. In addition, the provision clarifies that any failure to make a default schedule contribution is enforceable under section 515 of ERISA.

Restriction on payment of lump sums while plan is in critical status

Under the PPA, the payment of accelerated forms of payment, including lump sums, while a plan is in critical status is restricted. Under the provision, the restriction on payment of accelerated forms of payment applies only to participants whose benefit commencement date is after notice of the plan's critical status is provided. This change conforms the rule for multiemployer plans to the rule applicable to single-employer plans.

Definition of plan sponsor

The funding rules for multiemployer plans and the excise tax rules that apply in the event of a failure to comply with the funding rules refer to the term "plan sponsor." This term is not defined in the IRC. The provision adds a definition to the IRC that conforms with the applicable ERISA definition.

Excise tax on trustees for failure to adopt a timely rehabilitation plan

The PPA imposes an excise tax on the sponsor of a multiemployer plan in the event of a failure to timely adopt a rehabilitation plan. Under the PPA, the plan sponsor has a 240-day period in which it must adopt a plan. The excise tax for failure to timely adopt is based on the beginning of this 240-day period, rather than the end of the period. The provision revises the calculation of the excise tax so that it applies to the period beginning on the due date for adoption of the rehabilitation plan.

Effective date of excise tax provisions

The PPA provides that the excise tax provisions relating to a failure to satisfy the multiemployer plan funding rules are effective with respect to plan years beginning after 2007. The provision clarifies that the excise tax provisions are effective with respect to taxable years beginning after 2007.

3. Amendments relating to Title III of the PPA: Interest Rate Provisions

Extension of replacement of 30-year Treasury rates – (Act section 103(a))

The Pension Funding Equity Act of 2004 provided for a temporary interest rate. The Pension Funding Equity Act of 2004 also provided that, if certain requirements were satisfied, plan amendments to reflect such interest rate did not need to be made before the last day of the first plan year beginning on or after January 1, 2006. The PPA extended the temporary interest rate through 2007 and also extended the required amendment date by changing "January 1, 2006" to "January 1, 2008." The provision further extends the required amendment date to conform generally to the amendment period permitted under the PPA.

Interest rate assumption for determination of lump-sum distributions – (Act section 103(b))

The PPA amended the interest and mortality table used in calculating the minimum value of certain optional forms of benefit, such as lump sums. The provision clarifies that the mortality table required to be used in calculating the minimum value of optional forms of benefit is also used in adjusting benefits and limits for purposes of applying the IRC section 415 limitation on benefits that may be provided under a defined benefit plan. This clarification of the required mortality table is effective for years beginning after December 31, 2008. However, a plan may elect to use the mortality table for years beginning after December 31, 2007, and before January 1, 2009, or for any portion of such year.

4. Amendments relating to Title IV of the PPA: PBGG Guarantee and Related Provisions

Missing participants – (Act section 103(b))

Plans covered by missing participant program

The PPA extended the prior-law missing participant program to terminating multiemployer plans and to certain plans not subject to the termination insurance program of the Pension Benefit Guaranty Corporation ("PBGC"). Under the provision, the missing participant program applies to plans that have at no time provided for employer contributions. In addition, the provision limits the program to qualified plans.

5. Amendments relating to Title V of the PPA: Disclosure

Defined benefit plan funding notice and disclosure of withdrawal liability – (Act section 105(a))

Under the PPA, the administrator of a single employer or a multiemployer defined benefit plan must provide an annual plan funding notice (section 101(f) of ERISA). The provision conforms the measurement dates of several of the items that must be included in the notice and also conforms the information that must be provided by the administrator of a multiemployer plan with respect to the assets and liabilities of the plan to the information that must be provided by the administrator of a single employer plan.

Access to multiemployer pension plan information – (Act section 105(b))

Under the PPA, the administrator of a multiemployer plan is required to provide participants and employers copies of certain financial reports prepared by an investment manager, advisor or other fiduciary, upon request (section 101(k) of ERISA). However, the administrator is prohibited from disclosing "any individually identifiable information regarding any plan participant, beneficiary, employee, fiduciary, or contributing employer." The provision clarifies that this prohibition does not prevent the plan from disclosing the identities of the investment managers and advisors whose performance is being reported on or evaluated.

Under the PPA, the plan sponsor or administrator of a multiemployer plan must provide upon an employer's request certain information regarding the employer's withdrawal liability with respect to the plan (section 101(l) of ERISA). The provision repeals section 4221(e) of ERISA, which also requires the disclosure upon an employer's request information relating to the employer's withdrawal liability.
Disclosure of termination information to plan participants – (Act section 105(e))

In the case of an involuntarily termination of a plan, the PPA requires the plan sponsor (or administrator) and the PBGC to disclose certain information to affected parties, and special rules apply with respect to the disclosure of confidential information by the plan sponsor (or administrator). Under the provision, these special rules relating to the disclosure of confidential information also apply to the PBGC.

Under the PPA, the plan administrator must provide affected parties with certain information that it has provided to the PBGC. The provision clarifies that this information includes information that the plan administrator is required to disclose to the PBGC at the time the written notice of intent to terminate is given as well as information the plan administrator is required to disclose to the PBGC after the notice of intent to terminate is given.

Periodic pension benefit statements – (Act section 105(f))

The PPA revises the rules that apply under ERISA with respect to a plan administrator's obligation to provide periodic information relating to a participant's accrued benefits under a plan (section 105 of ERISA). The provision makes conforming changes to section 209 of ERISA, which also imposes recordkeeping and reporting obligations with respect to participant benefits.

Notice to participants or beneficiaries of blackout periods – (Act section 105(g))

The Sarbanes-Oxley Act of 2002 amended ERISA to require that participants and beneficiaries of an individual account plan be provided advance notice of a blackout period during which certain plan operations, such as the ability to make investment changes, will be restricted. The notice requirement does not apply to one-participant plans. The PPA amended the definition of one-participant plan to conform to Department of Labor regulations. The PPA, however, did not provide complete conformity with those regulations. The provision amends the PPA so that the definition of one-participant plan for purposes of the notice is in conformity with Department of Labor regulations. Under the provision, a one-participant plan means a retirement plan that on the first day of the plan year: (1) covered only one individual (or the individual and the individual's spouse) and the individual (or the individual and the individual's spouse) owned 100 percent of the plan sponsor (whether or not incorporated), or (2) covered only one or more partners (or partners and their spouses) in the plan sponsor. Thus, under the provision, plans that are not subject to title I of ERISA are not subject to the blackout notice provisions.[550]

6. Amendments relating to Title VI of the PPA: Investment Advice, Prohibited Transactions, and Fiduciary Rules

Prohibited transaction rules relating to financial investments – (Act section 106(b))

Under the PPA, an exemption from the prohibited transaction rules of the IRC and ERISA applies in the case of foreign exchange transactions between a plan and a bank or broker-dealer if certain requirements are met. Included in the PPA is a requirement that the exchange rate used by the bank or broker-dealer for a particular transaction cannot deviate by more or less than three percent from the interbank bid and asked rates for transactions of comparable size and maturity. Under the provision, the exchange rate cannot deviate by more than three percent.

7. Amendments relating to Title VII of the PPA: Benefit Accrual Standards

Benefit Accrual Standards – (Act section 107)

Preservation of capital

The PPA prohibits an applicable defined benefit plan account balance from being reduced below the aggregate amount of contributions. Under the provision, failure to comply with this rule is treated as a violation of the age discrimination rules under ERISA or the IRC, as applicable.

Application of present-value rules

The PPA permits an applicable defined benefit plan to distribute a participant's accrued benefit under the plan in an amount equal to the participant's hypothetical account balance under the plan without violating the present-value rules of ERISA section 205(g) and IRC section 417(e). ERISA section 203(e) and IRC section 411(a)(11), which allow automatic cash-outs of amounts not exceeding $5,000, apply the ERISA section 205(g) and IRC section 417(e) present-value rules by cross-reference. The provision adds cross-references to apply the new ERISA and IRC provisions for purposes of ERISA section 203(e) and IRC section 411(a)(11).

[550] This provision is effective as if included in the Sarbanes-Oxley Act.

Effective date

The general effective date under PPA section 701(e)(1) is periods beginning on or after June 29, 2005, and special effective dates are provided for certain provisions. The provision provides that the vesting provisions under PPA section 701 are effective on the basis of plan years and that the vesting provisions apply with respect to participants with an hour of service after the applicable effective date for a plan.

The PPA established interest credit requirements for applicable defined benefit plans, which, under the general effective date, would apply to periods beginning on or after June 29, 2005. PPA section 701(e)(3) provides that, in the case of a plan in existence on June 29, 2005, the new interest credit rules apply to years beginning after December 31, 2007, unless the employer elects to apply them for any period beginning after June 29, 2005, and before the rules would otherwise apply. The provision changes this rule so that it refers to any period beginning "on or after" June 29, 2005.

The PPA established rules with respect to a conversion of a plan into an applicable defined benefit plan. PPA section 701(e)(5) provides that these rules are applicable to plan amendments adopted after, and taking effect after, June 29, 2005. Similarly, ERISA section 204(b)(5)(B)(ii) and IRC section 411(b)(5)(B)(ii) apply the conversion rules to conversion amendments adopted after June 29, 2005. The provision clarifies that the effective date for the conversion rules is on or after June 29, 2005.

The PPA establishes a special effective date for the vesting and interest crediting requirements for applicable defined benefit plans in the case of a collectively bargained plan. The provision clarifies that these rules do not apply to plan years beginning before the earlier of: (1) the later of the termination of the collective bargaining agreement or January 1, 2008, or (2) January 1, 2010.

8. Amendments Relating to Title VIII of the PPA: Pension Related Revenue Provisions

<u>Deduction limitations</u>

Increase in deduction limit for single-employer plans – (Act section 108(a))

If an employer sponsors one or more defined benefit plans and one or more defined contribution plans that cover at least one of the same employees, an overall deduction limitation applies to the total contributions to all plans for a plan year. The overall deduction limit is generally the greater of: (1) 25 percent of compensation, or (2) the amount necessary to meet the minimum funding requirement of the defined benefit plan for the plan year. Under the PPA, in the case of a single-employer plan not covered by the PBGC, the combined plan limit is not less than the plan's funding shortfall as determined under the funding rules. Under the provision, in the case of a single-employer plan not covered by the PBGC, the combined plan limit is not less than the excess (if any) of the plan's funding target over the value of the plan's assets.

Updating deduction rules for combination of plans – (Act section 108(c))

If an employer sponsors one or more defined benefit plans and one or more defined contribution plans that cover at least one of the same employees, an overall deduction limitation applies to the total contributions to all plans for a plan year. The overall deduction limit is generally the greater of: (1) 25 percent of compensation, or (2) the amount necessary to meet the minimum funding requirement of the defined benefit plan for the plan year. The PPA provides that the overall deduction limit applies to contributions to one or more defined contribution plans only to the extent that such contributions exceed six percent of compensation. IRS guidance (Notice 2007-28, 2007-14 I.R.B. 880) takes the position that if defined contribution plan contributions are less than six percent of compensation, contributions to the defined benefit plan are still subject to limitation of the greater of 25 percent of compensation or the minimum required contribution. The provision provides that if defined contributions are less than six percent of compensation, the defined benefit plan is not subject to the overall deduction limit. If defined contributions exceed six percent of compensation, only defined contributions in excess of six percent are counted toward the overall deduction limit.

<u>Improvements in portability, distribution, and contribution rules</u>

Allow direct rollovers from retirement plans to Roth IRAs – (Act section 108(d))

The PPA permits distributions from tax-qualified retirement plans, tax-sheltered annuities, and governmental IRC section 457 plans to be rolled over directly from such plan into a Roth IRA, subject to certain conditions. Such conditions include recognition of the distribution in gross income (except to the extent it represents a return of after-tax contributions) and phase-out of the ability to perform such a rollover pursuant to the distributee's adjusted gross income. The provision provides that a rollover from a Roth designated account in a tax-qualified retirement plan or tax-sheltered annuity (described in IRC section 402A) to a Roth IRA is not subject to the gross income inclusion and adjusted gross income conditions.

Allow rollovers by nonspouse beneficiaries of certain retirement plan distributions – (Act section 108(f))

The PPA permits rollovers of benefits of nonspouse beneficiaries from qualified plans and similar arrangements. The provision clarifies that the current law treatment with respect to a trustee-to-trustee transfer from an inherited IRA to another inherited IRA continues to apply. Under the provision, effective for plan years beginning after December 31, 2009, rollovers by nonspouse beneficiaries are generally subject to the same rules as other eligible rollovers.

<u>Health and medical benefits</u>

Use of excess pension assets for future retiree health benefits and collectively bargained retiree health benefits – (Act section 108(i))

In the case of an IRC section 420 transfer, present law requires the funded status of the defined benefit plan to be maintained by employer contributions or asset transfers from the health accounts. Under the provision, asset transfers from the health accounts to maintain the plan's funded status are not subject to the excise tax on reversions.

The provision also allows assets transferred to a health benefits account in a qualified IRC section 420 transfer to be used to pay health liabilities in excess of current-year retiree health liabilities. In the case of a qualified future transfer, assets may be used to pay qualified current retiree health liabilities which the plan reasonably estimates will be incurred. In the case of a collectively bargained transfer, assets may be used to pay collectively bargained retiree health liabilities.

Distributions from governmental retirement plans for health and long-term care insurance for public safety officers – (Act section 108(j))

The PPA provides an exclusion from gross income for up to $3,000 annually for certain pension distributions used to pay for qualified health insurance premiums. Under IRS Notice 2007-7,[551] Q&A 23, the exclusion applies only to insurance issued by an insurance company regulated by a state (including a managed care organization that is treated as issuing insurance) and thus does not apply to self-insured plans. Under the provision, the exclusion applies to coverage under an accident or health plan (rather than accident or health insurance). That is, the exclusion applies to self-insured plans as well as to insurance issued by an insurance company.

Under the provision, when determining the portion of a distribution that would otherwise be includible in income, the otherwise includible amount is determined as if all amounts to the credit of the eligible public safety officer in all eligible retirement plans were distributed during the taxable year. The provision also clarifies that the income exclusion only applies with respect to distributions from the plan (or plans) maintained by the employer from which the individual retired as a public safety officer.

Annuities to surviving spouses and dependent children of special trial judges – (Act section 108(k))

Under the PPA, participation in the survivor annuity program for survivors of judges of the United States Tax Court is extended to special trial judges of the United States Tax Court, and conforming changes are made to various provisions of the IRC. One of the conforming changes is to specify that employment for purposes of the Federal Insurance Contributions Act ("FICA") includes service performed as a special trial judge of the United States Tax Court. Under the provision, this conforming amendment is repealed. Thus, the provision provides that employment as a special trial judge of the United States Tax Court is covered employment for purposes of FICA under the rules that otherwise apply to federal employees.

[551] 2007-5 I.R.B. 395.

Provisions for recall – (Act section 108(l))

Under the PPA, participation in the survivor annuity program for survivors of judges of the United States Tax Court is extended to special trial judges of the United States Tax Court, and conforming changes are made to various provisions of the IRC. One of the conforming changes is to specify that employment for purposes of the Federal Insurance Contributions Act ("FICA") includes service performed as a special trial judge of the United States Tax Court. Under the provision, this conforming amendment is repealed. Thus, the provision provides that employment as a special trial judge of the United States Tax Court is covered employment for purposes of FICA under the rules that otherwise apply to federal employees.

9. Amendments relating to Title IX of the PPA: Increase in Pension Plan Diversification and Participation in Other Pension Provisions

Defined contribution plans required to provide employees with freedom to invest their plan assets – (Act section 109(a))

Under the PPA, the diversification requirements do not apply with respect to a one-participant retirement plan. The provision conforms the IRC's definition of the term "one-participant retirement plan" to the definition of the term under ERISA.

Increasing participation through automatic contribution arrangements – (Act section 109(b))

The PPA provides rules permitting an employee to withdraw certain amounts (referred to as "permissible withdrawals") in the case of an eligible automatic contribution arrangement under an applicable employer plan. The provision repeals the requirement that an eligible automatic contribution arrangement satisfy, in the absence of a participant investment election, the requirements of ERISA section 404(c)(5) (which generally authorizes the Secretary of Labor to issue regulations under which a participant is treated as exercising control over the assets in the participant's account under a plan with respect to default investments). The provision also extends the permissible withdrawal rules to SIMPLE IRAs (IRC section 408(p)) and SARSEPs (IRC section 408(k)(6)). The provision also provides that a permissive withdrawal is disregarded for purposes of applying the annual limitation on elective deferrals that applies to a taxpayer under IRC section 402(g)(1).

The PPA also provides that, in the case of a distribution of an excess contribution and income allocable to such contribution in order to satisfy the rules relating to a qualified cash or deferral arrangement under IRC section 401(k) (or the similar distribution rules under IRC section 401(m) in the case of excess aggregate contributions relating to matching contributions or employee contributions), the income that must be distributed is the income allocable to the excess contribution (or excess aggregate contribution) through the end of the year for which the distribution is made. The provision applies this limit on the amount of income that must be distributed to the rules that apply to the distribution of excess deferrals and allocable income under IRC section 402(g).

Treatment of eligible combined defined benefit plans and qualified cash or deferred arrangements – (Act section 109(c))

Under the PPA, a qualified employer may establish a combined plan that consists of a defined benefit plan and a qualified cash or deferral arrangement described in IRC section 401(k), provided that certain requirements are satisfied. The PPA also provides that the rules of ERISA are applied to the defined benefit component and the individual account component of a combined plan in the same manner as if each component were not part of the combined plan. Thus, for example, the defined benefit component of the combined plan may be subject to the insurance program in Title IV of ERISA, while the individual account component is not. The provision provides that in the case of a termination of a combined plan, the individual account and defined benefit components must be terminated separately.

10. Amendments relating to Title X of the Act: Spousal Pension Protection Provisions

Extension of Tier II Railroad Retirement benefits to surviving former spouses – (Act section 110)

The PPA provides rules relating to the survivor benefits payable under the Railroad Retirement Act. The provision clarifies that a former spouse has an independent entitlement to immediate commencement of benefits if three conditions are satisfied. First, the employee must have completed 10 years of service in the railroad industry (or five years of service after December 31, 1995); second, the spouse or former spouse must have attained age 62; and third, the employee must have attained age 62. In addition, the provision provides that a former spouse's Tier II benefits under the Railroad Retirement Act continue after the death of the employee. The provision is effective for payments due for months after August, 2007.

11. Amendments relating to Title XI of the Act: Administrative Procedures

No reduction in unemployment compensation as a result of pension rollovers – (Act section 111(b))

Under present law, unemployment compensation payable by a state to an individual generally is reduced by the amount of retirement benefits received by the individual. Under the PPA, rollover contributions are not included in retirement payments for which states are required to reduce unemployment compensation under federal law, however, states are not prohibited from reducing unemployment compensation by such rollover contributions. Under the provision, unemployment compensation payable by a state to an individual may not be reduced by the amount of a rollover contribution.

WORKER, RETIREE, AND EMPLOYER RECOVERY ACT OF 2008 (WRERA), (PL 110-458, DECEMBER 23, 2008)

California Law (R&TC sections 17501 and 17551)

ERISA Preemption

Federal ERISA provisions apply to all pension plans in California. There are no California law provisions because federal law precludes state level administration of these plans. Thus, the technical corrections to ERISA provisions automatically apply to California.

IRC Changes

California conforms by reference to Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of Part I, relating to pension, profit-sharing, stock bonus plans, etc. (IRC sections 401 through 420) and Part II, relating to certain stock options (IRC sections 421 through 424), in R&TC section 17501. Additionally, California conforms by reference to IRC 457, relating to deferred compensation plans of state and local governments and tax-exempt organizations, in R&TC section 17551.

However, except for increases in the maximum amount of elective deferrals, R&TC sections 17501(b) and 17551(c) specifically provide that federal changes to Part I of Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of IRC sections 401 through 420, inclusive, and IRC section 457, relating to deferred compensation plans of state and local governments and tax-exempt organizations, automatically apply without regard to taxable year to the same extent as applicable for federal income tax purposes and thus adopt all changes made to those IRC sections without regard to the "specified date" contained in R&TC section 17024.5. Thus, the federal technical corrections to Part I of Subchapter D of Chapter 1 of Subtitle A of the IRC (IRC sections 401 through 420) automatically apply under California law without regard to taxable year to the same extent as applicable for federal income tax purposes.

Because California has not conformed to Part III of Subchapter D of Chapter 1 of Subtitle A of the IRC (IRC sections 430 through 436), the federal technical corrections to IRC sections 430 through 436 do not automatically apply.

Impact on California Revenue

ERISA Preemption

ERISA changes result in no conformity revenue impact. Any revenue impact would be considered baseline.

IRC Changes

No conformity revenue impact because California automatically conforms to this federal change in WRERA. Any revenue impact would be considered baseline.

WORKER, RETIREE, AND EMPLOYER RECOVERY ACT OF 2008 (WRERA), (PL 110-458, DECEMBER 23, 2008)

SUBTITLE B, OTHER PROVISIONS

Section	Section Title
121	Amendments Related to Sections 102 and 112 of the PPA

Background

In the case of a single-employer defined benefit pension plan, the PPA provides new rules for determining minimum required contributions that must be made to fund the plan.[552] In general, the minimum required contribution to a single-employer defined benefit pension plan for a plan year depends on a comparison of the value of the plan's assets as of the beginning of the plan year with the plan's funding target and the plan's target normal cost.[553] The plan's funding target for a plan year is the present value of all benefits accrued or earned as of the beginning of the plan year. A plan's target normal cost for a plan year is the present value of benefits expected to accrue or be earned during the plan year. In general, a plan has a funding shortfall for a plan year if the plan's funding target for the year exceeds the value of the plan's assets. In such a case, the minimum required contribution for the plan year generally is equal to the sum of the plan's target normal cost for the year and a portion of the funding shortfall for that year and prior plan years.[554]

Under the PPA's minimum funding rules, the value of plan assets generally is the fair market value of the assets. However, the value of plan assets may be determined on the basis of the averaging of fair market values, but only if such method: (1) is permitted under regulations; (2) does not provide for averaging of fair market values over more than the period beginning on the last day of the 25th month preceding the month in which the plan's valuation date occurs and ending on the valuation date; and (3) does not result in a determination of the value of plan assets that at any time is less than 90 percent or more than 110 percent of the fair market value of the assets at that time. The PPA's rules also provide that any averaging must be adjusted for contributions to the plan and distributions to participants as provided by the Secretary of the Treasury.

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[552] The IRC and ERISA contain parallel minimum funding rules.
[553] A plan with 100 or fewer participants is permitted to designate any day during the plan year as its valuation date for purposes of the minimum funding rules.
[554] A shortfall amortization base is generally established for each year for which a plan has a funding shortfall, and each base is amortized over a seven-year period. The base is generally comprised of the funding shortfall for that year, less the present value of shortfall amortization installments that apply to the current year and succeeding years on account of prior-year shortfall amortization bases. The aggregate of the shortfall amortization installments for the current plan year is referred to as the shortfall amortization charge, and this charge is added to the plan's target normal cost in determining the minimum required contribution.

Proposed regulations have been issued that permit the value of plan assets to be determined on the basis of averaging.[555] Under the proposed regulations, the average value of plan assets generally is increased for contributions that are included in the last valuation date during the averaging period but that were not included in the prior valuation dates during the averaging period. Similarly, the average value generally is decreased for distributions included in the last valuation date during the averaging period but that were not included in the prior valuation dates during the averaging period.

New Federal Law (ERISA section 303 and IRC section 430)

The provision provides that, in determining the value of a plan's assets under the averaging method, such averaging will be adjusted for expected earnings as specified by the Secretary of the Treasury. Such an adjustment is in addition to the present law adjustments for contributions and distributions. Expected earnings are to be determined by a plan's actuary on the basis of an assumed earnings rate for the plan that is specified by the actuary. The assumed earnings rate specified by the actuary cannot exceed the applicable third segment rate.[556]

Effective Date

The provision is effective as if included in the PPA.

California Law (R&TC sections 17501 and 17551)

ERISA Preemption

Federal ERISA provisions apply to all pension plans in California. There are no California law provisions because federal law precludes state level administration of these plans. Thus, the technical corrections automatically apply to California.

IRC Changes

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[555] 72 F.R. 74215 (December 31, 2007).

[556] The minimum funding rules specify the interest rates that must be used in determining a plan's target normal cost and funding target. Under the rules, present value generally is determined using three interest rates, each of which applies to benefit payments expected to be made from the plan during a certain period. The third segment rate applies to benefits reasonably determined to be payable after the end of the 20-year period that applies to the first and second segment rates. Each segment rate is a single interest rate determined by the Secretary of the Treasury on the basis of a corporate bond yield curve, taking into account only the portion of the yield curve based on corporate bonds maturing during the particular segment rate period. The yield curve used by the Secretary is based on yields on investment grade corporate bonds that are in the top three quality levels available.

California conforms by reference to Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of Part I, relating to pension, profit-sharing, stock bonus plans, etc. (IRC sections 401 through 420) and Part II, relating to certain stock options (IRC sections 421 through 424), in R&TC section 17501. Additionally, California conforms by reference to IRC 457, relating to deferred compensation plans of state and local governments and tax-exempt organizations, in R&TC section 17551.

However, except for increases in the maximum amount of elective deferrals, R&TC sections 17501(b) and 17551(c) specifically provide that federal changes to Part I of Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation (IRC sections 401 through 420, inclusive), and IRC section 457, relating to deferred compensation plans of state and local governments and tax-exempt organizations, automatically apply without regard to taxable year to the same extent as applicable for federal income tax purposes and thus adopt all changes made to those IRC sections without regard to the "specified date" contained in R&TC section 17024.5.

Because California has not conformed to Part III of Subchapter D of Chapter 1 of Subtitle A of the IRC (IRC sections 430 through 436), the federal changes to IRC section 430, relating to minimum funding standards for single-employer defined benefit pension plans, do not automatically apply.

<u>Impact on California Revenue</u>

ERISA Preemption

ERISA changes result in no conformity revenue impact. Any revenue impact would be considered baseline.

<u>Section</u>	<u>Section Title</u>
122	Modification of Interest Rate Assumption Required with Respect to Certain Small Employer Plans

<u>Background</u>

Annual benefits payable under a defined benefit pension plan generally may not exceed the lesser of: (1) 100 percent of average compensation, or (2) $185,000 (for 2008).[557] The dollar limit generally applies to a benefit payable in the form of a straight life annuity. If the benefit is not in the form of a straight life annuity (e.g., a lump sum), the benefit generally is adjusted to an equivalent straight life annuity. For purposes of adjusting a benefit in a form that is subject to the minimum value rules, such as a lump-sum benefit, the interest rate used generally

[557] IRC section 415(b)(1).

must be not less than the greater of: (1) 5.5 percent; (2) the rate that provides a benefit of not more than 105 percent of the benefit that would be provided if the rate (or rates) applicable in determining minimum lump sums were used; or (3) the interest rate specified in the plan.

New Federal Law (IRC section 415)

Under the provision, in the case of a plan maintained by an eligible employer, the interest rate used in adjusting a benefit in a form that is subject to the minimum value rules generally must be not less than the greater of: (1) 5.5 percent; or (2) the interest rate specified in the plan. The term eligible employer is defined in the same manner as under IRC section 408(p) (describing an employer which is eligible to sponsor a SIMPLE plan).[558] Thus, for any year, the term means an employer which had no more than 100 employees who received at least $5,000 of compensation from the employer for the preceding year. An eligible employer who maintains a defined benefit pension plan for one or more years and who fails to be an eligible employer in a subsequent year is treated as an eligible employer for the two years following the last year the employer was an eligible employer (provided that the reason for failure to qualify is not due to an acquisition, disposition, or similar transaction involving the eligible employer).

Effective Date

The provision is effective for years beginning after December 31, 2008.

California Law (R&TC sections 17501 and 17551)

California conforms by reference to Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of Part I, relating to pension, profit-sharing, stock bonus plans, etc. (IRC sections 401 through 420) and Part II, relating to certain stock options (IRC sections 421 through 424), in R&TC section 17501. Additionally, California conforms by reference to IRC 457, relating to deferred compensation plans of state and local governments and tax-exempt organizations, in R&TC section 17551.

However, except for increases in the maximum amount of elective deferrals, R&TC sections 17501(b) and 17551(c) specifically provide that federal changes to Part I of Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation (IRC sections 401 through 420, inclusive), and IRC section 457, relating to deferred compensation plans of state and local governments and tax-exempt organizations, automatically apply without regard to taxable year to the same extent as applicable for federal income tax purposes and thus adopt all changes made to those IRC sections without regard to the "specified date" contained in R&TC section 17024.5.

[558] IRC section 408(p)(1)(D).

Thus, the federal changes to IRC section 415, relating to limitations on benefits and contributions under qualified plans, automatically apply under California law without regard to taxable year to the same extent as applicable for federal income tax purposes.

Impact on California Revenue

No conformity revenue impact because California automatically conforms to this federal change in WRERA. Any revenue impact would be considered baseline.

Section	Section Title
123	Determination of Market Rate of Return for Governmental Plans

Background

The PPA amended the IRC, ERISA, and the Age Discrimination in Employment Act of 1967 (ADEA), to provide for parallel age discrimination rules in the case of an applicable defined benefit plan. Included among the rules is a requirement relating to interest credits provided under such a plan. Under the PPA, an applicable defined benefit plan is a defined benefit pension plan under which the accrued benefit (or any portion thereof) is calculated as the balance of a hypothetical account maintained for the participant or as an accumulated percentage of the participant's final average compensation. The PPA also provides that the Secretary of the Treasury is to provide rules which include in the definition of an applicable defined benefit plan any defined benefit plan (or portion of such a plan) which has an effect similar to an applicable defined benefit plan.

Under the parallel IRC, ERISA, and ADEA rules, an applicable defined benefit plan satisfies the interest credit requirement if the terms of the plan provide that any interest credit (or equivalent amount) for any plan year is at a rate that is not greater than a market rate of return. The PPA also provides that an interest rate (or equivalent amount) of less than zero shall in no event result in a hypothetical account balance or similar amount being less than the aggregate amount of hypothetical contributions credited to the account. The PPA provides that the Secretary of the Treasury may provide rules governing the calculation of a market rate of return and for permissible methods of crediting interest to the account (including fixed or variable interest rates) resulting in effective rates of return that meet the requirements of the provision. The IRC and ERISA rules do not apply in the case of an applicable defined benefit plan that is a governmental plan. A governmental plan is generally defined for this purpose as a plan that is established and maintained for its employees by the Government of the United States, by the government of any state or political subdivision thereof, or by an agency or instrumentality of any of the foregoing.[559]

[559] IRC section 414(d). The definition of governmental plan in IRC section 414(d) has three provisions. The first provision includes any plan that is established and maintained for its employees by the Government of the

In the case of a plan in existence on June 29, 2005, the interest credit requirements for an applicable defined benefit plan generally apply to years beginning after December 31, 2007. In the case of a plan maintained pursuant to one or more collective bargaining agreements, a delayed effective date applies.

New Federal Law (ADEA amendments)

Under the provision, ADEA is amended to provide that, in the case of a governmental plan, a rate of return or method of crediting interest that is established pursuant to any provision of federal, state, or local law (including any administrative rule or policy adopted in accordance with any such law) is generally treated as a market rate of return and as a permissible method of crediting interest for purposes of the PPA's interest credit requirement.[560] This special treatment does not apply, however, if the rate of return or method of crediting interest violates another requirement of ADEA (other than the interest credit requirement).

Effective Date

The provision is effective as if included in the PPA.

California Law (None)

ERISA Preemption

Federal ERISA provisions apply to all pension plans in California. There are no California law provisions because federal law precludes state level administration of these plans.

Impact on California Revenue

ERISA changes result in no conformity revenue impact. Any revenue impact would be considered baseline.

United States, by the government of any state or political subdivision thereof, or by an agency or instrumentality of any of the foregoing. The second provision relates to certain Railroad Retirement Act plans and plans of international organizations. The third provision relates to any plan maintained by an Indian tribal government or political subdivision thereof, or by an agency or instrumentality of any of an Indian tribal government.

[560] The definition of governmental plan for purposes of this provision only includes a plan that is established and maintained for its employees by the Government of the United States, by the government of any state or political subdivision thereof, or by an agency or instrumentality of any of the foregoing.

WORKER, RETIREE, AND EMPLOYER RECOVERY ACT OF 2008 (WRERA), (PL 110-458, DECEMBER 23, 2008)

Section	Section Title
124	Treatment of Certain Reimbursements from Governmental Plans for Medical Care

Background

The gross income of an employee generally does not include employer-provided coverage under an accident or health plan. With respect to amounts received under such a plan, IRC section 105(a) provides that such amounts are includible in gross income to the extent: (1) such amounts are attributable to contributions by the employer which were not includible in the gross income of the employee, or (2) are paid by the employer. Notwithstanding this general inclusion rule, IRC section 105(b) provides that gross income does not include amounts received if such amounts are paid, directly or indirectly, to the taxpayer to reimburse the taxpayer for medical care expenses of the taxpayer, the taxpayer's spouse, or the taxpayer's dependents.[561]

In Revenue Ruling 2006-36,[562] the Internal Revenue Service held that amounts paid to an employee under a medical expense reimbursement plan are not excludible from an employee's gross income if the plan permits amounts to be paid as medical benefits to a designated beneficiary, other than the employee's spouse or dependents. Thus, under the ruling, none of the amounts paid by such a plan to any person, including reimbursements of medical expenses of the employee, the employee's spouse, or the employee's dependents, are excludible.

New Federal Law (IRC section 105)

The provision provides that, for purposes of IRC section 105(b), amounts paid (directly or indirectly) to a taxpayer from a specified health plan shall not fail to be excluded from gross income solely because the plan provides for reimbursements of health care expenses of a deceased plan participant's beneficiary. In order for the provision to apply, the plan must have provided for reimbursement of a deceased participant's beneficiary on or before January 1, 2008. A specified plan is an accident or health plan that is funded by a medical trust that is established in connection with a public retirement system if such trust: (1) has been authorized by a state legislature; or (2) has received a favorable ruling from the Internal Revenue Service that the trust's income is not includible in gross income under IRC section 115 (providing an exclusion from gross income for states and their political subdivisions).

Effective Date

The provision is effective with respect to payments made before, on, or after December 23, 2008.

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[561] As defined in IRC section 152, but determined without regard to sections (b)(1), (b)(2), and (d)(1)(B).
[562] 2006-2 C.B. 353. The ruling is effective for plan years beginning after December 31, 2008, in the case of plans including certain reimbursement provisions on or before August 14, 2006.

California Law (R&TC sections 17131 and 17087)

California conforms to IRC section 105 as of the "specified date" of January 1, 2005, with modifications. California specifically does not conform to IRC section 105(i), regarding federal taxation of sick pay under the Railroad Unemployment Insurance Act.

Impact on California Revenue

Estimated Revenue Impact of Treatment for Certain Reimbursements from Governmental Plans for Medical Care For Payments Before, On, or After December 23, 2008 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
$0	$0	$0

There would be no revenue impact from conforming to this provision. The Joint Committee on Taxation estimates the revenue impact to be negligible.

Section	Section Title
125	Rollover of Amounts Received in Airline Carrier Bankruptcy to Roth IRAs

Background

The IRC provides for two types of individual retirement arrangements ("IRAs"): traditional IRAs and Roth IRAs.[563] In general, contributions (other than a rollover contribution) to a traditional IRA may be deductible, and distributions from a traditional IRA are includible in gross income to the extent not attributable to a return of nondeductible contributions. In contrast, contributions to a Roth IRA are not deductible, and qualified distributions from a Roth IRA are excludable from gross income. Distributions from a Roth IRA that are not qualified distributions are includible in gross income to the extent attributable to earnings. In general, a qualified distribution is a distribution that is made on or after the individual attains age 59½, death, or disability or which is a qualified special purpose distribution.

The total amount that an individual may contribute to one or more IRAs for a year is generally limited to the lesser of: (1) a dollar amount ($5,000 for 2008); or (2) the amount of the individual's compensation that is includible in gross income for the year. As under the rules relating to traditional IRAs, a contribution of up to the dollar limit for each spouse may be made to a Roth IRA provided the combined compensation of the spouses is at least equal to

[563] Traditional IRAs are described in IRC section 408, and Roth IRAs are described in IRC section 408A.

the contributed amount. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with adjusted gross income for the taxable year over certain indexed levels. The adjusted gross income phase-out ranges for 2008 are: (1) for single taxpayers, $101,000 to $116,000; (2) for married taxpayers filing joint returns, $159,000 to $169,000; and (3) for married taxpayers filing separate returns, $0 to $10,000.

The foregoing contribution limitations for IRAs do not apply in the case of a rollover contribution to an IRA. If certain requirements are satisfied, a participant in an employer-sponsored qualified plan (which includes a tax-qualified retirement plan described in IRC section 401(a), an employee retirement annuity described in IRC section 403(a), a tax-sheltered annuity described in IRC section 403(b), and a governmental IRC section 457(b) plan) or a traditional IRA may roll over distributions from the plan, annuity or IRA into another plan, annuity or IRA. For distributions after December 31, 2007, certain taxpayers also are permitted to make rollover contributions into a Roth IRA (subject to inclusion in gross income of any amount that would be includible were it not part of the rollover contribution).

New Federal Law (Uncodified Act section 125 of WRERA relating to IRC section 408A)

Under the provision, a qualified airline employee may contribute any portion of an airline payment amount to a Roth IRA within 180 days of receipt of such amount (or, if later, within 180 days of enactment of the provision). Such a contribution is treated as a qualified rollover contribution to the Roth IRA. Thus, the portion of the airline payment amount contributed to the Roth IRA is includible in gross income to the extent that such payment would be includible were it not part of the rollover contribution.

Under the provision, an airline payment amount is defined as any payment of any money or other property payable by a commercial passenger airline to a qualified airline employee: (1) under the approval of an order of a federal bankruptcy court in a case filed after September 11, 2001, and before January 1, 2007; and (2) in respect of the qualified airline employee's interest in a bankruptcy claim against the airline carrier, any note of the carrier (or amount paid in lieu of a note being issued), or any other fixed obligation of the carrier to pay a lump sum amount. An airline payment amount shall not include any amount payable on the basis of the carrier's future earnings or profits. In determining the amount that may be contributed to a Roth IRA under the provision, any reduction in the airline payment amount on account of employment tax withholding is disregarded. A qualified airline employee is an employee or former employee of a commercial passenger airline carrier who was a participant in a defined benefit plan maintained by the carrier that: (1) is qualified under IRC section 401(a); and (2) was terminated or became subject to the benefit accrual and other restrictions applicable to plans maintained by commercial passenger airlines pursuant to paragraphs 402(b)(2) and (3) of the PPA.

The provision also requires certain information reporting to the Secretary of Treasury and qualified airline employees with respect to airline payment amounts within 90 days of such payment (or if later, within 90 days of enactment of this provision).

WORKER, RETIREE, AND EMPLOYER RECOVERY ACT OF 2008 (WRERA), (PL 110-458, DECEMBER 23, 2008)

Effective Date

The proposal is effective with respect to contributions to a Roth IRA made after December 23, 2008, with respect to airline payment amounts paid before, on, or after December 23, 2008.

California Law (R&TC sections 17501 and 17551)

California conforms by reference to Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of Part I, relating to pension, profit-sharing, stock bonus plans, etc. (IRC sections 401 through 420) and Part II, relating to certain stock options (IRC sections 421 through 424), in R&TC section 17501. Additionally, California conforms by reference to IRC 457, relating to deferred compensation plans of state and local governments and tax-exempt organizations, in R&TC section 17551.

However, except for increases in the maximum amount of elective deferrals, R&TC sections 17501(b) and 17551(c) specifically provide that federal changes to Part I of Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation (IRC sections 401 through 420, inclusive), and IRC section 457, relating to deferred compensation plans of state and local governments and tax-exempt organizations, automatically apply without regard to taxable year to the same extent as applicable for federal income tax purposes and thus adopt all changes made to those IRC sections without regard to the “specified date” contained in R&TC section 17024.5.

Thus, the federal uncodified changes relating to Roth IRAs automatically apply under California law without regard to taxable year to the same extent as applicable for federal income tax purposes.

Impact on California Revenue

No conformity revenue impact because California automatically conforms to this federal change in WRERA. Any revenue impact would be considered baseline.

WORKER, RETIREE, AND EMPLOYER RECOVERY ACT OF 2008 (WRERA), (PL 110-458, DECEMBER 23, 2008)

Section	Section Title
126	Determination of Asset Value for Special Airline Funding Rules

Background

The PPA provides for special minimum funding rules for certain eligible plans. For purposes of the rules, an eligible plan is a single-employer defined benefit pension plan sponsored by an employer that is a commercial passenger airline or the principal business of which is providing catering services to a commercial passenger airline.

The plan sponsor of an eligible plan may make one of two alternative elections. In the case of a plan that meets certain benefit accrual and benefit increase restrictions, an election allowing a 17-year amortization of the plan's unfunded liability is available, with the minimum required contribution being determined under a special method. A plan that does not meet such requirements may elect to use a 10-year amortization period in amortizing the plan's shortfall amortization base for the first taxable year beginning in 2008.

The employer may select either a plan year beginning in 2006 or 2007 as the first plan year to which the 17-year amortization period election applies. Under the special method applicable to a plan that elects the 17-year amortization period, the minimum required contribution for any applicable plan year during the amortization period is the amount required to amortize the plan's unfunded liability, determined as of the first day of the plan year, in equal annual installments over the remaining amortization period. For this purpose, the amortization period is the 17-plan-year period beginning with the first applicable plan year. Thus, the annual amortization amount is redetermined each year, based on the plan's unfunded liability at that time and the remainder of the amortization period. For any plan years beginning after the end of the amortization period, the plan is subject to the generally applicable minimum funding rules (as provided under the PPA, including the benefit limitations applicable to underfunded plans).

For purposes of the 17-year amortization period election, a plan's unfunded liability is the unfunded accrued liability under the plan, determined under the unit credit funding method and a rate of interest of 8.85 percent is used in determining the plan's accrued liability. In addition, the value of plan assets used must be the fair market value.

New Federal Law (Uncodified Act section 126 of WRERA)

Under the provision, the value of plan assets for purposes of determining the minimum required contribution of an eligible employer under the 17-year amortization period election may be determined under a valuation method that is permissible under the minimum funding rules applicable to a single-employer defined benefit pension plan that is not sponsored by an eligible employer. Thus, the value of plan assets may be determined as fair market value or on the basis of the averaging method specified in IRC section 430(g)(3) and section 303(g)(3) of ERISA.

WORKER, RETIREE, AND EMPLOYER RECOVERY ACT OF 2008 (WRERA), (PL 110-458, DECEMBER 23, 2008)

Effective Date

The provision is effective for plan years beginning after December 31, 2007.

California Law (None)

ERISA Preemption

Federal ERISA provisions apply to all pension plans in California. There are no California law provisions because federal law precludes state level administration of these plans.

Impact on California Revenue

ERISA changes result in no conformity revenue impact. Any revenue impact would be considered baseline.

Section	Section Title
127	Modification of Penalty for Failure to File Partnership Returns

Background

A partnership generally is treated as a pass-through entity. Income earned by a partnership, whether distributed or not, is taxed to the partners. Distributions from the partnership generally are tax-free. The items of income, gain, loss, deduction, or credit of a partnership generally are taken into account by a partner as allocated under the terms of the partnership agreement. If the agreement does not provide for an allocation, or the agreed allocation does not have substantial economic effect, then the items are to be allocated in accordance with the partners' interests in the partnership. To prevent double taxation of these items, a partner's basis in its interest is increased by its share of partnership income (including tax-exempt income), and is decreased by its share of any losses (including nondeductible losses).

Under present law, a partnership is required to file a tax return for each taxable year. The partnership's tax return is required to include the names and addresses of the individuals who would be entitled to share in the taxable income if distributed and the amount of the distributive share of each individual. In addition to applicable criminal penalties, present law imposes an assessable civil penalty for the failure to timely file a partnership return. For returns required to be filed after December 20, 2007,[564] the penalty generally is $85 per partner for each month (or fraction of a month) that the failure continues, up to a maximum of 12 months for returns required to be filed after December 20, 2007.

New Federal Law (IRC section 6698)

Under the provision, the penalty for failure to file partnership returns is increased to $89 per partner for each month (or fraction of a month) that the failure continues, up to a maximum of 12 months.

Effective Date

The provision applies to returns required to be filed after December 31, 2008.

California Law (R&TC sections 19172, 19131 and 19132)

California does not conform to IRC section 6698 by reference, but instead has its own stand-alone rules for the failure-to-file partnership return penalties in R&TC section 19172. The penalty is $10 per partner for each month (or fraction of a month) that the failure continues, up to a maximum of five months.[565]

Additionally, a Limited Liability Company (LLC) that elects to be classified as a partnership is subject to an $800 annual minimum tax, plus an LLC fee based on income. As such, an LLC that elects to be classified as a partnership is subject to: (1) the failure-to-file partnership return penalty under R&TC section19172; (2) the failure-to-file penalty under R&TC section 19131, which is a penalty of 5 percent of the tax for each month (or fraction thereof) during which the failure continues, up to a maximum of 25 percent of the tax; and (3) the failure-to-pay-tax penalty under R&TC section 19132, which is 5% of the unpaid tax, plus 0.5% of the remaining tax unpaid tax per month, up to a maximum of 25%. (Note the penalties under R&TC sections 19131 and 19132 overlap; that is, the penalty for failure to pay tax under R&TC section 19132 is not assessed to the extent that the penalty for failure to file a return under R&TC section 19131 is assessed for the same taxable year.)

[564] The penalty was increased to $85 per partner per month (or fraction of a month) that the failure continues, up to a maximum of 12 months, in the Mortgage Forgiveness Debt Relief Act of 2007 (MFDRA)(Public Law 110-142). Prior to that Act, the penalty was $50 per partner per month (or fraction of a month) that the failure continues, up to a maximum of 5 months.

[565] The California penalty of $10 per partner per month (or fraction of a month) that the failure continues, up to a maximum of 5 months, is 20% of the federal penalty prior to the enactment of the MFDRA (Public Law 110-142).

WORKER, RETIREE, AND EMPLOYER RECOVERY ACT OF 2008 (WRERA), (PL 110-458, DECEMBER 23, 2008)

Impact on California Revenue

Estimated Revenue Impact of Modification of Penalty for Failure to File Partnership Returns For Returns Filed After December 31, 2008 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
$2,100,000	$1,900,000	$2,000,000

Estimates are based on a proration of federal projections developed for the Mortgage Forgiveness Debt Relief Act of 2007 and the Worker, Retiree, and Employer Recovery Act of 2008, adjusted to reflect California differences. Estimates assume that the state penalty would be equal to 20 percent of the federal penalty.

Section	Section Title
128	Modification of Penalty for Failure to File S Corporation Returns

Background

In general, an S corporation is not subject to corporate-level income tax on its items of income and loss. Instead, an S corporation passes through its items of income and loss to its shareholders. The shareholders take into account separately their shares of these items on their individual income tax returns.

Under present law, S corporations are required to file a tax return for each taxable year. The S corporation's tax return is required to include the following: the names and addresses of all persons owning stock in the corporation at any time during the taxable year; the number of shares of stock owned by each shareholder at all times during the taxable year; the amount of money and other property distributed by the corporation during the taxable year to each shareholder and the date of such distribution; each shareholder's pro rata share of each item of the corporation for the taxable year; and such other information as the Secretary may require.

Present law imposes an assessable monthly penalty for any failure to timely file an S corporation return or any failure to provide the information required to be shown on such a return. For returns required to be filed after December 20, 2007,[566] the penalty is $85 times the number of shareholders in the S corporation during any part of the taxable year for which the return was required, for each month (or a fraction of a month) during which the failure continues, up to a maximum of 12 months.

New Federal Law (IRC section 6699)

Under the provision, the penalty for failure to file S corporation returns is increased to $89 per shareholder for each month (or fraction of a month) that the failure continues, up to a maximum of 12 months.

Effective Date

The provision applies to returns required to be filed after December 31, 2008.

California Law (R&TC sections 19131 and 19132)

California does not conform to IRC section 6699 by reference, but instead has its own stand-alone rules for the failure to file S corporation return penalty in R&TC 19131. The penalty is 5 percent of the tax for each month (or fraction thereof) during which the failure continues, up to a maximum of 25 percent of the tax.[567]

Additionally, an S corporation is subject to the failure-to-pay-tax penalty under R&TC section 19132, which is 5 percent of the unpaid tax, plus 0.5 percent of the remaining tax unpaid tax per month, up to a maximum of 25 percent. (Note the penalties under R&TC sections 19131 and 19132 overlap; that is, the penalty for failure to pay tax under R&TC section 19132 is not assessed to the extent that the penalty for failure to file a return under R&TC section 19131 is assessed for the same taxable year.)

[566] This was a new penalty enacted in the Mortgage Forgiveness Debt Relief Act of 2007 (MFDRA)(Public Law 110-142). Prior to that Act, there was no comparable penalty on S corporation shareholders for failure to file S corporation returns.

[567] Like federal law prior to the enactment of the MFDRA (Public Law 110-142), California does not impose a per-shareholder penalty for failure to file S corporation returns.

Impact on California Revenue

Estimated Revenue Impact of Modification of Penalty for Failure to File S Corporation Returns For Returns Filed After December 31, 2008 Enactment Assumed After June 30, 2009		
2009 -10	2010 -11	2011 -12
$1,400,000	$1,400,000	$1,500,000

Estimates are based on a proration of federal projections developed for both the Mortgage Forgiveness Debt Relief Act of 2007 and the Worker, Retiree and Employer Recovery Act of 2008, adjusted to reflect California differences. Estimates assume that the state penalty would be equal to 20 percent of the federal penalty.

TITLE II – PENSION PROVISIONS RELATING TO ECONOMIC CRISIS

Section	Section Title
201	Temporary Waiver of Required Minimum Distribution Rules for Certain Retirement Plans and Accounts

Background

Required minimum distributions

Employer-provided qualified retirement plans and individual retirement accounts and annuities (IRAs) are subject to required minimum distribution rules. A qualified retirement plan for this purpose means a tax-qualified plan described in IRC section 401(a) (such as a defined benefit pension plan or an IRC section 401(k) plan), employee retirement annuities described in IRC section 403(a), tax-sheltered annuities described in IRC section 403(b), and a plan described in IRC section 457(b) that is maintained by a governmental employer.[568] An employer-provided qualified retirement plan that is a defined contribution plan is a plan which provides: (1) an individual account for each participant; and (2) for benefits based on the amount contributed to the participant's account, and any income, expenses, gains, losses, and forfeitures of accounts of other participants which may be allocated to such participant's account.[569]

[568] The required minimum distribution rules also apply to IRC section 457(b) plans maintained by tax-exempt employers other than governmental employers.
[569] IRC section 414(i).

Required minimum distributions generally must begin by April 1 of the calendar year following the later of the calendar year in which the individual (employee or IRA owner) reaches age 70½. However, in the case of an employer-provided qualified retirement plan, the required minimum distribution date for an individual who is not a 5-percent owner of the employer maintaining the plan is delayed to April 1 of the year following the year in which the individual retires.

For IRAs and defined contributions plans, the required minimum distribution for each year generally is determined by dividing the account balance as of the end of the prior year by a distribution period,[570] generally a number in the uniform lifetime table.[571] This table is based on joint life expectancies of the individual and a hypothetical beneficiary 10 years younger than the individual. For an individual with a spouse as designated beneficiary who is more than 10 years younger (and thus the number of years in the couple's joint life expectancy is greater than the uniform life time table), the joint life expectancy of the couple is used. There are special rules in the case of annuity payments from an insurance contract.

If an individual dies on or after the individual's required beginning date, the required minimum distribution is also determined by dividing the account balance as of the end of the prior year by a distribution period. The distribution period is equal to the remaining years of the beneficiary's life expectancy or, if there is no designated beneficiary, a distribution period equal to the remaining years of the deceased individual's single life expectancy, using the age of the deceased individual in the year of death.[572]

In the case of an individual who dies before the individual's required beginning date, there are two methods for satisfying the after death required minimum distribution rules, the life-expectancy rule or the five-year rule. Under the life-expectancy rule, annual required minimum distributions must begin no later than December 31 of the calendar year immediately following the calendar year in which the individual died. This rule is only available if the designated beneficiary is an individual (e.g., not the individual's estate or a charity). If the designated beneficiary is the individual's spouse, commencement of distributions can be delayed until December 31 of the calendar year in which the deceased individual would have attained age 70½. The required minimum distribution for each year is also determined by dividing the account balance as of the end of the prior year by a distribution period, which is determined by reference to the beneficiary's life expectancy.[573] Under the five-year rule, the individual's entire account must be distributed no later than December 31 of the calendar year containing the fifth anniversary of the individual's death.[574]

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[570] Treas. Reg. sec. 1.401(a)(9)-5.
[571] Treas. Reg. sec. 1.401(a)(9)-9.
[572] Treas. Reg. sec. 1.401(a)(9)-5, A-5(a).
[573] Treas. Reg. sec. 1.401(a)(9)-5, A-5(b).
[574] Treas. Reg. sec. 1.401(a)(9)-3, Q&A 1, 2.

A special after-death rule applies for an IRA if the beneficiary of the IRA is the surviving spouse. The surviving spouse is permitted to choose to calculate required minimum distributions while the spouse is alive, and after the spouse's death, as though the spouse is the IRA owner, rather than a beneficiary.

Roth IRAs are not subject to the minimum distribution rules during the IRA owner's lifetime. However, Roth IRAs are subject to the post-death minimum distribution rules that apply to traditional IRAs. For Roth IRAs, the IRA owner is treated as having died before the individual's required beginning date. Thus only the life-expectancy rule and the five-year rule apply.

Failure to make a required minimum distribution triggers a 50-percent excise tax, payable by the individual or the individual's beneficiary. The tax is imposed during the taxable year that begins with or within the calendar year during which the distribution was required.[575] The tax may be waived if the distribution did not occur because of reasonable error and reasonable steps are taken to remedy the violation.[576]

Eligible rollover distributions

With certain exceptions, distributions from an employer-provided qualified retirement plan are eligible to be rolled over tax free into another employer-provided qualified retirement plan or an IRA. This can be achieved by contributing the amount of the distribution to the other plan or IRA within 60 days of the distribution, or by a direct payment by the plan to the other plan or IRA (referred to as a "direct rollover"). Distributions that are not eligible for rollover include: (1) any distribution that is one of a series of periodic payments generally for a period of 10 years or more (or, if a shorter period, certain life expectancies) and (2) any distribution to the extent that the distribution is a required minimum distribution.[577]

For any distribution that is eligible for rollover, an employer-provided tax-qualified retirement plan must offer the distributee the right to have the distribution made in a direct rollover[578] and, before making the distribution, the plan administrator must provide the distributee with a written explanation of the direct rollover right and related tax consequences.[579] If a distributee does not choose to have the distribution made in a direct rollover, the distribution is generally subject to mandatory 20-percent income tax withholding.[580]

[575] IRC section 4974(a).
[576] IRC section 4974(d).
[577] IRC section 402(c)(4). Distributions that are not eligible rollover distributions also include distributions made upon hardship of the employee and any qualified disaster relief distribution (within the meaning of IRC section 72(t)(2)(G)).
[578] IRC section 401(a)(31).
[579] IRC section 402(f).
[580] IRC section 3405(c). This mandatory withholding does not apply to a distributee that is a beneficiary other than a surviving spouse of an employee.

WORKER, RETIREE, AND EMPLOYER RECOVERY ACT OF 2008 (WRERA), (PL 110-458, DECEMBER 23, 2008)

New Federal Law (IRC sections 401 and 402)

Under the provision, no minimum distribution is required for calendar year 2009 from individual retirement plans and employer-provided qualified retirement plans that are defined contribution plans (within the meaning of IRC section 414(i)). Thus any annual minimum distribution for 2009 from these plans required under current law, otherwise determined by dividing the account balance by a distribution period, is not required to be made. The next required minimum distribution would be for calendar year 2010. This relief applies to life-time distributions to employees and IRA owners and after-death distributions to beneficiaries.

In the case of an individual whose required beginning date is April 1, 2010 (e.g., the individual attained age 70½ in 2009), the first year for which a minimum distribution is required under current law is 2009. Under the provision, no distribution is required for 2009 and, thus, no distribution will be required to be made by April 1, 2010. However, the provision does not change the individual's required beginning date for purposes of determining the required minimum distribution for calendar years after 2009. Thus, for an individual whose required beginning date is April 1, 2010, the required minimum distribution for 2010 will be required to be made no later than the last day of calendar year 2010. If the individual dies on or after April 1, 2010, the required minimum distribution for the individual's beneficiary will be determined using the rule for death on or after the individual's required beginning date.

If the five-year rule applies to an account with respect to any decedent, under the provision, the five-year period is determined without regard to calendar year 2009. Thus, for example, for an account with respect to an individual who died in 2007, under the provision, the five-year period ends in 2013 instead of 2012.

If all or a portion of a distribution during 2009 is an eligible rollover distribution because it is no longer a required minimum distribution under this provision, the distribution shall not be treated as an eligible rollover distribution for purposes of the direct rollover requirement and notice and written explanation of the direct rollover requirement, as well as the mandatory 20-percent income tax withholding for eligible rollover distributions, to the extent the distribution would have been a required minimum distribution for 2009 absent this provision. Thus, for example, if an employer-provided qualified retirement plan distributes an amount to an individual during 2009 that is an eligible rollover distribution but would have been a required minimum distribution for 2009, the plan is permitted but not required to offer the employee a direct rollover of that amount and provide the employee with a written explanation of the requirement. If the employee receives the distribution, the distribution is not subject to mandatory 20-percent income tax withholding, and the employee can roll over the distribution by contributing it to an eligible retirement plan within 60 days of the distribution.

Effective Date

The provision is effective for calendar years beginning after December 31, 2008. However, the provision does not apply to any required minimum distribution for 2008 that is permitted to be made in 2009 by reason of an individual's required beginning date being April 1, 2009.

California Law (R&TC sections 17501 and 17551)

California conforms by reference to Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of Part I, relating to pension, profit-sharing, stock bonus plans, etc. (IRC sections 401 through 420) and Part II, relating to certain stock options (IRC sections 421 through 424), in R&TC section 17501. Additionally, California conforms by reference to IRC 457, relating to deferred compensation plans of state and local governments and tax-exempt organizations, in R&TC section 17551.

However, except for increases in the maximum amount of elective deferrals, R&TC sections 17501(b) and 17551(c) specifically provide that federal changes to Part I of Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation (IRC sections 401 through 420, inclusive), and IRC section 457, relating to deferred compensation plans of state and local governments and tax-exempt organizations, automatically apply without regard to taxable year to the same extent as applicable for federal income tax purposes and thus adopt all changes made to those IRC sections without regard to the "specified date" contained in R&TC section 17024.5.

Thus, the federal changes to IRC section 401, relating to qualified pension, profit-sharing and stock bonus plans, and to IRC section 402, relating to taxability of beneficiary of employees' trust, automatically apply under California law without regard to taxable year to the same extent as applicable for federal income tax purposes.

Impact on California Revenue

Baseline. The baseline revenue loss is estimated to be -$150 million in 2009-10, -$1.1 million in 2010-11, and -$350,000 in 2011-12.

Section	Section Title
202	Transition Rule Clarification

Background

The PPA modified the minimum funding rules for single-employer defined benefit pension plans, generally for plan years beginning after December 31, 2007. Under the PPA, the minimum required contribution to a single-employer defined benefit pension plan for a plan year generally depends on a comparison of the value of the plan's assets with the plan's funding target and target normal cost. A plan's funding target is the present value of all benefits accrued or earned as of the beginning of the plan year and a plan's target normal cost for a plan year is the present value of benefits expected to accrue or be earned during the plan year. In general, a plan has a funding shortfall if the plan's funding target for the year exceeds the value of the plan's assets, and a shortfall amortization base is generally required to be established for a plan year if the plan has a funding shortfall for a plan year.

Under a special rule, a shortfall amortization base does not have to be established for a plan year if the value of a plan's assets[581] is at least equal to the plan's funding target for the plan year. For purposes of the special rule, a transition rule applies for plan years beginning after 2007 and before 2011. The transition rule does not apply to a plan that: (1) is not in effect for 2007, or (2) was subject to certain deficit reduction contribution rules for 2007 (i.e., a plan covering more than 100 participants and with a funded current liability below a specified threshold).

Under the transition rule, a shortfall amortization base does not have to be established for a plan year during the transition period if the value of plan assets[582] for the plan year is at least equal to the applicable percentage of the plan's funding target for the year. The applicable percentage is 92 percent for 2008, 94 percent for 2009, and 96 percent for 2010. However, the transition rule does not apply to a plan for any plan year after 2008 unless, for each preceding plan year after 2007, the plan's shortfall amortization base was zero (i.e., the plan was eligible for the special rule each preceding year).

New Federal Law (ERISA section 303 and IRC section 430)

The provision extends the transition rule to plan year beginning after 2008 even if, for each preceding plan year after 2007, the plan's shortfall amortization base was not zero.

The provision provides that in determining a plan's funding shortfall for the year only the applicable percentage of the funding target is taken into account, rather than the entire funding target. The applicable percentage is 92 percent for 2008, 94 percent for 2009, and 96 percent for 2010.[583] Thus, for example, if a plan was funded at 91 percent for 2008, the funding shortfall for 2008 would be 1 percent and the plan would be able to continue to use the transition rule in 2009. The plan would then need to fund to 94 percent, rather than 100 percent, in 2009.

Effective Date

The provision is effective as if included in the PPA.

[581] Plan assets are reduced by any prefunding balance, but only if the employer elects to use any portion of the prefunding balance to reduce required contributions for the year.
[582] Plan assets are reduced by any prefunding balance, but only if the employer elects to use the prefunding balance to reduce required contributions for the year.
[583] IRC section 430(c)(5)(B).

WORKER, RETIREE, AND EMPLOYER RECOVERY ACT OF 2008 (WRERA), (PL 110-458, DECEMBER 23, 2008)

California Law (None)

ERISA Preemption

Federal ERISA provisions apply to all pension plans in California. There are no California law provisions because federal law precludes state level administration of these plans. Thus, the technical corrections automatically apply to California.

Impact on California Revenue

ERISA Preemption

ERISA changes result in no conformity revenue impact. Any revenue impact would be considered baseline. Baseline revenue gains are estimated to be $41,700,000 in 2008-09, $18,400,000 in 2009-10, and $4,900,000 in 2010-11.

Section	Section Title
203	Temporary Modification of Application of Limitation on Benefit Accruals

Background

A single-employer defined benefit pension plan is required to comply with certain funding-based limits described in IRC section 436 on benefits and benefit accruals.[584] These limits were added by the PPA and are generally applicable to plan years beginning after December 31, 2007. Among the limitations is the requirement that if the plan's adjusted funding target attainment percentage is less than 60 percent for a plan year, all future benefit accruals under the plan must cease as of the valuation date for the plan year ("future benefit accrual limitation"). This future benefit accrual limitation applies only for purposes of the accrual of benefits; service during the freeze period is counted for other purposes. For example, if accruals are frozen pursuant to the limitation, service performed during the freeze period still counts for vesting purposes. Written notice must be provided to plan participants and beneficiaries if an IRC section 436 limitation provision applies to a plan.

[584] IRC sections 401(a)(29) and 436. Parallel rules apply under ERISA.

The term “funding target attainment percentage” is defined in the same way as under the minimum funding rules applicable to single-employer defined benefit pension plans, and is the ratio, expressed as a percentage, that the value of the plan’s assets (generally reduced by any funding standard carryover balance and prefunding balance) bears to the plan’s funding target for the year (determined without regard to a whether a plan is in at-risk status under the minimum funding rules). A plan’s adjusted funding target attainment percentage is determined in the same way, except that the value of the plan’s assets and the plan’s funding target are both increased by the aggregate amount of purchases of annuities for employees other than highly compensated employees made by the plan during the two preceding plan years. Special rules apply for determining a plan’s adjusted funding target attainment percentage in the case of a fully funded plan and for plan years beginning in 2007 and before 2011.

The future benefit accrual limitation ceases to apply with respect to any plan year, effective as of the first day of the plan year, if the plan sponsor makes a contribution (in addition to any minimum required contribution for the plan year) equal to the amount sufficient to result in an adjusted funding target attainment percentage of 60 percent. The future benefit accrual limitation also does not apply for the first five years a plan (or a predecessor plan) is in effect.

If a limitation on future benefit accruals ceases to apply to a plan, all such benefit accruals resume, effective as of the day following the close of the period for which the limitation applies. In addition, IRC section 436 provides that nothing in the rules is to be construed as affecting a plan’s treatment of benefits which would have been paid or accrued but for the limitation.

New Federal Law (Uncodified section 203 of WRERA)

Under the provision, in the case of the first plan year beginning during the period of October 1, 2008, through September 30, 2009, the future benefit accrual limitation of IRC section 436 is applied by substituting the plan’s adjusted funding target attainment percentage for the preceding plan year for the percentage for such first plan year in the period. Thus, the future benefit accrual limitation of IRC section 436 is avoided if the plan’s adjusted funding target attainment percentage for the preceding plan year is 60 percent or greater. The provision is not intended to place a plan in a worse position with respect to the future benefit accrual limitation of IRC section 436 than would apply absent the provision. Thus, the provision does not apply if the adjusted funding target attainment percentage for the current plan year is greater than the preceding year.

Effective Date

The provision is effective for the first plan year beginning during the period beginning on October 1, 2008, and ending on September 30, 2009.

WORKER, RETIREE, AND EMPLOYER RECOVERY ACT OF 2008 (WRERA), (PL 110-458, DECEMBER 23, 2008)

California Law (None)

ERISA Preemption

Federal ERISA provisions apply to all pension plans in California. There are no California law provisions because federal law precludes state level administration of these plans.

Impact on California Revenue

ERISA changes result in no conformity revenue impact. Any revenue impact would be considered baseline.

Section	Section Title
204	Temporary Delay of Designation of Multiemployer Plans as in Endangered or Critical Status

Background

In general

Under IRC section 432,[585] additional funding rules apply to a multiemployer defined benefit pension plan that is in endangered or critical status. These rules require the adoption of and compliance with (1) a funding improvement plan in the case of a multiemployer plan in endangered status, and (2) a rehabilitation plan in the case of a multiemployer plan in critical status. In the case of a plan in critical status, additional required contributions and benefit reductions apply and employers are relieved of liability for minimum required contributions under the otherwise applicable funding rules, provided that a rehabilitation plan is adopted and followed.

IRC section 432 is effective for plan years beginning after 2007. The additional funding rules for plans in endangered or critical status do not apply to plan years beginning after December 31, 2014. If a plan is operating under a funding improvement or rehabilitation plan for its last year beginning before January 1, 2015, the plan shall continue to operate under such funding improvement or rehabilitation plan during any period after December 31, 2014, that such funding improvement or rehabilitation plan is in effect.

[585] Parallel rules apply under ERISA.

Annual certification of status; notice; annual reports

Not later than the 90th day of each plan year, the plan actuary must certify to the Secretary of the Treasury and to the plan sponsor whether or not the plan is in endangered or critical status for the plan year. In the case of a plan that is in a funding improvement or rehabilitation period, the actuary must certify whether or not the plan is making scheduled progress in meeting the requirements of its funding improvement or rehabilitation plan.

Failure of the plan's actuary to certify the status of the plan is treated as a failure to file the annual report (thus, an ERISA penalty of up to $1,100 per day applies).

If a plan is certified to be in endangered or critical status, notification of the endangered or critical status must be provided within 30 days after the date of certification to the participants and beneficiaries, the bargaining parties, the PBGC and the Secretary of Labor.

Endangered status

Definition of endangered status

A multiemployer plan is in endangered status if the plan is not in critical status and, as of the beginning of the plan year, (1) the plan's funded percentage for the plan year is less than 80 percent, or (2) the plan has an accumulated funding deficiency for the plan year or is projected to have an accumulated funding deficiency in any of the six succeeding plan years (taking into account amortization extensions). A plan's funded percentage is the percentage of plan assets over accrued liability of the plan. A plan that meets the requirements of both (1) and (2) is treated as in seriously endangered status.

Information to be provided to bargaining parties

Within 30 days of the adoption of a funding improvement plan, the plan sponsor must provide to the bargaining parties schedules showing revised benefit structures, revised contribution structures, or both, which, if adopted, may reasonably be expected to enable the multiemployer plan to meet the applicable benchmarks in accordance with the funding improvement plan. The applicable benchmarks are the requirements of the funding improvement plan (discussed below).

Funding improvement plan and funding improvement period

In the case of a multiemployer plan in endangered status, a funding improvement plan must be adopted within 240 days following the deadline for certifying a plan's status.[586] A funding improvement plan is a plan which consists of the actions, including options or a range of options, to be proposed to the bargaining parties, formulated to provide, based on reasonably

[586] This requirement applies for the initial determination year (i.e., the first plan year that the plan is in endangered status).

anticipated experience and reasonable actuarial assumptions, for the attainment by the plan of certain requirements.

The funding improvement plan must provide that during the funding improvement period, the plan will have a certain required increase in the funded percentage and no accumulated funding deficiency for any plan year during the funding improvement period, taking into account amortization extensions (the “applicable benchmarks”). In the case of a plan that is not in seriously endangered status, under the applicable benchmarks, the plan’s funded percentage must increase such that the funded percentage as of the close of the funding improvement period equals or exceeds a percentage equal to the sum of: (1) the funded percentage at the beginning of the period, plus (2) 33 percent of the difference between 100 percent and the percentage in (1). Thus, the difference between 100 percent and the plan’s funded percentage at the beginning of the period must be reduced by at least one-third during the funding improvement period.

The funding improvement period is the 10-year period beginning on the first day of the first plan year beginning after the earlier of: (1) the second anniversary of the date of adoption of the funding improvement plan, or (2) the expiration of collective bargaining agreements that were in effect on the due date for the actuarial certification of endangered status for the initial determination year and covering, as of such date, at least 75 percent of the plan’s active participants. The period ends if the plan is no longer in endangered status or if the plan enters critical status.

In the case of a plan in seriously endangered status that is funded 70 percent or less, under the applicable benchmarks, the difference between 100 percent and the plan’s funded percentage at the beginning of the period must be reduced by at least one-fifth during the funding improvement period. In the case of such plans, a 15-year funding improvement period is used. Special rules apply in the case of a seriously endangered plan that is more than 70 percent funded as of the beginning of the initial determination year.

Certain restrictions apply during the period beginning on the date of certification for the initial determination year and ending on the day before the first day of the funding improvement period and during the funding improvement period (e.g., upon the adoption of a funding improvement plan, the plan may not be amended to be inconsistent with the funding improvement plan).

Excise taxes

If the funding improvement plan requires an employer to make contributions to the plan, an excise tax applies upon the failure of the employer to make such required contributions within the time required under the plan. The amount of tax is equal to the amount of the required contribution the employer failed to make in a timely manner.

In the case of a plan in endangered status, which is not in seriously endangered status, a civil penalty of $1,100 a day applies for the failure of the plan to meet the applicable benchmarks by the end of the funding improvement period.

In the case of a plan in seriously endangered status, an excise tax applies for the failure to meet the benchmarks by the end of the funding improvement period. In such case, an excise tax applies based on the greater of: (1) the amount of the contributions necessary to meet such benchmarks, or (2) the plan's accumulated funding deficiency. The excise tax applies for each succeeding plan year until the benchmarks are met.

In the case of a failure which is due to reasonable cause and not to willful neglect, the Secretary of the Treasury may waive all or part of the excise tax on employers failing to make required contributions and the excise tax for failure to achieve the applicable benchmarks. The party against whom the tax is imposed has the burden of establishing that the failure was due to reasonable cause and not willful neglect.

Critical status

Definition of critical status

A multiemployer plan is in critical status for a plan year if as of the beginning of the plan year:

1. The funded percentage of the plan is less than 65 percent and the sum of (A) the market value of plan assets, plus (B) the present value of reasonably anticipated employer and employee contributions for the current plan year and each of the six succeeding plan years (assuming that the terms of the collective bargaining agreements continue in effect) is less than the present value of all benefits projected to be payable under the plan during the current plan year and each of the six succeeding plan years (plus administrative expenses),
2. (A) The plan has an accumulated funding deficiency for the current plan year, not taking into account any amortization extension, or (B) the plan is projected to have an accumulated funding deficiency for any of the three succeeding plan years (four succeeding plan years if the funded percentage of the plan is 65 percent or less), not taking into account any amortization extension,
3. (A) The plan's normal cost for the current plan year, plus interest for the current plan year on the amount of unfunded benefit liabilities under the plan as of the last day of the preceding year, exceeds the present value of the reasonably anticipated employer contributions for the current plan year, (B) the present value of nonforfeitable benefits of inactive participants is greater than the present value of nonforfeitable benefits of active participants, and (C) the plan has an accumulated funding deficiency for the current plan year, or is projected to have an accumulated funding deficiency for any of the four succeeding plan years (not taking into account amortization period extensions), or

4. The sum of (A) the market value of plan assets, plus (B) the present value of the reasonably anticipated employer contributions for the current plan year and each of the four succeeding plan years (assuming that the terms of the collective bargaining agreements continue in effect) is less than the present value of all benefits projected to be payable under the plan during the current plan year and each of the four succeeding plan years (plus administrative expenses).

Additional contributions during critical status

In the case of a plan in critical status, the provision imposes an additional required contribution ("surcharge") on employers otherwise obligated to make a contribution in the initial critical year, i.e., the first plan year for which the plan is in critical status. The amount of the surcharge is five percent of the contribution otherwise required to be made under the applicable collective bargaining agreement. The surcharge is 10 percent of contributions otherwise required in the case of succeeding plan years in which the plan is in critical status. The surcharge applies 30 days after the employer is notified by the plan sponsor that the plan is in critical status and the surcharge is in effect. The surcharges are due and payable on the same schedule as the contributions on which the surcharges are based. Failure to make the surcharge payment is treated as a delinquent contribution. The surcharge is not required with respect to employees covered by a collective bargaining agreement (or other agreement pursuant to which the employer contributes), beginning on the effective date of a collective bargaining agreement (or other agreement) that includes terms consistent with a schedule presented by the plan sponsor. The amount of the surcharge may not be the basis for any benefit accrual under the plan.

Reductions to previously earned benefits

Notwithstanding the anti-cutback rules that otherwise apply under the IRC and ERISA, the plan sponsor may generally make any reductions to adjustable benefits[587] which the plan sponsor deems appropriate, based upon the outcome of collective bargaining over the schedules required to be provided by the plan sponsor (as discussed below).

The plan sponsor must include in the schedules provided to the bargaining parties an allowance for funding the benefits of participants with respect to whom contributions are not currently required to be made, and shall reduce their benefits to the extent permitted under the IRC and ERISA and considered appropriate by the plan sponsor based on the plan's then current overall funding status.

[587] Adjustable benefits means (1) benefits, rights, and features under the plan, including postretirement death benefits, 60-month guarantees, disability benefits not yet in pay status, and similar benefits; (2) any early retirement benefit or retirement-type subsidy and any benefit payment option (other than the qualified joint-and-survivor annuity); and (3) benefit increase that would not be eligible for PBGC guarantee on the first day of the initial critical year because the increases were adopted (or, if later, took effect) less than 60 months before such first day.

Notice of any reduction of adjustable benefits must be provided at least 30 days before the general effective date of the reduction for all participants and beneficiaries. Benefits may not be reduced until the notice requirement is satisfied. Notice must be provided to (1) plan participants and beneficiaries; (2) each employer who has an obligation to contribute under the plans; and (3) each employee organization which, for purposes of collective bargaining, represents plan participants employed by such employer.

Notice to bargaining parties

Within 30 days after adoption of the rehabilitation plan, the plan sponsor must provide to the bargaining parties schedules showing revised benefit structures, revised contribution structures, or both which, if adopted, may reasonably be expected to enable the multiemployer plan to emerge from critical status in accordance with the rehabilitation plan.[588]

The schedules must reflect reductions in future benefit accruals and adjustable benefits and increases in contributions that the plan sponsor determined are reasonably necessary to emerge from critical status. One schedule must be designated as the default schedule and must assume no increases in contributions other than increases necessary to emerge from critical status after future benefit accruals and other benefits (other than benefits the reduction or elimination of which are not permitted under the anti-cutback rules) have been reduced. The plan sponsor may also provide additional information as appropriate.

Rehabilitation plan

If a plan is in critical status for a plan year, the plan sponsor must adopt a rehabilitation plan within 240 days following the required date for the actuarial certification of critical status.[589]

A rehabilitation plan is a plan which consists of actions, including options or a range of options to be proposed to the bargaining parties, formulated, based on reasonable anticipated experience and reasonable actuarial assumptions, to enable the plan to cease to be in critical status by the end of the rehabilitation period and may include reductions in plan expenditures (including plan mergers and consolidations), reductions in future benefits accruals or increases in contributions, if agreed to by the bargaining parties, or any combination of such actions.

A rehabilitation plan must provide annual standards for meeting the requirements of the rehabilitation. The plan must also include the schedules required to be provided to the bargaining parties.

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[588] A schedule of contribution rates provided by the plan sponsor and relied upon by bargaining parties in negotiating a collective bargaining agreement must remain in effect for the duration of the collective bargaining agreement.

[589] The requirement applies with respect to the initial critical year.

If the plan sponsor determines that, based on reasonable actuarial assumptions and upon exhaustion of all reasonable measures, the plan cannot reasonably be expected to emerge from critical status by the end of the rehabilitation period, the plan must include reasonable measures to emerge from critical status at a later time or to forestall possible insolvency. In such case, the plan must set forth alternatives considered, explain why the plan is not reasonably expected to emerge from critical status by the end of the rehabilitation period, and specify when, if ever, the plan is expected to emerge from critical status in accordance with the rehabilitation plan.

Rehabilitation period

The rehabilitation period is the 10-year period beginning on the first day of the first plan year following the earlier of: (1) the second anniversary of the date of adoption of the rehabilitation plan, or (2) the expiration of collective bargaining agreements that were in effect on the due date for the actuarial certification of critical status for the initial critical year and covering at least 75 percent of the active participants in the plan. The rehabilitation period ends if the plan emerges from critical status.

Restrictions apply during the period beginning on the date of certification and ending on the day before the first day of the rehabilitation period and during the rehabilitation period. For example, beginning on the date that notice of certification of the plan's critical status is sent, lump sum and other similar benefits may not be paid. The restriction does not apply if the present value of the participant's accrued benefit does not exceed $5,000. The restriction also does not apply to any makeup payment in the case of a retroactive annuity starting date or any similar payment of benefits owed with respect to a prior period.

Rules for reductions in future benefit accrual rates

Any schedule including reductions in future benefit accruals forming part of a rehabilitation plan must not reduce the rate of benefit accruals below: (1) a monthly benefit (payable as a single life annuity commencing at the participant's normal retirement age) equal to one percent of the contributions required to be made with respect to a participant or the equivalent standard accrual rate for a participant or group of participants under the collective bargaining agreements in effect as of the first day of the initial critical year; or (2) if lower, the accrual rate under the plan on such first day.

The equivalent standard accrual rate is determined by the plan sponsor based on the standard or average contribution base units, which the plan sponsor determines to be representative for active participants and such other factors that the plan sponsor determines to be relevant. The provision does not limit the ability of the plan sponsor to prepare and provide the bargaining parties with alternative schedules to the default schedule that establish lower or higher accrual and contribution rates than the rates described above.

Excise taxes

If the rehabilitation plan requires an employer to make contributions to the plan, an excise tax applies upon the failure of the employer to make such required contributions within the time required under the plan. The amount of tax is equal to the amount of the required contribution the employer failed to make in a timely manner.

In the case of a plan in critical status, if a rehabilitation plan is adopted and complied with, employers are not liable for contributions otherwise required under the general funding rules. In addition, the present-law excise tax on failures to make such contributions does not apply.

If a plan fails to leave critical status at the end of the rehabilitation period or fails to make scheduled progress in meeting its requirements under the rehabilitation plan for three consecutive years, the present law excise tax applies based on the greater of (1) the amount of the contributions necessary to leave critical status or make scheduled progress or (2) the plan's accumulated funding deficiency.

The excise tax applies for each succeeding plan year until the requirements are met. In the case of a failure which is due to reasonable cause and not to willful neglect, the Secretary of the Treasury may waive all or part of the excise tax on employers failing to make required contributions and the excise tax for failure to meet the rehabilitation plan requirements or make scheduled progress.

New Federal Law (Uncodified section 204 of WRERA)

Under the provision, the sponsor of a multiemployer defined benefit pension plan may elect for an applicable plan year to treat the plan's status for purposes of IRC section 432 the same as the plan's status for the preceding plan year. The applicable plan year is the first plan year beginning during the period from October 1, 2008, through September 30, 2009. Thus, for example, a calendar year plan that is not in critical or endangered status for 2008 may elect to retain its non-critical and non-endangered status for 2009, and a plan that was in either critical or endangered status for 2008 may elect to retain such status for 2009. If IRC section 432 did not apply to a plan for the year preceding the applicable plan year, the plan's sponsor may elect to treat the plan's status for the applicable plan year as the status that would have applied to the plan had IRC section 432 applied for the preceding plan year.

An election under the provision may only be revoked with the consent of the Secretary of the Treasury and special notice provisions apply with respect to the election and the notification of participants, the bargaining parties, the PBGC, and the Secretary of Labor.

In the case of a plan that elects to retain its endangered or critical status, the plan is not required to update its funding improvement or rehabilitation plan and schedules until the plan year that follows the applicable plan year. If an election is made by a plan under the provision and, without regard to the election, the plan is certified by the plan's actuary for the applicable plan year to be in critical status, the plan is treated as a plan in critical status for purposes of the special rules that relieve contributing employers from liability for minimum required contributions (that would apply under the otherwise applicable minimum funding rules) and the excise tax that applies in the case of a failure to make such contributions.

Effective Date

The provision is effective for the first plan year beginning during the period from October 1, 2008, through September 30, 2009.

California Law (None)

ERISA Preemption

Federal ERISA provisions apply to all pension plans in California. There are no California law provisions because federal law precludes state level administration of these plans.

Excise taxes

California does not conform to Chapter 43 of the IRC, relating to excise taxes on pension plans.

Impact on California Revenue

ERISA Preemption

ERISA changes result in no conformity revenue impact. Any revenue impact would be considered baseline. Baseline revenue gains are estimated to be $9,300,000 in 2009-10, $4,100,000 in 2010-11, and $1,100,000 in 2011-12.

Excise taxes

Not applicable.

WORKER, RETIREE, AND EMPLOYER RECOVERY ACT OF 2008 (WRERA), (PL 110-458, DECEMBER 23, 2008)

Section	Section Title
205	Temporary Extension of the Funding Improvement and Rehabilitation Periods for Multiemployer Pension Plans in Critical and Endangered Status for 2008 or 2009

Background

Under IRC section 432, additional funding rules apply to a multiemployer defined benefit pension plan that is in endangered or critical status. These rules require the adoption of and compliance with (1) a funding improvement plan in the case of a multiemployer plan in endangered status, and (2) a rehabilitation plan in the case of a multiemployer plan in critical status. IRC section 432 is effective for plan years beginning after 2007.

The funding improvement period is the 10-year period beginning on the first day of the first plan year beginning after the earlier of: (1) the second anniversary of the date of adoption of the funding improvement plan, or (2) the expiration of collective bargaining agreements that were in effect on the due date for the actuarial certification of endangered status for the initial determination year and covering, as of such date, at least 75 percent of the plan's active participants. The period ends if the plan is no longer in endangered status or if the plan enters critical status.

The rehabilitation period is the 10-year period beginning on the first day of the first plan year following the earlier of (1) the second anniversary of the date of adoption of the rehabilitation plan or (2) the expiration of collective bargaining agreements that were in effect on the due date for the actuarial certification of critical status for the initial critical year and covering at least 75 percent of the active participants in the plan. The rehabilitation period ends if the plan emerges from critical status.

New Federal Law (Uncodified section 205 of WRERA)

Under the provision, a plan sponsor of a multiemployer defined benefit pension plan may elect for a plan year beginning in 2008 or 2009 to extend the plan's otherwise applicable funding improvement or rehabilitation period by three years.

Effective Date

The provision is effective for plan years beginning after December 31, 2007.

California Law (None)

ERISA Preemption

Federal ERISA provisions apply to all pension plans in California. There are no California law provisions because federal law precludes state level administration of these plans.

WORKER, RETIREE, AND EMPLOYER RECOVERY ACT OF 2008 (WRERA), (PL 110-458, DECEMBER 23, 2008)

Impact on California Revenue

ERISA changes result in no conformity revenue impact. Any revenue impact would be considered baseline.

EXHIBIT A – 2008 Miscellaneous Federal Acts Impacting the Internal Revenue Code (IRC) Not Requiring a California Response

1. **Public Law 110-181, National Defense Authorization Act,** repealed a cross-reference to the IRC code, relating to sports fish and restoration and boating trust fund. Excise taxes are not administered by the FTB. Defer to BOE.

IRC Code Section	Public Law No.	Act Section No.	122 Stat. Page
9504	110-181	3529	603

In an uncodified provision repealed sections of Public Law 109-304 for duplicative or un-executable amendments.

2. **Public Law 110-190, Airport and Airway Extension Act of 2008,** amended the IRC relating to excise tax on airport and airway trust fund. Excise taxes are not administered by the FTB. Defer to BOE.

IRC Code Section	Public Law No.	Act Section No.	122 Stat. Page
1	110-190	1	643
4081	110-190	2(a)	643
4261	110-190	2(b)(1)	643
4271	110-190	2(b)(2)	643
4081	110-190	2(c)	643
9502	110-190	3(a)(b)	643
9502	110-190	3(c)	643

3. **Public Law 110-233, Genetic Information Nondiscrimination Act of 2008,** amended the IRC relating to prohibiting discrimination against individual participants and beneficiaries based on health status. Excise taxes are not administered by the FTB. Defer to BOE.

IRC Code Section	Public Law No.	Act Section No.	122 Stat. Page
9802	110-233	103(a),(c)	898
9832	110-233	103(d)	898
9834	110-233	103(e)(1)	898
9831	110-233	103(e)(2)	898
9802	110-233	103(f)(1)	898
9802	110-233	103(f)(2))	898

Discrimination in group premiums on genetic information and the imposition of tax on any failure of a group health plan to meet nondiscrimination requirements.

4. **Public Law 110-244, SAFETEA – LU Technical Corrections Act of 2008,** amended the IRC relating to highway trust fund. Excise taxes are not administered by the FTB. Defer to BOE.

IRC Code Section	Public Law No.	Act Section No.	122 Stat. Page
9503	110-244	121(c))	1608

The act made conforming amendments to the IRC relating to highway trust fund.

5. **Public Law 110-252, Military Appropriations Act,** provides an uncodified provision to the IRC relating approval of state law.

IRC Code Section	Public Law No.	Act Section No.	122 Stat. Page
3304	110-252	4001 - 4007	2353 - 2357

Uncodified provision provides payments to states having agreements for the payment of emergency unemployment compensation. Defer to Employment Development Department.

6. **Public Law 110-253, Federal Aviation Administration Extension Act of 2008,** amended the IRC relating to airport and airway trust fund. Excise taxes are not administered by the FTB. Defer to BOE.

IRC Code Section	Public Law No.	Act Section No.	122 Stat. Page
1	110-253	1	2417
4081	110-253	2(a)	2417
4261	110-253	2(b)(1)	2417
4271	110-253	2(b)(2)	2417
4081	110-253	2(c)	2417
9502	110-253	3(a), (b)	2417
9502	110-253	3(d)	2418

7. **Public Law 110-287, Renewal of Import Restriction under the Burmese Freedom and Democracy Act of 2003,** amended the IRC relating to the time for payment of Corporate Estimated taxes.

IRC Code Section	Public Law No.	Act Section No.	122 Stat. Page
6655	110-287	3	2649

In an uncodified provision retroactively amended Tax Increase Prevention and Reconciliation Act of 2005 section 401(1)(c) to increase the estimated tax rate. Not applicable to California.

EXHIBIT A – 2008 Miscellaneous Federal Acts Impacting the Internal Revenue Code (IRC) Not Requiring a California Response

8. **Public Law 110-428, Inmate Tax Fraud Prevention Act of 2008,** amended the IRC relating to disclosure of certain return and return information for tax administration purposes.

IRC Code Section	Public Law No.	Act Section No.	122 Stat. Page
1	110-428	1	4839
6103	110-428	2(a), (b)	4839
7803	110-428	2(c)	4840
6103	110-428	2(d)	4840
7207	110-428	2(e)	4840

The disclosure of prisoners' certain return and return information to the Federal Bureau of Prisons. Not applicable to California.

EXHIBIT B – Expiring Tax Provisions

California Sunset*	California Section	Federal Section	Federal Sunset	Description and Comments
06/30/08	17053.30 23630	N/A	N/A	Credit: Natural Heritage Preservation
12/31/08	17144.5	108	12/31/2012	Exclusion: Discharge of Indebtedness on Principal Residence
12/31/08	17255.5 24356.4	179B	Permanent	Deduction: Expensing of Capital Costs Incurred by Certain Refiners
12/31/08	18533(i)	6015	Permanent	Innocent Spouse Relief - IRS Relief from Joint and Several Liability on Joint Return.
12/31/08	21028	Title 31	Permanent	Taxpayers' Bill of Rights: Confidentiality/Taxpayer Communication
12/31/09	18721 – 18724	N/A	N/A	Voluntary Contribution: California Fund for Senior Citizens
12/31/09	18761 – 18766	N/A	N/A	Voluntary Contribution: Alzheimer's Disease & Related Disorders Research Fund
12/31/09	18845 – 18845.3	N/A	N/A	Voluntary Contributions: California Prostate Cancer Research Fund
12/31/09	23036.2	N/A	N/A	Limitation - Tax Reduction Allowed From Credits; Carryover; and Exemption**
12/31/09	23732	512	12/31/09	Exclusion of Gain or Loss on Sale or Exchange of Certain Brownfield Sites From Unrelated Business Taxable Income
12/31/09	23800	1367	12/31/2009	Basis Adjustment to Stock of S Corporations Making Charitable Contributions of Property***
12/31/09	24416.9	N/A	N/A	Net Operating Loss Suspension****
12/31/10	18825 – 18830	N/A	N/A	Voluntary Contribution: Veterans Quality of Life Fund
12/31/10	18846 – 18846.3	N/A	N/A	Voluntary Contribution: California Sexual Violence Victim Services Fund
12/31/10	18847 – 18847.3	N/A	N/A	Voluntary Contribution: California Colorectal Cancer Prevention Fund
12/31/11	17052.17 23617	45F	12/31/10	Credit: Employer Child Care Assistance
12/31/11	17052.18 23617.5	N/A	N/A	Credit: Employer Dependent Care Plan
12/31/11	17053.57 23657	N/A	N/A	Credit: Community Development Financial Institution Deposits
12/31/11	19551.1	N/A	N/A	Disclosure: Tax Information Furnished to Cities
12/31/12	18711 – 18716	N/A	N/A	Voluntary Contribution: State Children's Trust Fund

California Sunset*	California Section	Federal Section	Federal Sunset	Description and Comments
12/31/12	18741 – 18744	N/A	N/A	Voluntary Contribution: Fish & Game Preservation Fund
12/31/12	18791 – 18796	N/A	N/A	Voluntary Contribution: California Breast Cancer Research Fund
12/31/13	18851 – 18855	N/A	N/A	Voluntary Contribution: Emergency Food Assistance Program
12/31/13	24601	420	12/31/13	Transfer of Excess Pension Assets to Retiree Health Accounts
12/31/14	18705 – 18709	N/A	N/A	Voluntary Contribution: California Military Relief Fund
12/31/15	18801 – 18804	N/A	N/A	Voluntary Contribution: California Firefighters' Memorial Fund
12/31/15	18805 – 18808	N/A	N/A	Voluntary Contribution: California Peace Officer Memorial Fund
12/31/17	17053.62 23662	45H	Permanent	Credit: Environmental Credit for Production of Ultra Low Sulfur Diesel Fuel

*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 repeal date of the section is listed or the expiration applies to transactions occurring after this date.

**The limitation does not apply to taxpayers with business net income of less than $500,000.

***IRC section 1367 - A decrease in basis for charitable contribution does not apply to contributions made in taxable year December 31, 2009.

****The NOL suspension rule does not apply to corporations with taxable income of less than $500,000 or to disaster loss carryovers.

EXHIBIT C – Revenue Tables

Assumed Enactment After June 30, 2009

Table 1 - Economic Stimulus Act of 2008 (ESA)(PL 110-185)				
Act Section	**Provisions**	**2009-10**	**2010-11**	**2011-12**
101	Recovery Rebates for Individual - 2008	N/A	N/A	N/A
102	Temporary Increase in Limitations on Expensing of Certain Depreciable Business Assets	N/A	N/A	N/A
103	Special Allowance for Certain Property Acquired During 2008	N/A	N/A	N/A

Table 2 - Heartland, Habitat, Harvest, and Horticulture Act of 2008 (HHHHA)(PL 110-246)				
Act Section	**Provisions**	**2009-10**	**2010-11**	**2011-12**
15202	Time for Payment of Corporate Estimated Taxes	N/A	N/A	N/A
15301	Exclusion of Conservation Reserve Program Payments from SECA Tax for Certain Individuals	Defer to EDD	Defer to EDD	Defer to EDD
15302	Two-Year Extension of Special Rule Encouraging Contributions of Capital Gain Real Property For Conservation Purposes	-$1,300,000	No Impact	No Impact
15303	Deduction for Endangered Species Recovery Expenditures	-$100,000	-$700,000	-$900,000
15311	Temporary Reduction in Rate of Tax on Qualified Timber Gain of Corporation	Baseline	Baseline	Baseline
15312	Timber REIT Modernization	Baseline	Baseline	Baseline
15313	Mineral Royalty Income Qualifying Income for Timber REITs	Baseline	Baseline	Baseline
15314	Modification of Taxable REIT Subsidiary Asset Test for Timber REITs	Baseline	Baseline	Baseline
15315	Safe Harbor for Timber Property	N/A	N/A	N/A
15316	Qualified Forestry Conservation Bonds	N/A	N/A	N/A
15321-15322	Credit for Production of Cellulosic Biofuel and Comprehensive Study of Biofuel	N/A	N/A	N/A
15331	Modification of Alcohol Credit	N/A	N/A	N/A
15332	Calculation of Volume of Alcohol for Fuel Credits	N/A	N/A	N/A

Table 2 - Heartland, Habitat, Harvest, and Horticulture Act of 2008 (HHHHA)(PL 110-246)				
Act Section	**Provisions**	**2009-10**	**2010-11**	**2011-12**
15341	Increase in Loan Limits on Agricultural Bonds	N/A	N/A	N/A
15342	Allowance of Section 1031 Treatment for Exchange Involving Certain Mutual Ditch, Reservoir, or Irrigation Company Stock	N/A	N/A	N/A
15343	Agricultural Chemicals Security Credit	N/A	N/A	N/A
15344	Three Year Depreciation for Race Horses That are Two Years Old or Younger	-$1,800,000	-$1,900,000	-$2,000,000
15345	Temporary Tax Relief for Kiowa County, Kansas and Surrounding Area	N/A	N/A	N/A
15346	Competitive Certification Awards Modification Authority	N/A	N/A	N/A
15351	Limitation of Excess Farm Losses of Certain Taxpayer	$1,400,000	$4,000,000	$4,100,000
15352	Modification to Optional Method of Computing Net Earnings from Self-Employment.	Defer to EDD	Defer to EDD	Defer to EDD
15353	Information Reporting for Commodity Credit Corporation Transactions	$0	$0	$0

Table 3 - Heroes Earnings Assistance and Relief Tax Act of 2008 (HEARTA) (PL 110-245)				
Act Section	**Provisions**	**2009-10**	**2010-11**	**2011-12**
101	Recovery Rebate Provided to Military Families	N/A	N/A	N/A
102	Election to Include Combat Pay as Earned Income for Purposes of Earned Income Tax Credit	N/A	N/A	N/A
103	Modification of Mortgage Revenue Bonds for Veterans	N/A	N/A	N/A
104	Survivor and Disability Payments with Respect to Qualified Military Service	Baseline	Baseline	Baseline
105	Treatment of Differential Military Pay as Wages	Baseline	Baseline	Baseline
106	Special Period of Limitation When Uniformed Services Retired Pay is Reduced as a Result of Award of Disability Compensation	Baseline	Baseline	Baseline
107	Distribution from Retirement Plans to Individuals Called to Active Duty	-$8,000	-$6,000	-$8,000

Table 3 - Heroes Earnings Assistance and Relief Tax Act of 2008 (HEARTA) (PL 110-245)				
Act Section	**Provisions**	**2009-10**	**2010-11**	**2011-12**
108	Authority to Disclose Return Information for Certain Veteran Programs Made Permanent	N/A	N/A	N/A
109	Contributions of Military Death Gratuities to Roth IRAs and Education Savings Accounts	-$12,000	-$6,000	-$6,000
110	Suspension of 5-Year Period during Service with the Peace Corps	-$6,000	-$4,000	-$4,000
111	Credit for Employer Differential Wage Payments to Employees Who are Active Duty Members of the Uniformed Services	N/A	N/A	N/A
112	State Payments to Service Members Treated as Qualified Military Benefits	$0	$0	$0
113	Permanent Exclusion of Gain from Sale of a Principal Residence by Certain Employees of the Intelligence Community	-$7,000	-$7,000	-$7,000
114	Special Disposition Rules for Unused Benefits in Health Flexible Spending Arrangements of Individuals Called to Active Duty	$0	$0	$0
115	Technical Correction Related to Exclusion of Certain Property Tax Rebates and Other Benefits Provided to Volunteer Firefighters and Emergency Medical Responders	Defer to EDD	Defer to EDD	Defer to EDD
301	Revision of Tax Rules on Expatriation	N/A	N/A	N/A
302	Certain Domestically Controlled Foreign Persons Performing Services Under Contract With the United States Government Treated as American Employers	Defer to EDD	Defer to EDD	Defer to EDD
303	Increase in Minimum Penalty on Failure to File a Return of Tax	No Impact	$150,000	$350,000
401	Parity in the Application of Certain Limits to Health Benefits	N/A	N/A	N/A

Table 4 – Housing and Economic Recovery Act of 2008 (HERA)(PL 110-289)				
Act Section	**Provisions**	**2009-10**	**2010-11**	**2011-12**
3001-3005	Various Housing Tax Incentives Related to the Low-Income Housing Tax Credit	$0	$0	$0
3007	Recycling of Tax-Exempt Debt for Financing Residential Products	N/A	N/A	N/A

Table 4 – Housing and Economic Recovery Act of 2008 (HERA)(PL 110-289)				
Act Section	**Provisions**	**2009-10**	**2010-11**	**2011-12**
3008	Coordination of Certain Rules Applicable to Low-Income Housing Credit and Qualified Residential Rental Project Exempt Facility Bonds	N/A	N/A	N/A
3009	Hold Harmless for Reductions in Area Median Gross Income	N/A	N/A	N/A
3010	Exception to Annual Current Income Determination Requirement Where Determination Not Relevant	N/A	N/A	N/A
3011	First-time Homebuyer Credit	N/A	N/A	N/A
3012	Additional Standard Deduction for Real Property Taxes for Nonitemizers	N/A	N/A	N/A
3021	Temporary Increase in Volume Cap	N/A	N/A	N/A
3022	Repeal of Alternative Minimum Tax Limitations on Tax-Exempt Housing Bonds, Low-Income Housing Tax Credit, and Rehabilitation Credit	N/A	N/A	N/A
3023	Bonds Guaranteed by Federal Home Loan Banks Eligible for Treatment as Tax-Exempt Bonds	N/A	N/A	N/A
3024	Modification of Rules Pertaining to FIRPTA Nonforeign Affidavits	N/A	N/A	N/A
3025	Modification of Definition of Tax-Exempt Use Property for Purposes of the Rehabilitation Credit	N/A	N/A	N/A
3026	Extension of Special Rule for Mortgage Revenue Bonds for Residences Located in Disaster Areas	N/A	N/A	N/A
3027	Transfer of Funds Appropriated to Carry Out 2008 Recovery Rebates for Individuals	N/A	N/A	N/A
3031	Revisions to REIT Income Tests	Baseline	Baseline	Baseline
3032	Revisions to REIT Asset Tests	Baseline	Baseline	Baseline
3033	Conforming Foreign Currency Revisions	N/A	N/A	N/A
3041	Conforming Taxable REIT Subsidiary Asset Test	Baseline	Baseline	Baseline
3051	Holding Period Under Safe Harbor	N/A	N/A	N/A
3052	Determining Value of Sales Under Safe Harbor	N/A	N/A	N/A
3061	Conforming for Health Care Facilities	Baseline	Baseline	Baseline

Table 4 – Housing and Economic Recovery Act of 2008 (HERA)(PL 110-289)				
Act Section	**Provisions**	**2009-10**	**2010-11**	**2011-12**
3081	Election to Accelerate the AMT and Research Credits in Lieu of Bonus Depreciation	N/A	N/A	N/A
3082	Certain GO Zone Incentives	N/A	N/A	N/A
3091	Returns relating to Payments made in Settlement of Payment Card and Third-Party Network Transactions	Baseline	Baseline	Baseline
3092	Gain from Sale of Principal Residence Allocated to Nonqualified Use Not Excluded from Income	$1,200,000	$3,000,000	$4,100,000
3093	Delay in Application of Worldwide Allocation of Interest	N/A	N/A	N/A
3094	Time for Payment of Corporate Estimated Tax	N/A	N/A	N/A

Table 5 - Hubbard Act of 2008 (PL 110-317)				
Act Section	**Provisions**	**2009-10**	**2010-11**	**2011-12**
9	Repeal of Dollar Limitation on Contributions to Funeral Trusts	$50,000	$40,000	$40,000

Table 6 – Emergency Economic Stabilization Act of 2008 (EESA)(PL 110-343)				
Act Section	**Provisions**	**2009-10**	**2010-11**	**2011-12**
EESA Division A, Title III - Tax Provisions				
301	Gain or Loss from Sale or Exchange of Certain Preferred Stock	-$46,000,000	-$2,900,000	$500,000
302	Special Rules for Tax Treatment of Executive Compensation of Employers Participating in the Troubled Assets Relief Program	Indeterminate	Indeterminate	Indeterminate
303	Extension of Exclusion of Income from Discharge of Qualified Principal Residence Indebtedness	Defer to AB 111 or SB 97		
EESA Division B, Title I, Subtitle A - Energy Production Incentives				
101	Renewable Energy Credit	N/A	N/A	N/A

Table 6 – Emergency Economic Stabilization Act of 2008 (EESA)(PL 110-343)				
Act Section	**Provisions**	**2009-10**	**2010-11**	**2011-12**
102	Production Credit for Electricity Produced from Marine Renewables	N/A	N/A	N/A
103	Energy Credit	N/A	N/A	N/A
104	Energy Credit for Small Wind Property	N/A	N/A	N/A
105	Energy Credit for Geothermal Heat Pump Systems	N/A	N/A	N/A
106	Credit for Residential Energy Efficient Property	N/A	N/A	N/A
107	New Clean Renewable Energy Bonds	N/A	N/A	N/A
108	Energy Credit for Small Wind Property	N/A	N/A	N/A
109	Special Rule to Implement FERC and State Electric Restructuring Policy	N/A	N/A	N/A
EESA Division B, Title I, Subtitle B - Carbon Mitigation and Coal Provisions				
111	Expansion and Modification of Advanced Coal Project Investment Credit	N/A	N/A	N/A
112	Expansion and Modification of Coal Gasification Investment Credit	N/A	N/A	N/A
113	Temporary Increase in Coal Excise Tax; Funding of Black Lung Disability Fund	Defer to BOE	Defer to BOE	Defer to BOE
114	Special Rules for Refund of the Coal Excise Tax to Certain Coal Producers and Exporters	Defer to BOE	Defer to BOE	Defer to BOE
115	Tax Credit for Carbon Dioxide Sequestration	N/A	N/A	N/A
116	Certain Income and Gains Relating to Industrial Source Carbon Dioxide Treated as Qualifying Income for Publicly Traded Partnerships	-$40,000	-$30,000	-$50,000
EESA Division B, Title II - Energy Production Incentives				
201	Inclusion of Cellulosic Biofuel in Bonus Depreciation for Biomass Ethanol Plant Property	-$110,000	-$60,000	-$20,000
202	Credits for Biodiesel and Renewable Diesel	N/A	N/A	N/A
203	Clarification that Credits for Fuel are Designed to Provide an Incentive for United States Production	N/A	N/A	N/A
204	Extension and Modification of Alternative Fuel Credit	Defer to BOE	Defer to BOE	Defer to BOE

Table 6 – Emergency Economic Stabilization Act of 2008 (EESA)(PL 110-343)				
Act Section	**Provisions**	**2009-10**	**2010-11**	**2011-12**
205	Credit for New Qualified Plug-In Electric Drive Motor Vehicles	N/A	N/A	N/A
206	Exclusion from Heavy Truck Tax for Idling Reduction Units and Advanced Insulation	Defer to BOE	Defer to BOE	Defer to BOE
207	Alternative Fuel Vehicle Refueling Property Credit	N/A	N/A	N/A
208	Certain Income and Gains Relating to Alcohol Fuels and Mixtures, Biodiesel Fuels and Mixtures, and Alternative Fuels and Mixtures Treated as Qualifying Income for Publicly Traded Partnerships	-$300,000	-$200,000	-$250,000
209	Extension and Modification of Election to Expense Certain Refineries	-$6,000,000	-$9,000,000	-$34,000,000
210	Extension of Suspension of Taxable Income Limit on Percentage Depletion for Oil and Natural Gas Produced from Marginal Properties	N/A	N/A	N/A
211	Transportation Fringe Benefit to Bicycle Commuters	Baseline	Baseline	Baseline
EESA Division B, Title III - Energy Conservation and Efficiency Provisions				
301	Qualified Energy Conservation Bonds	N/A	N/A	N/A
302	Credit for Nonbusiness Energy Property	N/A	N/A	N/A
303	Energy Efficient Commercial Buildings Deduction	-$9,500,000	-$8,000,000	-$8,200,000
304	New Energy Efficient Home Credit	N/A	N/A	N/A
305	Modification of Energy Efficient Appliance Credit for Appliances Produced After 2007	N/A	N/A	N/A
306	Accelerated Recovery Period for Depreciation of Smart Meters and Smart Grid Systems	-$1,000,000	-$1,400,000	-$2,200,000
307	Qualified Green Building and Sustainable Design Projects	N/A	N/A	N/A
308	Special Depreciation Allowance for Certain Reuse and Recycling Property	-$2,300,000	-$1,500,000	-$1,200,000
EESA Division B, Title IV - Revenue Provisions				
401	Limitation of Deduction for Income Attributable to Domestic Production of Oil, Gas, or Primary Products Thereof	N/A	N/A	N/A

Table 6 – Emergency Economic Stabilization Act of 2008 (EESA)(PL 110-343)				
Act Section	**Provisions**	**2009-10**	**2010-11**	**2011-12**
402	Elimination of the Different Treatment of Foreign Oil and Gas Extraction Income and Foreign Oil Related Income for Purposes of the Foreign Tax Credit	N/A	N/A	N/A
403	Broker Reporting of Customer's Basis in Securities Transactions	Baseline	Baseline	Baseline
404	0.2 percent FUTA Surtax	Defer to EDD	Defer to EDD	Defer to EDD
405	Increase and Extension of Oil Spill Liability Trust Fund	Defer to BOE	Defer to BOE	Defer to BOE
EESA Division C, Title I, Alternative Minimum Tax Relief				
101	Extension of Alternative Minimum Tax Relief for Nonrefundable Personal Credits	N/A	N/A	N/A
102	Extension of Increased Alternative Minimum Tax Exemption Amount	N/A	N/A	N/A
103	Increase of AMT Refundable Credit Amount for Individuals with Long-Term Unused Credits for Prior Year Minimum Tax Liability, etc.	N/A	N/A	N/A
EESA Division C, Title II - Extension of Individual Tax Provisions				
201	Deduction for State and Local Sales Taxes	N/A	N/A	N/A
202	Deduction of Qualified Tuition and Related Expenses	N/A	N/A	N/A
203	Deduction for Certain Expenses of Elementary and Secondary School Teachers	N/A	N/A	N/A
204	Additional Standard Deduction for Real Property Taxes for Nonitemizers	-$31,000,000	No Impact	No Impact
205	Tax-Free Distributions from Individual Retirement Plans for Charitable Purposes	Baseline	Baseline	Baseline
206	Treatment of Certain Dividends of Regulated Investment Companies	N/A	N/A	N/A
207	Stock in RIC for Purposes of Determining Estates of Nonresidents Not Citizens	Defer to State Controller	Defer to State Controller	Defer to State Controller
208	Qualified Investment Entities	Baseline	Baseline	Baseline
EESA Division C, Title III - Extension of Business Tax Provisions				
301	Extension and Modification of Research Credit	-$39,000,000	-$39,000,000	-$40,000,000
302	New Markets Tax Credit	N/A	N/A	N/A

Table 6 – Emergency Economic Stabilization Act of 2008 (EESA)(PL 110-343)				
Act Section	**Provisions**	**2009-10**	**2010-11**	**2011-12**
303	Subpart F Exception for Active Financing Income	Baseline	Baseline	Baseline
304	Extension of Look-Thru Rule for Related Controlled Foreign Corporations	Baseline	Baseline	Baseline
305	Extension of 15-Year Straight-Line Cost Recovery for Qualified Leasehold Improvements and Qualified Restaurant Improvements; 15-Year Straight Line Cost Recovery for Certain Improvements to Retail Space	-$39,000,000	-$19,000,000	-$13,000,000
306	Modification of Tax Treatment of Certain Payments to Controlling Exempt Organizations	-$800,000	No Impact	No Impact
307	Basis Adjustment to Stock of S Corporations Making Charitable Contributions of Property	-$1,000,000	-$400,000	-$250,000
308	Increase in Limit on Cover Over of Rum Excise Tax to Puerto Rico and the Virgin Islands	Defer to BOE	Defer to BOE	Defer to BOE
309	Extension of Economic Development Credit for American Samoa	N/A	N/A	N/A
310	Extension of Mine Rescue Team Training Credit	N/A	N/A	N/A
311	Extension of Election to Expense Advanced Safety Mine Equipment	-$1,000,000	$200,000	$200,000
312	Deduction Allowable with Respect to Income Attributable to Domestic Production Activities in Puerto Rico	N/A	N/A	N/A
313	Qualified Zone Academy Bonds	N/A	N/A	N/A
314	Indian Employment Credit	N/A	N/A	N/A
315	Accelerated Depreciation for Business Property on Indian Reservations	N/A	N/A	N/A
316	Railroad Track Maintenance	N/A	N/A	N/A
317	Seven-Year Cost Recovery Period for Motorsports Racing Track Facility	-$3,700,000	-$500,000	-$200,000
318	Expensing of Environmental Remediation Costs	N/A	N/A	N/A
320	Extension of Increased Rehabilitation Credit for Structures in the Gulf Opportunity Zone	N/A	N/A	N/A
321	Enhanced Deduction for Qualified Computer Contributions	N/A	N/A	N/A

Table 6 – Emergency Economic Stabilization Act of 2008 (EESA)(PL 110-343)				
Act Section	**Provisions**	**2009-10**	**2010-11**	**2011-12**
322	Tax Incentives for Investment in the District of Columbia	N/A	N/A	N/A
323	Enhanced Charitable Deductions for Contributions of Food Inventory	-$2,700,000	$0	$0
324	Extension of Enhanced Charitable Deduction for Contributions of Book Inventory	-$1,000,000	$0	$0
EESA Division C, Title IV - Extension of Tax Administration Provisions				
401	Permanent Authority for Undercover Operations	N/A	N/A	N/A
402	Permanent Authority for Disclosure of Information Relating to Terrorists Activities	No Impact	No Impact	No Impact
EESA Division C, Title V, Subtitle A - General Provisions				
501	$8,500 Income Threshold Used to Calculate Refundable Portion of Child Tax Credit	N/A	N/A	N/A
502	Provisions Related to Film and Television Productions	N/A	N/A	N/A
503	Exemption from Excise Tax for Certain Wooden Arrows Designed for Use by Children	Defer to BOE	Defer to BOE	Defer to BOE
505	Certain Farming Business Machinery and Equipment Treated as 5-Year Property	-$14,400,000	-$8,500,000	-$7,400,000
506	Modification of Penalty on Understatement of Taxpayer's Liability by Tax Return Preparer	-$125,000	-$250,000	-$250,000
EESA Division C, Title V, Subtitle B - Paul Wellstone and Pete Domenici Mental Health Parity and Addiction Equity Act of 2008				
512	Mental Health Parity	Baseline	Baseline	Baseline
EESA Division C, Title VII, Subtitle A - Heartland and Hurricane Ike Disaster Relief				
702	Temporary Tax Relief for Areas Damaged by 2008 Mid-Western Severe Storms, Tornados, and Flooding	N/A	N/A	N/A
703	Reporting Requirements Relating to Disaster Relief Contributions	$0	$0	$0
706	Losses Attributable to Federally Declared Disasters	-$25,000,000	-$3,600,000	$0
EESA Division C, Title VII, Subtitle B - National Disaster Relief				
707	Expensing of Qualified Disaster Expenses	-$600,000	-$400,000	-$200,000

Table 6 – Emergency Economic Stabilization Act of 2008 (EESA)(PL 110-343)				
Act Section	**Provisions**	**2009-10**	**2010-11**	**2011-12**
708	Net Operating Losses Attributable to Federally Declared Disasters	-$9,600,000	$800,000	$1,100,000
709	Waiver of Certain Mortgage Revenue Bond Requirements Following Federally Declared Disasters	N/A	N/A	N/A
710	Special Depreciation Allowance for Qualified Disaster Property	-$54,000,000	-$27,000,000	-$3,300,000
711	Increased Expensing for Qualified Disaster Assistance Property	-$1,400,000	-$400,000	-$100,000
EESA Division C, Title VIII - Spending Reductions and Appropriate Revenue Raisers for New Tax Policy Relief				
801	Nonqualified Deferred Compensation from Certain Tax Indifferent Parties	$137,000,000	$78,000,000	$88,400,000

Table 7 – Worker, Retiree, and Employer Recovery Act of 2008 (WRERA)(PL 110-458)				
Act Section	**Provisions**	**2009-10**	**2010-11**	**2011-12**
WRERA Title I, Subtitle A, Technical Corrections Related to the Pension Protection Act of 2003				
101-112	Amendments Related to Titles I-XI	Baseline	Baseline	Baseline
WRERA Title I, Subtitle B, Other Provisions				
121	Amendments Related to Sections 102 and 112 of the PPA	Baseline	Baseline	Baseline
122	Modification of Interest Rate Assumption Required with Respect to Certain Small Employer Plans	Baseline	Baseline	Baseline
123	Determination of Market Rate of Return for Governmental Plans	Baseline	Baseline	Baseline
124	Treatment of Certain Reimbursements from Governmental Plans for Medical Care	$0	$0	$0
125	Rollover of Amounts Received in Airline Carrier Bankruptcy to Roth IRAs	Baseline	Baseline	Baseline
126	Determination of Asset Value for Special Airline Funding Rules	Baseline	Baseline	Baseline
127	Modification of Penalty for Failure to File Partnership Returns	$2,100,000	$1,900,000	$2,000,000
128	Modification of Penalty for Failure to File S Corporation Returns	$1,400,000	$1,400,000	$1,500,000

Table 7 – Worker, Retiree, and Employer Recovery Act of 2008 (WRERA)(PL 110-458)				
Act Section	**Provisions**	**2009-10**	**2010-11**	**2011-12**
WRERA Title II - Pension Provisions Relating to Economic Crisis				
201	Temporary Waiver of Required Minimum Distribution Rules for Certain Retirement Plans and Accounts	Baseline	Baseline	Baseline
202	Transition Rule Clarification	Baseline	Baseline	Baseline
203	Temporary Modification of Application of Limitation on Benefit Accruals	Baseline	Baseline	Baseline
204	Temporary Delay of Designation of Multiemployer Plans as in Endangered or Critical Status	Baseline	Baseline	Baseline
205	Temporary Extension of the Funding Improvement and Rehabilitation Periods for Multiemployer Pension Plans in Critical and Endangered Status for 2008 or 2009	Baseline	Baseline	Baseline