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State of California  
**Franchise Tax Board**

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## Summary of Federal Income Tax Changes 2010

### *Laws Affected*

Personal Income Tax Law (PITL)

Corporation Tax Law (CTL)

Administration of Franchise and Income Tax Law (AFITL)

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Summary of Federal Income Tax Changes  
2010

Prepared by the Staff of the  
Franchise Tax Board  
STATE OF CALIFORNIA

Members of the Board:

John Chiang, Chair  
Jerome E. Horton, Member  
Ana J. Matosantos, Member

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

# Summary of Federal Income Tax Changes – 2010

## TABLE OF CONTENTS

EXECUTIVE SUMMARY .....	1
2010 EXPIRING TAX PROVISIONS .....	2
TEMPORARY EXTENSION ACT OF 2010 .....	3
PUBLIC LAW 111-144, MARCH 2, 2010	
2 Extension of Unemployment Insurance Provisions .....	3
3 Extension and Improvement of Premium Assistance for COBRA Benefits .....	4
HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT .....	15
PUBLIC LAW 111-147, MARCH 18, 2010	
101 Payroll Tax Forgiveness for Hiring Unemployed Workers .....	15
102 Business Credit for Retention of Certain Newly Hired Individuals in 2010 .....	18
201 Increase in Expensing of Certain Depreciable Business Assets .....	20
301 Issuer Allowed Refundable Credit for Certain Qualified Tax Credit Bonds .....	22
441-445 Revenue Provisions Relating to the Highway Trust Fund .....	36
501 Reporting on Certain Foreign Accounts .....	38
502 Repeal of Certain Foreign Exceptions to Registered Bond Requirements .....	66
511 Disclosure of Information with Respect to Foreign Financial Assets .....	72
512 Penalties for Underpayments Attributable to Undisclosed Foreign Financial Assets .....	82
513 Modification of Statute of Limitations for Significant Omission of Income in Connection with Foreign Assets .....	86
521 Reporting of Activities with Respect to Passive Foreign Investment Companies .....	90
522 Secretary Permitted to Require Financial Institutions to File Certain Returns Related to Withholding on Foreign Transfers Electronically .....	92
531 Clarifications with Respect to Foreign Trusts which are Treated as Having a United States Beneficiary .....	95
532 Presumption that Foreign Trust has United States Beneficiary .....	97
533 Uncompensated Use of Trust Property .....	99
534 Reporting Requirement of United States Owners of Foreign Trusts .....	100
535 Minimum Penalty with Respect to Failure to Report on Certain Foreign Trusts .....	101
541 Substitute Dividends and Dividend Equivalent Payments Received by Foreign Persons Treated as Dividends .....	104
551 Delay in Application of Worldwide Allocation of Interest .....	108
561 Time for Payment of Corporate Estimated Taxes .....	112

## Summary of Federal Income Tax Changes – 2010

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA) .....	114
PUBLIC LAW 111-148, MARCH 23, 2010	
1322 Federal Program to Assist Establishment and Operation of Nonprofit, Member-Run Health Insurance Issuers.....	114
1401 Refundable Tax Credit for Providing Premium Assistance for Coverage under a Qualified Health Plan.....	122
1414 Disclosures to Carry out Eligibility Requirements for Certain Programs.....	129
1421 Credit for Employee Health Insurance Expenses of Small Businesses .....	131
1501 Requirement to Maintain Minimum Essential Coverage.....	136
1502 Reporting of Health Insurance Coverage.....	140
1513 Shared Responsibility for Employers.....	142
1514 Reporting of Employer Health Insurance Coverage .....	148
1515 Offering of Exchange-Participating Qualified Health Plans through Cafeteria Plans .....	150
1562 Conforming Amendments .....	153
3308 Reducing Part D Premium Subsidy for High-Income Beneficiaries .....	155
6301 Patient-Centered Outcomes Research .....	158
9001 Excise Tax on High-Cost Employer-Sponsored Health Coverage .....	160
9002 Inclusion of Cost of Employer-Sponsored Health Coverage on W-2.....	170
9003 Distributions for Medicine Qualified Only if for Prescribed Drug or Insulin .....	172
9004 Increase in Additional Tax on Distributions from HSAs and Archer MSAs Not Used for Qualified Medical Expenses .....	176
9005 Limitation on Health Flexible Spending Arrangements under Cafeteria Plans ..	179
9006 Expansion of Information Reporting Requirements .....	182
9007 Additional Requirements for Charitable Hospitals .....	185
9008 Imposition of Annual Fee on Branded Prescription Pharmaceutical Manufacturers and Importers.....	191
9009 Imposition of Annual Fee on Medical Device Manufacturers and Importers .....	195
9010 Imposition of Annual Fee on Health Insurance Providers.....	195
9012 Elimination of Deduction for Expenses Allocable to Medicare Part D Subsidy ..	201
9013 Modification of Itemized Deduction for Medical Expenses.....	203
9014 Limitation on Excessive Remuneration Paid by Certain Health Insurance Providers .....	205
9015 Additional Hospital Insurance Tax on High-Income Taxpayers.....	211
9016 Modification of Section 833 Treatment of Certain Health Organizations.....	214
9017 Excise Tax on Elective Cosmetic Medical Procedures.....	217
10907 Excise Tax on Indoor Tanning Services in Lieu of Elective Cosmetic Medical Procedures .....	217
9021 Exclusion of Health Benefits Provided by Indian Tribal Governments .....	218
9022 Establishment of Simple Cafeteria Plans for Small Businesses .....	221
9023 Qualifying Therapeutic Discovery Project Credit.....	226
10105 Amendments to Subtitle E .....	230
10108 Free Choice Vouchers.....	231
10908 Exclusion for Assistance Provided to Participants in State Student Loan Repayment Programs for Certain Health Professionals.....	233
10909 Expansion of Adoption Credit and Adoption Assistance Programs .....	235

## Summary of Federal Income Tax Changes – 2010

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010 (HCERA) .....	239
PUBLIC LAW 111-152, MARCH 30, 2010	
1004 Income Definitions.....	239
1402 Unearned Income Medicare Contribution.....	243
1405 Excise Tax on Medical Device Manufacturers .....	245
1408 Elimination of Unintended Application of Cellulosic Biofuel Producer Credit.....	248
1409 Codification of Economic Substance Doctrine and Penalties .....	250
1410 Time for Payment of Corporate Estimated Taxes .....	266
CONTINUING EXTENSION ACT OF 2010 .....	269
PUBLIC LAW 111-157, APRIL 12, 2010	
2 Extension of Unemployment Insurance Provisions .....	269
3 Extension and Improvement of Premium Assistance for COBRA Benefits .....	270
PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND PENSION RELIEF ACT OF 2010 .....	272
PUBLIC LAW 111-192, JUNE 25, 2010	
103 Establish a CMS-IRS Data Match to Identify Fraudulent Providers.....	272
201 Extended Period for Single-Employer Defined Benefit Plans to Amortize Certain Shortfall Amortization Bases.....	274
202 Application of Extended Amortization Period to Plans Subject to Prior Law Funding Rules.....	284
203 Lookback for Certain Benefit Restrictions .....	292
204 Lookback for Credit Balance Rule for Plans Maintained by Charities .....	297
211 Adjustments to Funding Standard Account Rules.....	301
DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT .....	307
PUBLIC LAW 111-203, JULY 21, 2010	
501-542 Nonadmitted and Reinsurance Reform Act of 2010.....	307
1601 Certain Swaps, etc., Not Treated as Section 1256 Contracts.....	308
STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS .....	312
TITLE II OF PUBLIC LAW 111-226, AUGUST 10, 2010	
211 Rules to Prevent Splitting Foreign Tax Credits from the Income to Which they Relate.....	312
212 Denial of Foreign Tax Credit with Respect to Foreign Income not Subject to United States Taxation by Reason of Covered Asset Acquisitions .....	317
213 Separate Application of Foreign Tax Credit Limitation, etc., to Items Resourced Under Treaties.....	326
214 Limitation on the Amount of Foreign Taxes Deemed Paid with Respect to Section 956 Inclusions .....	329
215 Special Rule with Respect to Certain Redemptions by Foreign Subsidiaries.....	336
216 Modification of Affiliation Rules for Purposes of Rules Allocating Interest Expense .....	339
217 Termination of Special Rules for Interest and Dividends Received from Persons Meeting the 80-Percent Foreign Business Requirements.....	342

## Summary of Federal Income Tax Changes – 2010

218	Limitation on Extension of Statute of Limitations for Failure to Notify Secretary of Certain Foreign Transfers.....	346
219	Elimination of Advance Refundability of Earned Income Credit.....	349
SMALL BUSINESS JOBS ACT OF 2010..... 351		
PUBLIC LAW 111-240, SEPTEMBER 27, 2010		
2011	Temporary Exclusion of 100 Percent of Gain on Certain Small Business Stock	351
2012	General Business Credits of Eligible Small Businesses for 2010 Carried Back 5 Years.....	353
2013	General Business Credits of Eligible Small Businesses in 2010 Not Subject to Alternative Minimum Tax.....	354
2014	Temporary Reduction in Recognition Period for Built-in Gains Tax.....	355
2021	Increased Expensing Limitations for 2010 and 2011; Certain Real Property Treated as Section 179 Property.....	357
2022	Additional First-Year Depreciation for 50 Percent of the Basis of Certain Qualified Property.....	360
2023	Special Rule for Long-Term Contract Accounting.....	363
2031	Increase Amount Allowed as Deduction for Start-Up Expenditures in 2010.....	366
2041	Limitation on Penalty for Failure to Disclose Reportable Transactions Based on Resulting Tax Benefits.....	368
2042	Deduction for Health Insurance Costs in Computing Self-Employment Taxes in 2010.....	372
2043	Removal of Cellular Telephones and Similar Telecommunications Equipment from Listed Property.....	374
2101	Information Reporting for Rental Property Expense Payments.....	377
2102	Increase in Information Return Penalties.....	380
2103	Report on Tax Shelter Penalties and Certain Other Enforcement Actions.....	382
2104	Application of Continuous Levy to Tax Liabilities of Certain Federal Contractors.....	386
2111	Participants in Government Section 457 Plans Allowed to Treat Elective Deferrals as Roth Contributions.....	389
2112	Rollovers from Elective Deferral Plans to Designated Roth Accounts.....	391
2113	Special Rules for Annuities Received from Only a Portion of a Contract.....	397
2121	Crude Tall Oil Ineligible for Cellulosic Biofuel Producer Credit.....	400
2122	Source Rules for Income on Guarantees.....	402
2131	Time for Payment of Corporate Estimated Taxes.....	405
TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010		
PUBLIC LAW 111-312, DECEMBER 17, 2010..... 408		
101	Temporary Extension of 2001 Tax Relief.....	408
102	Temporary Extension of 2003 Tax Relief.....	408
103	Temporary Extension of 2009 Tax Relief.....	408
201-202	Extension of Alternative Minimum Tax Relief for Nonrefundable Personal Credits and Increased Alternative Minimum Tax Exemption Amount.....	446

## Summary of Federal Income Tax Changes – 2010

301-304	Modify and Extend the Estate, Gift, and Generation Skipping Transfer Taxes After 2009 .....	448
401	Extension of Bonus Depreciation; Temporary 100 Percent Expensing for Certain Business Assets .....	463
402	Temporary Extension of Increased Small Business Expensing .....	469
501	Temporary Extension of Unemployment Insurance Provisions .....	472
502	Temporary Modification of Indicators under the Extended Benefit Program .....	472
503	Technical Amendment Relating to Collection of Unemployment Compensation Debts .....	473
601	Temporary Employee Payroll Tax Cut .....	473
701	Incentives for Biodiesel and Renewable Diesel.....	477
702	Credit for Refined Coal Facilities .....	480
703	New Energy Efficient Home Credit.....	482
704	Excise Tax Credits and Outlay Payments for Alternative Fuel and Alternative Fuel Mixtures.....	483
705	Special Rule for Sales or Dispositions to Implement FERC or State Electric Restructuring Policy for Qualified Electric Utilities .....	485
706	Suspension of Limitation on Percentage Depletion for Oil and Gas from Marginal Wells .....	487
707	Extension of Grants for Specified Energy Property in Lieu of Tax Credits.....	489
708	Extension of Provisions Related to Alcohol Used as Fuel .....	492
709	Energy Efficient Appliance Credit.....	496
710	Credit for Nonbusiness Energy Property .....	499
711	Alternative Fuel Vehicle Refueling Property .....	503
721	Deduction for Certain Expenses of Elementary and Secondary School Teachers....	505
722	Deduction for State and Local Taxes .....	506
723	Contributions of Capital Gain Real Property Made for Conservation Purposes .	507
724	Above-the-Line Deduction for Qualified Tuition and Related Expenses.....	512
725	Tax-Free Distributions for from Individual Retirement Plans for Charitable Purposes.....	514
726	Look-Thru of Certain Regulated Investment Company Stock in Determining Gross Estate of Non-Residents.....	519
727	Parity for Exclusion from Income for Employer-Provided Mass Transit and Parking Benefits .....	520
728	Refunds Disregarded in the Administration of Federal Programs and Federally Assisted Programs .....	522
731	Research Credit .....	523
732	Indian Employment Tax Credit .....	528
733	New Markets Tax Credit .....	530
734	Railroad Track Maintenance Credit.....	533
735	Mine Rescue Team Training Credit .....	534
736	Employer Wage Credit for Employees Who Are Active Duty Members of the Uniformed Services.....	535
737	15-Year Straight-Line Cost Recovery for Qualified Leasehold Improvements, Qualified Restaurant Building Improvements, and Qualified Retail Improvements .....	537

## Summary of Federal Income Tax Changes – 2010

738	7-Year Recovery Period for Motorsports Entertainment Complexes.....	541
739	Accelerated Depreciation for Business Property on an Indian Reservation.....	542
740	Enhanced Charitable Deduction for Contributions of Food Inventory.....	544
741	Enhanced Charitable Deduction for Contributions of Book Inventory to Public Schools .....	548
742	Enhanced Charitable Deduction for Corporate Contributions of Computer Inventory for Educational Purposes.....	550
743	Election to Expense Mine Safety Equipment .....	552
744	Special Expensing Rules for Certain Film and Television Productions .....	554
745	Expensing of Environmental Remediation Costs.....	556
746	Deduction Allowable with Respect to Income Attributable to Domestic Production Activities in Puerto Rico.....	558
747	Modification of Tax Treatment of Certain Payments to Controlling Exempt Organizations .....	560
748	Treatment of Certain Dividends of Regulated Investment Companies.....	562
749	RIC Qualified Investment Entity Treated Under FIRPTA .....	563
750	Exceptions for Active Financing Income.....	564
751	Look-Thru Treatment of Payments Between Related Controlled Foreign Corporations Under Foreign Holding Company Rules .....	568
752	Basis Adjustment to Stock of S Corps Making Charitable Contribution of Property . .....	570
753	Empowerment Zone Tax Incentives.....	571
754	Tax Incentives for Investment in the District of Columbia .....	579
755	Temporary Increase in Limit on Cover over Rum Excise Taxes to Puerto Rico and the Virgin Islands .....	584
756	American Samoa Economic Development Credit.....	585
757	Work Opportunity Credit.....	587
758	Qualified Zone Academy Bonds .....	594
759	Mortgage Insurance Premiums.....	599
760	Temporary Exclusion of 100 Percent of Gain on Certain Small Business Stock	600
761	Tax-Exempt Bond Financing.....	603
762	Increase in Rehabilitation Credit .....	604
763	Low-Income Housing Credit Rules for Buildings in GO Zones .....	605
764	Tax-Exempt Bond Financing.....	608
765	Bonus Depreciation Deduction Applicable to the GO Zone .....	612
REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010 .....		616
PUBLIC LAW 111-325, DECEMBER 22, 2010		
101	Capital Loss Carryovers of Regulated Investment Companies.....	617
201	Savings Provisions for Failures of Regulated Investment Companies to Satisfy Gross Income and Asset Tests.....	620
301	Modification of Dividend Designation Requirements and Allocation Rules for Regulated Investment Companies .....	623
302	Earnings and Profits of Regulated Investment Companies .....	628
303	Pass-Thru of Exempt-Interest Dividends and Foreign Tax Credits in Fund of Funds Structure.....	631

## Summary of Federal Income Tax Changes – 2010

304	Modification of Rules for Spillover Dividends of Regulated Investment Companies .....	632
305	Return of Capital Distributions of Regulated Investment Companies .....	634
306	Distributions in Redemption of Stock of a Regulated Investment Company .....	635
307	Repeal of Preferential Dividend Rule for Publicly Offered Regulated Investment Companies .....	637
308	Elective Deferral of Certain Late-Year Losses of Regulated Investment Companies .....	639
309	Exception to Holding Period Requirement for Certain Regularly Declared Exempt-Interest Dividends.....	644
401	Capital Loss Carryovers of Regulated Investment Companies.....	645
402	Deferral of Certain Gains and Losses of Regulated Investment Companies for Excise Tax Purposes .....	646
403	Distributed Amount for Excise Tax Purposes Determined on Basis of Taxes Paid by Regulated Investment Company.....	648
404	Increase in Required Distribution of Capital Gain Net Income.....	649
501	Repeal of Assessable Penalty with Respect to Liability for Tax of Regulated Investment Company.....	650
502	Modification of Sales Load Basis Deferral Rule for Regulated Investment Companies .....	651
EXHIBIT A – 2010 MISCELLANEOUS FEDERAL ACTS IMPACTING THE IRC NOT REQUIRING A CALIFORNIA RESPONSE .....		653
EXHIBIT B – EXPIRING TAX PROVISIONS.....		661
EXHIBIT C – REVENUE TABLES .....		663

## EXECUTIVE SUMMARY

### 2010 FEDERAL INCOME TAX CHANGES

Prepared by Staff of the Franchise Tax Board (FTB)

During 2010, the Internal Revenue Code (IRC) or its application by California was changed by:

PUBLIC LAW	TITLE	DATE
111-144	Temporary Extension Act of 2010	March 2, 2010
111-147	Hiring Incentives to Restore Employment (HIRE) Act	March 18, 2010
111-148	Patient Protection and Affordable Care Act	March 23, 2010
111-152	Health Care and Education Reconciliation Act of 2010	March 30, 2010
111-157	Continuing Extension Act of 2010	April 12, 2010
111-192	Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010	June 25, 2010
111-203	Dodd-Frank Wall Street Reform and Consumer Protection Act	July 21, 2010
111-226	State Fiscal Relief and Other Provisions; Revenue Offsets	August 10, 2010
111-240	Small Business Jobs Act of 2010	September 27, 2010
111-312	Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010	December 17, 2010
111-325	Regulated Investment Company Modernization Act of 2010	December 22, 2010
111-153, 111-159, 111-161, 111-171, 111-173, 111-197, 111-198, 111-205, 111-210, 111-216, 111-227, 111-237, 111-249, 111-322, 111-329, and 111-344	2010 Miscellaneous Federal Acts Impacting the 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 Laws, the IRC, and the California Revenue and Taxation Code (R&TC) impacted by the federal changes.

## 2010 EXPIRING TAX PROVISIONS

Following is a list of California tax provisions that expire in 2010:

California Sunset <sup>1</sup>	California Section	Federal Section	Federal Sunset	Description
See footnote <sup>2</sup>	17059	36	12/01/09	Credit: Principal Residence
12/31/10	18750 - 18753	N/A	N/A	Voluntary Contribution: California Sea Otter Fund

## EXHIBITS

This report contains the following exhibits:

- Exhibit A**            2010 Miscellaneous Federal Acts Impacting the IRC Not Requiring a California Response – Exhibit A provides short explanations of federal law changes that are either not administered by the FTB or are not applicable to California.
- Exhibit B**            Expiring Tax Provisions – Exhibit B provides a complete listing of expiring provisions in California tax law.
- Exhibit C**            Revenue Tables – Exhibit C provides the impact on California revenue were California to conform to the federal changes.

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<sup>1</sup> In general, this is the last taxable year to which the provision applies. Fiscal years beginning within this taxable year are also generally covered by the provision.

<sup>2</sup> This provision is repealed on December 1, 2013; however, the \$100 million limitation on the amount of total credit allowable was reached on July 2, 2009.

TEMPORARY EXTENSION ACT OF 2010  
Public Law 111-144, March 2, 2010

<u>Section</u>	<u>Section Title</u>
2	Extension of Unemployment Insurance Provisions

Background

The 2008 Supplemental Appropriations Act<sup>3</sup> added an uncodified provision providing payments to states having agreements for the payment of emergency unemployment compensation, with the eligibility period ending on March 31, 2009.

The 2010 Department of Defense Appropriations Act<sup>4</sup> extended the eligibility period for emergency unemployment compensation provided in the 2008 Supplemental Appropriations Act to February 28, 2010.

New Federal Law (IRC section 3304)

This provision extends the eligibility period for emergency unemployment compensation provided in the 2008 Supplemental Appropriations Act to April 5, 2010.

Effective Date

This provision is effective March 2, 2010.

California Law

Defer to the Employment Development Department (EDD).

Impact on California Revenue

Defer to the EDD.

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<sup>3</sup> Section 4007 of Public Law 110-252.

<sup>4</sup> Section 1009 of Public Law 111-118.

TEMPORARY EXTENSION ACT OF 2010  
Public Law 111-144, March 2, 2010

<u>Section</u>	<u>Section Title</u>
3	Extension and Improvement of Premium Assistance for COBRA Benefits

Background

In General

The IRC contains rules that require certain group health plans to offer certain individuals ("qualified beneficiaries") the opportunity to continue to participate for a specified period of time in the group health plan ("continuation coverage") after the occurrence of certain events that otherwise would have terminated such participation ("qualifying events").<sup>5</sup> These continuation coverage rules are often referred to as "COBRA continuation coverage" or "COBRA," which is a reference to the acronym for the law that added the continuation coverage rules to the IRC.<sup>6</sup>

The IRC imposes an excise tax on a group health plan if it fails to comply with the COBRA continuation coverage rules with respect to a qualified beneficiary. The excise tax with respect to a qualified beneficiary generally is equal to \$100 for each day in the noncompliance period with respect to the failure. A plan's noncompliance period generally begins on the date the failure first occurs and ends when the failure is corrected. Special rules apply that limit the amount of the excise tax if the failure would not have been discovered despite the exercise of reasonable diligence or if the failure is due to reasonable cause and not willful neglect.

In the case of a multiemployer plan, the excise tax generally is imposed on the group health plan. A multiemployer plan is a plan to which more than one employer is required to contribute, that is maintained pursuant to one or more collective bargaining agreements between one or more employee organizations and more than one employer, and that satisfies such other requirements as the Secretary of Labor may prescribe by regulation. In the case of a plan other than a multiemployer plan (a "single employer plan"), the excise tax generally is imposed on the employer.

Plans Subject to COBRA

A group health plan is defined as a plan of, or contributed to by, an employer (including a self-employed person) or employee organization to provide health care (directly or otherwise) to the employees, former employees, the employer, and others associated or formerly associated with the employer in a business relationship, or their families. A group health plan includes a self-insured plan. The term group health plan does not, however, include a plan under which substantially all of the coverage is for qualified long-term care services.

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<sup>5</sup> IRC section 4980B.

<sup>6</sup> The COBRA rules were added to the IRC by the Consolidated Omnibus Budget Reconciliation Act of 1985, Public Law 99-272. The rules were originally added as IRC sections 162(i) and (k), but were later restated as IRC section 4980B, pursuant to the Technical and Miscellaneous Revenue Act of 1988, Public Law 100-647.

TEMPORARY EXTENSION ACT OF 2010  
Public Law 111-144, March 2, 2010

The following types of group health plans are not subject to the IRC's COBRA rules: (1) a plan established and maintained for its employees by a church or by a convention or association of churches which is exempt from tax under IRC section 501 (a "church plan"); (2) a plan established and maintained for its employees by the federal government, the government of any state or political subdivision thereof, or by any instrumentality of the foregoing (a "governmental plan");<sup>7</sup> and (3) a plan maintained by an employer that normally employed fewer than 20 employees on a typical business day during the preceding calendar year<sup>8</sup> (a "small employer plan").

#### Qualifying Events and Qualified Beneficiaries

A qualifying event that gives rise to COBRA continuation coverage includes, with respect to any covered employee, the following events which would result in a loss of coverage of a qualified beneficiary under a group health plan (but for COBRA continuation coverage): (1) death of the covered employee; (2) the termination (other than by reason of such employee's gross misconduct), or a reduction in hours, of the covered employee's employment; (3) divorce or legal separation of the covered employee; (4) the covered employee becoming entitled to Medicare benefits under title XVIII of the Social Security Act; (5) a dependent child ceasing to be a dependent child under the generally applicable requirements of the plan; and (6) a proceeding in a case under the U.S. Bankruptcy Code commencing on or after July 1, 1986, with respect to the employer from whose employment the covered employee retired at any time.

A "covered employee" is an individual who is (or was) provided coverage under the group health plan on account of the performance of services by the individual for one or more persons maintaining the plan and includes a self-employed individual. A "qualified beneficiary" means, with respect to a covered employee, any individual who on the day before the qualifying event for the employee is a beneficiary under the group health plan as the spouse or dependent child of the employee. The term qualified beneficiary also includes the covered employee in the case of a qualifying event that is a termination of employment or reduction in hours.

#### Continuation Coverage Requirements

Continuation coverage that must be offered to qualified beneficiaries pursuant to COBRA must consist of coverage which, as of the time coverage is being provided, is identical to the coverage provided under the plan to similarly situated non-COBRA beneficiaries under the plan with respect to whom a qualifying event has not occurred. If coverage under a plan is modified for any group of similarly situated non-COBRA beneficiaries, the coverage must also be modified in the same manner for qualified beneficiaries. Similarly situated non-COBRA beneficiaries means the group of covered employees, spouses of covered employees, or dependent children of covered employees who (i) are receiving coverage under the group health plan for a reason other than pursuant to COBRA, and (ii) are the most similarly situated to the situation of the qualified beneficiary immediately before the qualifying event, based on all of the facts and circumstances.

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<sup>7</sup> A governmental plan also includes certain plans established by an Indian tribal government.

<sup>8</sup> If the plan is a multiemployer plan, then each of the employers contributing to the plan for a calendar year must normally employ fewer than 20 employees during the preceding calendar year.

TEMPORARY EXTENSION ACT OF 2010  
Public Law 111-144, March 2, 2010

The maximum required period of continuation coverage for a qualified beneficiary (i.e., the minimum period for which continuation coverage must be offered) depends upon a number of factors, including the specific qualifying event that gives rise to a qualified beneficiary's right to elect continuation coverage. In the case of a qualifying event that is the termination, or reduction of hours, of a covered employee's employment, the minimum period of coverage that must be offered to the qualified beneficiary is coverage for the period beginning with the loss of coverage on account of the qualifying event and ending on the date that is 18 months<sup>9</sup> after the date of the qualifying event. If coverage under a plan is lost on account of a qualifying event but the loss of coverage actually occurs at a later date, the minimum coverage period may be extended by the plan so that it is measured from the date when coverage is actually lost.

The minimum coverage period for a qualified beneficiary generally ends upon the earliest to occur of the following events: (1) the date on which the employer ceases to provide any group health plan to any employee; (2) the date on which coverage ceases under the plan by reason of a failure to make timely payment of any premium required with respect to the qualified beneficiary; and (3) the date on which the qualified beneficiary first becomes (after the date of election of continuation coverage) either (i) covered under any other group health plan (as an employee or otherwise) which does not include any exclusion or limitation with respect to any preexisting condition of such beneficiary or (ii) entitled to Medicare benefits under title XVIII of the Social Security Act. Mere eligibility for another group health plan or Medicare benefits is not sufficient to terminate the minimum coverage period. Instead, the qualified beneficiary must be actually covered by the other group health plan or enrolled in Medicare. Coverage under another group health plan or enrollment in Medicare does not terminate the minimum coverage period if such other coverage or Medicare enrollment begins on or before the date that continuation coverage is elected.

#### Election of Continuation Coverage

The COBRA rules specify a minimum election period under which a qualified beneficiary is entitled to elect continuation coverage. The election period begins not later than the date on which coverage under the plan terminates on account of the qualifying event, and ends not earlier than the later of 60 days or 60 days after notice is given to the qualified beneficiary of the qualifying event and the beneficiary's election rights.

#### Notice Requirements

A group health plan is required to give a general notice of COBRA continuation coverage rights to employees and their spouses at the time of enrollment in the group health plan.

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<sup>9</sup> In the case of a qualified beneficiary who is determined, under Title II or XVI of the Social Security Act, to have been disabled during the first 60 days of continuation coverage, the 18-month minimum coverage period is extended to 29 months with respect to all qualified beneficiaries if notice is given before the end of the initial 18-month continuation coverage period.

TEMPORARY EXTENSION ACT OF 2010  
Public Law 111-144, March 2, 2010

An employer is required to give notice to the plan administrator of certain qualifying events (including a loss of coverage on account of a termination of employment or reduction in hours) generally within 30 days of the qualifying event. A covered employee or qualified beneficiary is required to give notice to the plan administrator of certain qualifying events within 60 days after the event. The qualifying events giving rise to an employee or beneficiary notification requirement are the divorce or legal separation of the covered employee or a dependent child ceasing to be a dependent child under the terms of the plan. Upon receiving notice of a qualifying event from the employer, covered employee, or qualified beneficiary, the plan administrator is then required to give notice of COBRA continuation coverage rights within 14 days to all qualified beneficiaries with respect to the event.

#### Premiums

A plan may require payment of a premium for any period of continuation coverage. The amount of such premium generally may not exceed 102 percent<sup>10</sup> of the "applicable premium" for such period and the premium must be payable, at the election of the payor, in monthly installments.

The applicable premium for any period of continuation coverage means the cost to the plan for such period of coverage for similarly situated non-COBRA beneficiaries with respect to whom a qualifying event has not occurred, and is determined without regard to whether the cost is paid by the employer or employee. The determination of any applicable premium is made for a period of 12 months (the "determination period") and is required to be made before the beginning of such 12-month period.

In the case of a self-insured plan, the applicable premium for any period of continuation coverage of qualified beneficiaries is equal to a reasonable estimate of the cost of providing coverage during such period for similarly situated non-COBRA beneficiaries which is determined on an actuarial basis and takes into account such factors as the Secretary of Treasury prescribes in regulations. A self-insured plan may elect to determine the applicable premium on the basis of an adjusted cost to the plan for similarly situated non-COBRA beneficiaries during the preceding determination period.

A plan may not require payment of any premium before the day which is 45 days after the date on which the qualified beneficiary made the initial election for continuation coverage. A plan is required to treat any required premium payment as timely if it is made within 30 days after the date the premium is due or within such longer period as applies to, or under, the plan.

#### Other Continuation Coverage Rules

Continuation coverage rules which are parallel to the IRC's continuation coverage rules apply to group health plans under the Employee Retirement Income Security Act of 1974 (ERISA).<sup>11</sup> ERISA

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<sup>10</sup> In the case of a qualified beneficiary whose minimum coverage period is extended to 29 months on account of a disability determination, the premium for the period of the disability extension may not exceed 150 percent of the applicable premium for the period.

TEMPORARY EXTENSION ACT OF 2010  
Public Law 111-144, March 2, 2010

generally permits the Secretary of Labor and plan participants to bring a civil action to obtain appropriate equitable relief to enforce the continuation coverage rules of ERISA, and in the case of a plan administrator who fails to give timely notice to a participant or beneficiary with respect to COBRA continuation coverage, a court may hold the plan administrator liable to the participant or beneficiary in the amount of up to \$110 a day from the date of such failure.

Although the federal government and state and local governments are not subject to the IRC and ERISA's continuation coverage rules, other laws impose similar continuation coverage requirements with respect to plans maintained by such governmental employers.<sup>12</sup> In addition, many states have enacted laws or promulgated regulations that provide continuation coverage rights that are similar to COBRA continuation coverage rights in the case of a loss of group health coverage. Such state laws, for example, may apply in the case of a loss of coverage under a group health plan maintained by a small employer.

COBRA Changes Made by the *American Recovery and Reinvestment Act of 2009 (ARRA)*<sup>13</sup>

Premium Assistance

A temporary reduction in premiums for COBRA coverage is provided in ARRA to assistance eligible individuals who are involuntarily terminated from their employment. A premium subsidy of 65 percent is provided for a period of coverage. The period of the premium subsidy is limited to a maximum of 9 months of coverage. The premium subsidy is only provided with respect to involuntary terminations that occur on or after September 1, 2008, and before January 1, 2010.

ARRA COBRA changes permit a group health plan to provide a special enrollment right to "assistance eligible individuals" (AEI) to allow them to change coverage options under the plan in conjunction with electing COBRA continuation coverage.<sup>14</sup> ARRA only allows a group health plan to offer additional coverage options to AEIs and does not change the basic requirement under federal COBRA continuation coverage requirements that a group health plan must allow an assistance eligible individual to choose to continue with the coverage in which the individual is enrolled as of the qualifying event.<sup>15</sup> However, once the election of the other coverage is made, it becomes COBRA continuation coverage under the applicable COBRA continuation provisions.

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<sup>11</sup> Sections 601 to 608 of ERISA.

<sup>12</sup> Continuation coverage rights similar to COBRA continuation coverage rights are provided to individuals covered by health plans maintained by the federal government. 5 U.S.C. sec. 8905a. Group health plans maintained by a state that receives funds under Chapter 6A of Title 42 of the United States Code (the Public Health Service Act) are required to provide continuation coverage rights similar to COBRA continuation coverage rights for individuals covered by plans maintained by such state (and plans maintained by political subdivisions of such state and agencies and instrumentalities of such state or political subdivision of such state). 42 U.S.C. sec. 300bb-1.

<sup>13</sup> Section 3001 of Public Law 111-5, February 17, 2009.

<sup>14</sup> An employer can make this option available to covered employees under current law.

<sup>15</sup> All references to "federal COBRA continuation coverage" mean the COBRA continuation coverage provisions of the IRC, ERISA, and the PHSA.

TEMPORARY EXTENSION ACT OF 2010  
Public Law 111-144, March 2, 2010

Thus, for example, under the federal COBRA continuation coverage provisions, if a covered employee chooses different coverage pursuant to being provided this option, the different coverage elected must generally be permitted to be continued for the applicable required period (generally 18 months or 36 months, absent an event that permits coverage to be terminated under the federal COBRA continuation provisions) even though the premium subsidy is only for nine months.

ARRA provides an income threshold as an additional condition on an individual's entitlement to the premium subsidy during any taxable year. The income threshold applies based on the modified AGI for an individual income tax return for the taxable year in which the subsidy is received (i.e., either 2009 or 2010) with respect to which the AEI is the taxpayer, the taxpayer's spouse or a dependent of the taxpayer (within the meaning of IRC section 152, determined without regard to IRC sections 152(b)(1), (b)(2) and (d)(1)(B)). Modified AGI for this purpose means AGI as defined in IRC section 62, increased by any amount excluded from gross income under IRC sections 911, 931, or 933. Under this income threshold, if the premium subsidy is provided with respect to any COBRA continuation coverage which covers the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer during a taxable year and the taxpayer's modified AGI exceeds \$145,000 (or \$290,000 for joint filers), then the amount of the premium subsidy for all months during the taxable year must be repaid. The mechanism for repayment is an increase in the taxpayer's income tax liability for the year equal to such amount. For taxpayers with AGI between \$125,000 and \$145,000 (or \$250,000 and \$290,000 for joint filers), the amount of the premium subsidy for the taxable year that must be repaid is reduced proportionately.

Under this income threshold, for example, an AEI who is eligible for federal COBRA continuation coverage based on the involuntary termination of a covered employee in August 2009 but who is not entitled to the premium subsidy for the periods of coverage during 2009 due to having income above the threshold, may nevertheless be entitled to the premium subsidy for any periods of coverage in the remaining period (e.g. 5 months of coverage) during 2010 to which the subsidy applies if the modified AGI for 2010 of the relevant taxpayer is not above the income threshold.

ARRA allows an individual to make a permanent election (at such time and in such form as the Secretary of Treasury may prescribe) to waive the right to the premium subsidy for all periods of coverage. For the election to take effect, the individual must notify the entity (to which premiums are reimbursed under IRC section 6432(a)) of the election. This waiver provision allows an AEI who is certain that the modified AGI limit prevents the individual from being entitled to any premium subsidy for any coverage period to decline the subsidy for all coverage periods and avoid being subject to the recapture tax. However, this waiver applies to all periods of coverage (regardless of the tax year of the coverage) for which the individual might be entitled to the subsidy. The premium subsidy for any period of coverage cannot later be claimed as a tax credit or otherwise be recovered, even if the individual later determines that the income threshold was not exceeded for a relevant tax year. This waiver is made separately by each qualified beneficiary (who could be an AEI) with respect to a covered employee.

TEMPORARY EXTENSION ACT OF 2010  
Public Law 111-144, March 2, 2010

## Technical Changes

ARRA clarifies that a reference to a period of coverage is a reference to the monthly or shorter period of coverage with respect to which premiums are charged with respect to such coverage. For example, the provision is effective for a period of coverage beginning after the date of ARRA's enactment. In the case of a plan that provides and charges for COBRA continuation coverage on a calendar month basis, the ARRA changes are effective for the first calendar month following date of enactment.

ARRA specifically provides that if a person other than the individual's employer pays on the individual's behalf then the individual is treated as paying 35 percent of the premium, as required to be entitled to the premium subsidy. Thus, ARRA makes clear that, for this purpose, payment by an AEI includes payment by another individual paying on behalf of the individual, such as a parent or guardian, or an entity paying on behalf of the individual, such as a state agency or charity.

ARRA clarifies that, for the special 60-day election period for a qualified beneficiary who is eligible for a reduced premium and who has not elected COBRA continuation coverage as of ARRA's date of enactment,<sup>16</sup> the election period begins on such date of enactment and ends 60 days after the notice is provided to the qualified beneficiary of the special election period. In addition, ARRA clarifies that coverage elected under this special election right begins with the first period of coverage beginning on or after ARRA's date of enactment. ARRA also extends this special COBRA election opportunity to a qualified beneficiary who elected COBRA coverage but who is no longer enrolled on ARRA's date of enactment, for example, because the beneficiary was unable to continue paying the premium.

ARRA clarifies that a violation of the new notice requirements is also a violation of the notice requirements of the underlying COBRA provision. A notice must be provided to all individuals who terminated employment during the applicable time period, and not just to individuals who were involuntarily terminated.

Coverage under a flexible spending arrangement (FSA) is not eligible for the subsidy. ARRA clarifies that an FSA is defined as a health flexible spending arrangement offered under a cafeteria plan within the meaning of IRC section 125.<sup>17</sup>

ARRA provides for an expedited review, by the Secretary of Labor or Health and Human Services (in consultation with the Secretary of the Treasury), of denials of the premium subsidy. Such reviews must be completed within 15 business days after receipt of the individual's application for review. The 15-business-days timeframe is intended to give the Secretaries the flexibility necessary to make determinations within based upon evidence they believe, in their discretion, to

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<sup>16</sup> ARRA's date of enactment is February 17, 2009.

<sup>17</sup> Other FSA coverage does not terminate eligibility for coverage. Coverage under another group Health Reimbursement Account (HRA) will not terminate an individual's eligibility for the subsidy as long as the HRA is properly classified as an FSA under relevant IRS guidance. See Notice 2002-45, 2002-2 CB 93.

TEMPORARY EXTENSION ACT OF 2010  
Public Law 111-144, March 2, 2010

be appropriate. Additionally, ARRA intends that, if an individual is denied treatment as an AEI and also submits a claim for benefits to the plan that would be denied by reason of not being eligible for federal COBRA continuation coverage (or failure to pay full premiums), the individual would be eligible to proceed with expedited review irrespective of any claims for benefits that may be pending or subject to review under the provisions of section 503 of ERISA. Either Secretary's determination upon review is de novo and is the final determination of such Secretary.

ARRA also requires that various aspects of the new law, including the premium reduction, are treated as part of ERISA for purposes of administration and enforcement, including provisions that preempt state laws.

ARRA clarifies the reimbursement mechanism for the premium subsidy in several respects. First, it clarifies that the person to whom the reimbursement is payable is either: (1) the multiemployer group health plan; (2) the employer maintaining the group health plan subject to federal COBRA continuation coverage requirements; and (3) the insurer providing coverage under an insured plan. Thus, this is the person who is eligible to offset its payroll taxes for purposes of reimbursement. ARRA also clarifies that the credit for the reimbursement is treated as a payment of payroll taxes. Thus, it clarifies that any reimbursement for an amount in excess of the payroll taxes owed is treated in the same manner as a tax refund. Similarly, it clarifies that overstatement of reimbursement is a payroll tax violation. For example, the IRS can assert appropriate penalties for failing to truthfully account for the reimbursement. However, it is not intended that any portion of the reimbursement is taken into account when determining the amount of any penalty to be imposed against any person, required to collect, truthfully account for, and pay over any tax under IRC section 6672.

It is intended that reimbursement not be mirrored in the U.S. possessions that have mirror income tax codes (the Commonwealth of the Northern Mariana Islands, Guam, and the Virgin Islands). Rather, the intent of Congress is that reimbursement will have direct application to persons in those possessions.

Moreover, it is intended that income tax withholding payable to the government of any possession (American Samoa, the Commonwealth of the Northern Mariana Islands, the Commonwealth of Puerto Rico, Guam, or the Virgin Islands) (in contrast with FICA withholding payable to the U.S. Treasury) will not be reduced as a result of the application of this provision. A person liable for both FICA withholding payable to the U.S. Treasury and income tax withholding payable to a possession government will be credited or refunded any excess of the amount of FICA taxes treated as paid under the reimbursement rule of the provision over the amount of the person's liability for those FICA taxes.

#### Summary of ARRA COBRA Provisions Impacting the IRC

##### ***A. IRC section 139C – COBRA Premium Assistance***

ARRA provides that an AEI who elects COBRA coverage under the employer's group health plan is required to pay no more than 35 percent of the applicable premium for COBRA coverage, and that IRS will provide a "subsidy" for the remaining 65 percent. ARRA establishes that an AEI's

TEMPORARY EXTENSION ACT OF 2010  
Public Law 111-144, March 2, 2010

premium reduction is excluded from the gross income. Thus, a taxpayer's receipt of the subsidy for COBRA continuation coverage is not subject to federal income tax.

***B. IRC section 6432 – COBRA Premium Assistance Reimbursement***

ARRA provides a mechanism for reimbursing the person to which premiums are payable for the difference between the full premium and the amount paid by an AEI. Specifically, the person to which premiums are payable under COBRA continuation coverage must be reimbursed for the amount of the premiums that are not paid by AEI's on account of the 35 percent premium deduction.

The person to whom premiums are payable will be, except as IRS provides otherwise, would be either the employer, or the insurer. Specifically, the person entitled to reimbursement is:

- In the case of a group health plan that is a multiemployer plan (as defined by ERISA section 3(37)), the plan;
- In the case of a group health plan which is not a multiemployer plan and which is subject to the COBRA continuation provisions contained in the IRC, ERISA, Public Health Service Act (PHSA), or civil service provisions of the U.S. Code, and under which some or all of the coverage is not provided by insurance, the employer; and
- In the case of any group health plan not described in (1) or (2) above, the insurer providing the coverage under the plan.

A person entitled to reimbursement and who files a claim for reimbursement at such time and in such manner as the IRS may require will be treated as having paid to the IRS, on the date that the AEI's premium payment is received, payroll taxes in an amount equal to the portion of the reimbursement relating to that premium. To the extent that the amount treated as paid exceeds the amount of the person's liability for payroll taxes, the IRS will credit or refund the excess in the same manner as if it were an overpayment of payroll taxes.

***C. IRC section 6720C – Penalty for Failure to Notify Health Plan of Cessation of Eligibility for COBRA Premium Assistance***

ARRA provides that an AEI who is no longer eligible for the subsidized COBRA premium because of eligibility coverage under another group health plan or Medicare must notify the group health plan providing the subsidized COBRA coverage. The notice must be in writing and be provided in the time and manner that Department of Labor (DOL) may specify. The notice must inform the group health plan providing COBRA coverage of the eligibility under the other plan or Medicare. Any person who fails to provide the notice in the time and manner required by the DOL must pay a penalty of 110 percent of the premium reduction after termination of eligibility for the subsidized COBRA coverage. No penalty will be imposed if it is shown that the failure to provide the required notice is due to reasonable cause and not to willful neglect.

TEMPORARY EXTENSION ACT OF 2010  
Public Law 111-144, March 2, 2010

COBRA Changes Made by the *Department of Defense Appropriations, 2010 (DDA)*<sup>18</sup>

DDA extended (1) the maximum period of the premium summary from 9 months of coverage to 15 months of coverage, and (2) the premium-subsidy eligibility period by 60 days (i.e., the premium subsidy is provided with respect to terminations that occur before March 1, 2010, whereas prior law provided the premium subsidy is provided with respect to terminations that occur before January 1, 2010).

New Federal Law (IRC sections 35, 139C, 6432, and 6720C)

This provision extends the eligibility period for COBRA continuation coverage and premium assistance by one month, to March 31, 2010.

Additionally, the provision redefines “premium assistance eligible individual” for COBRA continuation coverage to treat as a qualifying event for such coverage the involuntary termination of employment after March 2, 2010, of any qualified beneficiary who did not make (or who made and discontinued) an election of such coverage on the basis of a reduction of hours of employment.

Effective Date

This provision is effective for taxable years ending after February 17, 2009, as if it were included in ARRA.

California Law & Impact on California Revenue

**A. IRC section 139C Provision**

California Law (R&TC section 17131)

The Personal Income Tax Law (PITL) conforms to the federal rules relating to items that are specifically excluded from gross income as of the “specified date” of January 1, 2009,<sup>19</sup> and as a result does not conform to this provision (that establishes that an AEI’s premium reduction is excludable from gross income).

However, the premium reduction provision is treated as a part of ERISA. Therefore, any state taxation of the premium reduction is prohibited by the ERISA preemption of state law.

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<sup>18</sup> Section 1010 of Public Law 111-118, December 19, 2009.

<sup>19</sup> For taxable years beginning on or after January 1, 2010, R&TC section 17131 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, 2009.

TEMPORARY EXTENSION ACT OF 2010  
Public Law 111-144, March 2, 2010

Impact on California Revenue

Baseline.

***B. IRC section 6432 Provision***

California Law

The Franchise Tax Board does not administer payroll taxes. Defer to the Employment Development Department (EDD).

Impact on California Revenue

Defer to the EDD.

***C. IRC section 6720C Provision***

California Law (None)

California does not conform to the penalty under IRC section 6720C, and has no comparable penalty.

Impact on California Revenue

Not applicable.

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HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

<u>Section</u>	<u>Section Title</u>
101	Payroll Tax Forgiveness for Hiring Unemployed Workers

Background

In General

Social security benefits and certain Medicare benefits are financed primarily by payroll taxes on wages.

Federal Insurance Contributions Act (“FICA”) Tax

The FICA tax applies to employers based on the amount of covered wages paid to an employee during the year. Generally, covered wages means all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash. Certain exceptions from covered wages are also provided. The tax imposed is composed of two parts: (1) the old age, survivors, and disability insurance (“OASDI”) tax equal to 6.2 percent of covered wages up to the taxable wage base (\$106,800 in 2010); and (2) the Medicare hospital insurance (“HI”) tax amount equal to 1.45 percent of covered wages. In addition to the tax on employers, each employee is subject to FICA taxes equal to the amount of tax imposed on the employer (the “employee portion”). The employee portion generally must be withheld and remitted to the federal government by the employer.

Self-Employment Contributions Act (“SECA”) Tax

As a parallel to FICA taxes, the SECA tax applies to the net income from self employment of self-employed individuals. The rate of the OASDI portion of SECA taxes is equal to the combined employee and employer OASDI FICA tax rates and applies to self-employment income up to the FICA taxable wage base. Similarly, the rate of the HI portion is the same as the combined employer and employee HI rates and there is no cap on the amount of self-employment income to which the rate applies.<sup>20</sup>

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<sup>20</sup> For purposes of computing net earnings from self employment, taxpayers are permitted a deduction equal to the product of the taxpayer’s earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI tax (12.4 percent) and HI tax (2.9 percent); i.e., 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee’s wages, which do not include FICA taxes paid by the employer, whereas the self-employed individual’s net earnings are economically equivalent to an employee’s wages plus the employer share of FICA taxes.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

New Federal Law (IRC sections 51, 3111, and 3221)

In General

The provision provides relief from the employer share of OASDI taxes on wages paid by a qualified employer with respect to certain employment. The provision applies to wages paid beginning on March 19, 2010, and ending on December 31, 2010. Covered employment is limited to service performed by a qualified individual: (1) in a trade or business of a qualified employer; or (2) in furtherance of the activities related to the purpose or function constituting the basis of the employer's exemption under IRC section 501 (in the case of a qualified employer that is exempt from tax under IRC section 501(a)).

Qualified Employer

A qualified employer is any employer other than the United States, any state, any local government, or any instrumentality of the foregoing. Notwithstanding the foregoing, a qualified employer includes any employer that is a public higher education institution (as defined in section 101(b) of the Higher Education Act of 1965).

Qualified Individual

A qualified individual is any individual who: (1) begins work for a qualified employer after February 3, 2010, and before January 1, 2011; (2) certifies by signed affidavit (under penalties of perjury) that he or she was employed for a total of 40 hours or less during the 60-day period ending on the date such employment begins; (3) is not employed to replace another employee of the employer unless such employee separated from employment voluntarily or for cause;<sup>21</sup> and (4) is not a related party (as defined under rules similar to IRC section 51(i) of the employer).

Employer Election

A qualified employer may elect to not have payroll tax forgiveness apply. The election is made in the manner required by the Secretary of the Treasury.

Coordination with Work Opportunity Tax Credit

Under the provision, a qualified employer may not receive the work opportunity tax credit on any wages paid to a qualified individual during the one-year period beginning on the hiring date of

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<sup>21</sup> It is intended that an employer may qualify for the credit when it hires an otherwise qualified individual to replace an individual whose employment was terminated, for cause or due to other facts and circumstances. For example, an employer may qualify for the credit with respect to wages paid pursuant to the reopening of a factory which had been previously closed due to lack of demand for the product being produced (i.e., the employer may qualify by rehiring qualified individuals who had in the past worked for the employer but were terminated when the factory was closed or by hiring qualified individuals who had not previously worked for the employer). In contrast, an employer who terminates the employment of an individual not for cause, but rather to claim the credit with respect to the hiring of the same or another individual is not eligible for the credit under this rule.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

such individual, if those wages qualify the employer for payroll tax forgiveness under this provision unless the employer makes an election not to have payroll tax forgiveness apply with respect to that individual.

#### Social Security Trust Funds

The Federal Old-Age and Survivors Trust Fund and the Federal Disability Insurance Trust Fund will receive transfers from the General Fund of the United States Treasury equal to any reduction in payroll taxes attributable to the payroll tax forgiveness provided under the provision. The amounts will be transferred from the General Fund at such times and in such a manner as to replicate to the extent possible the transfers which would have occurred to the Trust Funds had the provision not been enacted.

#### Effective Date

The provision applies to wages paid after March 18, 2010.

California Law (R&TC sections 17053.46, 17053.47, 17053.74, 23622.7, 23622.8, and 23646)

#### FICA and SECA Taxes

The FTB does not administer employment taxes. Defer to the Employment Development Department (EDD).

#### Coordination with Work Opportunity Tax Credit

California does not conform to the federal work opportunity credit under IRC section 51; however, the following California hiring credits<sup>22</sup> are reduced by the amount of the IRC section 51 credit: (1) the enterprise zone credit;<sup>23</sup> (2) the manufacturing enhancement area credit;<sup>24</sup> and (3) the local agency base recovery area credit.<sup>25</sup>

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<sup>22</sup> California law provides hiring credits for taxpayers conducting business activities within geographically targeted economic development areas (EDAs). EDAs include enterprise zones (EZs), manufacturing enhancement areas (MEAs), targeted tax areas (TTAs), and local agency military base recovery areas (LAMBRAAs).

An employer located in an EDA is eligible for a hiring credit equal to a percentage of wages paid to individuals from targeted groups (i.e. qualified employees). To some extent, the definition of qualified employees for the EDA hiring credits is similar to the definition of qualified employees for purposes of the federal work opportunity tax credit.

<sup>23</sup> R&TC sections 17053.74(b)(4)(A)(iv)(XI) and 23622.7(b)(4)(A)(iv)(XI).

<sup>24</sup> R&TC sections 17053.47(f) and 23622.8(e).

<sup>25</sup> R&TC sections 17053.46(g) and 23646(g).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

Impact on California Revenue

FICA and SECA Taxes

Defer to the EDD.

Coordination with Work Opportunity Tax Credit

Baseline.

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<u>Section</u>	<u>Section Title</u>
102	Business Credit for Retention of Certain Newly Hired Individuals in 2010

Background

Present federal law does not provide a tax credit specifically for the retention of new employees.

However, present law provides for a general business credit consisting of various business tax credits.<sup>26</sup> The general business credit, to the extent it exceeds the relevant tax liability for the taxable year, may be carried back one year (but, in the case of a new credit, not to a taxable year before that credit is first allowable) and carried forward 20 years.<sup>27</sup>

New Federal Law (IRC section 38)

Under the provision, an employer's general business credit is increased by \$1,000 for each retained worker that satisfies a minimum employment period. Generally, a retained worker is an individual who is a qualified individual as defined under the payroll tax forgiveness provision, above (new IRC section 3111(d)). However, the credit is available only with respect to such an individual, if the individual: (1) is employed by the employer on any date during the taxable year; (2) continues to be employed by the employer for a period of not less than 52 consecutive weeks; and (3) receives wages for such employment during the last 26 weeks of such period that are least 80-percent of such wages during the first 26 weeks of such period.

The portion of the general business credit attributable to the retention credit may not be carried back to a taxable year that begins prior to March 18, 2010.

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<sup>26</sup> IRC section 38.

<sup>27</sup> IRC section 39.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

Effective Date

The provision is effective for taxable years ending after March 18, 2010.

California Law (R&TC sections 17053.34, 17053.46, 17053.47, 17053.74, 17053.80, 23622.7, 23622.8, 23623, 23634, and 23646)

California does not conform to the general business credit under IRC section 38; thus, California does not conform to this new federal credit specifically for the retention of new employees.

California provides its own state hiring credits: (1) a tax credit for hiring individuals in economic development areas; and (2) a new jobs tax credit.

Credits for Hiring Individuals in Economic Development Areas

California provides hiring credits for taxpayers conducting business activities within geographically targeted economic development areas (EDAs). EDAs include enterprise zones, manufacturing enhancement areas, targeted tax areas, and local agency military base recovery areas.

An employer located in an EDA is eligible for a hiring credit equal to a percentage of wages paid to individuals from targeted groups (i.e. qualified employees). To some extent, the definition of qualified employees for the EDA hiring credits is similar to the definition of qualified employees for purposes of the federal work opportunity tax credit.

New Jobs Tax Credit

For taxable years beginning on or after January 1, 2009, California provides a credit against tax for a qualified employer in the amount of \$3,000 for each increase in a qualified full-time employee hired by a qualified employer in the taxable year, determined on an annual full-time equivalent basis. For qualified full-time employees that are employed less than a full year, the credit is reduced on a pro-rata basis by the number of hours for employees paid on an hourly basis or by the number weeks for salaried employees employed by the qualified employer in the taxable year.

Any credits not used in the taxable year may be carried forward up to eight years. The credit is not subject to the 50-percent limitation for business credits that applies to taxable years beginning on or after January 1, 2008, and ending January 1, 2010. Any deductions an employer is allowed for qualified wages are not reduced by the amount of the credit.

Taxpayers may only claim this credit on an original timely filed return received by the FTB on or before a cut-off date specified by the FTB, which is the last day of the calendar quarter within which the FTB estimates it will have received timely filed original returns claiming the credit that cumulatively total \$400,000,000 for all taxable years. The date received on a return will be determined by the FTB. Determinations made by the FTB with respect to the cut-off date, the date

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

a return is received, and whether a return has been timely filed may not be reviewed in any administrative or judicial proceeding.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
201	Increase in 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.<sup>28</sup> For taxable years beginning in 2009, the maximum amount that a taxpayer may expense is \$250,000 of the cost of qualifying property placed in service for the taxable year. The \$250,000 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 \$800,000.<sup>29</sup> For taxable years beginning in 2010, the maximum amount that a taxpayer may expense 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 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

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<sup>28</sup> 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 400N(e)).

<sup>29</sup> The temporary \$250,000 and \$800,000 amounts were enacted in the Economic Stimulus Act of 2008, Public Law 110-185, and extended for taxable years beginning in 2009 by the American Recovery and Reinvestment Act of 2009, Public Law 111-5.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

under rules prescribed by the Secretary.<sup>30</sup> An election under IRC section 179 generally is revocable only with prior consent of the Secretary.<sup>31</sup>

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).

New Federal Law (IRC section 179)

The provision increases for one year the amount a taxpayer may deduct under section 179. The provision provides that the maximum amount a taxpayer may expense, for taxable years beginning after 2009 and before 2011, is \$250,000 of the cost of qualifying property placed in service for the taxable year. The \$250,000 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 \$800,000.

Effective Date

The provision is effective for taxable years beginning after December 31, 2009.

California Law (R&TC sections 17201, 17255, and 24356)

California conforms to the federal election to deduct (or “expense”) the cost of qualifying property under IRC section 179, rather than to recover such costs through depreciation deductions (commonly referred to as “small business expensing”), as of the “specified date” of January 1, 2009,<sup>32</sup> with significant modifications.

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<sup>30</sup> IRC section 179(c)(1). Under Treas. Reg. section 1.179-5, applicable to property placed in service in taxable years beginning after 2002 and before 2008, a taxpayer is permitted to make or revoke an election under IRC section 179 without the consent of the Commissioner on an amended federal tax return for that taxable year. This amended return must be filed within the time prescribed by law for filing an amended return for the taxable year. T.D. 9209, July 12, 2005.

<sup>31</sup> IRC section 179(c)(2) provides that with respect to any taxable year beginning after 2002 and before 2011, a taxpayer may revoke its IRC section 179 election with respect to any property, and such revocation, once made is irrevocable.

<sup>32</sup> Under the PITL, for taxable years beginning on or after January 1, 2010, R&TC section 17201(a) conforms to IRC section 179 as of the “specified date” of January 1, 2009, with modifications in R&TC section 17255. Under the CTL, for taxable years beginning on or after January 1, 2010, R&TC 24356(b) conforms to IRC section 179 as of the “specified date” of January 1, 2009, with modifications.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

California specifically does not conform to the increased “small business expensing” that was first enacted in the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003<sup>33</sup> and then extended and modified in several federal acts.<sup>34</sup> Thus, under California law, both corporate and non-corporate taxpayers with a sufficiently small amount of annual investment in qualified depreciable property 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.

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<u>Section</u>	<u>Section Title</u>
301	Issuer Allowed Refundable Credit for Certain Qualified Tax Credit Bonds

Background

Build America Bonds

IRC section 54AA, added to the IRC by the American Recovery and Reinvestment Act of 2009 (“ARRA”),<sup>35</sup> permits an issuer to elect to have an otherwise tax-exempt bond, issued prior to January 1, 2011, treated as a “build America bond.”<sup>36</sup> In general, build America bonds are taxable governmental bonds, the interest on which is subsidized by the federal government by

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<sup>33</sup> Public Law 108-27, Section 202.

<sup>34</sup> Public Law 108-357, Section 201; Public Law 109-222, Section 101; Public Law 110-28, Section 8212; and Public Law 111-5, Section 1202.

<sup>35</sup> Public Law 111-5.

<sup>36</sup> IRC section 54AA.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

means of a tax credit to the holder (“tax-credit build America bonds”) or, in the case of certain qualified bonds, a direct payment to the issuer (“direct-pay build America bonds”).

#### Definition and General Requirements

A build America bond is any obligation (other than a private activity bond) if the interest on such obligation would be (but for IRC section 54AA) excludable from gross income under IRC section 103, and the issuer makes an irrevocable election to have the rules in IRC section 54AA apply.<sup>37</sup> In determining if an obligation would be tax-exempt under IRC section 103, the credit (or the payment discussed below for direct-pay build America bonds) is not treated as a federal guarantee.<sup>38</sup> Further, for purposes of the restrictions on arbitrage in IRC section 148, the yield on a tax-credit build America bond is determined without regard to the credit;<sup>39</sup> the yield on a direct-pay build America bond is reduced by the payment made pursuant to IRC section 6431.<sup>40</sup> A build America bond does not include any bond if the issue price has more than a de minimis amount of premium over the stated principal amount of the bond.<sup>41</sup>

#### Treatment of Holders of Tax-Credit Build America Bonds

The holder of a tax-credit build America bond accrues a tax credit in the amount of 35 percent of the interest paid on the interest payment dates of the bond during the calendar year.<sup>42</sup> The interest payment date is any date on which the holder of record of the build America bond is entitled to a payment of interest under such bond.<sup>43</sup> The sum of the accrued credits is allowed against regular and alternative minimum tax; unused credit may be carried forward to succeeding taxable years.<sup>44</sup> The credit, as well as the interest paid by the issuer, is included in gross income, and the credit may be stripped under rules similar to those provided in IRC section 54A regarding

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<sup>37</sup> IRC section 54AA(d). Subject to updated IRS reporting forms or procedures, an issuer of build America bonds makes the election required by IRC section 54AA on its books and records on or before the issue date of such bonds. Notice 2009-26, 2009-16 I.R.B. 833.

<sup>38</sup> IRC section 54AA(d)(2)(A). IRC section 149(b) provides that IRC section 103(a) shall not apply to any state or local bond if such bond is federally guaranteed.

<sup>39</sup> IRC section 54AA(d)(2)(B).

<sup>40</sup> IRC section 6431(c).

<sup>41</sup> IRC section 54AA(d)(2)(C).

<sup>42</sup> IRC section 54AA(a) and (b). Original issue discount (“OID”) is not treated as a payment of interest for purposes of determining the credit under the provision. OID is the excess of an obligation’s stated redemption price at maturity over the obligation’s issue price (IRC section 1273(a)).

<sup>43</sup> IRC section 54AA(e).

<sup>44</sup> IRC section 54AA(c).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

qualified tax-credit bonds.<sup>45</sup> Rules similar to those that apply for S corporations, partnerships and regulated investment companies with respect to qualified tax-credit bonds also apply to the credit.<sup>46</sup>

#### Special Rules for Direct-Pay Build America Bonds

Under the special rule for qualified bonds, in lieu of the tax credit to the holder, the issuer is allowed a credit equal to 35 percent of each interest payment made under such bond.<sup>47</sup> A “qualified bond,” that is, a direct-pay build America bond, is any build America bond issued as part of an issue if 100 percent of the excess of available project proceeds of such issue over the amounts in a reasonably required reserve with respect to such issue are to be used for capital expenditures.<sup>48</sup> Direct-pay build America bonds also must be issued before January 1, 2011. The issuer must make an irrevocable election to have the special rule for qualified bonds apply.<sup>49</sup>

The payment by the Secretary is to be made contemporaneously with the interest payment made by the issuer, and may be made either in advance or as reimbursement.<sup>50</sup> In lieu of payment to the issuer, the payment may be made to a person making interest payments on behalf of the issuer.<sup>51</sup>

#### Qualified Tax Credit Bonds

Qualified tax credit bonds include qualified forestry conservation bonds, new clean renewable energy bonds (“New CREBs”), qualified energy conservation bonds (“QECs”), qualified zone

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<sup>45</sup> IRC section 54AA(f).

<sup>46</sup> IRC section 54AA(f).

<sup>47</sup> IRC section 54AA(g)(1). OID is not treated as a payment of interest for purposes of calculating the refundable credit under the provision.

<sup>48</sup> IRC section 54AA(g). Under Treas. Reg. section 150-1(b), capital expenditure means any cost of a type that is properly chargeable to capital account (or would be so chargeable with a proper election or with the application of the definition of placed in service under Treas. Reg. section 1.150-2(c)) under general federal income tax principles. For purposes of applying the “general-federal-income-tax-principles” standard, an issuer should generally be treated as if it were a corporation subject to taxation under Subchapter C of Chapter 1 of the IRC. An example of a capital expenditure would include expenditures made for the purchase of fiber-optic cable to provide municipal broadband service.

<sup>49</sup> IRC section 54AA(g)(2)(B). Subject to updated IRS reporting forms or procedures, an issuer of direct-pay build America bonds makes the election required by IRC section 54AA(g)(2)(B) on its books and records on or before the issue date of such bonds. Notice 2009-26, 2009-16 I.R.B. 833.

<sup>50</sup> IRC section 6431.

<sup>51</sup> IRC section 6431(b).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

academy bonds (“QZABs”) issued after the date of enactment (October 3, 2008) of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, and qualified school construction bonds (“QSCBs”).<sup>52</sup> Qualified tax credit bonds generally are not interest-bearing obligations. Rather, the taxpayer holding a qualified tax credit bond on a credit allowance date is entitled to a tax credit.<sup>53</sup> The annual amount of the credit is determined by multiplying the bond’s applicable credit rate by the outstanding face amount of the bond.<sup>54</sup> The credit rate for an issue of qualified tax credit bonds is determined by the Secretary and is estimated to be a rate that permits issuance of the qualified tax credit bonds without discount and interest cost to the qualified issuer.<sup>55</sup> The Secretary determines credit rates for tax credit bonds based on general assumptions about credit quality of the class of potential eligible issuers and such other factors as the Secretary deems appropriate. The Secretary may determine credit rates based on general credit market yield indices and credit ratings.<sup>56</sup> The credit accrues quarterly,<sup>57</sup> is includible in gross income (as if it were an interest payment on the bond),<sup>58</sup> and can be claimed against regular income tax liability and alternative minimum tax liability.<sup>59</sup> Unused credits may be carried forward to succeeding taxable years.<sup>60</sup> In addition, under regulations prescribed by the Secretary, credits may be stripped.<sup>61</sup>

Qualified tax credit bonds are subject to a maximum maturity limitation. The maximum maturity is the term which the Secretary estimates will result in the present value of the obligation to repay the principal on a qualified tax credit bond being equal to 50 percent of the face amount of such bond.<sup>62</sup> The discount rate used to determine the present value amount is the average annual

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<sup>52</sup> IRC section 54A(d).

<sup>53</sup> IRC section 54A(a).

<sup>54</sup> IRC section 54A(b)(2).

<sup>55</sup> IRC section 54A(b)(3). However, for New CREBs and QECs, the applicable credit rate is 70 percent of the otherwise applicable rate.

<sup>56</sup> See Internal Revenue Service, Notice 2009-15, *Credit Rates on Tax Credit Bonds*, 2009-6 I.R.B. 1 (January 22, 2009). Given the differences in credit quality and other characteristics of individual issuers, the Secretary cannot set credit rates in a manner that will allow each issuer to issue tax credit bonds at par.

<sup>57</sup> IRC section 54(A)(b)(1).

<sup>58</sup> IRC section 54A(f).

<sup>59</sup> IRC section 54A(c).

<sup>60</sup> IRC section 54A(c).

<sup>61</sup> IRC section 54A(i).

<sup>62</sup> IRC section 54A(d)(5).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

interest rate of tax-exempt obligations having a term of 10 years or more which are issued during the month the qualified tax credit bonds are issued.

For qualified tax credit bonds, 100 percent of the available project proceeds must be used within the three-year period that begins on the date of issuance.<sup>63</sup> Available project proceeds are the sum of: (1) the excess of the proceeds from the sale of the bond issue over issuance costs (not to exceed two percent); and (2) any investment earnings on such sale proceeds.<sup>64</sup> To the extent less than 100 percent of the available project proceeds are used to finance qualified projects during the three-year spending period, bonds will continue to qualify as qualified tax credit 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 qualified 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 tax credit bonds also are subject to the arbitrage requirements of IRC section 148 that apply to traditional tax-exempt bonds.<sup>65</sup> Principles under IRC section 148 and the regulations thereunder apply for purposes of determining the yield restriction and arbitrage rebate requirements applicable to qualified tax credit bonds. 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 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 tax credit bonds are issued.

Issuers of qualified tax credit bonds are required to report issuance to the IRS in a manner similar to the information returns required for tax-exempt bonds.<sup>66</sup> In addition, issuers of qualified tax credit bonds are required to certify that applicable state and local law requirements governing conflicts of interest are satisfied with respect to an issue, and if the Secretary prescribes additional conflicts of interest rules governing the appropriate members of Congress, federal, state, and local officials, and their spouses, the issuer must certify compliance with such additional rules with respect to an issue.<sup>67</sup>

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<sup>63</sup> IRC section 54A(d)(2).

<sup>64</sup> IRC section 54A(e)(4).

<sup>65</sup> IRC section 54A(d)(4).

<sup>66</sup> IRC section 54A(d)(3).

<sup>67</sup> IRC section 54A(d)(6).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

### New CREBs

A New CREB is any bond issued as part of an issue if: (1) 100 percent of the available project proceeds of such issue are to be used for capital expenditures incurred by governmental bodies, public power providers, or cooperative electric companies for one or more qualified renewable energy facilities; (2) the bond is issued by a qualified issuer; and (3) the issuer designates such bond as a New CREB.<sup>68</sup> Qualified renewable energy facilities are facilities that: (1) qualify for the tax credit under IRC section 45 (other than Indian coal and refined coal production facilities), without regard to the placed-in-service date requirements of that section; and (2) are owned by a public power provider, governmental body, or cooperative electric company.<sup>69</sup>

The term “qualified issuers” includes: (1) public power providers; (2) a governmental body; (3) cooperative electric companies; (4) a not-for-profit electric utility that has received a loan or guarantee under the Rural Electrification Act;<sup>70</sup> and (5) clean renewable energy bond lenders.<sup>71</sup> The term “public power provider” means a state utility with a service obligation, as such terms are defined in section 217 of the Federal Power Act<sup>72</sup> (as in effect on the date of the enactment of this paragraph).<sup>73</sup> A “governmental body” means any state or Indian tribal government, or any political subdivision thereof.<sup>74</sup> The term “cooperative electric company” means a mutual or cooperative electric company (described in IRC section 501(c)(12) or IRC section 1381(a)(2)(C)).<sup>75</sup> A clean renewable energy bond lender means a cooperative that is owned by, or has outstanding loans to, 100 or more cooperative electric companies and is in existence on February 1, 2002 (including any affiliated entity which is controlled by such lender).<sup>76</sup>

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<sup>68</sup> IRC section 54C(a).

<sup>69</sup> IRC section 54C(d)(1).

<sup>70</sup> Public Law 74-605.

<sup>71</sup> IRC section 54C(d)(6).

<sup>72</sup> 16 U.S.C. 791a et seq.

<sup>73</sup> IRC section 54C(d)(2).

<sup>74</sup> IRC section 54C(d)(3).

<sup>75</sup> IRC section 54C(d)(4). A mutual or cooperative electric company can be tax exempt under IRC section 501(c)(12) only if 85 percent or more of its income consists of amounts collected from members for the sole purpose of meeting losses and expenses (the “85-percent income test”). Certain types of income, e.g., income from qualified pole rentals, are not taken into account for purposes of the 85-percent income test. IRC section 501(c)(12)(C).

<sup>76</sup> IRC section 54C(d)(5).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

There is a national limitation for New CREBs of \$2.4 billion.<sup>77</sup> No more than one third of the national limit may be allocated to projects of public power providers, governmental bodies, or cooperative electric companies.<sup>78</sup> Allocations to governmental bodies and cooperative electric companies may be made in the manner the Secretary determines appropriate. Allocations to projects of public power providers shall be made, to the extent practicable, in such manner that the amount allocated to each such project bears the same ratio to the cost of such project as the maximum allocation limitation to projects of public power providers bears to the cost of all such projects.<sup>79</sup>

As with other qualified tax credit bonds, a taxpayer holding New CREBs on a credit allowance date is entitled to a tax credit. However, the credit rate on New CREBs is set by the Secretary at a rate that is 70 percent of the rate that would permit issuance of such bonds without discount and interest cost to the issuer.<sup>80</sup>

### QECs

A QEC is any bond issued as part of an issue if: (1) 100 percent of the available project proceeds of such issue are to be used for one or more qualified conservation purposes; (2) the bond is issued by a state or local government; and (3) the issuer designates such bond as a QEC.<sup>81</sup>

The term “qualified conservation purpose” means:

1. Capital expenditures incurred for purposes of reducing energy consumption in publicly owned buildings by at least 20 percent; implementing green community programs (including the use of loans, grants, or other repayment mechanisms to implement such programs);<sup>82</sup> rural development involving the production of electricity from renewable energy resources; or any facility eligible for the production tax credit under IRC section 45 (other than Indian coal and refined coal production facilities);<sup>83</sup>

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<sup>77</sup> IRC section 54C(c)(4) increases the original \$800 million allocation by \$1.6 billion for a total of \$2.4 billion.

<sup>78</sup> IRC sections 54C(c)(2) and (c)(4).

<sup>79</sup> IRC section 54C(c)(3).

<sup>80</sup> IRC section 54C(b).

<sup>81</sup> IRC section 54D(a).

<sup>82</sup> For example, states may issue QECs to finance retrofits of existing private buildings through loans and/or grants to individual homeowners or businesses, or through other repayment mechanisms. Other repayment mechanisms can include periodic fees assessed on a government bill or utility bill that approximates the energy savings of energy efficiency or conservation retrofits. Retrofits can include heating, cooling, lighting, water saving, storm water-reducing, or other efficiency measures.

<sup>83</sup> IRC section 54D(f)(1)(A).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

2. Expenditures with respect to facilities or grants that support research in: (a) development of cellulosic ethanol or other non-fossil fuels; (b) technologies for the capture and sequestration of carbon dioxide produced through the use of fossil fuels; (c) increasing the efficiency of existing technologies for producing non-fossil fuels; (d) automobile battery technologies and other technologies to reduce fossil fuel consumption in transportation; or (e) technologies to reduce energy use in buildings;<sup>84</sup>
3. Mass commuting facilities and related facilities that reduce the consumption of energy, including expenditures to reduce pollution from vehicles used for mass commuting;<sup>85</sup>
4. Demonstration projects designed to promote the commercialization of: (a) green building technology; (b) 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 combusting fossil fuels in order to produce electricity;<sup>86</sup> and
5. Public education campaigns to promote energy efficiency (other than movies, concerts, and other events held primarily for entertainment purposes).<sup>87</sup>

There is a national limitation on QECs of \$3.2 billion.<sup>88</sup> Allocations of QECs are made to the states with sub-allocations to large local governments.<sup>89</sup> Allocations are made to the states according to their respective populations, reduced by any sub-allocations to large local governments (defined below) within the states. Sub-allocations to large local governments shall be an amount of the national QEC limitation that bears the same ratio to the amount of such limitation that otherwise would be allocated to the state in which such large local government is located as the population of such large local government bears to the population of such state. The term “large local government” means any municipality or county if such municipality or county has a population of 100,000 or more. Indian tribal governments also are treated as large local governments for these purposes (without regard to population).

Each state or large local government receiving an allocation of QECs may further allocate issuance authority to issuers within such state or large local government. However, any allocations to

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<sup>84</sup> IRC section 54D(f)(1)(B).

<sup>85</sup> IRC section 54D(f)(1)(C).

<sup>86</sup> IRC section 54D(f)(1)(D).

<sup>87</sup> IRC section 54D(f)(1)(E).

<sup>88</sup> IRC section 54D(d).

<sup>89</sup> IRC section 54D(e).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

issuers within the state or large local government shall be made in a manner that results in not less than 70 percent of the allocation of QECs to such state or large local government being used to designate bonds that are not private activity bonds (i.e., the bond cannot meet the private business tests or the private loan test of IRC section 141).<sup>90</sup>

As with other qualified tax credit bonds, the taxpayer holding QECs on a credit allowance date is entitled to a tax credit. However, the credit rate on the bonds is set by the Secretary at a rate that is 70 percent of the rate that would permit issuance of such bonds without discount and interest cost to the issuer.<sup>91</sup>

### QZABs

A QZAB is any bond issued as part of an issue if: (1) 100 percent of the available project proceeds of such issue are to be used for a qualified purpose with respect to a qualified zone academy established by an eligible local education agency; (2) the bond is issued by a state or local government within the jurisdiction of which such academy is located; (3) the issuer designates such bond as a QZAB and certifies that the private business contribution requirement will be met and it has the written approval of the eligible local education agency for such bond issuance.<sup>92</sup>

A “qualified purpose” is: (1) rehabilitating or repairing the public school facility in which the qualified zone academy is established; (2) providing equipment for use at such academy; (3) developing course materials for education to be provided at such academy; and (4) training teachers and other school personnel in such academy.<sup>93</sup>

A public school (or academic program within a public school) is a “qualified zone academy” if: (1) the public school or program provides education and training below the college level; (2) the public school or program is designed in cooperation with business to enhance the academic curriculum, increase graduation and employment rates, and better prepare students for the rigors of college and the workforce; (3) students in such public school or program will be subject to the same academic standards and assessments as other students educated by the eligible local education agency; (4) the comprehensive education plan of such public school or program is approved by the eligible local education agency; and (5) either the public school is located in an empowerment zone or enterprise community designated under the IRC, or it is reasonably

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<sup>90</sup> IRC section 54D(e)(3). In the case of any bond used for the purpose of providing grants, loans or other repayment mechanisms for capital expenditures to implement green community programs, such bond shall not be treated as a private activity bond for purposes of determining whether this requirement is met. IRC section 54D(e)(4).

<sup>91</sup> IRC section 54D(b).

<sup>92</sup> IRC section 54E(a).

<sup>93</sup> IRC section 54E(d)(3).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

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.<sup>94</sup>

In general, the private business contribution requirement is met where 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 present value (as of the date of the issue) equal to at least 10 percent of the bond proceeds.<sup>95</sup>

There is a national QZAB limitation for each calendar year. For 2009 and 2010, the limitation is \$1.4 billion.<sup>96</sup> The limitation is allocated by the Secretary among the states on the basis of their respective populations of individuals below the poverty line; each state education agency then make an allocation of its shares of the national limitation to qualified zone academies in the state.<sup>97</sup> Unused limitation may be carried only to the first two years following the unused limitation year.<sup>98</sup> For this purpose, a limitation amount shall be treated as used on a first-in first-out basis.

## QSCBs

### *In general*

QSCBs must meet three requirements: (1) 100 percent of the available project proceeds of the bond issue must be used for the construction, rehabilitation, or repair of a public school facility or for the acquisition of land on which such a bond-financed facility is to be constructed; (2) the bond must be issued by a state or local government within the jurisdiction of which such school is located; and (3) the issuer must designate such bonds as a QSCB.<sup>99</sup>

### *National limitation*

There is a national limitation on QSCBs of \$11 billion for calendar years 2009 and 2010, respectively.<sup>100</sup>

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<sup>94</sup> IRC section 54E(d)(1); Public Law 79-396.

<sup>95</sup> IRC section 54E(b).

<sup>96</sup> IRC section 54E(c)(1).

<sup>97</sup> IRC section 54E(c)(2).

<sup>98</sup> IRC section 54E(c)(4).

<sup>99</sup> IRC section 54F(a).

<sup>100</sup> IRC section 54F(c).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

*Allocation to the states*

The national limitation is tentatively allocated among the states in proportion to respective amounts each such state is eligible to receive under section 1124 of the Elementary and Secondary Education Act of 1965<sup>101</sup> for the most recent fiscal year ending before such calendar year. Forty percent of the limitation is then allocated among the largest school districts, and the amount each state is allocated under the tentative allocation formula is then reduced by the amount received by any local large educational agency within the state.<sup>102</sup> The limitation amount allocated to a state is allocated by the state to issuers within such state.

For allocation purposes, a “state” includes the District of Columbia and any possession of the United States. The provision provides a special rule for allocation for possessions of the United States other than Puerto Rico under the national limitation for states.<sup>103</sup> Under this special rule, an allocation to a possession other than Puerto Rico is made on the basis of the respective populations of individuals below the poverty line (as defined by the Office of Management and Budget) rather than respective populations of children aged five through seventeen. This special allocation reduces the state allocation share of the national limitation otherwise available for allocation among the states. Under another special rule, the Secretary of the Interior may allocate \$200 million of school construction bonds for 2009 and 2010, respectively, to Indian schools.<sup>104</sup> This special allocation for Indian schools is to be used for purposes of the construction, rehabilitation, and repair of schools funded by the Bureau of Indian Affairs. For purposes of such allocations Indian tribal governments are qualified issuers. The special allocation for Indian schools does not reduce the state allocation share of the national limitation otherwise available for allocation among the states.

If an amount allocated under this allocation to the states is unused for a calendar year it may be carried forward by the state to the next calendar year.<sup>105</sup>

*Allocation to large school districts*

Forty percent of the national limitation is allocated among large local educational agencies in proportion to the respective amounts each agency received under section 1124 of the Elementary and Secondary Education Act of 1965 for the most recent fiscal year ending before such calendar year.<sup>106</sup> With respect to a calendar year, the term large local educational agency means any local

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<sup>101</sup> Public Law 89-10.

<sup>102</sup> IRC section 54F(d).

<sup>103</sup> IRC section 54F(d)(3).

<sup>104</sup> IRC section 54F(d)(4).

<sup>105</sup> IRC section 54F(e).

<sup>106</sup> IRC section 54F(d)(2).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

educational agency if such agency is: (1) among the 100 local educational agencies with the largest numbers of children aged five through 17 from families living below the poverty level; or (2) one of not more than 25 local educational agencies (other than in (1), immediately above) that the Secretary of Education determines are in particular need of assistance, based on a low level of resources for school construction, a high level of enrollment growth, or other such factors as the Secretary of Education deems appropriate. If any amount allocated to large local educational agency is unused for a calendar year the agency may reallocate such amount to the state in which the agency is located.

New Federal Law (IRC sections 54F and 6431)

For bonds originally issued after March 18, 2010, the provision allows an issuer of New CREBS, QECs, QZABs, or QSCBs to make an irrevocable election on or before the issue date of such bonds to receive a payment under IRC section 6431 in lieu of providing a tax credit to the holder of the bonds.<sup>107</sup> The payment to the issuer on each payment date is equal to (1) in the case of a bond issued by a qualified small issuer, 65 percent of the amount of interest payable on such bond by such issuer with respect to such date, and (2) in the case of a bond issued by any other person, 45 percent of the amount of interest payable on such bond by such issuer with respect to such date. Thus, the amount of the payment to the issuer is a function of the market determined interest rate on the bond and not a rate set by the Secretary. For purposes of the provision, a “qualified small issuer” means, with respect to any calendar year, any issuer that is not reasonably expected to issue tax-exempt bonds (other than private activity bonds), New CREBS, QECs, QZABs, and QSCBs during such calendar year that have an aggregate face amount exceeding \$30 million.<sup>108</sup> Bonds for which the election is made count against the national limitation in the same way that they would if no election were made.

Interest paid to the holder of the bond is includible in the holder's gross income. The payment made to the issuer under IRC section 6431 is not includible in the issuer's income, and the issuer's deduction for interest paid on the bond is reduced by the amount paid to the issuer under IRC section 6431.

The provision also adds a technical correction relating to QSCBs. The technical correction provides first that the limitation amount allocated to a state is to be allocated to issuers within such state by the state education agency (or such other agency as is authorized under state law to make such allocation). In addition, the technical correction provides that the rule in

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<sup>107</sup> It is anticipated that the election procedure will be similar to the procedure for making the election required under IRC section 54AA(g) for a direct-pay build America bond. See Notice 2009-26, 2009-16 I.R.B. 833.

<sup>108</sup> It is anticipated that rules similar to IRC section 265(b)(3)(E) will apply in determining whether the \$30 million limitation is satisfied. It is further anticipated that in the case of any composite, pooled or other conduit financing issue, the proceeds of which are used directly or indirectly to make or finance loans to one or more ultimate borrowers, the \$30 million limitation will be applied at the borrower level. IRC section 265(b)(3)(G).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

IRC section 54F(e), permitting the carryover of unused QSCB limitation by a state or Indian tribal government, shall also apply to the 40 percent of QSCB limitation that is allocated among the largest school districts.

Effective Date

The provision is effective for bonds issued after March 18, 2010. The technical correction is effective as if it were included in section 1521 of the American Recovery and Reinvestment Act of 2009.<sup>109</sup>

California Law (R&TC sections 17143 and 24272)

California does not conform to federal tax-credit bonds, and income from such bonds is not includable in California gross income.

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.

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 (subdivision (b) of section 26 of Article XIII). The R&TC further provides 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 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

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<sup>109</sup> Public Law 111-5.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

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 federal 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 as the measure of the tax for the privilege of exercising the corporate franchise.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

Impact on California Revenue

Not applicable.

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<u>Sections</u>	<u>Section Title</u>
441 - 445	Revenue Provisions Relating to the Highway Trust Fund

Background

Extension of Expenditure Authority

The Highway Trust Fund was established in 1956. It is divided into two accounts, a Highway Account and a Mass Transit Account, each of which is the funding source for specific transportation programs. The Highway Trust Fund is funded by taxes on motor fuels (gasoline, kerosene, diesel fuel, and certain alternative fuels), a tax on heavy vehicle tires, a retail sales tax on certain trucks, trailers and tractors, and an annual use tax for heavy highway vehicles. The current expenditure authority for the Highway Trust Fund generally expires on March 1, 2010.<sup>110</sup>

The Sport Fish Restoration and Boating Trust Fund is the funding source for certain coastal wetlands preservation, recreational boating safety, sport fish restoration and other programs. The current expenditure authority for the Sport Fish Restoration and Boating Trust Fund generally expires on March 1, 2010.

Crediting of Interest

With respect to trust funds established by the IRC, the IRC requires that the Secretary invest the balances not needed to meet current withdrawals in interest-bearing obligations of the United States. The interest is credited to the respective Trust Fund.<sup>111</sup> However, as of September 30, 1998, the ability of the Highway Trust Fund to earn interest on its unexpended balances was terminated.<sup>112</sup>

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<sup>110</sup> Public Law 111-118, Division B, section 1008 (2009).

<sup>111</sup> IRC section 9602(b).

<sup>112</sup> IRC section 9503(f)(2).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

Transfers from the Highway Trust Fund to the General Fund for Certain Payments and Credits

Under present law, revenues from the highway excise taxes generally are dedicated to the Highway Trust Fund. However, under IRC section 9503(c)(2), certain transfers are made from the Highway Trust Fund into the General Fund, relating to amounts paid in respect of gasoline used on farms, amounts paid in respect of gasoline used for certain non-highway purposes or by local transit systems, amounts relating to fuels not used for taxable purposes, and income tax credits for certain uses of fuels.

New Federal Law (IRC sections 9502, 9503, and 9504)

Extension of Expenditure Authority

The provision extends expenditure authority for the Highway Trust Fund through December 31, 2010. It also extends the expenditure authority for the Sport Fish Restoration and Boating Trust Fund through December 31, 2010.

Crediting of Interest

*Restoration of forgone interest*

The provision transfers \$19.5 billion to the Highway Trust Fund, of that amount \$14.7 billion is appropriated to the Highway Account of the Highway Trust Fund and \$4.8 billion is appropriated to the Mass Transit Account. The amounts appropriated pursuant to this provision remain available without fiscal-year limitation.

*Repeal of provision prohibiting the crediting of interest*

The provision repeals the requirement that obligations held by the Highway Trust Fund not be interest-bearing. The provision permits amounts in the Trust Fund to be invested in interest-bearing obligations of the United States and have the interest be credited to, and form a part of, the Highway Trust Fund. Thus, the Highway Trust Fund will accrue interest under the provision.

Termination of Transfers from the Highway Trust Fund for Certain Repayments and Credits

The provision repeals IRC section 9503(c)(2), eliminating the requirement that the Highway Trust Fund reimburse the General Fund for credits and payments related to nontaxable uses.

Effective Date

The provisions are generally effective on March 18, 2010. The expenditure authority provisions are effective September 30, 2009. The provision terminating transfers from the Highway Trust Fund is effective for transfers relating to amounts paid and credits allowed after March 18, 2010.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

California Law

The FTB does not administer excise taxes. Defer to the Board of Equalization (BOE).

Impact on California Revenue

Defer to the BOE.

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<u>Section</u>	<u>Section Title</u>
501	Reporting on Certain Foreign Accounts

Background

Withholding on Payments to Foreign Persons

Payments of U.S.-source fixed or determinable annual or periodical (“FDAP”) income, including interest, dividends, and similar types of investment income, that are made to foreign persons are subject to U.S. withholding tax at a 30-percent rate, unless the withholding agent can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty.<sup>113</sup> The term “FDAP income” includes all items of gross income,<sup>114</sup> except gains on sales of property (including market discount on bonds and option premiums).<sup>115</sup>

Interest is derived from U.S. sources if it is paid by the United States or any agency or instrumentality thereof, a state or any political subdivision thereof, or the District of Columbia. Interest is also from U.S. sources if it is paid by a resident or a domestic corporation on a bond,

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<sup>113</sup> IRC sections 871, 881, 1441, and 1442; Treas. Reg. section 1.1441-1(b). For purposes of the withholding tax rules applicable to payments to nonresident alien individuals and foreign corporations, a withholding agent is defined broadly to include any U.S. or foreign person that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding. Treas. Reg. section 1.1441-7(a).

<sup>114</sup> Although technically insurance premiums paid to a foreign insurer or reinsurer are FDAP income, they are exempt from withholding under Treas. Reg. section 1.1441-2(a)(7) if the insurance contract is subject to the excise tax under IRC section 4371.

<sup>115</sup> Treas. Reg. section 1.1441-2(b)(1)(i), -2(b)(2). However, gain on a sale or exchange of IRC section 306 stock of a domestic corporation is FDAP income to the extent IRC section 306(a) treats the gain as ordinary income. Treas. Reg. section 1.306-3(h).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

note, or other interest-bearing obligation.<sup>116</sup> Dividend income is sourced by reference to the payor's place of incorporation.<sup>117</sup> Thus, dividends paid by a domestic corporation are generally treated as entirely U.S.-source income. Similarly, dividends paid by a foreign corporation are generally treated as entirely foreign-source income. Rental income is sourced by reference to the location or place of use of the leased property.<sup>118</sup> The nationality or the country of residence of the lessor or lessee does not affect the source of rental income. Rental income from property located or used in the United States (or from any interest in such property) is U.S.-source income, regardless of whether the property is real or personal, intangible or tangible. Royalties are sourced in the place of use (or the privilege of use) of the property for which the royalties are paid.<sup>119</sup> This source rule applies to royalties for the use of either tangible or intangible property, including patents, copyrights, secret processes, formulas, goodwill, trademarks, trade names, and franchises.

The principal statutory exemptions from the 30-percent withholding tax apply to interest on bank deposits, portfolio interest, and gains derived from the sale of property. Since 1984, the United States has not imposed withholding tax on portfolio interest received by a nonresident individual or foreign corporation from sources within the United States.<sup>120</sup> Portfolio interest includes, generally, any interest (including original issue discount) other than interest received by a 10-percent shareholder,<sup>121</sup> certain contingent interest,<sup>122</sup> interest received by a controlled foreign corporation from a related person,<sup>123</sup> and interest received by a bank on an extension of credit

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<sup>116</sup> IRC section 861(a)(1); Treas. Reg. section 1.861-2(a)(1). Interest paid by the U.S. branch of a foreign corporation is also treated as U.S.-source interest under IRC section 884(f)(1).

<sup>117</sup> IRC sections 861(a)(2) and 862(a)(2).

<sup>118</sup> IRC section 861(a)(4).

<sup>119</sup> IRC section 861(a)(4).

<sup>120</sup> IRC sections 871(h) and 881(c). Congress believed that the imposition of a withholding tax on portfolio interest paid on debt obligations issued by U.S. persons might impair the ability of domestic corporations to raise capital in the Eurobond market (i.e., the global market for U.S. dollar-denominated debt obligations). Congress also anticipated that repeal of the withholding tax on portfolio interest would allow the Treasury Department direct access to the Eurobond market. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, pp. 391-92.

<sup>121</sup> IRC section 871(h)(3). A 10-percent shareholder includes any person who owns 10 percent or more of the total combined voting power of all classes of stock of the corporation (in the case of a corporate obligor), or 10 percent or more of the capital or profits interest of the partnership (in the case of a partnership obligor). The attribution rules of IRC section 318 apply for this purpose, with certain modifications.

<sup>122</sup> IRC section 871(h)(4). Contingent interest generally includes any interest if the amount of such interest is determined by reference to any receipts, sales, or other cash flow of the debtor or a related person; any income or profits of the debtor or a related person; any change in value of any property of the debtor or a related person; any dividend, partnership distributions, or similar payments made by the debtor or a related person; and any other type of contingent interest identified by Treasury regulation. Certain exceptions also apply.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

made pursuant to a loan agreement entered into in the ordinary course of its trade or business.<sup>124</sup> In the case of interest paid on a debt obligation that is in registered form,<sup>125</sup> the portfolio interest exemption is available only to the extent that the U.S. person otherwise required to withhold tax (the “withholding agent”) has received a statement made by the beneficial owner of the obligation (or a securities clearing organization, bank, or other financial institution that holds customers’ securities in the ordinary course of its trade or business) that the beneficial owner is not a U.S. person.<sup>126</sup>

Interest on deposits with foreign branches of domestic banks and domestic savings and loan associations is not treated as U.S.-source income and is thus exempt from U.S. withholding tax (regardless of whether the recipient is a U.S. or foreign person).<sup>127</sup> In addition, interest on bank deposits, deposits with domestic savings and loan associations, and certain amounts held by insurance companies are not subject to the U.S. withholding tax when paid to a foreign person, unless the interest is effectively connected with a U.S. trade or business of the recipient.<sup>128</sup> Similarly, interest and original issue discount on certain short-term obligations is also exempt from U.S. withholding tax when paid to a foreign person.<sup>129</sup> Additionally, there is no information reporting with respect to payments of such amounts.<sup>130</sup>

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<sup>123</sup> IRC section 881(c)(3)(C). A related person includes, among other things, an individual owning more than 50 percent of the stock of the corporation by value, a corporation that is a member of the same controlled group (defined using a 50-percent common ownership test), a partnership if the same persons own more than 50 percent in value of the stock of the corporation and more than 50 percent of the capital interests in the partnership, any U.S. shareholder (as defined in IRC section 951(b) and generally including any U.S. person who owns 10 percent or more of the voting stock of the corporation), and certain persons related to such a U.S. shareholder.

<sup>124</sup> IRC section 881(c)(3)(A).

<sup>125</sup> An obligation is treated as in registered form if: (1) it is registered as to both principal and interest with the issuer (or its agent) and transfer of the obligation may be effected only by surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder; (2) the right to principal and stated interest on the obligation may be transferred only through a book entry system maintained by the issuer or its agent; or (3) the obligation is registered as to both principal and interest with the issuer or its agent and may be transferred through both of the foregoing methods. Treas. Reg. section 5f.103-1(c).

<sup>126</sup> IRC section 871(h)(2)(B), (5); Treas. Reg. section 1.871-14(e). This certification of non-U.S. ownership most commonly is made on an IRS Form W-8. This certification is not valid if the Secretary determines that statements from the person making the certification do not meet certain requirements.

<sup>127</sup> IRC section 861(a)(1)(B); Treas. Reg. section 1.1441-1(b)(4)(iii).

<sup>128</sup> IRC sections 871(i)(2)(A), 881(d); Treas. Reg. section 1.1441-1(b)(4)(ii). If the bank deposit interest is effectively connected with a U.S. trade or business, it is subject to regular U.S. income tax rather than withholding tax.

<sup>129</sup> IRC sections 871(g)(1)(B), 881(a)(3); Treas. Reg. section 1.1441-1(b)(4)(iv).

<sup>130</sup> Treas. Reg. section 1.1461-1(c)(2)(ii)(A), (B). However, Treasury regulations require a bank to report interest if the recipient is a resident of Canada and the deposit is maintained at an office in the United States. Treas. Reg. sections 1.6049-4(b)(5), 1.6049-8. This reporting is required to comply with the obligations of the United States under the

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

Gains derived from the sale of property by a nonresident alien individual or foreign corporation generally are exempt from U.S. tax, unless they are or are treated as effectively connected with the conduct of a U.S. trade or business. Gains derived by a nonresident alien individual generally are subject to U.S. taxation only if the individual is present in the United States for 183 days or more during the taxable year.<sup>131</sup> Foreign corporations are subject to tax with respect to certain gains on disposal of timber, coal, or domestic iron ore and certain gains from contingent payments made in connection with sales or exchanges of patents, copyrights, goodwill, trademarks, and similar intangible property.<sup>132</sup> Gain from the disposition of certain U.S. real property interests (which include interests in U.S. real property holding corporations) are treated as effectively connected with a U.S. trade or business.<sup>133</sup> Special rules apply in the case of interests in real estate investment trusts or interests in regulated investment companies that are or which would be, if not for certain exceptions, U.S. real property holding corporations.<sup>134</sup> Most gains realized by foreign investors on the sale of portfolio investment securities thus are exempt from U.S. taxation.

The 30-percent withholding tax may be reduced or eliminated by a tax treaty between the United States and the country in which the recipient of income otherwise subject to withholding is resident. Most U.S. income tax treaties provide a zero rate of withholding tax on interest payments (other than certain interest the amount of which is determined by reference to certain income items or other amounts of the debtor or a related person). Most U.S. income tax treaties also reduce the rate of withholding on dividends to 15 percent (in the case of portfolio dividends) and to five percent (in the case of “direct investment” dividends paid to a 10-percent-or-greater shareholder).<sup>135</sup> For royalties, the U.S. withholding rate is typically reduced to five percent or to zero. In each case, the reduced withholding rate is available only to a beneficial owner who is

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U.S.-Canada income tax treaty. T.D. 8664, 1996-1 C.B. 292. In 2001, the IRS and the Treasury Department issued proposed regulations that would require annual reporting to the IRS of U.S. bank deposit interest paid to any foreign individual. 66 Fed. Reg. 3925 (Jan. 17, 2001). The 2001 proposed regulations were withdrawn in 2002 and replaced with proposed regulations that would require reporting with respect to payments made only to residents of certain specified countries (Australia, Denmark, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, and the United Kingdom). 67 Fed. Reg. 50,386 (Aug. 2, 2002). The proposed regulations have not been finalized.

<sup>131</sup> IRC section 871(a)(2). In most cases, however, an individual satisfying this presence test will be treated as a U.S. resident under IRC section 7701(b)(3), and thus will be subject to full residence-based U.S. income taxation.

<sup>132</sup> IRC sections 881(a), 631(b), (c).

<sup>133</sup> IRC section 897. IRC section 1445 imposes withholding requirements with respect to such dispositions.

<sup>134</sup> See IRC section 897(h).

<sup>135</sup> A number of recent U.S. income tax treaties eliminate withholding tax on dividends paid to a majority (typically 80-percent or greater) shareholder, including the present treaties with Australia, Belgium, Denmark, Finland, Germany, Japan, Mexico, the Netherlands, Sweden, and the United Kingdom.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

treated as a resident of the treaty country within the meaning of the treaty and satisfies all other treaty requirements including any applicable limitation on benefits provisions of the treaty.

#### Refund or Credits of Taxes Withheld from Foreign Persons

A withholding agent that makes payments of U.S.-source amounts to a foreign person is required to report those payments, including any amounts of U.S. tax withheld, to the IRS on federal forms 1042 and 1042-S by March 15 of the calendar year following the year in which the payment is made.<sup>136</sup> To the extent that the withholding agent deducts and withholds an amount, the withheld tax is credited to the recipient of the income.<sup>137</sup> If the agent withholds more than is required, and results in an overpayment of tax, the excess may be refunded to the recipient of the income upon filing of a timely claim for refund.

#### *Payment of tax*

The date an amount is paid is relevant for determining the limitations period in which to claim a refund, the amount of refund available,<sup>138</sup> and the period for which interest may accrue on any overpayment.<sup>139</sup> An amount that is withheld, paid, or credited as an estimate or deposit of tax generally does not count as the payment of tax until applied to a specific tax liability. To the extent that amounts previously withheld, paid or credited as an estimate or deposit of tax are applied to the tax liability for a year, they are deemed to have been paid as of the last day prescribed for payment of the tax, for both the recipient of the income<sup>140</sup> and the withholding agent.<sup>141</sup> Amounts that are refunded, credited to other periods, or offset against other liabilities are not considered as paid for this purpose.<sup>142</sup> Any amount that was previously paid but has been credited to a later year is considered credited on the last day prescribed for the payment of tax.<sup>143</sup>

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<sup>136</sup> Treas. Reg. sections 1.1461-1(b), (c). IRS Form 1042, "Annual Withholding Tax Return for U.S. Source Income of Foreign Persons," is the IRS form on which a withholding agent reports a summary of the total U.S.- source income paid and withholding tax withheld on foreign persons for the year. IRS Form 1042-S, "Foreign Person's U.S. Source Income Subject to Withholding," is the IRS form on which a withholding agent reports, to the foreign person and the IRS, a foreign person's U.S.-source income that is subject to reporting.

<sup>137</sup> IRC section 1462.

<sup>138</sup> See IRC sections 6511(a) (prescribing the period within which a claim must be filed) and 6511(b)(2) (limiting the amount that can be recovered if a claim is not filed within three years of filing a return). If a return is not filed, a claim for refund of any tax paid must be filed within two years of payment.

<sup>139</sup> IRC sections 6611(b)(2), (d).

<sup>140</sup> IRC section 6513(b)(3).

<sup>141</sup> IRC section 6513(c)(2).

<sup>142</sup> IRC section 6513(d).

<sup>143</sup> IRC section 6513(d).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

*Interest on overpayments*

The IRS is generally required to pay interest to a taxpayer whenever there is an overpayment of tax.<sup>144</sup> An overpayment of tax exists whenever more than the correct amount of tax is paid as of the last date prescribed for the payment of the tax. The last date prescribed for the payment of the income tax is the original due date of the return.<sup>145</sup> However, no interest is required to be paid by the IRS if it refunds or credits the amount due within 45 days of the filing of the return.<sup>146</sup> Notwithstanding these general rules, if a required return on which the payment should have been reported is either not filed, or is filed late, no interest on the overpayment accrues for any period prior to the filing of the return.<sup>147</sup>

Different interest rates are provided for the payment of interest depending upon the type of taxpayer, whether the interest relates to an underpayment or overpayment, and the size of the underpayment or overpayment. Interest on both underpayments and overpayments is compounded daily.<sup>148</sup> A special net interest rate of zero applies in situations where interest is both payable and allowable on offsetting amounts of overpayment and underpayment.<sup>149</sup> For individuals, interest on both underpayments and overpayments accrues at a rate equal to the short term applicable federal rate (“AFR”) plus three percentage points.<sup>150</sup> Interest on corporate overpayments generally accrues at a rate equal to the short term AFR plus two percentage points, unless the overpayment exceeds \$10,000 in which case interest accrues at a rate equal to the short term AFR plus one-half percentage point.

*Period of overpayment*

If the overpayment is to be refunded to the taxpayer, interest accrues on the overpayment from the later of the due date of the return or the date the payment is made until a date that is not more than 30 days before the date of the refund check.<sup>151</sup> If the overpayment is to be credited or offset against some other liability, interest will accrue until the date it is so credited or offset.

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<sup>144</sup> IRC section 6611.

<sup>145</sup> IRC section 6601(b).

<sup>146</sup> IRC section 6611(e).

<sup>147</sup> IRC section 6611(b)(3).

<sup>148</sup> IRC section 6622.

<sup>149</sup> IRC section 6621(d).

<sup>150</sup> IRC section 6621.

<sup>151</sup> IRC section 6611(b)(2).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

A payment is not considered made by the taxpayer earlier than the time the taxpayer files a return showing the liability. However, in *MNOPF Trustees, Ltd. v. United States*,<sup>152</sup> the Federal Circuit held that overpayment interest accrued on the taxes unnecessarily withheld from the date that the withholdings were paid to the IRS, because MNOPF was a tax-exempt organization, and, therefore, was not required to file tax returns. As a result, the court rejected arguments by the government that interest commenced no earlier than the filing of the refund claims. The court reasoned that IRC sections 6611(d) and 6513(b)(3) did not apply because those sections only relate to taxable income and the taxpayer was exempt from federal taxation. Instead, the court held that the organization's overpayment was deemed paid, pursuant to IRC section 6611(b)(2), on the date the withholding agent filed the returns reporting the withheld taxes.

No interest accrues on an overpayment if the IRS makes the refund within 45 days of the later of the filing or the due date of the return showing the refund. If the IRS fails to make the refund within such 45-day period, interest is required to be paid for the entire period of the overpayment. For example, an individual taxpayer files his return on April 15, properly showing a refund due of \$10,000. If the IRS pays the refund within 45 days, no interest on the overpayment will be required. However, if the IRS does not pay the refund until the 46th day, interest will be required from April 15.

#### Certification of Foreign Status and Reporting by U.S. Withholding Agents

The U.S. withholding tax rules are administered through a system of self-certification. Thus, a nonresident investor seeking to obtain withholding tax relief for U.S.-source investment income typically must provide a certification, on federal Form W-8 to the withholding agent to establish foreign status and eligibility for an exemption or reduced rate. A provision of federal Form W-8 also establishes an exemption from the rules that apply to many U.S. persons governing information reporting on federal Form 1099 and backup withholding (discussed below).<sup>153</sup>

There are four relevant types of federal Forms W-8.<sup>154</sup> Three of these forms are designed to be provided to the withholding agent by the beneficial owner of a payment of U.S.-source income:<sup>155</sup> (1) federal Form W-8BEN, that is provided by a beneficial owner of U.S.-source non-effectively-connected income; (2) federal Form W-8ECI, that is provided by a beneficial owner of U.S.-source

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<sup>152</sup> 123 F.3d 1460, 1465 (Fed. Cir. 1997).

<sup>153</sup> See Treas. Reg. section 1.1441-1(b)(5).

<sup>154</sup> A fifth type of IRS Form W-8, the W-8CE, is filed to provide the payor with notice of a taxpayer's expatriation.

<sup>155</sup> The United States imposes tax on the beneficial owner of income, not its formal recipient. For example, if a U.S. citizen owns securities that are held in "street" name at a brokerage firm, that U.S. citizen (and not the brokerage firm nominee) is treated as the beneficial owner of the securities. A corporation (and not its shareholders) ordinarily is treated as the beneficial owner of the corporation's income. Similarly, a foreign complex trust ordinarily is treated as the beneficial owner of income that it receives, and a U.S. beneficiary or grantor is not subject to tax on that income unless and until he receives a distribution.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

effectively-connected income;<sup>156</sup> and (3) federal Form W-8EXP, that is provided by a beneficial owner of U.S.-source income that is an exempt organization or foreign government.<sup>157</sup> Each of these forms requires that the beneficial owner provide its name and address and certify that the beneficial owner is not a U.S. person. Federal Form W-8BEN also includes a certification of eligibility for treaty benefits (for completion where applicable). All certifications on federal Forms W-8 are made under penalties of perjury.

The fourth type of federal Form W-8 is federal Form W-8IMY that is provided by a payee that receives a payment of U.S.-source income as an intermediary for the beneficial owner of that income. The intermediary's federal Form W-8IMY must be accompanied by a federal Form W-8BEN, W-8EXP, or W-8ECI, as applicable,<sup>158</sup> furnished by the beneficial owner, unless the intermediary is a qualified intermediary ("QI"), a withholding foreign partnership, or a withholding foreign trust. The rules applicable to qualified intermediaries are discussed below. A withholding foreign partnership or trust is a foreign partnership or trust that has entered into an agreement with the IRS to collect appropriate federal Forms W-8 from its partners or beneficiaries and act as a U.S. withholding agent with respect to those persons.<sup>159</sup>

#### Information Reporting and Backup Withholding with Respect to U.S. Persons

Every person engaged in a trade or business must file with the IRS an information return on federal Form 1099 (or, for wages or other compensation, on federal Form W-2) for payments of certain amounts totaling at least \$600 that it makes to another person in the course of its trade or business.<sup>160</sup> Detailed rules are provided for the reporting of various types of investment income, including interest, dividends, and gross proceeds from brokered transactions (such as a sale of stock).<sup>161</sup> In general, the requirement to file federal Form 1099 applies with respect to amounts paid to U.S. persons and is linked to the backup withholding rules of IRC section 3406. Thus, to avoid backup withholding, a U.S. payee (other than exempt recipients, including

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<sup>156</sup> The federal Form W-8ECI requires that the beneficial owner specify the items of income to which the form is intended to apply and certify that those amounts are effectively connected with the conduct of a trade or business in the United States and includible in the beneficial owner's gross income for the taxable year.

<sup>157</sup> The federal Form W-8EXP requires that the beneficial owner certify as to its qualification as a foreign government, an international organization, a foreign central bank of issue or a foreign tax-exempt organization, in each case meeting certain requirements.

<sup>158</sup> In limited cases, the intermediary may furnish documentary evidence, other than the IRS Form W-8, of the status of the beneficial owner.

<sup>159</sup> Rev. Proc. 2003-64, 2003-32 I.R.B. 306 (July 10, 2003), provides procedures for qualification as a withholding foreign partnership or withholding foreign trust in addition to providing model withholding agreements.

<sup>160</sup> IRC section 6041; Treas. Reg. sections 1.6041-1, 1.6041-2.

<sup>161</sup> See IRC sections 6042 (dividends), 6045 (broker reporting), 6049 (interest), and the corresponding Treasury regulations.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

corporations and financial institutions) of interest, dividends, or gross proceeds generally must furnish to the payor a federal Form W-9 providing that person's name and taxpayer identification number.<sup>162</sup> That information is then used to complete federal Form 1099.

If a federal Form W-9 is not provided by a U.S. payee (other than payees exempt from reporting), the payor is required to impose a backup withholding tax of 28 percent of the gross amount of the payment.<sup>163</sup> The backup withholding tax may be credited by the payee against regular income tax liability.<sup>164</sup> This combination of reporting and backup withholding is designed to ensure that U.S. persons not exempt from reporting pay tax with respect to investment income, either by providing the IRS with the information that it needs to audit payment of the tax or, in the absence of such information, requiring collection of the tax on payment.

As described above, amounts paid to foreign persons are generally exempt from information reporting on federal Form 1099. Foreign persons are subject to a separate information reporting requirement linked to the nonresident withholding provisions of chapter 3 of the IRC. In the case of U.S.-source investment income, the information reporting, backup withholding and nonresident withholding rules apply broadly to any financial institution or other payor, including foreign financial institutions.<sup>165</sup> As a practical matter, however, these reporting and withholding requirements are difficult to enforce with respect to foreign financial institutions, unless these institutions have some connection to the United States, e.g., the institution is a foreign subsidiary of a U.S. financial institution, or the foreign financial institution is doing business in the United States. Moreover, to the extent that these rules apply to foreign financial institutions, the rules may also be modified by QI agreements between the institutions and the IRS, as described below.

#### The Qualified Intermediary Program

A QI is defined as a foreign financial institution or a foreign clearing organization, other than a U.S. branch or U.S. office of such institution or organization, or a foreign branch of a U.S. financial

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<sup>162</sup> See Treas. Reg. sections 31.3406(d)-1, 31.3406(h)-3.

<sup>163</sup> IRC section 3406(a)(1).

<sup>164</sup> IRC section 3406(h)(10).

<sup>165</sup> See Treas. Reg. sections 1.1441-7(a) (definition of withholding agent includes foreign persons), 31.3406(a)-2 (payor for backup withholding purposes means the person (the payor) required to file information returns for payments of interest, dividends, and gross proceeds (and other amounts)), 1.6049-4(a)(2) (definition of payor for interest reporting purposes does not exclude foreign persons), 1.6042-3(b)(2) (payor for dividend reporting purposes has the same meaning as for interest reporting purposes), 1.6045-1(a)(1) (brokers required to report include foreign persons). But see Treas. Reg. sections 1.6049-5(b) (exception for interest from sources outside the U.S. paid outside the U.S. by a non-U.S. payor or a non-U.S. middleman), 1.6045-1(g)(1)(i) (exception for sales effected at an office outside the U.S. by a non-U.S. payor or a non-U.S. middleman), 1.6042-3(b)(1)(iv) (exceptions for distributions from sources outside the U.S. by a non-U.S. payor or a non-U.S. middleman).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

institution that has entered into a withholding and reporting agreement (a “QI agreement”) with the IRS.<sup>166</sup>

A foreign financial institution that becomes a QI is not required to forward beneficial ownership information with respect to its customers to a U.S. financial institution or other withholding agent of U.S.-source investment-type income to establish the customer’s eligibility for an exemption from, or reduced rate of, U.S. withholding tax.<sup>167</sup> Instead, the QI is permitted to establish for itself the eligibility of its customers for an exemption or reduced rate, based on a federal Form W-8 or W-9, or other specified documentary evidence, and information as to residence obtained under the know-your-customer rules to which the QI is subject in its home jurisdiction as approved by the IRS or as specified in the QI agreement.<sup>168</sup> The QI certifies as to eligibility on behalf of its customers, and provides withholding rate pool information to the U.S. withholding agent as to the portion of each payment that qualifies for an exemption or reduced rate of withholding.

The IRS has published a model QI agreement for foreign financial institutions.<sup>169</sup> A prospective QI must submit an application to the IRS providing specified information, and any additional information and documentation requested by the IRS. The application must establish to the IRS’s satisfaction that the applicant has adequate resources and procedures to comply with the terms of the QI agreement.

Before entering into a QI agreement that provides for the use of documentary evidence obtained under a country’s know-your-customer rules, the IRS must receive that country’s know-your-customer practices and procedures for opening accounts and responses to 18 related items.<sup>170</sup> If the IRS has already received this information, a particular prospective QI need not submit it again. The IRS has received such information and has approved know-your-customer rules in 59 countries.

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<sup>166</sup> The definition also includes: a foreign branch or office of a U.S. financial institution or U.S. clearing organization; a foreign corporation for purposes of presenting income tax treaty claims on behalf of its shareholders; and any other person acceptable to the IRS, in each case that such person has entered into a withholding agreement with the IRS. Treas. Reg. section 1.1441-1(e)(5)(ii).

<sup>167</sup> U.S. withholding agents are allowed to rely on a QI’s federal Form W-8IMY without any underlying beneficial owner documentation. By contrast, nonqualified intermediaries are required both to provide a federal Form W-8IMY to a U.S. withholding agent and to forward with that document federal Forms W-8 or W-9 or other specified documentation for each beneficial owner.

<sup>168</sup> See Rev. Proc. 2000-12, 2000-1 C.B. 387, QI agreement sections 2.12, 5.03, 6.01.

<sup>169</sup> Rev. Proc. 2000-12, 2000-1 C.B. 387, *supplemented by* Announcement 2000-50, 2000-1 C.B. 998, and *modified by* Rev. Proc. 2003-64, 2003-2 C.B. 306, and Rev. Proc. 2005-77, 2005-2 C.B. 1176. The QI agreement applies only to foreign financial institutions, foreign clearing organizations, and foreign branches or offices of U.S. financial institutions or U.S. clearing organizations. However, the principles of the QI agreement may be used to conclude agreements with other persons defined as QIs.

<sup>170</sup> See Rev. Proc. 2000-12, 2000-1 C.B. 387, sec. 3.02.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

A foreign financial institution or other eligible person becomes a QI by entering into an agreement with the IRS. Under the agreement, the financial institution acts as a QI only for accounts that the financial institution has designated as QI accounts. A QI is not required to act as a QI for all of its accounts; however, if a QI designates an account as one for which it will act as a QI, it must act as a QI for all payments made to that account.

The model QI agreement describes in detail the QI's withholding and reporting obligations. Certain key aspects of the model agreement are described below.<sup>171</sup>

*Withholding and reporting responsibilities*

As a technical matter, all QIs are withholding agents for purposes of the nonresident withholding and reporting rules, and payors (who are required to withhold and report) for purposes of the backup withholding and federal Form 1099 information reporting rules. However, under the QI agreement, a QI may choose not to assume primary responsibility for nonresident withholding. In that case, the QI is not required to withhold on payments made to non-U.S. customers, or to report those payments on federal Form 1042-S. Instead, the QI must provide a U.S. withholding agent with a federal Form W-8IMY that certifies as to the status of its (unnamed) non-U.S. account holders and withholding rate pool information.

Similarly, a QI may choose not to assume primary responsibility for federal Form 1099 reporting and backup withholding. In that case, the QI is not required to backup withhold on payments made to U.S. customers or to file federal Forms 1099. Instead, the QI must provide a U.S. payor with a federal Form W-9 for each of its U.S. non-exempt recipient account holders (i.e., account holders that are U.S. persons not generally exempt from federal Form 1099 reporting and backup withholding).<sup>172</sup>

A QI may elect to assume primary nonresident withholding and reporting responsibility, primary backup withholding and federal Form 1099 reporting responsibility, or both.<sup>173</sup> A QI that assumes such responsibility is subject to all of the related obligations imposed by the IRS on U.S.

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<sup>171</sup> Additional detail can be found in Joint Committee on Taxation, *Selected Issues Relating to Tax Compliance with Respect to Offshore Accounts and Entities* (JCX-65-08), July 23, 2008.

<sup>172</sup> Regardless of whether a QI assumes primary federal Form 1099 reporting and backup withholding responsibility, the QI is responsible for federal Form 1099 reporting and backup withholding on certain reportable payments that are not reportable amounts. See Rev. Proc. 2000-12, 2001-1 C.B. 387, QI agreement sections 2.43 (defining reportable amount), 2.44 (defining reportable payment), 3.05, 8.04. The reporting responsibility differs depending on whether the QI is a U.S. payor or a non-U.S. payor. Examples of payments for which the QI assumes primary federal Form 1099 reporting and backup withholding responsibility include certain broker proceeds from the sale of certain assets owned by a U.S. non-exempt recipient and payments of certain foreign-source income to a U.S. non-exempt recipient if such income is paid in the United States or to an account maintained in the United States.

<sup>173</sup> To the extent that a QI assumes primary responsibility for an account, it must do so for all payments made by the withholding agent to that account. See Rev. Proc. 2000-12, QI agreement section 3.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

withholding agents or payors. The QI must also provide the U.S. withholding agent (or U.S. payor) additional information about the withholding rates to enable the withholding agent to appropriately withhold and report on payments made through the QI. These rates can be supplied with respect to withholding rate pools that aggregate payments of a single type of income (e.g., interest or dividends) that is subject to a single rate of withholding.

If a U.S. non-exempt recipient has not provided a federal Form W-9, the QI must disclose the name, address, and taxpayer identification number (“TIN”) (if available) to the withholding agent (and the withholding agent must apply backup withholding). However, no such disclosure is necessary if the QI is, under local law, prohibited from making the disclosure and the QI has followed certain procedural requirements (including providing for backup withholding, as described further below).

*Documentation of account holders*

A QI agrees to use its best efforts to obtain documentation regarding the status of their account holders in accordance with the terms of its QI agreement.<sup>174</sup> A QI must apply presumption rules<sup>175</sup> unless a payment can be reliably associated with valid documentation from the account holder. The QI agrees to adhere to the know-your-customer rules set forth in the QI agreement with respect to the account holder from whom the evidence is obtained. A QI may treat an account holder as a foreign beneficial owner of an amount if the account holder provides a valid federal Form W-8 (other than a federal Form W-8IMY) or valid documentary evidence that supports the account holder’s status as a foreign person.<sup>176</sup> With such documentation, a QI generally may treat an account holder as entitled to a reduced rate of withholding if all the requirements for the reduced rate are met and the documentation supports entitlement to a reduced rate. A QI may not reduce the rate of withholding if the QI knows that the account holder is not the beneficial owner of a payment to the account. If a foreign account holder is the beneficial owner of a payment, then a QI may shield the account holder’s identity from U.S. custodians and the IRS. If a foreign account holder is not the beneficial owner of a payment (for example, because the account holder is a nominee), the account holder must provide the QI with

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<sup>174</sup> See Rev. Proc. 2000-12, QI agreement section 5.

<sup>175</sup> The QI agreement contains its own presumption rules. See Rev. Proc. 2000-12, QI agreement sec. 5.13(C). An amount subject to withholding that is paid outside the United States to an account maintained outside the United States is presumed made to an undocumented foreign account holder (i.e., subject to 30-percent withholding). Payments of U.S. source deposit interest and certain other U.S. source interest and original issue discount paid outside of the United States to an offshore account is presumed made to an undocumented U.S. nonexempt account holder (i.e., subject to backup withholding). For payments of foreign source income, broker proceeds and certain other amounts, the QI can assume such payments are made to an exempt recipient if the amounts are paid outside the United States to an account maintained outside the United States.

<sup>176</sup> Documentary evidence is any documentation obtained under know-your-customer rules per the QI agreement, evidence sufficient to establish a reduced rate of withholding under Treas. Reg. section 1.1441-6, and evidence sufficient to establish status for purposes of chapter 61 under Treas. Reg. section 1.6049-5(c). See Rev. Proc. 2000-12, QI agreement sec. 2.12.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

an IRS Form W-8IMY for itself along with specific information about each beneficial owner to which the payment relates. A QI that receives this information may shield the account holder's identity from a U.S. custodian, but not from the IRS.<sup>177</sup>

In general, if an account holder is a U.S. person, the account holder must provide the QI with an IRS Form W-9 or appropriate documentary evidence that supports the account holder's status as a U.S. person. However, if a QI does not have sufficient documentation to determine whether an account holder is a U.S. or foreign person, the QI must apply certain presumption rules detailed in the QI agreement. These presumption rules may not be used to grant a reduced rate of nonresident withholding; instead they merely determine whether a payment should be subject to full nonresident withholding (at a 30-percent rate), subject to backup withholding (at a 28-percent rate), or treated as exempt from backup withholding. In general, under the QI agreement presumptions, U.S.-source investment income that is paid outside the United States to an offshore account is presumed to be paid to an undocumented foreign account holder. A QI must treat such a payment as subject to withholding at a 30-percent rate and report the payment to an unknown account holder on federal Form 1042-S. However, most U.S.-source deposit interest and interest or original issue discount on short-term obligations that is paid outside the United States to an offshore account is presumed made to an undocumented U.S. non-exempt recipient account holder and thus is subject to backup withholding at a 28-percent rate.<sup>178</sup> Importantly, both foreign-source income and broker proceeds are presumed to be paid to a U.S. exempt recipient (and thus are exempt from both nonresident and backup withholding) when such amounts are paid outside the United States to an offshore account.

*QI information return requirements*

A QI must file IRS Form 1042 by March 15 of the year following any calendar year in which the QI acts as a QI. A QI is not required to file federal Form 1042-S for amounts paid to each separate account holder, but instead files a separate federal Form 1042-S for each type of reporting pool.<sup>179</sup> A QI must file separate federal Forms 1042-S for amounts paid to certain types of account holders, including: (1) other QIs which receive amounts subject to foreign withholding; (2) each foreign account holder of a nonqualified intermediary or other flow-through entity to the extent that the QI can reliably associate such amounts with valid documentation; and (3) unknown recipients of amounts subject to withholding paid through a nonqualified intermediary or other flow-through entity to the extent the QI cannot reliably associate such amounts with valid documentation. Federal Form 1042 must also include an attachment setting forth the aggregate amounts of reportable payments paid to U.S. non-exempt recipient account holders, and the

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<sup>177</sup> This rule restricts one of the principal benefits of the QI regime, nondisclosure of account holders, to financial institutions that have assumed the documentation and other obligations associated with QI status.

<sup>178</sup> These amounts are statutorily exempt from nonresident withholding when paid to non-U.S. persons.

<sup>179</sup> A reporting pool consists of income that falls within a particular withholding rate and within a particular income code, exemption code, and recipient code as determined on federal Form 1042-S.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

number of such account holders, whose identity is prohibited by foreign law (including by contract) from disclosure.<sup>180</sup>

A QI has specified federal Form 1099<sup>181</sup> filing requirements including: (1) filing an aggregate federal Form 1099 for each type of reportable amount paid to U.S. non-exempt recipient account holders whose identities are prohibited by law from being disclosed; (2) filing an aggregate federal Form 1099 for reportable payments other than reportable amounts<sup>182</sup> paid to U.S. non-exempt recipient account holders whose identities are prohibited by law from being disclosed; (3) filing separate federal Forms 1099 for reportable amounts paid to U.S. non-exempt recipient account holders for whom the QI has not provided a federal Form W-9 or identifying information to a withholding agent; (4) filing separate federal Forms 1099 for reportable payments other than reportable amounts paid to U.S. non-exempt recipient account holders; (5) filing separate federal Forms 1099 for reportable amounts paid to U.S. non-exempt recipient account holders for which the QI has assumed primary federal Form 1099 reporting and backup withholding responsibility; and (6) filing separate federal Forms 1099 for reportable payments to an account holder that is a U.S. person if the QI has applied backup withholding and the amount was not otherwise reported on a federal Form 1099.

*Foreign law prohibition of disclosure*

The QI agreement includes procedures to address situations in which foreign law (including by contract) prohibits the QI from disclosing the identities of U.S. non-exempt recipients (such as individuals). Separate procedures are provided for accounts established with a QI prior to January 1, 2001, and for accounts established on or after January 1, 2001.

Accounts established prior to January 1, 2001 – For accounts established prior to January 1, 2001, if the QI knows that the account holder is a U.S. non-exempt recipient, the QI must: (1) request from the account holder the authority to disclose its name, address, TIN (if available), and reportable payments; (2) request from the account holder the authority to sell any assets that generate, or could generate, reportable payments; or (3) request that the account holder disclose itself by mandating the QI to provide a federal Form W-9 completed by the account holder. The QI must make these requests at least two times during each calendar year and in a manner consistent with the QI's normal communications with the account holder (or at the time and in the manner that the QI is authorized to communicate with the account holder). Until the QI

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<sup>180</sup> For undisclosed accounts, QIs must separately report each type of reportable payment (determined by reference to the types of income reported on federal Forms 1099) and the number of undisclosed account holders receiving such payments.

<sup>181</sup> If the QI is required to file federal Forms 1099, it must file the appropriate form for the type of income paid (e.g., federal Form 1099-DIV for dividends, federal Form 1099-INT for interest, and federal Form 1099-B for broker proceeds).

<sup>182</sup> The term reportable amount generally includes those amounts that would be reported on federal Form 1042-S if the amount were paid to a foreign account holder. The term reportable payment generally refers to amounts subject to backup withholding, but it has a different meaning depending upon the status of the QI as a U.S. or non-U.S. payor.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

receives a waiver on all prohibitions against disclosure, authorization to sell all assets that generate, or could generate, reportable payments, or a mandate from the account holder to provide a federal Form W-9, the QI must backup withhold on all reportable payments paid to the account holder and report those payments on federal Form 1099 or, in certain cases, provide another withholding agent with all of the information required for that withholding agent to backup withhold and report the payments on federal Form 1099.

Accounts established on or after January 1, 2001 – For any account established by a U.S. non-exempt recipient on or after January 1, 2001, the QI must: (1) request from the account holder the authority to disclose its name, address, TIN (if available), and reportable payments; (2) request from the account holder, prior to opening the account, the authority to exclude from the account holder's account any assets that generate, or could generate, reportable payments; or (3) request that the account holder disclose itself by mandating the QI to transfer a federal Form W-9 completed by the account holder.

If a QI is authorized to disclose the account holder's name, address, TIN, and reportable amounts, it must obtain a valid federal Form W-9 from the account holder, and, to the extent the QI does not have primary federal Form 1099 and backup withholding responsibility, provide the federal Form W-9 to the appropriate withholding agent promptly after obtaining the form. If a federal Form W-9 is not obtained, the QI must provide the account holder's name, address, and TIN (if available) to the withholding agents from whom the QI receives reportable amounts on behalf of the account holder, together with the withholding rate applicable to the account holder. If a QI is not authorized to disclose an account holder's name, address, TIN (if available), and reportable amounts, but is authorized to exclude from the account holder's account any assets that generate, or could generate, reportable payments, the QI must follow procedures designed to ensure that it will not hold any assets that generate, or could generate, reportable payments in the account holder's account.<sup>183</sup>

#### *External audit procedures*

The IRS generally does not audit a QI with respect to withholding and reporting obligations covered by a QI agreement if an approved external auditor conducts an audit of the QI. An external audit must be performed in the second and fifth full calendar years in which the QI agreement is in effect. In general, the IRS must receive the external auditor's report by June 30 of the year following the year being audited.

Requirements for the external audit are provided in the QI agreement. In general, the QI must permit the external auditor to have access to all relevant records of the QI, including information regarding specific account holders. In addition, the QI must permit the IRS to communicate directly with the external auditor, review the audit procedures followed by the external auditor, and examine the external auditor's work papers and reports.

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<sup>183</sup> Under both of these procedures, if the QI is a non-U.S. payor, a U.S. non-exempt recipient may effectively avoid disclosure and backup withholding by investing in assets that generate solely non-reportable payments such as foreign source income (such as bonds issued by a foreign government) paid outside of the United States.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

In addition to the external audit requirements set forth in the QI agreement, the IRS has issued further guidance (the “QI audit guidance”) for an external auditor engaged by a QI to verify the QI’s compliance with the QI agreement.<sup>184</sup> An external auditor must conduct its audit in accordance with the procedures described in the QI agreement. However, the QI audit guidance is intended to assist the external auditor in understanding and applying those procedures. The QI audit guidance does not amend, modify, or interpret the QI agreement.

*Term of a QI agreement*

A QI agreement expires on December 31 of the fifth full calendar year after the year in which the QI agreement first takes effect, although it may be renewed. Either the IRS or the QI may terminate the QI agreement prior to its expiration by delivering a notice of termination to the other party. However, the IRS generally does not terminate a QI agreement unless there is a significant change in circumstances or an event of default occurs, and the IRS determines that the change in circumstance or event of default warrants termination. In the event that an event of default occurs, a QI is given an opportunity to cure it within a specified time.

Know-Your-Customer Due-Diligence Requirements

*United States*

The U.S. know-your-customer rules<sup>185</sup> require financial institutions<sup>186</sup> to develop and maintain a written customer identification program and anti-money laundering policies and procedures. Additionally, financial institutions must perform customer due diligence. The due-diligence requirements are enhanced where the account or the financial institution has a higher risk profile.<sup>187</sup>

A customer identification program at a minimum requires the financial institution to collect the name, date of birth (for individuals), address,<sup>188</sup> and identification number<sup>189</sup> for new customers.

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<sup>184</sup> Rev. Proc. 2002-55, 2002-2 C.B. 435.

<sup>185</sup> The U.S. know-your-customer rules are primarily found in the Bank Secrecy Act of 1970 and in Title III, The International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001 of the USA PATRIOT Act.

<sup>186</sup> The term financial institution is broadly defined under 31 U.S.C. sections 5312(a)(2) or (c)(1) and includes U.S. banks and agencies or branches of foreign banks doing business in the United States, insurance companies, credit unions, brokers and dealers in securities or commodities, money services businesses, and certain casinos.

<sup>187</sup> Relevant risks include the types of accounts held at the financial institution, the methods available for opening accounts, the types of customer identification information available, and the size, location, and customer base of the financial institution. 31 C.F.R. sec. 103.121(b)(2).

<sup>188</sup> For a person other than an individual the address is the principal place of business, local office, or other physical location. 31 C.F.R. sec. 103.121(b)(2)(i)(3)(iii).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

In fulfilling their customer due-diligence requirements, financial institutions are required to verify enough customer information to enable the financial institution to form a “reasonable belief that it knows the true identity of each customer.”<sup>190</sup>

In many cases the know-your-customer rules do not require financial institutions to look through an entity to determine its ultimate ownership.<sup>191</sup> However, based on the financial institution’s risk assessment, the financial institution may need to obtain information about individuals with authority or control over such an account in order to verify the identity of the customer.<sup>192</sup> A financial institution’s customer due diligence must include gathering sufficient information on a business entity and its owners for the financial institution to understand and assess the risks of the account relationship.<sup>193</sup>

Enhanced due diligence is required if customers are deemed to be of higher risk, and is mandated for certain types of accounts including foreign correspondent accounts, private banking accounts, and accounts for politically exposed persons. Private banking accounts are considered to be of significant risk and enhanced due diligence requires identification of nominal and beneficial owners for these accounts.<sup>194</sup>

Financial institutions must maintain records for a minimum of five years after the account is closed or becomes dormant. They are required to monitor accounts including the frequency, size and ultimate destinations of transfers and must update customer due diligence and enhanced due diligence when there are significant changes to the customer’s profile (for example, volume of transaction activity, risk level, or account type).

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<sup>189</sup> For a U.S. person the identification number is the TIN. For a non-U.S. person the identification number could be a TIN, passport number, alien identification number, or number and country of issuance of any other government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard. 31 C.F.R. sec. 103.121(b)(2)(i)(4).

<sup>190</sup> See 31 C.F.R. sec. 103.121(b)(2).

<sup>191</sup> For example, a financial institution is not “required to look through trust, escrow, or similar accounts to verify the identities of beneficiaries and instead will only be required to verify the identity of the named accountholder.” See 68 Fed. Reg. 25,090, 25,094 (May 9, 2003).

<sup>192</sup> See 31 C.F.R. sec. 103.121(b)(2)(ii)(C).

<sup>193</sup> In order to assess the risk of the account relationship, a financial institution may need to ascertain the type of business, the purpose of the account, the source of the account funds, and the source of the wealth of the owner or beneficial owner of the entity.

<sup>194</sup> 31 C.F.R. section 103.178. A private banking account is an account that (1) requires a minimum deposit of not less than 1 million dollars; (2) is established for the benefit of one or more non-U.S. persons who are direct or beneficial owners of the account; and (3) is administered or managed by an officer, employee or agent of the financial institution. Beneficial owner for these purposes is defined as an individual who has a level of control over, or entitlement to the funds or assets in the account. 31 C.F.R. sections 103.175(b) and 103.175(o).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

*European Union Third Money Laundering Directive*

The European Union (“EU”) Third Money Laundering Directive<sup>195</sup> is also applicable to a broad range of persons including credit institutions and financial institutions as well as to persons acting in the exercise of certain professional activities.<sup>196</sup> It requires systems, adequate policies and procedures for customer due diligence, reporting, record keeping, internal controls, risk assessment, risk management, compliance management, and communication. Required customer due-diligence measures go further than the know-your-customer rules in the United States in requiring identification and verification of the beneficial owner and an understanding of the ownership and control structure of the customer in addition to the basic customer identification program and customer due-diligence requirements.

A beneficial owner is defined as the natural person who ultimately owns or controls the customer and/or the natural person on whose behalf a transaction or activity is being conducted. For corporations, beneficial owner includes: (1) the natural person or persons who ultimately owns or controls a legal entity through direct or indirect ownership or control over a sufficient percentage (25 percent plus one share) of the shares or voting rights in that legal entity; and (2) the natural person or persons who otherwise exercises control over the management of the legal entity.<sup>197</sup> For foundations, trusts, and like entities that administer and distribute funds, beneficial owner includes: (1) in cases in which future beneficiaries are determined, a natural person who is the beneficiary of 25 percent or more of the property; (2) in cases in which future beneficiaries have yet to be determined, the class of person in whose main interest the legal arrangement is set up or operates; and (3) natural person who exercises control over 25 percent or more of the property.<sup>198</sup> Under the EU Third Money Laundering Directive, EU member states generally must require identification of the customer and any beneficial owners before the establishment of a business relationship.<sup>199</sup>

The EU Third Money Laundering Directive requires ongoing account monitoring including scrutiny of transactions throughout the course of relationship to ensure that the transactions conducted are consistent with the customer and the business risk profile. It requires documents and other information to be updated and requires performance of customer due-diligence procedures at appropriate times (such as a change in account signatories or change in the use of an account)

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<sup>195</sup> Directive 2005/60/EC of the European Parliament and of the Council, October 26, 2005 (“EU Third Money Laundering Directive”).

<sup>196</sup> The directive applies to auditors, accountants, tax advisors, notaries, legal professionals, real estate agents, certain persons trading in goods (cash transactions in excess of EUR 15,000), and casinos.

<sup>197</sup> EU Third Money Laundering Directive Art. 3(6)(a). Inquiries into beneficial ownership generally may stop at the level of any owner that is a company listed on a regulated market.

<sup>198</sup> EU Third Money Laundering Directive Art. 3(6)(b).

<sup>199</sup> EU Third Money Laundering Directive Art. 9.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

for existing customers on a risk sensitive basis. Records must be maintained for up to five years after the customer relationship has ended.

New Federal Law (IRC sections 1471, 1472, 1473, 1474, 6414, 6501, 6513, 6611, and 6724)

The provision adds a new chapter 4 to the IRC that provides for withholding taxes to enforce new reporting requirements on specified foreign accounts owned by specified United States persons or by United States owned foreign entities. The provision establishes rules for withholdable payments to foreign financial institutions and for withholdable payments to other foreign entities.

Withholdable Payments to Foreign Financial Institutions

The provision requires a withholding agent to deduct and withhold a tax equal to 30 percent on any withholdable payment made to a foreign financial institution if the foreign financial institution does not meet certain requirements. Specifically, withholding is generally not required if an agreement is in effect between the foreign financial institution and the Secretary of the Treasury (the "Secretary") under which the institution agrees to:

1. Obtain information regarding each holder of each account maintained by the institution as is necessary to determine which accounts are United States accounts;
2. Comply with verification and due-diligence procedures as the Secretary requires with respect to the identification of United States accounts;
3. Report annually certain information with respect to any United States account maintained by such institution;
4. Deduct and withhold 30 percent from any pass-thru payment that is made to:  
(1) a recalcitrant account holder or another financial institution that does not enter into an agreement with the Secretary; or (2) a foreign financial institution that has elected to be withheld upon rather than to withhold with respect to the portion of the payment that is allocable to recalcitrant account holders or to foreign financial institutions that do not have an agreement with the Secretary;
5. Comply with requests by the Secretary for additional information with respect to any United States account maintained by such institution; and
6. Attempt to obtain a waiver in any case in which any foreign law would (but for a waiver) prevent the reporting of information required by the provision with respect to any United States account maintained by such institution, and if a waiver is not obtained from each account holder within a reasonable period of time, to close the account.

If the Secretary determines that the foreign financial institution is out of compliance with the agreement, the agreement may be terminated by the Secretary. The provision applies with respect to United States accounts maintained by the foreign financial institution and, except as

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

provided by the Secretary, to United States accounts maintained by each other financial institution that is a member of the same expanded affiliated group (other than any foreign financial institution that also enters into an agreement with the Secretary).

It is expected that in complying with the requirements of this provision, the foreign financial institution and the other members of the same expanded affiliated group comply with know-your-customer, anti-money laundering, anti-corruption, or other similar rules to which they are subject, as well as with such procedures and rules as the Secretary may prescribe, both with respect to due diligence by the foreign financial institution and verification by or on behalf of the IRS to ensure the accuracy of the information, documentation, or certification obtained to determine if the account is a United States account. The Secretary may use existing know-your customer, anti-money laundering, anti-corruption, and other regulatory requirements as a basis in crafting due-diligence and verification procedures in jurisdictions where those requirements provide reasonable assurance that the foreign financial institution is in compliance with the requirements of this provision.

The provision allowing for withholding on payments made to an account holder that fails to provide the information required under this provision is not intended to create an alternative to information reporting. It is anticipated that the Secretary may require, under the terms of the agreement, that the foreign financial institution achieve certain levels of reporting and make reasonable attempts to acquire the information necessary to comply with the requirements of this section or to close accounts where necessary to meet the purposes of this provision. It is anticipated that the Secretary may also require, under the terms of the agreement that, in the case of new accounts, the foreign financial institution may not withhold as an alternative to collecting the required information.

A foreign financial institution may be deemed, by the Secretary, to meet the requirements of this provision if: (1) the institution complies with procedures prescribed by the Secretary to ensure that the institution does not maintain United States accounts, and meets other requirements as the Secretary may prescribe with respect to accounts of other foreign financial institutions; or (2) the institution is a member of a class of institutions for which the Secretary has determined that the requirements are not necessary to carry out the purposes of this provision. For instance, it is anticipated that the Secretary may provide rules that would permit certain classes of widely held collective investment vehicles, and to the limited extent necessary to implement these rules, the entities providing administration, distribution and payment services on behalf of those vehicles, to be deemed to meet the requirements of this provision. It is anticipated that a foreign financial institution that has an agreement with the Secretary may meet the requirements under this provision with respect to certain members of its expanded affiliated group if the affiliated foreign financial institution complies with procedures prescribed by the Secretary and does not maintain United States accounts. Additionally, the Secretary may identify classes of institutions that are deemed to meet the requirements of this provision if such institutions are subject to similar due diligence and reporting requirements under other provisions in the IRC. Such institutions may include certain controlled foreign corporations owned by U.S. financial institutions and certain U.S. branches of foreign financial institutions that are treated as U.S. payors under present law.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

Under the provision, a foreign financial institution may elect to have a U.S. withholding agent or a foreign financial institution that has entered into an agreement with the Secretary withhold on payments made to the electing foreign financial institution rather than acting as a withholding agent for the payments it makes to other foreign financial institutions that either do not enter into agreements with the Secretary or that themselves have elected not to act as a withholding agent, or for payments it makes to account holders that fail to provide required information. If the election under this provision is made, the withholding tax will apply with respect to any payment made to the electing foreign financial institution to the extent the payment is allocable to accounts held by foreign financial institutions that do not enter into an agreement with the Secretary or to payments made to recalcitrant account holders.

A payment may be allocable to accounts held by a recalcitrant account holder or a foreign financial institution that does not meet the requirements of this section either as a result of such person holding an account directly with the electing foreign financial institution, or in relation to an indirect account held through other foreign financial institutions that either do not enter into an agreement with the Secretary or are themselves electing foreign financial institutions.

The electing foreign financial institution must notify the withholding agent of its election and must provide information necessary for the withholding agent to determine the appropriate amount of withholding. The information may include information regarding the amount of any payment that is attributable to a withholdable payment and information regarding the amount of any payment that is allocable to recalcitrant account holders or to foreign financial institutions that have not entered into agreements with the Secretary. Additionally, the electing foreign financial institution must waive any right under a treaty with respect to an amount deducted and withheld pursuant to the election. To the extent provided by the Secretary, the election may be made with respect to certain classes or types of accounts.

A foreign financial institution meets the annual information reporting requirements under the provision by reporting the following information:

1. The name, address, and TIN of each account holder that is a specified United States person;
2. The name, address, and TIN of each substantial United States owner of any account holder that is a United States owned foreign entity;
3. The account number;
4. The account balance or value (determined at such time and in such manner as the Secretary provides); and
5. Except to the extent provided by the Secretary, the gross receipts and gross withdrawals or payments from the account (determined for such period and in such manner as the Secretary may provide).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

This information is required with respect to each United States account maintained by the foreign financial institution and, except as provided by the Secretary, each United States account maintained by each other foreign financial institution that is a member of the same expanded affiliated group (other than any foreign financial institution that also enters into an agreement with the Secretary).

Alternatively, a foreign financial institution may make an election and report under IRC sections 6041 (information at source), 6042 (returns regarding payments of dividends and corporate earnings and profits), 6045 (returns of brokers), and 6049 (returns regarding payments of interest), as if such foreign financial institution were a U.S. person (i.e., elect to provide full federal Form 1099 reporting under these sections). Under this election, the foreign financial institution reports on each account holder that is a specified United States person or United States owned foreign entity as if the holder of the account were a natural person and citizen of the United States. As a result, both U.S.- and foreign-source amounts (including gross proceeds) are subject to reporting under this election regardless of whether the amounts are paid inside or outside the United States. If a foreign financial institution makes this election, the institution is also required to report the following information with respect to each United States account maintained by the institution: (1) the name, address, and TIN of each account holder that is a specified United States person; (2) the name, address, and TIN of each substantial United States owner of any account holder that is a United States owned foreign entity; and (3) the account number. This election can be made by a foreign financial institution even if other members of its expanded affiliated group do not make the election. The Secretary has authority to specify the time and manner of the election and to provide other conditions for meeting the reporting requirements of the election.

Foreign financial institutions that have entered into QI or similar agreements with the Secretary, under IRC section 1441 and the regulations thereunder, are required to meet the requirements of this provision in addition to any other requirements imposed under the QI or similar agreement.

Under the provision, a United States account is any financial account held by one or more specified United States persons or United States owned foreign entities. Depository accounts are not treated as United States accounts for these purposes if each holder of the account is a natural person and the aggregate value of all depository accounts held (in whole or in part) by each holder of the account maintained by the financial institution does not exceed \$50,000. A foreign financial institution may, however, elect to include all depository accounts held by U.S. individuals as United States accounts. To the extent provided by the Secretary, financial institutions that are members of the same expanded affiliated group may be treated as a single financial institution for purposes of determining the aggregate value of depository accounts maintained at the financial institution.

In addition, a financial account is not a United States account if the account is held by a foreign financial institution that has entered into an agreement with the Secretary or is otherwise subject to information reporting requirements that the Secretary determines would make the reporting duplicative. It is anticipated that the Secretary may exclude certain financial accounts held by bona fide residents of any possession of the United States maintained by a financial institution

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

organized under the laws of the possession if the Secretary determines that such reporting is not necessary to carry out the purposes of this provision.

Except as otherwise provided by the Secretary, a financial account is any depository or custodial account that is maintained by a foreign financial institution, and any equity or debt interest in a foreign financial institution (other than interests that are regularly traded on an established securities market). Any equity or debt interest that is treated as a financial account with respect to any financial institution is treated for purposes of this provision as maintained by the financial institution. It is anticipated that the Secretary may determine that certain short-term obligations, or short-term deposits, pose a low risk of U.S. tax evasion and thus, may not treat such obligations or deposits as financial accounts for purposes of this provision.

A United States owned foreign entity is any foreign entity that has one or more substantial United States owners. A foreign entity is any entity that is not a U.S. person.

A foreign financial institution is any financial institution that is a foreign entity, and except as provided by the Secretary, does not include a financial institution organized under the laws of any possession of the United States. The Secretary may exercise its authority to issue guidance that it deems necessary to prevent financial institutions organized under the laws of U.S. possessions from being used as intermediaries in arrangements under which U.S. tax avoidance or evasion is facilitated.

Except as otherwise provided by the Secretary, a financial institution for purposes of this provision is any entity that: (1) accepts deposits in the ordinary course of a banking or similar business; (2) as a substantial portion of its business, holds financial assets for the account of others; or (3) is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities,<sup>200</sup> interests in partnerships, commodities,<sup>201</sup> or any interest (including a futures or forward contract or option) in such securities, partnership interests, or commodities. Accordingly, the term financial institution may include among other entities, investment vehicles such as hedge funds and private equity funds. Additionally, the Secretary may provide exceptions for certain classes of institutions. Such exceptions may include entities such as certain holding companies, research and development subsidiaries, or financing subsidiaries within an affiliated group of non-financial operating companies. It is anticipated that the Secretary may prescribe special rules addressing the circumstances in which certain categories of companies, such as certain insurance companies, are financial institutions, or the circumstances in which certain contracts or policies, for example annuity contracts or cash value life insurance contracts, are financial accounts or United States accounts for these purposes.

For purposes of this provision, a recalcitrant account holder is any account holder that: (1) fails to comply with reasonable requests for information necessary to determine if the account is a United

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<sup>200</sup> As defined in IRC section 475(c)(2), without regard to the last sentence thereof.

<sup>201</sup> As defined in IRC section 475(e)(2).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

States account; (2) fails to provide the name, address, and TIN of each specified United States person and each substantial United States owner of a United States owned foreign entity; or (3) fails to provide a waiver of any foreign law that would prevent the foreign financial institution from reporting any information required under this provision.

A pass-thru payment is any withholdable payment or other payment to the extent it is attributable to a withholdable payment.

The reporting requirements apply with respect to United States accounts maintained by a foreign financial institution and, except as otherwise provided by the Secretary, with respect to United States accounts maintained by each other foreign financial institution that is a member of the same expanded affiliated group as such foreign financial institution. An expanded affiliated group for these purposes is an affiliated group as defined in IRC section 1504(a) except that “more than 50 percent” is substituted for “at least 80 percent” each place it appears in that section, and is determined without regard to paragraphs (2) and (3) of IRC section 1504(b). A partnership or any other entity that is not a corporation is treated as a member of an expanded affiliated group if such entity is controlled by members of such group.<sup>202</sup>

This provision does not apply with respect to a payment to the extent that the beneficial owner of such payment is: (1) a foreign government, a political subdivision of a foreign government, or a wholly owned agency of any foreign government or political subdivision; (2) an international organization or any wholly owned agency or instrumentality thereof; (3) a foreign central bank of issue; or (4) any other class of persons identified by the Secretary as posing a low risk of U.S. tax evasion.

Under the provision, a withholding agent includes any person, in whatever capacity, having the control, receipt, custody, disposal, or payment of any withholdable payment.

Except as provided by the Secretary, a withholdable payment is any payment of interest (including any original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income from sources within the United States. The term also includes any gross proceeds from the sale or other disposition of any property that could produce interest or dividends from sources within the United States, including dividend equivalent payments treated as dividends from sources in the United States pursuant to section 541 of the Act. Any item of income effectively connected with the conduct of a trade or business within the United States that is taken into account under IRC sections 871(b)(1) or 882(a)(2) is not treated as a withholdable payment for purposes of the provision. In determining the source of a payment, IRC section 861(a)(1)(B) (the rule for sourcing interest paid by foreign branches of domestic financial institutions) does not apply. The Secretary may determine that certain payments made with respect to short-term debt or short-term deposits, including gross proceeds paid pose little risk of United States tax evasion and may be excluded from withholdable payments for purposes of this provision.

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<sup>202</sup> Control for these purposes has the same meaning as control for purposes of IRC section 954(d)(3).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

A substantial United States owner is: (1) with respect to any corporation, any specified U.S. person that directly or indirectly owns more than 10 percent of the stock (by vote or value) of such corporation; (2) with respect to any partnership, a specified United States person that directly or indirectly owns more than 10 percent of the profits or capital interests of such partnership; and (3) with respect to any trust, any specified United States person treated as an owner of any portion of such trust under the grantor trust rules,<sup>203</sup> or to the extent provided by the Secretary, any specified United States person that holds, directly or indirectly, more than 10 percent of the beneficial interests of the trust. To the extent the foreign entity is a corporation or partnership engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, interests in partnerships, commodities, or any interest (including a futures or forward contract or option) in such securities, interests or commodities, the 10-percent threshold is reduced to zero percent. In determining whether an entity is a United States owned foreign entity (and whether any person is a substantial United States owner of such entity), only specified United States persons are considered.

Except as otherwise provided by the Secretary, a specified United States person is any U.S. person other than: (1) a publicly traded corporation or a member of the same expanded affiliated group as a publicly traded corporation; (2) any tax-exempt organization or individual retirement plan; (3) the United States or a wholly owned agency or instrumentality of the United States; (4) a state, the District of Columbia, any possession of the United States, or a political subdivision or wholly owned agency of a state, the District of Columbia, or a possession of the United States; (5) a bank;<sup>204</sup> (6) a real estate investment trust;<sup>205</sup> (7) a regulated investment company;<sup>206</sup> (8) a common trust fund;<sup>207</sup> and (9) a trust that is exempt from tax under IRC section 664(c)<sup>208</sup> or is described in IRC section 4947(a)(1).<sup>209</sup>

#### Withholdable Payments to Other Foreign Entities

The provision requires a withholding agent to deduct and withhold a tax equal to 30 percent of any withholdable payment made to a non-financial foreign entity if the beneficial owner of such payment is a non-financial foreign entity that does not meet specified requirements.

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<sup>203</sup> Subpart E of Part I of Subchapter J of Chapter 1 of the IRC.

<sup>204</sup> As defined in IRC section 581.

<sup>205</sup> As defined in IRC section 856.

<sup>206</sup> As defined in IRC section 851.

<sup>207</sup> As defined in IRC section 584(a).

<sup>208</sup> This includes charitable remainder annuity trusts and charitable remainder unitrusts.

<sup>209</sup> This includes certain charitable trusts not exempt under IRC section 501(a).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

A non-financial foreign entity is any foreign entity that is not a financial institution under the provision. A non-financial foreign entity meets the requirements of the provision (i.e., payments made to such entity will not be subject to the imposition of 30-percent withholding tax) if the payee or the beneficial owner of the payment provides the withholding agent with either a certification that the foreign entity does not have a substantial United States owner, or provides the withholding agent with the name, address, and TIN of each substantial United States owner. Additionally, the withholding agent must not know or have reason to know that the certification or information provided regarding substantial United States owners is incorrect, and the withholding agent must report the name, address, and TIN of each substantial United States owner to the Secretary.

The provision does not apply to any payment beneficially owned by a publicly traded corporation or a member of an expanded affiliated group of a publicly traded corporation (defined as above but without the inclusion of partnerships or other non-corporate entities). Publicly traded corporations (and their affiliates) receiving payments directly from U.S. withholding agents may present a lower risk of U.S. tax evasion than other non-financial foreign entities. The provision also does not apply to any payment beneficially owned by any: (1) entity that is organized under the laws of a possession of the United States and that is wholly owned by one or more bona fide residents of the possession; (2) foreign government, political subdivision of a foreign government, or wholly owned agency or instrumentality of any foreign government or political subdivision of a foreign government; (3) international organization or any wholly owned agency or instrumentality of an international organization; (4) foreign central bank of issue; (5) any other class of persons identified by the Secretary for purposes of the provision; or (6) class of payments identified by the Secretary as posing a low risk of U.S. tax evasion. It is anticipated that the Secretary may exclude certain payments made for goods, services, or the use of property if the payment is made pursuant to an arm's-length transaction in the ordinary course of the payor's trade or business.

It is expected that the Secretary will provide coordinating rules for application of the withholding provisions applicable to foreign financial institutions and to foreign entities that are non-financial foreign entities under this provision.

#### Credits and Refunds

In general, the determination of whether an overpayment of tax deducted and withheld under the provision results in an overpayment by the beneficial owner of the payment is made in the same manner as if the tax had been deducted and withheld under Subchapter A of Chapter 3 of the IRC (withholding tax on nonresident aliens and foreign corporations). An amount of tax required to be withheld by a foreign financial institution under its agreement with the Secretary is treated the same as if it were required to be withheld on a withholdable payment made to a foreign financial institution that does not enter into an agreement with the Secretary. Under the provision, if a beneficial owner of a payment is entitled under an income tax treaty to a reduced rate of withholding tax on the payment, that beneficial owner may be eligible for a credit or refund of the excess of the amount withheld under the provision over the amount permitted to be withheld under the treaty. Similarly, if a payment is of an amount not otherwise subject to U.S. tax (because, for instance, the payment represents gross proceeds from the sale of stock or is

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

interest eligible for the portfolio interest exemption), the beneficial owner of the payment generally is eligible for a credit or refund of the full amount of the tax withheld.

The Secretary has the authority to administer credit and refund procedures which may include requirements for taxpayers claiming credits or refunds of amounts withheld from payments to which the provision applies to supply appropriate documentation establishing that they are the beneficial owners of the payments from which tax was withheld, and that, in circumstances in which treaty benefits are being claimed, they are eligible for treaty benefits. No credit or refund is allowed with respect to tax properly deducted and withheld unless the beneficial owner of the payment provides the Secretary with such information as the Secretary may require in order to determine whether the beneficial owner of the payment is a United States owned foreign entity and the identity of any substantial United States owners of such entity. It is intended that any such guidance provided by the Secretary under this provision, including documentation and requirements to provide information, be consistent with existing income tax treaties.

If tax is withheld under the provision, this credit and refund mechanism ensures that the provisions are consistent with U.S. obligations under existing income tax treaties. U.S. income tax treaties do not require the United States and its treaty partners to follow a specific procedure for providing treaty benefits.<sup>210</sup> For example, in cases in which proof of entitlement to treaty benefits is demonstrated in advance of payment, the United States may permit reduced withholding or exemption at the time of payment. Alternatively, the United States may require withholding at the relevant statutory rate at the time of payment and allow treaty country residents to obtain treaty benefits through a refund process. The credit and refund mechanism ensures that residents of treaty partners continue to obtain treaty benefits in the event tax is withheld under the provision.

A special rule applies with respect to any tax properly deducted and withheld from a specified financial institution payment, which is defined as any payment with respect to which a foreign financial institution is the beneficial owner. Credits and refunds with respect to specified financial institution payments generally are not allowed. However, refunds and credits are allowed if, with

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<sup>210</sup> See, for example, the Commentaries on the OECD Model Tax Convention on Income and on Capital, that make clear that individual countries are free to establish procedures for providing any reduced tax rates agreed to by treaty partners. These procedures can include both relief at source and/or full withholding at domestic rates, followed by a refund. See, e.g., Commentary 26.2 to Article 1.

A number of Articles of the Convention limit the right of a state to tax income derived from its territory. As noted in paragraph 19 of the Commentary on Article 10 as concerns the taxation of dividends, the Convention does not settle procedural questions and each state is free to use the procedure provided in its domestic law in order to apply the limits provided by the Convention. A state can therefore automatically limit the tax that it levies in accordance with the relevant provisions of the Convention, subject to possible prior verification of treaty entitlement, or it can impose the tax provided for under its domestic law and subsequently refund the part of that tax that exceeds the amount that it can levy under the provisions of the Convention.

Ibid. While Commentary 26.2 notes that a refund mechanism is not the preferred approach, the Act establishes such a mechanism for beneficial owners in certain circumstances. This approach serves to address, in part, observed difficulties in identifying U.S. persons who inappropriately seek treaty benefits to which they are not entitled.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

respect to the payment, the foreign financial institution is entitled to an exemption or a reduced rate of tax by reason of any treaty obligation of the United States. In such a case, the foreign financial institution is entitled to an exemption or a reduced rate of tax only to the extent provided under the treaty. In no event will interest be allowed or paid with respect to any credit or refund of tax properly withheld on a specified financial institution payment.

Under the provision, the grace period for which the government is not required to pay interest on an overpayment is increased from 45 days to 180 days for overpayments resulting from excess amounts deducted and withheld under chapters 3 or 4 of the IRC. The increased grace period applies to refunds of withheld taxes with respect to: (1) returns due after March 18, 2010; (2) claims for refund filed after March 18, 2010; and (3) IRS-initiated adjustments if the refunds are paid after March 18, 2010. It is anticipated that the Secretary may specify the proper form and information required for a claim for refund under IRC section 6611(e)(2) and may provide that a purported claim that does not include such information is not considered filed.

#### General Provisions

Every person required to deduct and withhold any tax under the provision is liable for such tax and is indemnified against claims and demands of any person for the amount of payments made in accordance with the provision.

No person may use information under the provision except for the purpose of meeting any requirements under the provision or for purposes permitted under IRC section 6103. However, the identity of foreign financial institutions that have entered into an agreement with the Secretary is not treated as return information for purposes of IRC section 6103.

The Secretary is expected to provide for the coordination of withholding under this provision with other withholding provisions of the IRC, including providing for the proper crediting of amounts deducted and withheld under this provision against amounts required to be deducted and withheld under other provisions of the IRC. The Secretary may provide further coordinating rules to prevent double withholding, including in situations involving tiered U.S. withholding agents.

The provision makes several conforming amendments to other provisions in the IRC. The provision grants authority to the Secretary to prescribe regulations necessary and appropriate to carry out the purposes of the provision, and to prevent the avoidance of this provision.

#### Effective Date

The provision generally applies to payments made after December 31, 2012. The provision, however, does not require any amount to be deducted or withheld from any payment under any obligation outstanding on the date that is two years after March 18, 2010, or from the gross proceeds from any disposition of such an obligation. It is anticipated that the Secretary may provide guidance as to the application of the material modification rules under IRC section 1001 in determining whether an obligation is considered to be outstanding on the date that is two years after March 18, 2010.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

The interest provisions increasing the grace period for which the government is not required to pay interest on an overpayment from 45 to 180 days apply to: (1) returns with due dates after March 18, 2010; (2) claims for credit or refund of overpayment filed after March 18, 2010; and (3) refunds paid on adjustments initiated by the Secretary paid after March 18, 2010.

California Law (R&TC sections 19002, 19340, and 19341)

California does not conform to new chapter 4 of the IRC,<sup>211</sup> entitled “Taxes to Enforce Reporting on Certain Foreign Accounts”

Additionally, California does not conform to the federal rules that apply to interest on overpayments<sup>212</sup> or to deemed-payment-of-tax dates,<sup>213</sup> and instead provides its own rules.<sup>214</sup>

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
502	Repeal of Certain Foreign Exceptions to Registered Bond Requirements

Background

Registration-Required Obligations and Treatment of Bonds not Issued in Registered Form

In general, a taxpayer may deduct all interest paid or accrued within the taxable year on indebtedness.<sup>215</sup> For registration-required obligations, a deduction for interest is allowed only if the obligation is in registered form. Generally, an obligation is treated as issued in registered form if the issuer or its agent maintains a registration of the identity of the owner of the obligation and

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<sup>211</sup> IRC sections 1471, 1472, 1473, and 1474.

<sup>212</sup> IRC section 6611.

<sup>213</sup> IRC section 6513.

<sup>214</sup> For rules that apply to interest on overpayments, see R&TC sections 19340 and 19341. For rules that apply to deemed-payment-of-tax dates, see R&TC section 19002.

<sup>215</sup> IRC section 163(a).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

the obligation can be transferred only through this registration system.<sup>216</sup> A registration-required obligation is any obligation other than one that: (1) is made by a natural person; (2) matures in one year or less; (3) is not of a type offered to the public; or (4) is a foreign targeted obligation.<sup>217</sup>

In applying this requirement, the IRS has adopted a flexible approach that recognizes that a debt obligation that is formally in bearer (i.e., not in registered) form is nonetheless “in registered form” for these purposes where there are arrangements that preclude individual investors from obtaining definitive bearer securities or that permit such securities to be issued only upon the occurrence of an extraordinary event.<sup>218</sup>

A foreign targeted obligation (to which the registration requirement does not apply) is any obligation satisfying the following requirements: (1) there are arrangements reasonably designed to ensure that such obligation will be sold (or resold in connection with the original issue) only to a person who is not a United States person; (2) interest is payable only outside the United States and its possessions; and (3) the face of the obligation contains a statement that any United States person who holds this obligation will be subject to limitations under the U.S. income tax laws.<sup>219</sup>

In addition to the denial of an interest deduction, interest on a state or local bond that is a registration-required obligation will not qualify for the applicable tax exemption if the bond is not in registered form.<sup>220</sup> Also, an excise tax is imposed on the issuer of any registration required

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<sup>216</sup> An obligation is treated as in registered form if (1) it is registered as to both principal and interest with the issuer (or its agent) and transfer of the obligation may be effected only by surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder, (2) the right to principal and stated interest on the obligation may be transferred only through a book entry system maintained by the issuer or its agent, or (3) the obligation is registered as to both principal and interest with the issuer or its agent and may be transferred through both of the foregoing methods. Treas. Reg. section 5f.103-1(c).

<sup>217</sup> IRC section 163(f)(2)(A). The registration requirement is intended to preserve liquidity while reducing opportunities for noncompliant taxpayers to conceal income and property from the reach of the income, estate and gift taxes. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* (JCS-38-82), December 31, 1982, p. 190.

<sup>218</sup> Priv. Ltr. Rul. 1993-43-018 (1993); Priv. Ltr. Rul. 1993-43-019 (1993); Priv. Ltr. Rul. 1996-13-002 (1996). The IRS held that the registration requirement may be satisfied by “dematerialized book-entry systems” developed in some foreign countries, even if, under such a system, a holder is entitled to receive a physical certificate, tradable as a bearer instrument, in the event the clearing organization maintaining the system goes out of existence, because “cessation of operation of the book-entry system would be an extraordinary event.” Notice 2006-99, 2006-2 C.B. 907.

<sup>219</sup> IRC section 163(f)(2)(B).

<sup>220</sup> IRC section 103(b)(3). For the purposes of this section, registration-required obligation is any obligation other than one that: (1) is not of a type offered to the public; (2) matures in one year or less; or (3) is a foreign targeted obligation.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

obligation that is not in registered form.<sup>221</sup> The excise tax is equal to one percent of the principal amount of the obligation multiplied by the number of calendar years (or portions thereof) during the period beginning on the date of issuance of the obligation and ending on the date of maturity.

Moreover, any gain realized by the beneficial owner of a registration-required obligation that is not in registered form on the sale or other disposition of the obligation is treated as ordinary income (rather than capital gain), unless the issuer of the obligation was subject to the excise tax described above.<sup>222</sup> Finally, deductions for losses realized by beneficial owners of registration-required obligations that are not in a registered form are disallowed.<sup>223</sup> For the purposes of ordinary income treatment and denial of deduction for losses, a registration-required obligation is any obligation other than one that: (1) is made by a natural person; (2) matures in one year or less; or (3) is not of a type offered to the public.

#### Treatment as Portfolio Interest

Payments of U.S.-source “fixed or determinable annual or periodical” income, including interest, dividends, and similar types of investment income, that are made to foreign persons are subject to U.S. withholding tax at a 30-percent rate, unless the withholding agent can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty.<sup>224</sup> In 1984, the Congress repealed the 30-percent tax on portfolio interest received by a nonresident individual or foreign corporation from sources within the United States.<sup>225</sup>

The term “portfolio interest” means any interest (including original issue discount) that is: (1) paid on an obligation that is in registered form and for which the beneficial owner has provided to the U.S. withholding agent a statement certifying that the beneficial owner is not a U.S. person; or

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<sup>221</sup> IRC section 4701.

<sup>222</sup> IRC section 1287.

<sup>223</sup> IRC section 165(j).

<sup>224</sup> IRC sections 871 and 881; Treas. Reg. section 1.1441-1(b). Generally, the determination by a withholding agent of the U.S. or foreign status of a payee and of its other relevant characteristics (e.g., as a beneficial owner or intermediary, or as an individual, corporation, or flow-through entity) is made on the basis of a withholding certificate that is a federal Form W-8 or a federal Form 8233 (indicating foreign status of the payee or beneficial owner) or a federal Form W-9 (indicating U.S. status of the payee).

<sup>225</sup> IRC sections 871(h) and 881(c). Congress believed that the imposition of a withholding tax on portfolio interest paid on debt obligations issued by U.S. persons might impair the ability of U.S. corporations to raise capital in the Eurobond market (i.e., the global market for U.S. dollar-denominated debt obligations). Congress also anticipated that repeal of the withholding tax on portfolio interest would allow the U.S. Treasury Department direct access to the Eurobond market. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, pp. 391-92.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

(2) paid on an obligation that is not in registered form and that meets the foreign targeting requirements of IRC section 163(f)(2)(B).<sup>226</sup> Portfolio interest, however, does not include interest received by a 10-percent shareholder,<sup>227</sup> certain contingent interest,<sup>228</sup> interest received by a controlled foreign corporation from a related person,<sup>229</sup> or interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.<sup>230</sup>

#### Requirement that U.S. Treasury Obligations be in Registered Form

Under title 31 of the United States Code, every “registration-required obligation” of the U.S. Treasury must be in registered form.<sup>231</sup> For this purpose, a foreign targeted obligation is excluded from the definition of a registration-required obligation.<sup>232</sup> Thus, a foreign targeted obligation of the Treasury can be in bearer (rather than registered) form.

#### New Federal Law (IRC sections 149, 163, 165, 871, 881, 1287, and 4701)

#### Repeal of the Foreign Targeted Obligation Exception to the Registration Requirement

The provision repeals the foreign targeted obligation exception to the denial of a deduction for interest on bonds not issued in registered form. Thus, under the provision, a deduction for interest is disallowed with respect to any obligation not issued in registered form, unless that obligation: (1) is issued by a natural person; (2) matures in one year or less; or (3) is not of a type offered to the public.

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<sup>226</sup> In repealing the 30-percent tax on portfolio interest, under the Deficit Reduction Act of 1984, Congress expressed concern about potential compliance problems in connection with obligations issued in bearer form. Given the foreign targeted exception to the registration requirement under IRC section 163(f)(2)(A), U.S. persons intent on evading U.S. tax on interest income might attempt to buy U.S. bearer obligations overseas, claiming to be foreign persons. These persons might then claim the statutory exemption from withholding tax for the interest paid on the obligations and fail to declare the interest income on their U.S. tax returns, without concern that their ownership of the obligations would come to the attention of the IRS. Because of these concerns, Congress expanded the Treasury’s authority to require registration of obligations designed to be sold to foreign persons. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (JCS-41-84)*, December 31, 1984, p. 393.

<sup>227</sup> IRC section 871(h)(3).

<sup>228</sup> IRC section 871(h)(4).

<sup>229</sup> IRC section 881(c)(3)(C).

<sup>230</sup> IRC section 881(c)(3)(A).

<sup>231</sup> 31 U.S.C. IRC section 3121(g)(3). For purposes of title 31 of the United States Code, registration-required obligation is defined as any obligation except: (1) an obligation not of a type offered to the public; (2) an obligation having a maturity (at issue) of not more than one year; or (3) a foreign targeted obligation.

<sup>232</sup> 31 U.S.C. section 3121(g)(2).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

Also, the provision repeals the foreign targeted obligation exception to the denial of the tax exemption on interest on state and local bonds not issued in registered form. Therefore, under the provision, interest paid on state and local bonds not issued in registered form will not qualify for tax exemption unless that obligation: (1) is not of a type offered to the public; or (2) matures in one year or less.

The bill preserves the ordinary income treatment under present law of any gain realized by the beneficial owner from the sale or other disposition of a registration-required obligation that is not in registered form. Similarly, the bill does not change the present law rule disallowing deductions for losses realized by a beneficial owner of a registration-required obligation that is not in a registered form.

#### Preservation of Exception to the Registration Requirement for Excise Tax Purposes

Under the provision, the foreign targeted obligation exception is available with respect to the excise tax applicable to issuers of registration-required obligations that are not in registered form. Thus, the excise tax applies with respect to any obligation that is not in registered form unless the obligation: (1) is issued by a natural person; (2) matures in one year or less; (3) is not of a type offered to the public; or (4) is a foreign targeted obligation.

#### Repeal of Treatment as Portfolio Interest

The provision repeals the treatment as portfolio interest of interest paid on bonds that are not issued in registered form but meet the foreign targeting requirements of IRC section 163(f)(2)(B). Under the provision, interest qualifies as portfolio interest only if it is paid on an obligation that is issued in registered form and either: (1) the beneficial owner has provided the withholding agent with a statement certifying that the beneficial owner is not a United States person (on federal Form W-8); or (2) the Secretary has determined that such statement is not required in order to carry out the purposes of the subsection. It is anticipated that the Secretary may exercise its authority under this rule to waive the requirement of collecting federal Forms W-8 in circumstances in which the Secretary has determined there is a low risk of tax evasion and there are adequate documentation standards within the country of tax residency of the beneficial owner of the obligations in question. Generally, however, as a result of the provision, interest paid to a foreign person on an obligation that is not issued in registered form is subject to U.S. withholding tax at a 30-percent rate, unless the withholding agent can establish that the beneficial owner of the amount is eligible for an exemption from withholding other than the portfolio interest exemption or for a reduced rate of withholding under an income tax treaty.

#### Dematerialized Book-Entry Systems Treated as Registered Form

The provision provides that a debt obligation held through a dematerialized book-entry system, or other book-entry system specified by the Secretary, is treated, for purposes of IRC section 163(f),

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

as held through a book entry system for the purpose of treating the obligation as in registered form.<sup>233</sup> A debt obligation that is formally in bearer form is treated, for the purposes of IRC section 163(f), as held in a book-entry system as long as the debt obligation may be transferred only through a dematerialized book entry system or other book entry system specified by the Secretary.

Effective Date

The provision applies to debt obligations issued after March 18, 2012.

California Law (R&TC sections 17201, 17224, 17230, 24344, 24344, 24344.5, and 24344.7)

Repeal of the Foreign Targeted Obligation Exception to the Registration Requirement

Under both the PITL and the CTL, for taxable years beginning on or after January 1, 2010, California conforms to the denial of a deduction for interest on certain obligations not in registered form under IRC section 163(f) as of the “specified date” of January 1, 2009. Thus, California does not conform to this provision (that repeals the foreign targeted obligation exception to the registration requirement). However, because taxpayers are required to follow the new federal rules for registration-required obligations, there is no conformity impact to the amount of California deductible bond interest.

Preservation of Exception to the Registration Requirement for Excise Tax Purposes

The FTB does not administer excise taxes. Defer to the Board of Equalization (BOE).

Repeal of Treatment as Portfolio Interest

California does not conform to the federal portfolio interest rules.

Dematerialized Book-Entry Systems Treated as Registered Form

Under both the PITL and the CTL, for taxable years beginning on or after January 1, 2010, California conforms to the denial of a deduction for interest on certain obligations not in registered form under IRC section 163(f) as of the “specified date” of January 1, 2009. Thus, California does not conform to the new federal rule that provides that a debt obligation held through a dematerialized book-entry system, or other book-entry system specified by the Secretary, is treated, for purposes of IRC section 163(f), as held through a book entry system for the purpose of treating the obligation as in registered form. However, there is no conformity impact because this provision codifies rules that had been previously held by the IRS in private letter rulings under the federal law that California is in current conformity with.

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<sup>233</sup> By reason of cross references, this rule will also apply to IRC sections 165(j), 312(m), 871(h), 881(c), 1287, and 4701.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

Impact on California Revenue

Repeal of the Foreign Targeted Obligation Exception to the Registration Requirement

No impact.

Preservation of Exception to the Registration Requirement for Excise Tax Purposes

Defer to the BOE.

Repeal of Treatment as Portfolio Interest

Not applicable.

Dematerialized Book-Entry Systems Treated as Registered Form

No impact.

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<u>Section</u>	<u>Section Title</u>
511	Disclosure of Information with Respect to Foreign Financial Assets

Background

U.S. persons who transfer assets to, and hold interests in, foreign bank accounts or foreign entities may be subject to self-reporting requirements under both Title 26 (the Internal Revenue Code) and Title 31 (the Bank Secrecy Act) of the United States Code.

Since its enactment, the Bank Secrecy Act has been expanded beyond its original focus on large currency transactions, while retaining its broad purpose of obtaining self-reporting of information with “a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings.”<sup>234</sup> As the reporting regime has expanded,<sup>235</sup> reporting obligations have been imposed on both financial institutions and account holders. With respect to account holders, a U.S. citizen, resident, or person doing business in the United States is required to keep records and file reports, as specified by the Secretary, when that person enters into a transaction or maintains an

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<sup>234</sup> 31 U.S.C. section 5311.

<sup>235</sup> See e.g., Title III of the USA PATRIOT Act, Public Law 107-56 (October 26, 2001) (sections 351 through 366 amended the Bank Secrecy Act as part of a series of reforms directed at international financing of terrorism).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

account with a foreign financial agency.<sup>236</sup> Regulations promulgated pursuant to broad regulatory authority granted to the Secretary in the Bank Secrecy Act<sup>237</sup> provide additional guidance regarding the disclosure obligation with respect to foreign accounts. The Bank Secrecy Act specifies only that such disclosure contain the following information “in the way and to the extent the Secretary prescribes:” (1) the identity and address of participants in a transaction or relationship; (2) the legal capacity in which a participant is acting; (3) the identity of real parties in interest; and (4) a description of the transaction.

Treasury Department Form TD F 90-22.1, “Report of Foreign Bank and Financial Accounts,” (the “FBAR”) must be filed by June 30 of the year following the year in which the \$10,000 filing threshold is met.<sup>238</sup> The FBAR is filed with the Treasury Department at the IRS Detroit Computing Center. Failure to file the FBAR is subject to both criminal<sup>239</sup> and civil penalties.<sup>240</sup> Since 2004, the civil sanctions have included penalties not to exceed: (1) \$10,000 for failures that are not willful; and (2) the greater of \$100,000 or 50 percent of the balance in the account for willful failures. Although the FBAR is received and processed by the IRS, it is neither part of the income tax return filed with the IRS nor filed in the same office as that return. As a result, for purposes of Title 26, the FBAR is not considered “return information,” and its distribution to other law enforcement agencies is not limited by the nondisclosure rules of Title 26.<sup>241</sup>

Although the obligation to file an FBAR arises under Title 31, individual taxpayers subject to the FBAR reporting requirements are alerted to this requirement in the preparation of annual federal income tax returns. Part III (“Foreign Accounts and Trusts”) of Schedule B of the 2008 federal Form 1040 includes the question, “At any time during 2008, did you have an interest in or signatory or any other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account?” and directs taxpayers to “See page B-2 for exceptions and filing requirements for Form TD F 90-22.1.” The federal Form 1040 instructions advise individuals who answer “yes” to this question to identify the foreign country or

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<sup>236</sup> 31 U.S.C. sec. 5314. The term “agency” in the Bank Secrecy Act includes financial institutions.

<sup>237</sup> 31 U.S.C. sec. 5314(a) provides: “Considering the need to avoid impeding or controlling the export or import of monetary instruments and the need to avoid burdening unreasonably a person making a transaction with a foreign financial agency, the Secretary of the Treasury shall require a resident or citizen of the United States or a person in, and doing business in, the United States, to keep records, file reports, or keep records and file reports, when the resident, citizen, or person makes a transaction or maintains a relation for any person with a foreign financial agency.”

<sup>238</sup> 31 C.F.R. sec. 103.27(c). The \$10,000 threshold is the aggregate value of all foreign financial accounts in which a U.S. person has a financial interest or over which the U.S. person has signature or other authority.

<sup>239</sup> 31 U.S.C. sec. 5322 (failure to file is punishable by a fine up to \$250,000 and imprisonment for five years, that may double if the violation occurs in conjunction with certain other violations).

<sup>240</sup> 31 U.S.C. sec. 5321(a)(5).

<sup>241</sup> IRC section 6103 bars disclosure of return information, unless permitted by an exception.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

countries in which such accounts are located.<sup>242</sup> Responding to this question does not discharge one's obligations under Title 31 and constitutes "return information" protected from routine disclosure to those charged with enforcing Title 31. In addition, federal Form 1040 instructions identify certain types of accounts that are not subject to disclosure, including those instances in which the combined value of all accounts held by the taxpayer did not exceed \$10,000 at any point during the relevant tax year.

The FBAR requires disclosure of any account in which the filer has a financial interest or as to which the filer has signature or other authority (in which case the filer must identify the owner of the account). The Treasury Department and the IRS revised the FBAR and its accompanying instructions in October, 2008, to clarify the filing requirements for U.S. persons holding interests in foreign bank accounts.<sup>243</sup> For example, the terminology has been updated to reflect new types of financial transactions. For example, "financial account" now specifies that debit or prepaid credit cards are financial accounts,<sup>244</sup> and the definition of "signature or other authority" now encompasses the ability to indirectly exercise this authority, even in the absence of written instructions.<sup>245</sup> The revised instructions also provide that foreign individuals doing business in the

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<sup>242</sup> 31 C.F.R. sec. 103.24.

<sup>243</sup> Treasury Department Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts, and its instructions states:

A financial interest in a bank, securities, or other financial account in a foreign country means an interest described in one of the following three paragraphs: 1. A United States person has a financial interest in each account for which such person is the owner of record or has legal title, whether the account is maintained for his or her own benefit or for the benefit of others including non-United States persons. 2. A United States person has a financial interest in each bank, securities, or other financial account in a foreign country for which the owner of record or holder of legal title is: (a) a person acting as an agent, nominee, attorney, or in some other capacity on behalf of the U.S. person; (b) a corporation in which the United States person owns directly or indirectly more than 50 percent of the total value of shares of stock or more than 50 percent of the voting power for all shares of stock; (c) a partnership in which the United States person owns an interest in more than 50 percent of the profits (distributive share of income, taking into account any special allocation agreement) or more than 50 percent of the capital of the partnership; or (d) a trust in which the United States person either has a present beneficial interest, either directly or indirectly, in more than 50 percent of the assets or from which such person receives more than 50 percent of the current income. 3. A United States person has a financial interest in each bank, securities, or other financial account in a foreign country for which the owner of record or holder of legal title is a trust, or a person acting on behalf of a trust, that was established by such United States person and for which a trust protector has been appointed. A trust protector is a person who is responsible for monitoring the activities of a trustee, with the authority to influence the decisions of the trustee or to replace, or recommend the replacement of, the trustee. Correspondent or "nostro" accounts (international interbank transfer accounts) maintained by banks that are used solely for the purpose of bank-to-bank settlement need not be reported on this form, but are subject to other Bank Secrecy Act filing requirements. This exception is intended to encompass those accounts utilized for bank-to-bank settlement purposes only.

<sup>244</sup> See Chief Counsel Advice 200603026 (January 20, 2006) for a discussion of whether payment card accounts constitute financial accounts.

<sup>245</sup> According to the instructions to the FBAR, a person has "signature authority" over an account "if such person can control the disposition of money or other property in it by delivery of a document containing his or her signature (or his or her signature and that of one or more other persons) to the bank or other person with whom the account is

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

United States may be required to file an FBAR.<sup>246</sup> In August, 2009, the IRS requested public comments to help determine the scope and nature of future additional guidance.<sup>247</sup>

The revised instructions explain the basis for reporting other information in more detail, and provide that: (1) all foreign persons with an interest in the account must be identified (including foreign identification numbers for each); (2) the highest value held in the account at any point in the year must be disclosed; (3) corporate employees with signature authority but no financial interest are generally required to disclose the signature authority, unless the corporate Chief Financial Officer (“CFO”) (or in the case of an employee of a subsidiary, the parent company’s CFO) certifies that the account will be reported on the corporate filing; and (4) any amended or delinquent filing should be identified as such, and accompanied by an explanatory statement.

In addition to the FBAR requirements under Title 31, there are additional reports required by the Code to be filed with the IRS by U.S. persons engaged in foreign activities, directly or indirectly, through a foreign business entity. Upon the formation, acquisition or ongoing ownership of certain foreign corporations, U.S. persons that are officers, directors, or shareholders must file a federal Form 5471, “Information Return of U.S. Persons with Respect to Certain Foreign Corporations.”<sup>248</sup> Similarly, a federal Form 8865, “Return of U.S. Persons with Respect to Certain Foreign Partnerships,” must be filed with respect to certain interests in a controlled foreign partnership; a federal Form 3520, “Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts,” must be filed with respect to certain foreign trusts; and a federal Form 8858, “Information Return of U.S. Persons With Respect To Foreign Disregarded Entities” must be filed with respect to a foreign disregarded entity.<sup>249</sup> To the extent that the U.S. person engages in

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maintained.” “Other authority” exists in a person “who can exercise comparable power over an account by communication to the bank or other person with whom the account is maintained, either directly or through an agent, nominee, attorney, or in some other capacity on behalf of the US person, either orally or by some other means.”

<sup>246</sup> Although the revised instructions currently track the language of the statute in stating that a person in or doing business in the United States is within its purview, and thus merely clarify what has long been required, the IRS announced that pending publication of guidance on the scope of the statute, people could rely on the earlier, unrevised instructions to determine whether they are required to file an FBAR (Announcement 2009-51, 2009-25 I.R.B. 1105). Subsequently, the IRS announced that persons with only signature authority over a foreign financial account as well as for signatories or owners of financial interest in a foreign commingled fund have until June 30, 2010, to file an FBAR for the 2008 and earlier calendar years with respect to those accounts. Notice 2009-62, 2009-35 I.R.B. 260.

<sup>247</sup> Notice 2009-62, 2009-35 I.R.B. 260, specifically requested comments concerning: (1) when a person having only signature authority or having an interest in a commingled fund should be relieved of filing an FBAR; (2) the circumstances under which the FBAR filing exceptions for officers and employees of banks and some publicly traded domestic corporations should be expanded; (3) when an interest in a foreign entity should be subject to FBAR reporting; and (4) whether the passive asset and passive income thresholds are appropriate and should apply conjunctively.

<sup>248</sup> IRC sections 6038 and 6046.

<sup>249</sup> Federal Form 8858 is used to satisfy reporting requirements of IRC sections 6011, 6012, 6031, 6038, and related regulations.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

such foreign activities indirectly through a foreign business entity, other self-reporting requirements may apply. In addition, a U.S. person that capitalizes a foreign entity generally is required to file a federal Form 926, "Return by a U.S. Transferor of Property to a Foreign Corporation."<sup>250</sup>

With the exception of the questions included on federal Form 1040, Schedule B, there is no requirement to disclose the information includible on FBAR on an individual tax return.

#### FBAR Enforcement Responsibility

Until 2003, the Financial Crimes and Enforcement Network ("FinCEN"), an agency of the Department of the Treasury, had responsibility for civil penalty enforcement of FBAR.<sup>251</sup> As a result, persons who were more than 180 days delinquent in paying any FBAR penalties were referred for collection action to the Financial Management Service of the Treasury Department, which is responsible for such non-tax collections.<sup>252</sup> Continued nonpayment resulted in a referral to the Department of Justice for institution of court proceedings against the delinquent person. In 2003, the Secretary delegated civil enforcement to the IRS.<sup>253</sup> This change reflected the fact that a major purpose of the FBAR was to identify potential tax evasion, and therefore was not closely aligned with FinCEN's core mission.<sup>254</sup> The authority delegated to the IRS in 2003 included the authority to determine and enforce civil penalties,<sup>255</sup> as well as to revise the form and instructions. However, the collection and enforcement powers available to enforce the Internal Revenue Code under Title 26 are not available to the IRS in the enforcement of FBAR civil penalties, which remain collectible only in accord with the procedures for non-tax collections described above.

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<sup>250</sup> IRC section 6038B. The filing of this form may also be required upon future contributions to the foreign corporation.

<sup>251</sup> Treas. Directive 15-14 (December 1, 1992), in which the Secretary delegated to the IRS authority to investigate violations of the Bank Secrecy Act. If the IRS Criminal Investigation Division declines to pursue a possible criminal case, it is to refer the matter to FinCEN for civil enforcement.

<sup>252</sup> 31 U.S.C. sec. 3711(g).

<sup>253</sup> 31 C.F.R. sec. 103.56(g). Memorandum of Agreement and Delegation of Authority for Enforcement of FBAR Requirements (April 2, 2003); News Release, Internal Revenue Service, IR-2003-48 (April 10, 2003).

<sup>254</sup> Secretary of the Treasury, "A Report to Congress in Accordance with sec. 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act)" (April 24, 2003).

<sup>255</sup> A penalty may be assessed before the end of the six-year period beginning on the date of the transaction with respect to which the penalty is assessed. 31 U.S.C. sec. 5321(b)(1). A civil action for collection may be commenced within two years of the later of the date of assessment and the date a judgment becomes final in any related criminal action. 31 U.S.C. sec. 5321(b)(2).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

In general, information reported on an FBAR is available to the IRS and other law enforcement agencies. In contrast, information on income tax returns—including Schedule B information regarding foreign bank accounts—is not readily available to those within the IRS who are charged with administering FBAR compliance, despite the fact that federal returns and return information may be the best source of information for this purpose.

The nondisclosure constraints on IRS personnel who examine income tax liability (i.e., federal Form 1040 reporting) generally preclude the sharing of tax return information with any other IRS personnel or Treasury officials, except for tax administration purposes.<sup>256</sup> Tax administration is defined as “the administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws or related statutes” and does not necessarily include administration of Title 31.<sup>257</sup> Because Title 31 includes enforcement of non-tax provisions of the Bank Secrecy Act, Title 31 is not, per se, a “related statute,” for purposes of finding that a disclosure of such information would be for tax administration purposes. As a result, IRS personnel charged with investigating and enforcing the civil penalties under Title 31 are not routinely permitted access to federal Form 1040 information that would support or shed light on the existence of an FBAR violation. Instead, there must be a determination, in writing, that the FBAR violation was in furtherance of a Title 26 violation in order to support a finding that the statutes are “related statutes” for purposes of authorizing the disclosure. The effect of this prerequisite is to subsume the bank account information reported on federal Form 1040 under the scope of “return information” and therefore, the protection from disclosure provided under Title 26.<sup>258</sup>

## Penalties

Failure to comply with the FBAR filing requirements is subject to penalties imposed under Title 31 of the United States Code, and may be both civil and criminal. Since the initial enactment of the Bank Secrecy Act, a willful failure to comply with the FBAR reporting requirement has been subject to a civil penalty. In 2004, the available penalties were expanded to include a reduced penalty for a non-willful failure to file.<sup>259</sup> Willful failure to file an FBAR may be subject to penalties in amounts not to exceed the greater of \$100,000 or 50 percent of the amount in the account at the time of the violation.<sup>260</sup> A non-willful, but negligent, failure to file is subject to a penalty of \$10,000 for

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<sup>256</sup> IRC section 6103(h)(1). In essence, IRC section 6103(h)(1) authorizes officers and employees of both the Treasury Department and the IRS to have access to return information on the basis of a “need to know” in order to perform a tax administration function.

<sup>257</sup> IRC section 6103(b)(4).

<sup>258</sup> Internal Revenue Manual, paragraphs 4.26.14.2 and 4.26.14.2.1.

<sup>259</sup> American Jobs Creation Act of 2004, Public Law 108-357, section 821(b), 118 Stat. 1418. This provision is codified in 31 U.S.C. sec. 5321(a)(5).

<sup>260</sup> 31 U.S.C. sec. 5321(a)(5)(C).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

each negligent violation.<sup>261</sup> The penalty may be waived if: (1) there is reasonable cause for the failure to report; and (2) the amount of the transaction or balance in the account was properly reported. In addition, serious violations are subject to criminal prosecution, potentially resulting in both monetary penalties and imprisonment. Civil and criminal sanctions are not mutually exclusive.

Failure to comply with information returns required by the Internal Revenue Code is subject to a variety of sanctions, including: (1) suspension of the applicable statute of limitations;<sup>262</sup> (2) disallowance of otherwise permitted tax attributes, deductions or credits;<sup>263</sup> and (3) imposition of penalties. For most information returns, the failure to file penalty is \$50 per return, up to a maximum of \$250,000 per taxpayer.<sup>264</sup> Failures to disclose control of any foreign business entity,<sup>265</sup> foreign parties with 25-percent ownership interest in a domestic company,<sup>266</sup> domestic officers and 10-percent owners of a foreign corporation,<sup>267</sup> or change in ownership of a foreign partnership<sup>268</sup> are subject to penalties of \$10,000, plus \$10,000 for every 30 days the failure to file persists longer than 90 days after the taxpayer is informed of the failure. A failure to report a transfer to a foreign corporation is subject to a penalty equal to 10 percent of the value of the transfer, but is capped at \$10,000 if the failure is not willful.<sup>269</sup> Failure to report the creation of a foreign trust is subject to a 35-percent penalty on the reportable amount (or five percent for a federal Form 3520-A report), plus \$10,000 for every 30 days the failure to file persists after 90 days from the date on which the taxpayer is informed of the failure to file. The penalty is capped at the gross reportable amount.<sup>270</sup>

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<sup>261</sup> 31 U.S.C. sec. 5321(a)(5)(B)(i), (ii).

<sup>262</sup> IRC section 6501(c)(8).

<sup>263</sup> IRC sections 1295, 6038.

<sup>264</sup> IRC section 6721.

<sup>265</sup> IRC section 6038.

<sup>266</sup> IRC section 6038A.

<sup>267</sup> IRC section 6046.

<sup>268</sup> IRC section 6046A.

<sup>269</sup> IRC section 6038B.

<sup>270</sup> IRC section 6048.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

New Federal Law (IRC section 6038D)

The provision requires individual taxpayers with an interest in a “specified foreign financial asset” during the taxable year to attach a disclosure statement to their income tax return for any year in which the aggregate value of all such assets is greater than \$50,000. Although the nature of the information required is similar to the information disclosed on an FBAR, it is not identical. For example, a beneficiary of a foreign trust who is not within the scope of the FBAR reporting requirements because his interest in the trust is less than 50 percent may nonetheless be required to disclose the interest in the trust with his tax return under this provision if the value of his interest in the trust together with the value of other specified foreign financial assets exceeds the aggregate value threshold. Nothing in this provision is intended as a substitute for compliance with the FBAR reporting requirements, which are unchanged by this provision.

“Specified foreign financial assets” are depository or custodial accounts at foreign financial institutions and, to the extent not held in an account at a financial institution: (1) stocks or securities issued by foreign persons; (2) any other financial instrument or contract held for investment that is issued by or has a counterparty that is not a U.S. person; and (3) any interest in a foreign entity. The information to be included on the statement includes identifying information for each asset and its maximum value during the taxable year. For an account, the name and address of the institution at which the account is maintained, and the account number are required. For a stock or security, the name and address of the issuer, and any other information necessary to identify the stock or security and terms of its issuance must be provided. For all other instruments or contracts, or interests in foreign entities, the information necessary to identify the nature of the instrument, contract or interest must be provided, along with the names and addresses of all foreign issuers and counterparties. An individual is not required under this provision to disclose interests that are held in a custodial account with a U.S. financial institution nor is an individual required to separately identify any stock, security instrument, contract, or interest in a foreign financial account disclosed under the provision. In addition, the provision permits the Secretary to issue regulations that would apply the reporting obligations to a domestic entity in the same manner as if such entity were an individual if that domestic entity is formed or availed of to hold such interests, directly or indirectly.

Individuals who fail to make the required disclosures are subject to a penalty of \$10,000 for the taxable year. An additional penalty may apply if the Secretary notifies an individual by mail of the failure to disclose and the failure to disclose continues. If the failure continues beyond 90 days following the mailing, the penalty increases by \$10,000 for each 30-day period (or a fraction thereof), up to a maximum penalty of \$50,000 for one taxable period. The computation of the penalty is similar to that applicable to failures to file reports with respect to certain foreign corporations under IRC section 6038. Thus, an individual who is notified of his failure to disclose with respect to a single taxable year under this provision and who takes remedial action on the 95th day after such notice is mailed incurs a penalty of \$20,000 comprising the base amount of \$10,000, plus \$10,000 for the fraction (i.e., the five days) of a 30-day period following the lapse of 90 days after the notice of noncompliance was mailed. An individual who postpones remedial action until the 181st day is subject to the maximum penalty of \$50,000: the base amount of \$10,000, plus \$30,000 for the three 30-day periods, plus \$10,000 for the one fraction (i.e., the

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

single day) of a 30-day period following the lapse of 90 days after the notice of noncompliance was mailed.

No penalty is imposed under the provision against an individual who can establish that the failure was due to reasonable cause and not willful neglect. Foreign law prohibitions against disclosure of the required information cannot be relied upon to establish reasonable cause.

To the extent the Secretary determines that the individual has an interest in one or more foreign financial assets but the individual does not provide enough information to enable the Secretary to determine the aggregate value thereof, the aggregate value of such identified foreign financial assets will be presumed to have exceeded \$50,000 for purposes of assessing the penalty.

The provision also grants authority to promulgate regulations necessary to carry out the intent. Such regulations may include exceptions for nonresident aliens and classes of assets identified by the Secretary, including those assets which the Secretary determines are subject to reporting requirements under other provisions of the IRC. In particular, regulatory exceptions to avoid duplicative reporting requirements are anticipated.

Effective Date

The provision is effective for taxable years beginning after March 18, 2010.

California Law (R&TC sections 19141.2 and 19141.5)

Offshore Information Reporting Requirements

California conforms, with modifications, to the federal information reporting requirements for: (1) certain foreign corporations and partnerships;<sup>271</sup> (2) certain foreign-owned corporations;<sup>272</sup> (3) notice of certain transfers to foreign persons;<sup>273</sup> and (4) foreign corporations engaged in U.S. business.<sup>274</sup>

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<sup>271</sup> R&TC section 19141.2.

<sup>272</sup> R&TC section 19141.5(a).

<sup>273</sup> R&TC section 19141.5(b).

<sup>274</sup> R&TC section 19141.5(c).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

Penalties for Failure to Furnish Required Offshore Information Returns

*Certain foreign corporations and partnerships*

California conforms to the federal penalties for failure to furnish required information on certain foreign corporations and partnerships, modified to provide that the California penalty is \$1,000 for a taxpayer that fails to make the required disclosure for the taxable year. An additional penalty may apply if the FTB notifies a corporation by mail of the failure and the failure continues. If the failure continues beyond 90 days following the mailing, the penalty increases by \$1,000 for each 30-day period (or fraction thereof), up to a maximum of \$24,000.<sup>275</sup>

*Certain foreign-owned corporations*

California conforms to the federal penalty amounts for failure to furnish information on certain foreign-owned corporations. Corporations that fail to make required disclosures are subject to a penalty of \$10,000 for each taxable year that the failure occurs. An additional penalty may apply if the FTB notifies a taxpayer by mail of the failure and the failure to disclose continues. If the failure continues beyond 90 days following the mailing, the penalty increases by \$10,000 for each 30-day period (or fraction thereof).<sup>276</sup>

*Notice of certain transfers to foreign persons*

California conforms to the federal penalty amounts for failure to furnish information of certain transfers to foreign persons. The penalty is 10 percent of the fair market value of the property at the time of the exchange, not to exceed \$100,000.

*Foreign corporations engaged in U.S. business*

California conforms to the federal penalty amounts for failure to furnish information of foreign corporations engaged in U.S. business. Foreign corporations that fail to make required disclosures are subject to a penalty of \$10,000 for each taxable year that the failure occurs. An additional penalty may apply if the FTB notifies a foreign corporation by mail of the failure and the failure to disclose continues. If the failure continues beyond 90 days following the mailing, the penalty increases by \$10,000 for each 30-day period (or fraction thereof).

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<sup>275</sup> R&TC section 19141.2(c). The federal penalty under IRC section 6038 is \$10,000 for a taxpayer that fails to make the required disclosure for the taxable year. An additional penalty may apply if the FTB notifies a taxpayer by mail of the failure and the failure to disclose continues. If the failure continues beyond 90 days following the mailing, the penalty increases by \$10,000 for each 30-day period (or fraction thereof), up to a maximum of \$50,000.

<sup>276</sup> R&TC section 19141.5(a)(2).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

Specified Foreign Financial Asset Information Requirements

California does not conform to the requirement imposed by this provision that individual taxpayers with an interest in a “specified foreign financial asset” during the taxable year attach a disclosure statement to their income tax return for any year in which the aggregate value of all such assets is greater than \$50,000, or to the penalties for failure to furnish such information.<sup>277</sup>

Impact on California Revenue

Estimated Revenue Impact of Disclosure of Information with Respect to Foreign Financial Assets For Taxable Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
\$1,000,000	\$800,000	\$800,000

Estimates are based on a proration of federal estimates developed by the Joint Committee on Taxation.

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<u>Section</u>	<u>Section Title</u>
512	Penalties for Underpayments Attributable to Undisclosed Foreign Financial Assets

Background

The IRC imposes penalties equal to 20 percent of the portion of any underpayments that are attributable to any of the following five grounds: (1) negligence or disregard of rules or regulations; (2) any substantial understatement<sup>278</sup> of income tax; (3) any substantial valuation misstatement; (4) any substantial overstatement of pension liabilities; and (5) any substantial estate or gift tax valuation understatement. With the exception of a penalty based on negligence or disregard of rules or regulations, these penalties are commonly referred to as accuracy-related penalties,

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<sup>277</sup> Under current law, the FTB may request a copy of any information return that is added, on or after January 1, 2009, to Part III of Subchapter A of Chapter 61 of the IRC as a newly-required information return required to be filed with the Secretary of the Treasury. Thus, the FTB may request a copy of any “specified foreign financial asset” disclosure statement that is required under this provision; however, such information is not required to be provided unless specifically requested.

<sup>278</sup> If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or \$5,000 (or, in the case of corporations, by the lesser of (1) 10 percent of the correct tax (or, if greater, \$10,000) or (2) \$10 million), then a substantial understatement exists.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

because the imposition of the penalty does not require an inquiry into the culpability of the taxpayer. If the penalty is asserted, a taxpayer may defend against the penalty by demonstrating that there was “reasonable cause” for the underpayment, and the taxpayer acted in good faith.<sup>279</sup> Regulations provide that reasonable cause exists in cases in which the taxpayer “reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor’s analysis of the pertinent facts and authorities and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged” by the IRS.<sup>280</sup>

A penalty for a substantial understatement may be reduced to the extent of the portion of the understatement attributable to an item on the return for which the challenged tax treatment is supported by substantial authority or is adequately disclosed on the return and there was a reasonable basis for such treatment. The tax treatment is considered to have been adequately disclosed only if all relevant facts are disclosed with the return. Regardless of whether an item would otherwise meet either of these tests, this defense is not available with respect to penalties imposed on understatements arising from tax shelters.<sup>281</sup> The Secretary may prescribe a list of positions which the Secretary believes do not meet the requirements for substantial authority under this provision.

Under present law, failure to comply with the various information reporting requirements generally does not, in itself, determine the amount of the penalty imposed on an underpayment of tax. However, such failure to comply may be relevant to: (1) establishing negligence under IRC section 6662 or fraudulent intent;<sup>282</sup> (2) determining whether penalties based on culpability are applicable; or (3) determining whether certain defenses are available.

In the context of transactions that are subject to the “reportable transaction” disclosure regime,<sup>283</sup> a separate accuracy-related penalty may apply.<sup>284</sup> That penalty applies to “listed

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<sup>279</sup> IRC section 6664(c).

<sup>280</sup> Treas. Reg. sections 1.6662-4(g)(4)(i)(B) and 1.6664-4(c).

<sup>281</sup> A tax shelter is defined for this purpose as a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, other entity, plan, or arrangement is the avoidance or evasion of federal income tax. IRC section 6662(d)(2)(C).

<sup>282</sup> IRC section 6663 imposes a penalty of 75 percent on that portion of the understatement attributable to fraud. If the government proves that such understatement was attributable to fraud, there is a rebuttable presumption that any other understatement is attributable to fraud.

<sup>283</sup> IRC sections 6011 through 6112 require taxpayers and their advisers to disclose certain transactions determined to have the potential for tax avoidance. All such transactions are referred to as “reportable transactions,” and include within that class of transactions, those that are “listed,” that is, the subject of published guidance in which the Secretary announces his intent to challenge such transactions.

<sup>284</sup> IRC section 6662A.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

transactions” and other “reportable transactions” that have a significant tax avoidance purpose (a “reportable avoidance transaction”). The penalty rate and defenses available to avoid the IRC section 6662A penalty vary, based on the adequacy of disclosure. In general, a 20-percent accuracy-related penalty is imposed on any understatement attributable to an adequately disclosed listed transaction or reportable avoidance transaction.<sup>285</sup> An exception is available if the taxpayer satisfies a higher standard under the reasonable cause and good faith exception. This higher standard requires the taxpayer to demonstrate that there was: (1) adequate disclosure of the relevant facts affecting the treatment on the taxpayer’s return; (2) substantial authority for the treatment on the taxpayer’s return; and (3) a reasonable belief that the treatment on the taxpayer’s return was more likely than not the proper treatment.<sup>286</sup> If the transaction is not adequately disclosed, the reasonable cause exception is not available and the taxpayer is subject to a penalty equal to 30 percent of the understatement.<sup>287</sup>

New Federal Law (IRC section 6662)

The provision adds a new accuracy related penalty to IRC section 6662. The new provision, which is subject to the same defenses as are otherwise available under IRC section 6662, imposes a 40-percent penalty on any understatement attributable to an undisclosed foreign financial asset. The term “undisclosed foreign financial asset” includes all assets subject to certain information reporting requirements<sup>288</sup> for which the required information was not provided by the taxpayer as required under the applicable reporting provisions. An understatement is attributable to an undisclosed foreign financial asset if it is attributable to any transaction involving such asset. Thus, a U.S. person who fails to comply with the various self-reporting requirements for a foreign financial asset and engages in a transaction with respect to that asset incurs a penalty on any resulting underpayment that is double the otherwise applicable penalty for substantial understatements or negligence. For example, if a taxpayer fails to disclose amounts held in a foreign financial account, any underpayment of tax related to the transaction that gave rise to the income would be subject to the penalty provision, as would any underpayment related to interest, dividends or other returns accrued on such undisclosed amounts.

Effective Date

The provision is effective for taxable years beginning after March 18, 2010.

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<sup>285</sup> IRC section 6662A(a).

<sup>286</sup> IRC section 6664(d).

<sup>287</sup> The information reporting requirements identified include IRC sections 6038, 6038A, new 6038D, 6046A, and 6048.

<sup>288</sup> The information reporting requirements identified include IRC sections 6038, 6038A, new 6038D, 6046A, and 6048.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

California Law (R&TC sections 19164, 19164.5, and 19774)

Accuracy-Related Penalty

California conforms to federal accuracy-related penalty as of the “specified date” of January 1, 2009, with modifications.<sup>289</sup> Thus, California does not conform to the new federal accuracy-related penalty for underpayments attributable to undisclosed foreign financial assets.

Reportable Transaction Accuracy-Related Penalty

California conforms to the federal separate accuracy-related penalty on reportable transactions as of the “specified date” of January 1, 2009, with modifications.<sup>290</sup>

Noneconomic Substance Transaction Understatement (NEST) Penalty

The NEST penalty is standalone California penalty imposed on any understatement attributable to any transaction that lacks economic substance. A “noneconomic substance transaction understatement” is an understatement resulting from the disallowance of any loss, deduction or credit, or addition to income that is attributable to a transaction that lacks economic substance. A transaction is treated as lacking economic substance if the taxpayer lacks a valid nontax California business purpose for entering into the transaction. The NEST penalty is 20 percent of the understatement if the transaction is adequately disclosed and 40 percent of the understatement if it is not. Reasonable-cause and adequate-disclosure exceptions do not apply, and the penalty may only be relieved by the Chief Counsel of the FTB.

Penalty Coordination

California law provides coordination among these penalties to provide that an understatement is only subject to one understatement penalty (i.e., the general accuracy-related penalty, the reportable transaction accuracy-related penalty, or the NEST penalty).

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<sup>289</sup> For taxable years beginning on or after January 1, 2010, R&TC section 19164 conforms to IRC section 6662, relating to imposition of accuracy-related penalty on underpayments, as of the “specified date” of January 1, 2009, with modifications.

<sup>290</sup> For taxable years beginning on or after January 1, 2010, R&TC section 19164.5 conforms to IRC section 6662A, relating to imposition of accuracy-related penalty on understatements with respect to reportable transactions, as of the “specified date” of January 1, 2009, with modifications.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

Impact on California Revenue

Estimated Revenue Impact of Penalties for Underpayments Attributable to Undisclosed Foreign Financial Assets For Taxable Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
\$500,000	\$400,000	\$400,000

Estimates are based on a proration of federal estimates developed by the Joint Committee on Taxation.

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<u>Section</u>	<u>Section Title</u>
513	Modification of Statute of Limitations for Significant Omission of Income in Connection with Foreign Assets

Background

Taxes are generally required to be assessed within three years after a taxpayer's return was filed, whether or not it was timely filed.<sup>291</sup> Of the exceptions to this general rule, only IRC section 6501(c)(8) is specifically targeted at the identification of, and collection of information about, cross-border transactions. Under this exception, the limitation period for assessment of any tax imposed under the IRC with respect to any event or period to which information about certain cross-border transactions required to be reported relates does not expire any earlier than three years after the required information is actually provided to the Secretary by the person required to file the return.<sup>292</sup> In general, such information reporting is due with the taxpayer's return; thus, the three-year limitation period commences when a timely and complete (including all information reporting) return is filed. Without the inclusion of the information reporting with the return, the limitation period does not commence until such time as the information reports are subsequently provided to the Secretary, even though the return has been filed.

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<sup>291</sup> IRC section 6501(a). Returns that are filed before the date they are due are deemed filed on the due date. See IRC section 6501(b)(1) and (2).

<sup>292</sup> Required information reporting subject to this three-year rule is reporting under IRC sections 6038 (certain foreign corporations and partnerships), 6038A (certain foreign-owned corporations), 6038B (certain transfers to foreign persons), 6046 (organizations, reorganizations, and acquisitions of stock of foreign corporations), 6046A (interests in foreign partnerships), and 6048 (certain foreign trusts).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

In the case of a false or fraudulent return filed with the intent to evade tax, or if the taxpayer fails to file a required return, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time.<sup>293</sup> The limitation period also may be extended by taxpayer consent.<sup>294</sup> If a taxpayer engages in a listed transaction but fails to include any of the information required under IRC section 6011 on any return or statement for a taxable year, the limitation period with respect to such transaction will not expire before the date which is one year after the earlier of the date on which the Secretary is provided the information so required, or the date that a “material advisor” (as defined in IRC section 6111) makes its IRC section 6112(a) list available for inspection pursuant to a request by the Secretary under IRC section 6112(b)(1)(A).<sup>295</sup>

A special rule is provided where there is a substantial omission of income. If a taxpayer omits substantial income on a return, any tax with respect to that return may be assessed and collected within six years of the date on which the return was filed. In the case of income taxes, “substantial” means at least 25 percent of the amount that was properly includible in gross income; for estate and gift taxes, it means 25 percent of a gross estate or total gifts. For this purpose, the gross income of a trade or business means gross receipts, without reduction for the cost of sales or services.<sup>296</sup> An amount is not considered to have been omitted if the item properly includible in income is disclosed on the return.<sup>297</sup>

In addition to the exceptions described, there are also circumstances under which the three-year limitation period is suspended. For example, service of an administrative summons triggers the suspension either beginning six months after service (in the case of John Doe summonses),<sup>298</sup> or when a proceeding to quash a summons is initiated by a taxpayer named in a summons to a third-party record keeper. Judicial proceedings initiated by the government to enforce a summons generally do not suspend the limitation period.

#### New Federal Law (IRC sections 6229 and 6501)

The provision authorizes a new six-year limitations period for assessment of tax on understatements of income attributable to foreign financial assets. The present exception that

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<sup>293</sup> IRC section 6501(c).

<sup>294</sup> IRC section 6501(c)(4).

<sup>295</sup> IRC section 6501(c)(10).

<sup>296</sup> IRC section 6501(e)(1)(A)(i).

<sup>297</sup> IRC section 6501(e)(1)(A)(ii) provides that, in determining whether an amount was omitted, any amounts that are disclosed in the return or in a statement attached to the return in a manner adequate to apprise the Secretary of the nature and amount of such item are not taken into account.

<sup>298</sup> IRC section 7609(e)(2).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

provides a six-year period for substantial omission of an amount equal to 25 percent of the gross income reported on the return is not changed.

The new exception applies if there is an omission of gross income in excess of \$5,000 and the omitted gross income is attributable to an asset with respect to which information reports are required under IRC section 6038D, as applied without regard to the dollar threshold, the statutory exception for nonresident aliens and any exceptions provided by regulation. If a domestic entity is formed or availed of to hold foreign financial assets and is subject to the reporting requirements of IRC section 6038D in the same manner as an individual, the six-year limitations period may also apply to that entity. The Secretary is permitted to assess the resulting deficiency at any time within six years of the filing of the income tax return.

In providing that the applicability of IRC section 6038D information reporting requirements is to be determined without regard to the statutory or regulatory exceptions, the statute ensures that the longer limitation period applies to omissions of income with respect to transactions involving foreign assets owned by individuals. Thus, a regulatory provision that alleviates duplicative reporting obligations by providing that a report that complies with another provision of the IRC may satisfy one's obligations under new IRC section 6038D does not change the nature of the asset subject to reporting. The asset remains one that is subject to the requirements of IRC section 6038D for purposes of determining whether the exception to the three-year statute of limitations applies.

The provision also suspends the limitations period for assessment if a taxpayer fails to provide timely information returns required with respect to passive foreign investment corporations<sup>299</sup> and the new self-reporting of foreign financial assets. The limitations period will not begin to run until the information required by those provisions has been furnished to the Secretary. The provision also clarifies that the extension is not limited to adjustments to income related to the information required to be reported by one of the enumerated sections.

#### Effective Date

The provision applies to returns filed after March 18, 2010, as well as for any other return for which the assessment period specified in IRC section 6501 has not yet expired as of March 18, 2010.

California Law (R&TC sections 18622, 19057, 19058, 19059, 19060, 19065, 19066.5, and 19755)

#### In General

California does not conform to the federal statute-of-limitations rules under IRC section 6501. Instead, California has its own statute-of-limitations rules that provide that taxes are generally

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<sup>299</sup> IRC section 1295(b), (f).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

required to be assessed within four years after a taxpayer's return was filed, whether or not it was timely filed.<sup>300</sup>

#### Substantial Omissions

A special rule is provided where there is a substantial omission of income. If a taxpayer omits more than 25 percent of the amount that was properly includible in gross income, any tax with respect to that return may be assessed and collected within six years of the date on which the return was filed. For this purpose, the gross income of a trade or business means gross receipts, without reduction for the cost of sales or services. An amount is not considered to have been omitted if the item properly includible in income is disclosed on the return. Additionally, for corporations, a proceeding in court for the collection of tax may be commenced without assessment at any time within six years after the return was filed.<sup>301</sup>

#### Federal Adjustments

If any item required to be shown on a federal tax return is adjusted by the IRS, and such item increases California tax, taxpayers are required to report the changes to the FTB within six months after the federal determination date. If IRS changes are reported to the FTB within six months, the California statute of limitations is the later of two years from the date the FTB is notified, or the normal statute.<sup>302</sup> If IRS changes are not reported to the FTB within six months, the California statute of limitations is four years from the date the FTB is notified.<sup>303</sup>

#### Eight-Year Statute on Abusive Tax Avoidance Transactions

For deficiencies related to an abusive tax avoidance transaction, taxes are required to be assessed within eight years after the return was filed.<sup>304</sup>

#### Foreign Corporations

For foreign corporations subject to information reporting requirements, the statute of limitations for assessing tax is four years from the date the information is furnished to the FTB.<sup>305</sup>

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<sup>300</sup> R&TC section 19057.

<sup>301</sup> R&TC section 19058.

<sup>302</sup> R&TC sections 18622 and 19059.

<sup>303</sup> R&TC section 19060.

<sup>304</sup> R&TC section 19755.

<sup>305</sup> R&TC section 19066.5.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

Impact on California Revenue

Baseline.

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<u>Section</u>	<u>Section Title</u>
521	Reporting of Activities with Respect to Passive Foreign Investment Companies

Background

In general, active foreign business income derived by a foreign corporation with U.S. owners is not subject to current U.S. taxation until the corporation makes a dividend distribution to those owners. Certain rules, however, restrict the benefit of deferral of U.S. tax on income derived through foreign corporations. One such regime applies to U.S. persons who own stock of passive foreign investment companies (“PFICs”). A PFIC generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consist of assets that produce, or are held for the production of, passive income.<sup>306</sup> Various sets of income inclusion rules apply to U.S. persons that are shareholders in a PFIC, regardless of their percentage ownership in the company. One set of rules applies to PFICs under which U.S. shareholders pay tax on certain income or gain realized through the companies, plus an interest charge intended to eliminate the benefit of deferral.<sup>307</sup> A second set of rules applies to PFICs that are “qualified electing funds” (“QEF”), under which electing U.S. shareholders currently include in gross income their respective shares of the company’s earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.<sup>308</sup> A third set of rules applies to marketable PFIC stock, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as “marking to market.”<sup>309</sup>

In general, a U.S. person that is a direct or indirect shareholder of a PFIC must file federal Form 8621, “Return by a Shareholder of a Passive Foreign Investment Company or Qualifying Electing Fund” for each tax year in which that U.S. person: (1) recognizes gain on a direct or indirect disposition of PFIC stock; (2) receives certain direct or indirect distributions from a PFIC; or

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<sup>306</sup> IRC section 1297.

<sup>307</sup> IRC section 1291.

<sup>308</sup> IRC sections 1293-1295.

<sup>309</sup> IRC section 1296.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

(3) is making a reportable election.<sup>310</sup> The IRC includes a general reporting requirement for certain PFIC shareholders which is contingent upon the issuance of regulations.<sup>311</sup> Although Treasury issued proposed regulations in 1992 requiring U.S. persons to file annually federal Form 8621 for each PFIC of which the person is a shareholder during the taxable year, such regulations have not been finalized and current federal Form 8621 requires reporting only based on one of the triggering events described above.<sup>312</sup>

New Federal Law (IRC sections 1291 and 1298)

The provision requires that, unless otherwise provided by the Secretary, each U.S. person who is a shareholder of a PFIC must file an annual information return containing such information as the Secretary may require. A person that meets the reporting requirements of this provision may, however, also meet the reporting requirements of section 511 of the act and new IRC section 6038D requiring disclosure of information with respect to foreign financial assets. It is anticipated that the Secretary will exercise regulatory authority under this provision or new IRC section 6038D to avoid duplicative reporting.

Effective Date

The provision is effective on March 18, 2010.

California Law (R&TC section 18181)

California specifically does not conform to IRC sections 1291 and 1298, relating to the treatment of certain passive foreign investment companies.

Impact on California Revenue

Not applicable.

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<sup>310</sup> See the instructions to federal Form 8621. According to the form, reportable elections include the following: (i) an election to treat the PFIC as a QEF; (ii) an election to recognize gain on the deemed sale of a PFIC interest on the first day of the PFIC's tax year as a QEF; (iii) an election to treat an amount equal to the shareholder's post-1986 earnings and profits of a CFC as an excess distribution on the first day of a PFIC's tax year as a QEF that is also a controlled foreign corporation under IRC section 957(a); (iv) an election to extend the time for payment of the shareholder's tax on the undistributed earnings and profits of a QEF; (v) an election to treat as an excess distribution the gain recognized on the deemed sale of the shareholder's interest in the PFIC, or to treat such shareholder's share of the PFIC's post-1986 earnings and profits as an excess distribution, on the last day of its last tax year as a PFIC under IRC section 1297(a) if eligible; or (vi) an election to mark-to-market the PFIC stock that is marketable within the meaning of IRC section 1296(e).

<sup>311</sup> IRC section 1291(e) by reference to IRC section 1246(f).

<sup>312</sup> Prop. Treas. Reg. section 1.1291-1(i).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

<u>Section</u>	<u>Section Title</u>
522	Secretary Permitted to Require Financial Institutions to File Certain Returns Related to Withholding on Foreign Transfers Electronically

Background

Withholding Responsibility

A withholding agent is any person required to withhold U.S. income tax under IRC sections 1441, 1442, 1443, or 1461. For purposes of these sections, a withholding agent is any person, whether a U.S. or a foreign person, that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding.<sup>313</sup> A withholding agent is personally liable for the tax required to be withheld.<sup>314</sup>

Reporting Liability of a Withholding Agent

Every withholding agent must file an annual return with the IRS on federal Form 1042, "Annual Withholding Tax Return for U.S. Source Income of Foreign Persons," reporting all taxes withheld during the preceding year and remitting any taxes still owing for such preceding year.<sup>315</sup> Federal Form 1042 must be filed on or before March 15 of the year following the year of the payment. The form must be filed even though no tax has been withheld from income paid during the year.<sup>316</sup> A withholding agent must also file an information return, federal Form 1042-S, that is entitled "Foreign Person's U.S. Source Income Subject to Withholding," on or before March 15 of the year succeeding the year of payment. Federal Form 1042-S requires the withholding agent to provide all items of income specified in IRC section 1441(b) paid during the previous year to foreign persons.<sup>317</sup> Federal Form 1042-S must be filed for each foreign recipient to whom payments were made during the preceding year,<sup>318</sup> even if no tax was required to have been withheld. A copy of federal Form 1042-S must be sent to the payee.

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<sup>313</sup> Treas. Reg. section 1.1441-7(a)(1).

<sup>314</sup> IRC section 1461.

<sup>315</sup> Treas. Reg. section 1.1461-1(b)(1).

<sup>316</sup> Treas. Reg. section 1.1461-1(b)(1).

<sup>317</sup> Treas. Reg. section 1.1461-1(c)(1). Federal Form 1042-S filings provide information important for the Secretary's purposes in properly effecting refund claims and in meeting IRS's obligations under exchange of information agreements with various treaty partners. Also, the IRS has the ability to validate electronically filed federal Form 1042-S upon such filing, thereby serving to better ensure the reliability of information included in such filings.

<sup>318</sup> Treas. Reg. section 1.1461-1(c)(1). If payments are made to a nominee or representative of a foreign payee, federal Form 1042-S must also be sent to the beneficial owner of such payments, if known to the withholding agent.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

### IRS's Authority to Require Electronic Filing

The Internal Revenue Service Restructuring and Reform Act of 1998 (“RRA 1998”)<sup>319</sup> states that it is a congressional policy to promote the paperless filing of federal tax returns. Section 2001(a) of RRA 1998 set a goal for the IRS to have at least 80 percent of all federal tax and information returns filed electronically by 2007. Section 2001(b) of RRA 1998 requires the IRS to establish a ten-year strategic plan to eliminate barriers to electronic filing.

The Secretary has limited authority to issue regulations specifying which returns must be filed electronically. First, in general, such regulations can only apply to persons required to file at least 250 returns during the year.<sup>320</sup> Second, the Secretary is prohibited from requiring that income tax returns of individuals, estates, and trusts be submitted in any format other than paper (although these returns may be filed electronically by choice). Third, the Secretary, in determining which returns must be filed on magnetic media, must take into account relevant factors, including the ability of a taxpayer to comply with magnetic media filing at reasonable cost.<sup>321</sup> Finally, a failure to comply with the regulations mandating electronic filing cannot in itself support a penalty for failure to file an information return, with certain exceptions for corporations and partnerships.<sup>322</sup>

Accordingly, the Secretary requires corporations and tax-exempt organizations that have assets of \$10 million or more and file at least 250 returns during a calendar year, including income tax, information, excise tax, and employment tax returns, to file electronically their federal Forms 1120/1120-S income tax returns and federal Form 990 information returns for tax years ending on or after December 31, 2006. Private foundations and charitable trusts that file at least 250 returns during a calendar year are required to file electronically their federal Form 990-PF information returns for tax years ending on or after December 31, 2006, regardless of their asset size. Taxpayers can request waivers of the electronic filing requirement if they cannot meet that requirement due to technological constraints, or if compliance with the requirement would result in undue financial burden.

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<sup>319</sup> Public Law 105-206 (1998).

<sup>320</sup> Partnerships with more than 100 partners are required to file electronically. IRC section 6011(e)(2). For returns filed after December 31, 2010, under the recently-enacted Worker, Homeownership, and Business Act of 2009, any individual tax return, including any return of the tax imposed by subtitle A of the IRC on individuals, estates, or trusts, prepared by a tax return preparer, is required to be filed electronically unless the tax return preparer reasonably expects to file ten or fewer tax returns during such calendar year. IRC section 6011(e)(3).

<sup>321</sup> IRC section 6011(e).

<sup>322</sup> IRC section 6724(c). If a corporation fails to comply with the electronic filing requirements for more than 250 returns that it is required to file, it may be subject to the penalty for failure to file information returns under IRC section 6721. For partnerships, the penalty may only be imposed if the failure extends to more than 100 returns.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

New Federal Law (IRC section 6011)

The provision provides an exception to the general annual 250-returns threshold and permits the Secretary to issue regulations to require filing on magnetic media for any return filed by a “financial institution” with respect to any taxes withheld by the “financial institution” for which it is personally liable.<sup>323</sup> Under the provision, the Secretary is authorized to require a financial institution to electronically file returns with respect to any taxes withheld by the financial institution even though such financial institution would be required to file less than 250 returns during the year.

The provision also makes a conforming amendment to IRC section 6724, permitting assertion of a failure-to-file penalty under IRC section 6721 against a financial institution that fails to comply with the electronic filing requirements.

Effective Date

The provision applies to returns the due date for which (determined without regard to extensions) is after March 18, 2010.

California Law (R&TC sections 18407 and 18409)

California generally conforms to IRC section 6011, relating to general requirement of return, statement, or list, as of the “specified date” of January 1, 2009,<sup>324</sup> and has stand-alone state law requiring the FTB to prescribe regulations providing standards for determining which returns are required to be filed on magnetic media (or in other machine-readable forms), and such standards apply to taxpayers required to file returns on magnetic media (or in other machine-readable forms) to the IRS as of the “specified date” of January 1, 2009.<sup>325</sup> However, California does not conform to IRC section 1461 under which a financial institution is personally liable for withheld tax.

Impact on California Revenue

Not applicable.

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<sup>323</sup> The “financial institution” is personally liable for any tax withheld in accordance with IRC section 1461.

<sup>324</sup> For taxable years beginning on or after January 1, 2010, R&TC section 18407 conforms to IRC section 6011, relating to general requirement of return, statement, or list, as of the “specified date” of January 1, 2009, with modifications.

<sup>325</sup> R&TC section 18409.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

<u>Section</u>	<u>Section Title</u>
531	Clarifications with Respect to Foreign Trusts which are Treated as Having a United States Beneficiary

Background

Under the grantor trust rules, a U.S. person that directly or indirectly transfers property to a foreign trust<sup>326</sup> is generally treated as the owner of the portion of the trust comprising the transferred property for any taxable year in which there is a U.S. beneficiary of any portion of the trust.<sup>327</sup> This treatment generally does not apply to transfers by reason of death, or to transfers of property to the trust in exchange for at least the fair market value of the transferred property.<sup>328</sup> A trust is treated as having a U.S. beneficiary for the taxable year unless: (1) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a U.S. person; and (2) if the trust were terminated at any time during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of a U.S. person.<sup>329</sup>

Regulations under IRC section 679 employ a broad approach in determining whether a foreign trust is treated as having a U.S. beneficiary. The determination of whether the trust has a U.S. beneficiary is made for each taxable year of the transferor. The default rule under the statute and regulations is that a trust has a U.S. beneficiary unless during the U.S. transferor's taxable year the trust meets the two requirements as stated above. Income or corpus may be paid or accumulated to or for the benefit of a U.S. person if, directly or indirectly, income may be distributed to or accumulated for the benefit of a U.S. person, or corpus of the trust may be distributed to or held for the future benefit of a U.S. person.<sup>330</sup> The determination is made without regard to whether income or corpus is actually distributed, and without regard to whether a U.S. person's interest in the trust income or corpus is contingent on a future event. A person who is not a named beneficiary and is not a member of a class of beneficiaries will not be taken into account if the transferor can show that the person's contingent interest in the trust is so remote as to be negligible.<sup>331</sup> In considering whether a foreign trust has a U.S. beneficiary under the

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<sup>326</sup> A trust is a foreign trust if it is not a U.S. person. IRC section 7701(a)(31)(B). A trust is a U.S. person if: (1) a U.S. court is able to exercise primary supervision over the administration of the trust; and (2) one or more U.S. persons have the authority to control all substantial decisions of the trust. IRC section 7701(a)(30)(E).

<sup>327</sup> IRC section 679(a)(1). This rule does not apply to transfers to trusts established to fund certain deferred compensation plan trusts or to trusts exempt from tax under IRC section 501(c)(3).

<sup>328</sup> IRC section 679(a)(2).

<sup>329</sup> IRC section 679(c)(1).

<sup>330</sup> Treas. Reg. section 1.679-2(a)(2)(i).

<sup>331</sup> Treas. Reg. section 1.679-2(a)(2)(ii).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

terms of the trust, the trust instrument must be read together with other relevant factors including: (1) all written and oral agreements and understandings related to the trust; (2) memoranda or letters of wishes; (3) all records that relate to the actual distribution of income and corpus; and (4) all other documents that relate to the trust, whether or not of any purported legal effect.<sup>332</sup> Other factors taken into account in determining whether a foreign trust is deemed to have a U.S. beneficiary include whether: (1) the terms of the trust allow the trust to be amended to benefit a U.S. person; (2) the trust instrument does not allow such an amendment, but the law applicable to the foreign trust may require payments or accumulations of income or corpus to a U.S. person; or (3) the parties to the trust ignore the terms of the trust, or it reasonably expected that they will do so to benefit a U.S. person.<sup>333</sup>

If a foreign trust that was not treated as a grantor trust acquires a U.S. beneficiary and is treated as a grantor trust under IRC section 679 for the taxable year, the transferor is taxable on the trust's undistributed net income<sup>334</sup> computed at the end of the preceding taxable year.<sup>335</sup> Any additional amount included in the transferor's gross income as a result of this provision is subject to the interest charge rules of IRC section 668.<sup>336</sup>

New Federal Law (IRC section 679)

In determining whether, under IRC section 679, a foreign trust has a U.S. beneficiary, the provision clarifies that an amount is treated as accumulated for the benefit of a U.S. person even if the U.S. person's interest in the trust is contingent on a future event. Under the provision, if any person has the discretion (by authority given in the trust agreement, by power of appointment, or otherwise) to make a distribution from the trust to, or for the benefit of, any person, the trust is treated as having a U.S. beneficiary unless: (1) the terms of the trust specifically identify the class of persons to whom such distributions may be made; and (2) none of those persons is a U.S. person during the taxable year. The provision is meant to be consistent with existing regulations under IRC section 679.

The provision clarifies that if any U.S. person who directly or indirectly transfers property to the trust is directly or indirectly involved in any agreement or understanding (whether written, oral, or otherwise) that may result in the income or corpus of the trust being paid or accumulated to or for the benefit of a U.S. person, such agreement or understanding is treated as a term of the trust.

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<sup>332</sup> Treas. Reg. section 1.679-2(a)(4)(i).

<sup>333</sup> Treas. Reg. section 1.679-2(a)(4)(ii).

<sup>334</sup> Undistributed net income is defined in IRC section 665(a).

<sup>335</sup> IRC section 679(b).

<sup>336</sup> Treas. Reg. section 1.679-2(c)(1).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

It is assumed for these purposes that a transferor of property to the trust is generally directly or indirectly involved with agreements regarding the accumulation or disposition of the income and corpus of the trust.

Effective Date

The proposal is effective on March 18, 2010.

California Law (R&TC sections 17024.5 and 17731)

The PITL generally conforms to Subpart E of the Internal Revenue Code, relating to grantors and others treated as substantial owners, as of the specified date of January 1, 2009;<sup>337</sup> however, this provision is not applicable under California law because the PITL specifically does not conform to the definition of a foreign trust under IRC section 679.<sup>338</sup>

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
532	Presumption that Foreign Trust has United States Beneficiary

Background

Under the grantor trust rules, a U.S. person that directly or indirectly transfers property to a foreign trust<sup>339</sup> is generally treated as the owner of the portion of the trust comprising that property for any taxable year in which there is a U.S. beneficiary of any portion of the trust.<sup>340</sup> This treatment generally does not apply to transfers by reason of death, or to transfers of property to the trust in

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<sup>337</sup> For taxable years beginning on or after January 1, 2010, R&TC section 17731 conforms to Subchapter J of Chapter 1 of the IRC, relating to estates, trusts, beneficiaries, and decedents, as of the “specified date” of January 1, 2009, with modifications.

<sup>338</sup> R&TC section 17024.5(b)(6).

<sup>339</sup> A trust is a foreign trust if it is not a U.S. person. IRC section 7701(a)(31)(B). A trust is a U.S. person if: (1) a U.S. court is able to exercise primary supervision over the administration of the trust; and (2) one or more U.S. persons have the authority to control all substantial decisions of the trust. IRC section 7701(a)(30)(E).

<sup>340</sup> IRC section 679(a)(1). This rule does not apply to transfers to trusts established to fund certain deferred compensation plan trusts or to trusts exempt from tax under IRC section 501(c)(3).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

exchange for at least the fair market value of the transferred property.<sup>341</sup> A trust is treated as having a U.S. beneficiary for the taxable year unless: (1) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a U.S. person; and (2) if the trust were terminated at any time during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of a U.S. person.<sup>342</sup>

IRC section 6048 imposes various reporting obligations on foreign trusts and persons creating, making transfers to, or receiving distributions from such trusts. Within 90 days after a U.S. person transfers property to a foreign trust, the transferor must provide written notice of the transfer to the Secretary.<sup>343</sup>

New Federal Law (IRC section 679)

Under the provision, if a U.S. person directly or indirectly transfers property to a foreign trust,<sup>344</sup> the Secretary may treat the trust as having a U.S. beneficiary for purposes of IRC section 679 unless such U.S. person submits information as required by the Secretary and demonstrates to the satisfaction of the Secretary that: (1) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a U.S. person; and (2) if the trust were terminated during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of a U.S. person.

Effective Date

The provision applies to transfers of property after March 18, 2010.

California Law (R&TC sections 17024.5 and 17731)

California generally conforms to the federal rules relating to grantors and others treated as substantial owners, as of the specified date of January 1, 2009;<sup>345</sup> however, because California specifically does not conform to the definition of a foreign trust under IRC section 679,<sup>346</sup> this provision is not applicable under California law.

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<sup>341</sup> IRC section 679(a)(2).

<sup>342</sup> IRC section 679(c)(1).

<sup>343</sup> IRC section 6048(a).

<sup>344</sup> A foreign trust for this purpose does not include deferred compensation and charitable trusts described in IRC section 6048(a)(3)(B)(ii).

<sup>345</sup> For taxable years beginning on or after January 1, 2010, R&TC section 17731 conforms to Subchapter J of Chapter 1 of the IRC, relating to estates, trusts, beneficiaries, and decedents, as of the “specified date” of January 1, 2009, with modifications.

<sup>346</sup> R&TC section 17024.5(b)(6).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
533	Uncompensated Use of Trust Property

Background

Under IRC section 643(i), a loan of cash or marketable securities made by a foreign trust to any U.S. grantor, U.S. beneficiary, or any other U.S. person who is related to a U.S. grantor or U.S. beneficiary generally is treated as a distribution by the foreign trust to such grantor or beneficiary. This rule applies for purposes of determining if the foreign trust is a simple or complex trust, computing the distribution deduction for the trust, determining the amount of gross income of the beneficiaries, and computing any accumulation distribution. Loans to tax-exempt entities are excluded from this rule.<sup>347</sup> A trust treated under this rule as making a distribution is not treated as a simple trust for the year of the distribution.<sup>348</sup> This rule does not apply for purposes of determining if a trust has a U.S. beneficiary under IRC section 679.

A subsequent repayment, satisfaction, or cancellation of a loan treated as a distribution under IRC section 643(i) is disregarded for tax purposes.<sup>349</sup> This section applies a broad set of related-party rules that treat a loan of cash or marketable securities to a spouse, sibling, ancestor, descendant of the grantor or beneficiary, other trusts in which the grantor or beneficiary has an interest, and corporations or partnerships controlled by the beneficiary or grantor or by family members of the beneficiary or grantor, as a distribution to the related grantor or beneficiary.<sup>350</sup>

New Federal Law (IRC sections 643 and 679)

The provision expands IRC section 643(i) to provide that any use of trust property by the U.S. grantor, U.S. beneficiary or any U.S. person related to a U.S. grantor or U.S. beneficiary is treated as a distribution of the fair market value of the use of the property to the U.S. grantor or U.S.

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<sup>347</sup> IRC section 643(i)(2)(C).

<sup>348</sup> IRC section 643(i)(2)(D).

<sup>349</sup> IRC section 643(i)(3).

<sup>350</sup> IRC section 643(i)(2)(B) treats a person as a related person if the relationship between such person would result in a disallowance of losses under IRC sections 267 or 707(b), broadened to include the spouses of members of the family described in such sections.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

beneficiary. The use of property is not treated as a distribution to the extent that the trust is paid the fair market value for the use of the property within a reasonable period of time. A subsequent return of property treated as a distribution under IRC section 643(i) is disregarded for tax purposes.

For purposes of determining whether a foreign trust has a U.S. beneficiary under IRC section 679, a loan of cash or marketable securities or the use of any other trust property by a U.S. person is treated as a payment from the trust to the U.S. person in the amount of the loan or the fair market value of the use of the property. A loan or use of property is not treated as a payment to the extent that the U.S. person repays the loan at a market rate of interest or pays the fair market value for the use of the trust property within a reasonable period of time.

Effective Date

The provision applies to loans made and uses of property after March 18, 2010.

California Law (R&TC sections 17024.5 and 17731)

California generally conforms to IRC section 643 as of the specified date of January 1, 2009;<sup>351</sup> however, because California specifically does not conform to the definition of a foreign trust under IRC section 679,<sup>352</sup> this provision is not applicable under California law.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
534	Reporting Requirement of United States Owners of Foreign Trusts

Background

IRC section 6048 imposes various reporting obligations on foreign trusts and persons creating, making transfers to, or receiving distributions from such trusts. If a U.S. person is treated as the owner of any portion of a foreign trust under the rules of Subpart E of Part I of Subchapter J of Chapter 1 of the IRC (grantor trust provisions), the U.S. person is responsible for ensuring that the

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<sup>351</sup> For taxable years beginning on or after January 1, 2010, R&TC section 17731 conforms to Subchapter J of Chapter 1 of the IRC, relating to estates, trusts, beneficiaries, and decedents, as of the “specified date” of January 1, 2009, with modifications.

<sup>352</sup> R&TC section 17024.5(b)(6).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

trust files an information return for the year and that the trust provides other information as the Secretary may require to each U.S. person who: (1) is treated as the owner of any portion of the trust; or (2) receives (directly or indirectly) any distribution from the trust.<sup>353</sup>

New Federal Law (IRC section 6048)

The provision requires a U.S. person that is treated as an owner of any portion of a foreign trust under the rules of Subpart E of part I of Subchapter J of Chapter 1 of the IRC (grantor trust provisions) to provide information as the Secretary may require with respect to the trust, in addition to ensuring that the trust complies with its reporting obligations.

Effective Date

The proposal is effective for taxable years beginning after March 18, 2010.

California Law (R&TC section 17024.5)

California specifically does not conform to the definition of a foreign trust,<sup>354</sup> and does not have a foreign trust reporting requirement similar IRC section 6048; thus, this provision is not applicable under California law.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
535	Minimum Penalty with Respect to Failure to Report on Certain Foreign Trusts

Background

IRC section 6048 imposes various reporting obligations on foreign trusts and persons creating, making transfers to, or receiving distributions from such trusts. Generally, a trust is a foreign trust unless a U.S. court is able to exercise primary supervision over the trust's administration and a U.S. trustee has authority to control all substantial decisions of the trust.<sup>355</sup> If a U.S. person

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<sup>353</sup> IRC section 6048(b)(1).

<sup>354</sup> R&TC section 17024.5(b)(6).

<sup>355</sup> IRC section 7701(a)(30)(E), (31)(B). In addition, for purposes of IRC section 6048, the IRS can classify a trust as foreign if it "has substantial activities, or holds substantial property, outside the United States" (IRC section 6048(d)(2)).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

creates or transfers property to a foreign trust, the U.S. person generally must report this event and certain other information by the due date for the U.S. person's tax return, including extensions, for the tax year in which the creation of the trust or the transfer occurs.<sup>356</sup> Similar rules apply in the case of the death of a U.S. citizen or resident if the decedent was treated as the owner of any portion of a foreign trust under the grantor trust rules or if any portion of a foreign trust was included in the decedent's gross estate. If a U.S. person directly or indirectly receives a distribution from a foreign trust, the U.S. person generally must report the distribution by the due date for the U.S. person's tax return, including extensions, for the tax year during which the distribution is received.<sup>357</sup> If a U.S. person is the owner of any portion of a foreign grantor trust at any time during the year, the person is responsible for causing an information return to be filed for the trust, which must, among other things, give the name of a U.S. agent for the trust.<sup>358</sup>

If a notice or return required under the rules just described is not filed when due or is filed without all required information, the person required to file is generally subject to a penalty based on the "gross reportable amount."<sup>359</sup> The gross reportable amount is: (1) the value of the property transferred to the foreign trust if the delinquency is failure to file notice of the creation of or a transfer to a foreign trust; (2) the value (on the last day of the year) of the portion of a grantor trust owned by a U.S. person who fails to cause an annual return to be filed for the trust; and (3) the amount distributed to a distributee who fails to report distributions.<sup>360</sup> The initial penalty is 35 percent of the gross reportable amount in cases (1) and (3) and five percent in case (2).<sup>361</sup> If the return is more than 90 days late, additional penalties are imposed of \$10,000 for every 30 days the delinquency continues, except that the aggregate of the penalties may not exceed the gross reportable amount.<sup>362</sup>

#### Maximum Penalty with Respect to Failure to Report on Certain Foreign Trusts

In no event may the penalties imposed with respect to any failure to report under IRC section 6048 exceed the gross reportable amount.<sup>363</sup>

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<sup>356</sup> IRC section 6048(a).

<sup>357</sup> IRC section 6048(c).

<sup>358</sup> IRC section 6048(b).

<sup>359</sup> IRC section 6677(a).

<sup>360</sup> IRC section 6677(c).

<sup>361</sup> IRC section 6677(b).

<sup>362</sup> IRC section 6677(a).

<sup>363</sup> IRC section 6677(a).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

New Federal Law (IRC section 6677)

Increase of the Minimum Penalty with Respect to Failure to Report on Certain Foreign Trusts

Under the provision, the initial penalty for failing to report under IRC section 6048 is the greater of \$10,000 or 35 percent of the gross reportable amount in cases (1) and (3) and the greater of \$10,000 or five percent of the gross reportable amount in case (2). Thus, an initial penalty of \$10,000 may be imposed even where the Secretary has insufficient information to determine the gross reportable amount. The additional \$10,000 penalty for every additional 30 days of delinquency continues to apply.

Amendment to the maximum penalty with respect to failure to report on certain foreign Trusts

The provision provides that the penalties with respect to failure to report on certain foreign trusts may exceed the gross reportable amount. However, to the extent that a taxpayer provides sufficient information for the Secretary to determine that the aggregate amount of the penalties exceeds the gross reportable amount, the Secretary is required to refund such excess to the taxpayer.

Effective Date

The provision applies to notices and returns required to be filed after December 31, 2009.

California Law (R&TC section 17024.5)

California specifically does not conform to the definition of a foreign trust;<sup>364</sup> thus, this provision is not applicable under California law.

Impact on California Revenue

Not applicable.

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<sup>364</sup> R&TC section 17024.5(b)(6).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

<u>Section</u>	<u>Section Title</u>
541	Substitute Dividends and Dividend Equivalent Payments Received by Foreign Persons Treated as Dividends

Background

Payments of U.S.-source “fixed or determinable annual or periodical” income, including interest, dividends, and similar types of investment income, made to foreign persons are generally subject to U.S. tax, collected by withholding, at a 30-percent rate, unless the withholding agent can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty.<sup>365</sup> Dividends paid by a domestic corporation are generally U.S.-source<sup>366</sup> and therefore potentially subject to withholding tax when paid to foreign persons.

The source of notional principal contract income generally is determined by reference to the residence of the recipient of the income.<sup>367</sup> Consequently, a foreign person’s income related to a notional principal contract that references stock of a domestic corporation, including any amount attributable to, or calculated by reference to, dividends paid on the stock, generally is foreign source and is therefore not subject to U.S. withholding tax.

In contrast, a substitute dividend payment made to the transferor of stock in a securities lending transaction or a sale-repurchase transaction is sourced in the same manner as actual dividends paid on the transferred stock.<sup>368</sup> Accordingly, because dividends paid with respect to the stock of a U.S. company are generally U.S. source, if a foreign person lends stock of a U.S. company to another person (or sells the stock to the other person and later repurchases the stock in a transaction treated as a loan for U.S. federal income tax purposes) and receives substitute dividend payments from that other person, the substitute dividend payments are U.S. source and

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<sup>365</sup> IRC sections 871, 881, 1441, 1442; Treas. Reg. section 1.1441-1(b). For purposes of the withholding tax rules applicable to payments to nonresident alien individuals and foreign corporations, a withholding agent is defined broadly to include any U.S. or foreign person that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding. Treas. Reg. section 1.1441-7(a).

<sup>366</sup> IRC section 861(a)(2).

<sup>367</sup> Treas. Reg. section 1.863-7(b)(1). A notional principal contract is a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. Treas. Reg. section 1.446-3(c)(1).

<sup>368</sup> Treas. Reg. section 1.861-3(a)(6). This regulation defines a substitute dividend payment as a payment, made to the transferor of a security in a securities-lending transaction or a sale-repurchase transaction, of an amount equivalent to a dividend distribution which the owner of the transferred security is entitled to receive during the term of the transaction.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

are generally subject to U.S. withholding tax.<sup>369</sup> In 1997, the Treasury and the IRS issued Notice 97-66 to address concerns that the sourcing rule just described (and the accompanying character rule) could cause the total U.S. withholding tax imposed in a series of securities lending or sale-repurchase transactions to be excessive.<sup>370</sup> In that Notice, the Treasury and the IRS also stated that they intended to propose new regulations to provide detailed guidance on how substitute dividend payments made by one foreign person to another foreign person were to be treated. To date, no regulations have been proposed.<sup>371</sup>

New Federal Law (IRC section 871)

The provision treats a dividend equivalent as a dividend from U.S. sources for certain purposes, including the U.S. withholding tax rules applicable to foreign persons.

A dividend equivalent is any substitute dividend made pursuant to a securities lending or a sale-repurchase transaction that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States or any payment made under a specified notional principal contract that directly or indirectly is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States. A dividend equivalent also includes any other payment that the Secretary determines is substantially similar to a payment described in the immediately preceding sentence. Under this rule, for example, the Secretary may conclude that payments under certain forward contracts or other financial contracts that reference stock of U.S. corporations are dividend equivalents.

A specified notional principal contract is any notional principal contract that has any one of the following five characteristics: (1) in connection with entering into the contract, any long party to the contract transfers the underlying security to any short party to the contract; (2) in connection with the termination of the contract, any short party to the contract transfers the underlying security to any long party to the contract; (3) the underlying security is not readily tradable on an established securities market; (4) in connection with entering into the contract, any short party to the contract posts the underlying security as collateral with any long party to the contract; or

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<sup>369</sup> For purposes of the imposition of the 30-percent withholding tax, substitute dividend payments (and substitute interest payments) received by a foreign person under a securities lending or sale-repurchase transaction have the same character as dividend (and interest) income received in respect of the transferred security. Treas. Reg. sections 1.871-7(b)(2) and 1.881-2(b)(2).

<sup>370</sup> Notice 97-66, 1997-2 C.B. 328 (December 1, 1997).

<sup>371</sup> There is evidence that some taxpayers have taken the position that Notice 97-66 sanctions the elimination of withholding tax in certain situations. See United States Senate, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, *Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends*, Staff Report, September 11, 2008, pp. 18-20, 22-23, 40, 47, 52. In the Obama administration's fiscal year 2010 budget, the Treasury Department has announced that, to address the avoidance of U.S. withholding tax through the use of securities lending transactions, it plans to revoke Notice 97-66 and issue guidance that eliminates the benefits of those transactions but minimizes over-withholding. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals, May 2009, p. 37.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

(5) the Secretary identifies the contract as a specified notional principal contract.<sup>372</sup> For purposes of these characteristics, for any underlying security of any notional principal contract, a long party is any party to the contract that is entitled to receive any payment under the contract that is contingent upon or determined by reference to the payment of a U.S.-source dividend on the underlying security, and a short party is any party to the contract that is not a long party in respect of the underlying security. An underlying security in a notional principal contract is the security with respect to which the dividend equivalent is paid. For these purposes, any index or fixed basket of securities is treated as a single security. In applying this rule, it is intended that such a security will be deemed to be regularly traded on an established securities market if every component of such index or fixed basket is a security that is readily tradable on an established securities market.

For payments made more than two years after the provision's date of enactment, a specified notional principal contract also includes any notional principal contract unless the Secretary determines that the contract is of a type that does not have the potential for tax avoidance.

No inference is intended as to whether the definition of specified notional principal contract, or any determination under this provision that a transaction does not have the potential for the avoidance of taxes on U.S.-source dividends (or, in the case of a debt instrument, U.S.- source interest), is relevant in determining whether an agency relationship exists under general tax principles or whether a foreign party to a contract should be treated as having beneficial tax ownership of the stock giving rise to U.S.-source dividends.

The payments that are treated as U.S.-source dividends under the provision are the gross amounts that are used in computing any net amounts transferred to or from the taxpayer. The example of a "total return swap" referencing stock of a domestic corporation (an example of a notional principal contract to which the provision generally applies), illustrates the consequences of this rule. Under a typical total return swap, a foreign investor enters into an agreement with a counterparty under which amounts due to each party are based on the returns generated by a notional investment in a specified dollar amount of the stock underlying the swap. The investor agrees for a specified period to pay to the counterparty: (1) an amount calculated by reference to a market interest rate (such as the London Interbank Offered Rate ("LIBOR")) on the notional amount of the underlying stock; and (2) any depreciation in the value of the stock. In return, the counterparty agrees for the specified period to pay the investor: (1) any dividends paid on the stock; and (2) any appreciation in the value of the stock. Amounts owed by each party under this swap typically are netted so that only one party makes an actual payment. The provision treats any dividend-based amount under the swap as a payment even though any actual payment under the swap is a net amount determined in part by other amounts (for example, the interest amount and the amount of any appreciation or depreciation in value of the referenced stock). Accordingly, a counterparty to a total return swap may be obligated to withhold and remit tax on the gross

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<sup>372</sup> Any notional principal contract identified by the Secretary as a specified notional principal contract will be subject to the provision's general effective date described below.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

amount of a dividend equivalent even though, as a result of a netting of payments due under the swap, the counterparty is not required to make an actual payment to the foreign investor.

If there is a chain of dividend equivalents (under, for example, transactions similar to those described in Notice 97-66), and one or more of the dividend equivalents is subject to tax under the provision or under IRC section 881, the Secretary may reduce that tax, but only to the extent that the taxpayer either establishes that the tax has been paid on another dividend equivalent in the chain, or that such tax is not otherwise due, or as the Secretary determines is appropriate to address the role of financial intermediaries in such chain. An actual dividend is treated as a dividend equivalent for purposes of this rule.

For purposes of chapter 3 (withholding of tax on nonresident aliens and foreign corporations) and chapter 4 (taxes to enforce reporting on certain foreign accounts), each person that is a party to a contract or other arrangement that provides for the payment of a dividend equivalent is treated as having control of the payment. Accordingly, Treasury may provide guidance requiring either party to withhold tax on dividend equivalents.

The rule treating dividend equivalents as U.S.-source dividends is not intended to limit the authority of the Secretary: (1) to determine the appropriate source of income from financial arrangements (including notional principal contracts) under present law IRC section 863 or 865; or (2) to provide additional guidance addressing the source and characterization of substitute payments made in securities lending and similar transactions.

Effective Date

The provision applies to payments made on or after September 18, 2010.

California Law (None)

California does not conform to the federal sourcing rules under IRC section 871.

Impact on California Revenue

Not applicable.

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HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

<u>Section</u>	<u>Section Title</u>
551	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.<sup>373</sup> 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 that 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 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.<sup>374</sup> For example, both definitions generally exclude all

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<sup>373</sup> However, exceptions to the fungibility principle are provided in particular cases, some of which are described below.

<sup>374</sup> One such exception is that the affiliated group for interest-allocation purposes includes IRC section 936 corporations (certain electing domestic corporations that have income from the active conduct of a trade or business in Puerto Rico or another U.S. possession) that are excluded from the consolidated group.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

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.”<sup>375</sup> A financial corporation includes 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 that is required by state or federal law to be operated separately from any other entity that is not a financial institution.<sup>376</sup> 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.<sup>377</sup>

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.

#### Worldwide Interest Allocation

##### *In general*

The American Jobs Creation Act of 2004 (“AJCA”)<sup>378</sup> modified the interest expense allocation rules described above (that 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

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<sup>375</sup> Treas. Reg. section 1.861-11T(d)(4).

<sup>376</sup> IRC section 864(e)(5)(C).

<sup>377</sup> IRC section 864(e)(5)(D).

<sup>378</sup> Public Law 108-357, section 401.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

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 the worldwide affiliated group's worldwide third-party interest expense multiplied by the ratio that the foreign assets of the worldwide affiliated group bears to the total assets of the worldwide affiliated group,<sup>379</sup> over 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.<sup>380</sup>

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,<sup>381</sup> 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.

*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.<sup>382</sup> For these purposes, items of income or gain from a transaction or series of transactions are disregarded if a

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<sup>379</sup> 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.

<sup>380</sup> 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.

<sup>381</sup> 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.

<sup>382</sup> See Treas. Reg. section 1.904-4(e)(2).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

principal purpose for the transaction or transactions is to qualify any corporation as a financial corporation.

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*

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, 2017, in which a worldwide affiliated group exists which includes at least one foreign corporation that meets the requirements for inclusion in a worldwide affiliated group.<sup>383</sup> The common parent of the pre-election worldwide affiliated group must make the election for the first taxable year beginning after December 31, 2017, in which a worldwide affiliated group includes a financial corporation. Once either election is made, it applies to the common parent and all other members of the worldwide affiliated group or to all members of the financial institution group, as applicable, for the taxable year for which the election is made and all subsequent taxable years, unless revoked with the consent of the Secretary of the Treasury.

New Federal Law (IRC section 864)

The provision delays the effective date of the worldwide interest allocation rules for two years, until taxable years beginning after December 31, 2019. The required dates for making the worldwide affiliated group election and the financial institution group election are changed accordingly.

Effective Date

The provision is effective on March 18, 2010.

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<sup>383</sup> As originally enacted under AJCA, the worldwide interest allocation rules were effective for taxable years beginning after December 31, 2008. However, the Housing and Economic Recovery Act of 2008 delayed the implementation of the worldwide interest allocation rules for two years, until taxable years beginning after December 31, 2010. Public Law 110-289, section 3093. The implementation of the worldwide interest allocation rules was further delayed by seven years, until taxable years beginning after December 31, 2017, by the Worker, Homeownership, and Business Assistance Act of 2009. Public Law 111-92, section 15.

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

California Law (R&TC sections 24344 and 24425)

California does not conform to IRC section 864, and instead has its own interest-expense allocation rules.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
561	Time for Payment of Corporate Estimated Taxes

Background

In general, corporations are required to make quarterly estimated tax payments of their income tax liability.<sup>384</sup> 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. In the case of a corporation with assets of at least \$1 billion (determined as of the end of the preceding taxable year), payments due in July, August, or September, 2014, are increased to 133.25 percent of the payment otherwise due and the next required payment is reduced accordingly.<sup>385</sup>

New Federal Law (IRC section 6665)

The provision increases the required payment of estimated taxes otherwise due in July, August, or September 2014, 2015, and 2010 are increased to 157.75 percent, 121.50 percent, and 106.50 percent, respectively, of the payment otherwise due, with the next required payment for each adjusted year is reduced accordingly.

Effective Date

The provision is effective March 18, 2010.

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<sup>384</sup> IRC section 6655.

<sup>385</sup> The Hiring Incentives to Restore Employment ("HIRE") Act, Sec.561; Public Law 111-124, Sec. 4; Public Law 111-92, Sec. 18; Public Law 111-42, Sec. 202(b)(1).

HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT  
Public Law 111-147, March 18, 2010

California Law (R&TC section 19025)

California law does not conform to IRC section 6655, and instead has its own rules for estimated tax payments.

For taxable years beginning on or after January 1, 2010, required estimated payments are required in the following percentages:

Quarter Installment	Percent of Estimated Tax
1 <sup>st</sup>	30
2 <sup>nd</sup>	40
3 <sup>rd</sup>	0
4 <sup>th</sup>	30

Corporate taxpayers who are not required to make an estimate payment installment in the first quarter are required to make the following installment payments in subsequent quarters:

Quarter Installment	Percent of Estimated Tax
2 <sup>nd</sup>	60
3 <sup>rd</sup>	0
4 <sup>th</sup>	40

Corporate taxpayers who are not required to make an estimate payment installment in the first two quarters are required to make the following installment payments in subsequent quarters:

Quarter Installment	Percent of Estimated Tax
3 <sup>rd</sup>	70
4 <sup>th</sup>	30

Corporate taxpayers who are not required to make an estimate payment installment in the first three quarters are required to pay 100 percent in the fourth quarter.

Impact on California Revenue

Not applicable.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

<u>Section</u>	<u>Section Title</u>
1322	Federal Program to Assist Establishment and Operation of Nonprofit, Member-Run Health Insurance Issuers
	<i>Includes amendments made by:</i>
<u>Act/Section</u>	<u>Section Title</u>
PPACA section 10104	Amendments to Subtitle D

Background

In General

Although present law provides that certain limited categories of organizations that offer insurance may qualify for exemption from federal income tax, present law generally does not provide tax-exempt status for newly-established, member-run nonprofit health insurers that are established and funded pursuant to the Consumer Oriented, Not-for-Profit Health Plan program created under the bill and described below.

Taxation of Insurance Companies

*Taxation of stock and mutual companies providing health insurance*

Present law provides special rules for determining the taxable income of insurance companies (Subchapter L of the IRC). Both mutual insurance companies and stock insurance companies are subject to federal income tax under these rules. Separate sets of rules apply to life insurance companies and to property and casualty insurance companies. Insurance companies are subject to federal income tax at regular corporate income tax rates.

An insurance company that provides health insurance is subject to federal income tax as either a life insurance company or as a property and casualty insurance company, depending on its mix of lines of business and on the resulting portion of its reserves that are treated as life insurance reserves. For federal income tax purposes, an insurance company is treated as a life insurance company if the sum of its: (1) life insurance reserves; and (2) unearned premiums and unpaid losses on non-cancellable life, accident or health contracts not included in life insurance reserves, comprise more than 50 percent of its total reserves.<sup>386</sup>

*Life insurance companies*

A life insurance company, whether stock or mutual, is taxed at regular corporate rates on its life insurance company taxable income (LICTI). LICTI is life insurance gross income reduced by life

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<sup>386</sup> IRC section 816(a).

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

insurance deductions.<sup>387</sup> An alternative tax applies if a company has a net capital gain for the taxable year, if such tax is less than the tax that would otherwise apply. Life insurance gross income is the sum of: (1) premiums; (2) decreases in reserves; and (3) other amounts generally includible by a taxpayer in gross income. Methods for determining reserves for federal income tax purposes generally are based on reserves prescribed by the National Association of Insurance Commissioners for purposes of financial reporting under state regulatory rules.

Because deductible reserves might be viewed as being funded proportionately out of taxable and tax-exempt income, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by a portion of tax-exempt interest (known as a proration rule).<sup>388</sup> Similarly, a life insurance company is allowed a dividends-received deduction for intercorporate dividends from nonaffiliates only in proportion to the company's share of such dividends.<sup>389</sup>

*Property and casualty insurance companies*

The taxable income of a property and casualty insurance company is determined as the sum of the amount earned from underwriting income and from investment income (as well as gains and other income items), reduced by allowable deductions.<sup>390</sup> For this purpose, underwriting income and investment income are computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners.<sup>391</sup>

Underwriting income means premiums earned during the taxable year less losses incurred and expenses incurred.<sup>392</sup> Losses incurred include certain unpaid losses (reported losses that have not been paid, estimates of losses incurred but not reported, resisted claims, and unpaid loss adjustment expenses). Present law limits the deduction for unpaid losses to the amount of discounted unpaid losses, which are discounted using prescribed discount periods and a prescribed interest rate, to take account partially of the time value of money.<sup>393</sup> Any net decrease

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<sup>387</sup> IRC section 801.

<sup>388</sup> IRC sections 807(b)(2)(B) and (b)(1)(B).

<sup>389</sup> IRC sections 805(a)(4) and 812. Fully deductible dividends from affiliates are excluded from the application of this proration formula (so long as such dividends are not themselves distributions from tax-exempt interest or from dividend income that would not be fully deductible if received directly by the taxpayer). In addition, the proration rule includes in prorated amounts the increase for the taxable year in policy cash values of life insurance policies and annuity and endowment contracts owned by the company (the inside buildup on which is not taxed).

<sup>390</sup> IRC section 832.

<sup>391</sup> IRC section 832(b)(1)(A).

<sup>392</sup> IRC section 832(b)(3). In determining premiums earned, the company deducts from gross premiums the increase in unearned premiums for the year (IRC section 832(b)(4)(B)). The company is required to reduce the deduction for increases in unearned premiums by 20 percent, reflecting the matching of deferred expenses to deferred income.

<sup>393</sup> IRC section 846.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

in the amount of unpaid losses results in income inclusion, and the amount included is computed on a discounted basis.

In calculating its reserve for losses incurred, a proration rule requires that a property and casualty insurance company must reduce the amount of losses incurred by 15 percent of: (1) the insurer's tax-exempt interest; (2) the deductible portion of dividends received (with special rules for dividends from affiliates); and (3) the increase for the taxable year in the cash value of life insurance, endowment, or annuity contracts the company owns (IRC section 832(b)(5)). This rule reflects the fact that reserves are generally funded in part from tax-exempt interest, from wholly or partially deductible dividends, or from other untaxed amounts.

### Tax Exemption for Certain Organizations

#### *In general*

IRC section 501(a) generally provides for exemption from federal income tax for certain organizations. These organizations include: (1) qualified pension, profit sharing, and stock bonus plans described in IRC section 401(a); (2) religious and apostolic organizations described in IRC section 501(d); and (3) organizations described in IRC section 501(c). IRC section 501(c) describes 28 different categories of exempt organizations, including: charitable organizations (IRC section 501(c)(3)); social welfare organizations (IRC section 501(c)(4)); labor, agricultural, and horticultural organizations (IRC section 501(c)(5)); professional associations (IRC section 501(c)(6)); and social clubs (IRC section 501(c)(7)).<sup>394</sup>

#### *Insurance organizations described in IRC section 501(c)*

Although most organizations that engage principally in insurance activities are not exempt from federal income tax, certain organizations that engage in insurance activities are described in IRC section 501(c) and exempt from tax under IRC section 501(a). IRC section 501(c)(8), for example, describes certain fraternal beneficiary societies, orders, or associations operating under the lodge

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<sup>394</sup> Certain organizations that operate on a cooperative basis are taxed under special rules set forth in Subchapter T of the IRC. The two principal criteria for determining whether an entity is operating on a cooperative basis are: (1) ownership of the cooperative by persons who patronize the cooperative (e.g., the farmer members of a cooperative formed to market the farmers' produce); and (2) return of earnings to patrons in proportion to their patronage. In general, cooperative members are those who participate in the management of the cooperative and who share in patronage capital. For federal income tax purposes, a cooperative that is taxed under the Subchapter T rules generally computes its income as if it were a taxable corporation, with one exception—the cooperative may deduct from its taxable income distributions of patronage dividends. In general, patronage dividends are the profits of the cooperative that are rebated to its patrons pursuant to a preexisting obligation of the cooperative to do so. Certain farmers' cooperatives described in IRC section 521 are authorized to deduct not only patronage dividends from patronage sources, but also dividends on capital stock and certain distributions to patrons from non-patronage sources.

Separate from the Subchapter T rules, the IRC provides tax exemption for certain cooperatives. IRC section 501(c)(12), for example, provides that certain rural electric and telephone cooperatives are exempt from tax under IRC section 501(a), provided that 85 percent or more of the cooperative's income consists of amounts collected from members for the sole purpose of meeting losses or expenses, and certain other requirements are met.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

system or for the exclusive benefit of their members that provide for the payment of life, sick, accident, or other benefits to the members or their dependents. IRC section 501(c)(9) describes certain voluntary employees' beneficiary societies that provide for the payment of life, sick, accident, or other benefits to the members of the association or their dependents or designated beneficiaries. IRC section 501(c)(12)(A) describes certain benevolent life insurance associations of a purely local character. IRC section 501(c)(15) describes certain small non-life insurance companies with annual gross receipts of no more than \$600,000 (\$150,000 in the case of a mutual insurance company). IRC section 501(c)(26) describes certain membership organizations established to provide health insurance to certain high-risk individuals.<sup>395</sup> IRC section 501(c)(27) describes certain organizations established to provide workmen's compensation insurance.

*Certain IRC section 501(c)(3) organizations*

Certain health maintenance organizations (HMOs) have been held to qualify for tax exemption as charitable organizations described in IRC section 501(c)(3). In *Sound Health Association v. Commissioner*,<sup>396</sup> the Tax Court held that a staff model HMO qualified as a charitable organization. A staff model HMO generally employs its own physicians and staff and serves its subscribers at its own facilities. The court concluded that the HMO satisfied the IRC section 501(c)(3) community benefit standard, as its membership was open to almost all members of the community. Although membership was limited to persons who had the money to pay the fixed premiums, the court held that this was not disqualifying, because the HMO had a subsidized premium program for persons of lesser means to be funded through donations and Medicare and Medicaid payments. The HMO also operated an emergency room open to all persons regardless of income. The court rejected the government's contention that the HMO conferred primarily a private benefit to its subscribers, stating that when the potential membership is such a broad segment of the community, benefit to the membership is benefit to the community.

In *Geisinger Health Plan v. Commissioner*,<sup>397</sup> the court applied the IRC section 501(c)(3) community-benefit standard to an individual practice association (IPA) model HMO. In the IPA model, health care generally is provided by physicians practicing independently in their own offices, with the IPA usually contracting on behalf of the physicians with the HMO. Reversing a Tax Court decision, the court held that the HMO did not qualify as charitable, because the community benefit standard requires that an HMO be an actual provider of health care rather than merely an arranger or deliverer of health care, which is how the court viewed the IPA model in that case.

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<sup>395</sup> When IRC section 501(c)(26) was enacted in 1996, the House Ways and Means Committee, in reporting out the bill, stated as its reasons for change: "The Committee believes that eliminating the uncertainty concerning the eligibility of certain state health insurance risk pools for tax-exempt status will assist states in providing medical care coverage for their uninsured high-risk residents." H.R. Rep. No. 104-496, Part I, "Health Coverage Availability and Affordability Act of 1996," 104th Cong., 2d Sess., March 25, 1996, 124. See also Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress*, JCS-12-96, December 18, 1996, 351.

<sup>396</sup> 71 T.C. 158 (1978), acq. 1981-2 C.B. 2.

<sup>397</sup> 985 F.2d 1210 (3rd Cir. 1993), rev'g T.C. Memo. 1991-649.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

More recently, in *IHC Health Plans, Inc. v. Commissioner*,<sup>398</sup> the court ruled that three affiliated HMOs did not operate primarily for the benefit of the community they served. The organizations in the case did not provide health care directly, but provided group insurance that could be used at both affiliated and non-affiliated providers. The court found that the organizations primarily performed a risk-bearing function and provided virtually no free or below-cost health care services. In denying charitable status, the court held that a health-care provider must make its services available to all in the community plus provide additional community or public benefits.<sup>399</sup> The benefit must either further the function of government-funded institutions or provide a service that would not likely be provided within the community but for the subsidy. Further, the additional public benefit conferred must be sufficient to give rise to a strong inference that the public benefit is the primary purpose for which the organization operates.<sup>400</sup>

*Certain organizations providing commercial-type insurance*

IRC section 501(m) provides that an organization may not be exempt from tax under IRC section 501(c)(3) (generally, charitable organizations) or IRC section 501(c)(4) (social welfare organizations) unless no substantial part of its activities consists of providing commercial-type insurance. For this purpose, commercial-type insurance excludes, among other things: (1) insurance provided at substantially below cost to a class of charitable recipients; and (2) incidental health insurance provided by an HMO of a kind customarily provided by such organizations.

When IRC section 501(m) was enacted in 1986, the following reasons for the provision were stated: "The committee is concerned that exempt charitable and social welfare organizations that engaged in insurance activities are engaged in an activity whose nature and scope is so inherently commercial that tax-exempt status is inappropriate. The committee believes that the tax-exempt status of organizations engaged in insurance activities provides an unfair competitive advantage to these organizations. The committee further believes that the provision of insurance to the general public at a price sufficient to cover the costs of insurance generally constitutes an activity that is commercial. In addition, the availability of tax-exempt status ... has allowed some large insurance entities to compete directly with commercial insurance companies. For example, the Blue Cross/Blue Shield organizations historically have been treated as tax-exempt organizations described in IRC sections 501(c)(3) or (4). This group of organizations is now among the largest health-care insurers in the United States. Other tax-exempt charitable and social welfare organizations engaged in insurance activities also have a competitive advantage over commercial insurers who do not have tax-exempt status...."<sup>401</sup>

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<sup>398</sup> 325 F.3d 1188 (10th Cir. 2003).

<sup>399</sup> 325 F.3d 1188 (10th Cir. 2003), at 1198.

<sup>400</sup> 325 F.3d 1188 (10th Cir. 2003), at 1198.

<sup>401</sup> H.R. Rep. No. 99-426, "Tax Reform Act of 1985," Report of the Committee on Ways and Means, 99<sup>th</sup> Cong., 1<sup>st</sup> Sess., December 7, 1985, 664. See also Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87, May 4, 1987, 584.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

*Unrelated business income tax*

Most organizations that are exempt from tax under IRC section 501(a) are subject to the unrelated business income tax rules of IRC sections 511 through 515. The unrelated business income tax generally applies to 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. Certain types of income are specifically exempt from the unrelated business income tax, such as dividends, interest, royalties, and certain rents, unless derived from debt-financed property or from certain 50-percent controlled subsidiaries.

New Federal Law (IRC sections 501, 4958, and 6033)

In General

The provision authorizes \$6 billion in funding for, and instructs the Secretary of Health and Human Services ("HHS") to establish, the Consumer Operated and Oriented Plan (CO-OP, herein referred to as the "program") to foster the creation of qualified nonprofit health insurance issuers to offer qualified health plans in the individual and small group markets in the states in which the issuers are licensed to offer such plans. Federal funds are to be distributed as loans to assist with start-up costs and grants to assist in meeting state solvency requirements.

Under the provision, the Secretary of HHS must require any person receiving a loan or grant under the program to enter into an agreement with the Secretary of HHS requiring the recipient of funds to meet and continue to meet any requirement under the provision for being treated as a qualified nonprofit health insurance issuer, and any requirements to receive the loan or grant. The provision also requires that the agreement prohibit the use of loan or grant funds for carrying on propaganda or otherwise attempting to influence legislation or for marketing.

If the Secretary of HHS determines that a grant or loan recipient failed to meet the requirements described in the preceding paragraph, and failed to correct such failure within a reasonable period from when the person first knew (or reasonably should have known) of such failure, then such person must repay the Secretary of HHS an amount equal to 110 percent of the aggregate amount of the loans and grants received under the program, plus interest on such amount for the period during which the loans or grants were outstanding. The Secretary of HHS must notify the Secretary of the Treasury of any determination of a failure that results in the termination of the grantee's federal tax-exempt status.

Qualified Nonprofit Health Insurance Issuers

The provision defines a qualified nonprofit health insurance issuer as an organization that meets the following requirements:

1. The organization is organized as a nonprofit, member corporation under state law;
2. Substantially all of its activities consist of the issuance of qualified health plans in the individual and small-group markets in each state in which it is licensed to issue such plans;

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

3. None of the organization, a related entity, or a predecessor of either was a health insurance issuer as of July 16, 2009;
4. The organization is not sponsored by a state or local government, any political subdivision thereof, or any instrumentality of such government or political subdivision;
5. Governance of the organization is subject to a majority vote of its members;
6. The organization's governing documents incorporate ethics and conflict-of-interest standards protecting against insurance industry involvement and interference;
7. The organization must operate with a strong consumer focus, including timeliness, responsiveness, and accountability to its members, in accordance with regulations to be promulgated by the Secretary of HHS;
8. Any profits made must be used to lower premiums, improve benefits, or for other programs intended to improve the quality of health care delivered to its members;
9. The organization meets all other requirements that other issuers of qualified health plans are required to meet in any state in which it offers a qualified health plan, including solvency and licensure requirements, rules on payments to providers, rules on network adequacy, rate and form-filing rules, and any applicable state premium assessments. Additionally, the organization must coordinate with certain other state insurance reforms under this Act; and
10. The organization does not offer a health plan in a state until that state has in effect (or the Secretary of HHS has implemented for the state), the market reforms required by part A of title XXVII of the Public Health Service Act ("PHSA"), as amended by this Act.

#### Tax Exemption for Qualified Nonprofit Health Insurance Issuers

An organization receiving a grant or loan under the program qualifies for exemption from federal income tax under IRC section 501(a) with respect to periods during which the organization is in compliance with the above-described requirements of the program, and with the terms of any program grant or loan agreement to which such organization is a party. Such organizations also are subject to organizational and operational requirements applicable to certain IRC section 501(c) organizations, including the prohibitions on private inurement and political activities, the limitation on lobbying activities, taxation of excess benefit transactions (IRC section 4958), and taxation of unrelated business taxable income under IRC section 511.

Program participants are required to file an application for exempt status with the IRS in such manner as the Secretary of the Treasury may require, and are subject to annual information reporting requirements. In addition, such an organization is required to disclose on its annual information return the amount of reserves required by each state in which it operates and the amount of reserves on hand.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

Effective Date

The provision is effective on March 23, 2010.

California Law (R&TC sections 13201–13222 and Section 28 of Article XIII of the California Constitution)

Insurance Companies in General

Insurance companies must be admitted to do business in California. Once admitted, insurance companies pay the gross premiums tax that is administered by the Board of Equalization (BOE). Insurance companies are not subject to tax under the PITL or the CTL.

Nonadmitted Insurance Policyholders

The FTB administers the tax on nonadmitted insurance policyholders. Policyholders who purchase or renew an insurance contract during the calendar quarter from an insurance company that is not authorized to transact business in California must pay a “nonadmitted insurance tax.” The tax is 3 percent on all premiums paid or to be paid to nonadmitted insurers on contracts covering risks located in California, and is imposed on any corporation, partnership, limited liability company, individual society, association, organization, governmental or quasi-governmental entity, joint-stock company, estate or trust, receiver, trustee, assignee, referee, or any other person acting in a fiduciary capacity.<sup>402</sup>

Policyholders subject to the tax must file Form 570, Nonadmitted Insurance Tax Return, to the FTB on or before the first day of the third month following the close of any calendar quarter during which a nonadmitted insurance contract took effect or was renewed.

Impact on California Revenue

Defer to the BOE.

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<sup>402</sup> R&TC sections 13201–13222.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

<u>Section</u>	<u>Section Title</u>
1401	Refundable Tax Credit for Providing Premium Assistance for Coverage under a Qualified Health Plan

*Includes amendments made by:*

<u>Act/Section</u>	<u>Section Title</u>
PPACA section 10105	Amendments to Subtitle E
HCERA section 1001	Tax Credits

### Background

Currently there is no tax credit that is generally available to low or middle income individuals or families for the purchase of health insurance. Some individuals may be eligible for health coverage through state Medicaid programs which consider income, assets, and family circumstances. However, these Medicaid programs are not in the IRC.

#### Health Coverage Tax Credit

Certain individuals are eligible for the health coverage tax credit ("HCTC"). The HCTC is a refundable tax credit equal to 80 percent of the cost of qualified health coverage paid by an eligible individual. In general, eligible individuals are individuals who receive a trade adjustment allowance (and individuals who would be eligible to receive such an allowance but for the fact that they have not exhausted their regular unemployment benefits), individuals eligible for the alternative trade adjustment assistance program, and individuals over age 55 who receive pension benefits from the Pension Benefit Guaranty Corporation. The HCTC is available for "qualified health insurance," which includes certain employer-based insurance, certain state-based insurance, and in some cases, insurance purchased in the individual market.

The credit is available on an advance basis through a program established and administered by the Treasury Department. The credit generally is delivered as follows: the eligible individual sends his or her portion of the premium to the Treasury, and the Treasury then pays the full premium (the individual's portion and the amount of the refundable tax credit) to the insurer. Alternatively, an eligible individual is also permitted to pay the entire premium during the year and claim the credit on his or her income tax return.

Individuals entitled to Medicare and certain other governmental health programs, covered under certain employer-subsidized health plans, or with certain other specified health coverage, are not eligible for the credit.

#### COBRA Continuation Coverage Premium Reduction

The Consolidated Omnibus Reconciliation Act of 1985 ("COBRA")<sup>403</sup> requires that a group health plan must offer continuation coverage to qualified beneficiaries in the case of a qualifying event

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<sup>403</sup> Public Law 99-272.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

(such as a loss of employment). A plan may require payment of a premium for any period of continuation coverage. The amount of such premium generally may not exceed 102 percent of the "applicable premium" for such period and the premium must be payable, at the election of the payor, in monthly installments.

Section 3001 of the American Recovery and Reinvestment Act of 2009,<sup>404</sup> as amended by the Department of Defense Appropriations Act, 2010,<sup>405</sup> and the Temporary Extension Act of 2010,<sup>406</sup> provides that, for a period not exceeding 15 months, an assistance-eligible individual is treated as having paid any premium required for COBRA continuation coverage under a group health plan if the individual pays 35 percent of the premium. Thus, if the assistance-eligible individual pays 35 percent of the premium, the group health plan must treat the individual as having paid the full premium required for COBRA continuation coverage, and the individual is entitled to a subsidy for 65 percent of the premium. An assistance-eligible individual generally is any qualified beneficiary who elects COBRA continuation coverage and the qualifying event with respect to the covered employee for that qualified beneficiary is a loss of group health plan coverage on account of an involuntary termination of the covered employee's employment (for other than gross misconduct).<sup>407</sup> In addition, the qualifying event must occur during the period beginning September 1, 2008, and ending March 31, 2010.

The COBRA continuation coverage subsidy also applies to temporary continuation coverage elected under the Federal Employees Health Benefits Program and to continuation health coverage under state programs that provide coverage comparable to continuation coverage. The subsidy is generally delivered by requiring employers to pay the subsidized portion of the premium for assistance eligible individuals. The employer then treats the payment of the subsidized portion as a payment of employment taxes and offsets its employment tax liability by the amount of the subsidy. To the extent that the aggregate amount of the subsidy for all assistance eligible individuals for which the employer is entitled to a credit for a quarter exceeds the employer's employment tax liability for the quarter, the employer can request a tax refund or can claim the credit against future employment tax liability.

There is an income limit on the entitlement to the COBRA continuation coverage subsidy. Taxpayers with modified adjusted gross income exceeding \$145,000 (or \$290,000 for joint filers), must repay any subsidy received by them, their spouse, or their dependant, during the taxable

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<sup>404</sup> Public Law 111-5.

<sup>405</sup> Public Law 111-118.

<sup>406</sup> Public Law 111-144.

<sup>407</sup> The Temporary Extension Act of 2010 (TEA)(Public Law 111-144) expanded eligibility for the COBRA subsidy to include individuals who experience a loss of coverage on account of a reduction in hours of employment followed by the involuntary termination of employment of the covered employee. For an individual entitled to COBRA because of a reduction in hours and who is then subsequently involuntarily terminated from employment, the termination is considered a qualifying event for purposes of the COBRA subsidy, as long as the termination occurs during the period beginning on March 3, 2010, and ending on March 31, 2010.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

year. For taxpayers with modified adjusted gross incomes between \$125,000 and \$145,000 (or \$250,000 and \$290,000 for joint filers), the amount of the subsidy that must be repaid is reduced proportionately. The subsidy is also conditioned on the individual not being eligible for certain other health coverage. To the extent that an eligible individual receives a subsidy during a taxable year to which the individual was not entitled due to income or being eligible for other health coverage, the subsidy overpayment is repaid on the individual's income tax return as additional tax. However, in contrast to the HCTC, the subsidy for COBRA continuation coverage may only be claimed through the employer and cannot be claimed at the end of the year on an individual tax return.

New Federal Law (IRC sections 36B and 280C)

Premium Assistance Credit

The provision creates a refundable tax credit (the "premium assistance credit") for eligible individuals and families who purchase health insurance through an exchange. The premium assistance credit, which is refundable and payable in advance directly to the insurer, subsidizes the purchase of certain health insurance plans through an exchange.

Under the provision, an eligible individual enrolls in a plan offered through an exchange and reports his or her income to the exchange. Based on the information provided to the exchange, the individual receives a premium assistance credit based on income and the Treasury pays the premium assistance credit amount directly to the insurance plan in which the individual is enrolled. The individual then pays to the plan in which he or she is enrolled the dollar difference between the premium tax credit amount and the total premium charged for the plan.<sup>408</sup> Individuals who fail to pay all or part of the remaining premium amount are given a mandatory three-month grace period prior to an involuntary termination of their participation in the plan. For employed individuals who purchase health insurance through a state exchange, the premium payments are made through payroll deductions. Initial eligibility for the premium assistance credit is based on the individual's income for the tax year ending two years prior to the enrollment period. Individuals (or couples) who experience a change in marital status or other household circumstance, experience a decrease in income of more than 20 percent, or receive unemployment insurance, may update eligibility information or request a redetermination of their tax credit eligibility.

The premium assistance credit is available for individuals (single or joint filers) with household incomes between 100 and 400 percent of the federal poverty level ("FPL") for the family size involved who do not received health insurance through an employer or a spouse's employer.<sup>409</sup> Household income is defined as the sum of: (1) the taxpayer's modified adjusted gross income;

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<sup>408</sup> Although the credit is generally payable in advance directly to the insurer, individuals may elect to purchase health insurance out-of-pocket and apply to the IRS for the credit at the end of the taxable year. The amount of the reduction in premium is required to be included with each bill sent to the individual.

<sup>409</sup> Individuals who are lawfully present in the United States, but are not eligible for Medicaid because of their immigration status, are treated as having a household income equal to 100 percent of the FPL (and thus eligible for the premium assistance credit) as long as their household income does not actually exceed 100 percent of the FPL.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

plus (2) the aggregate modified adjusted gross incomes of all other individuals taken into account in determining that taxpayer's family size (but only if such individuals are required to file a tax return for the taxable year). Modified adjusted gross income is defined as adjusted gross income increased by: (1) the amount (if any) normally excluded by IRC section 911 (the exclusion from gross income for citizens or residents living abroad); plus (2) any tax-exempt interest received or accrued during the tax year. To be eligible for the premium assistance credit, taxpayers who are married (within the meaning of IRC section 7703) must file a joint return. Individuals who are listed as dependants on a return are ineligible for the premium assistance credit.

As described in Table 1 below, premium assistance credits are available on a sliding scale basis for individuals and families with household incomes between 100 and 400 percent of the FPL to help offset the cost of private health insurance premiums. The premium assistance credit amount is determined by the Secretary of HHS based on the percentage of income the cost of premiums represents, rising from two percent of income for those at 100 percent of the FPL for the family size involved to 9.5 percent of income for those at 400 percent of the FPL for the family size involved. Beginning in 2014, the percentages of income are indexed to the excess of premium growth over income growth for the preceding calendar year (in order to hold steady the share of premiums that enrollees at a given poverty level pay over time). Beginning in 2018, if the aggregate amount of premium assistance credits and cost-sharing reductions exceeds 0.504 percent of the gross domestic product for that year, the percentage of income is also adjusted to reflect the excess (if any) of premium growth over the rate of growth in the consumer price index for the preceding calendar year. For purposes of calculating household size, individuals who are in the country illegally are not included. Individuals who are listed as dependants on a return are ineligible for the premium assistance credit.

Premium assistance credits, or any amounts that are attributable to them, cannot be used to pay for abortions for which federal funding is prohibited. Premium assistance credits are not available for months in which an individual has a free choice voucher.

#### The Low-Income Premium Credit Phase Out

The premium assistance credit increases, on a sliding scale in a linear manner, as shown in the table below:

Household Income (expressed as a percent of poverty line)	Initial Premium (percentage)	Final Premium (percentage)
100% through 133%	2.0	3.0
133% through 150%	3.0	4.0
150% through 200%	4.0	6.3
200% through 250%	6.3	8.05
250% through 300%	8.05	9.5
300% through 400%	9.5	9.5

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

The premium assistance credit amount is tied to the cost of the second lowest-cost silver plan (adjusted for age) which: (1) is in the rating area where the individual resides; (2) is offered through an exchange in the area in which the individual resides; and (3) provides self-only coverage in the case of an individual who purchases self-only coverage, or family coverage in the case of any other individual. If the plan in which the individual enrolls offers benefits in addition to essential health benefits, even if the state in which the individual resides requires such additional benefits, the portion of the premium that is allocable to those additional benefits is disregarded in determining the premium assistance credit amount.<sup>410</sup> Premium assistance credits may be used for any plan purchased through an exchange, including bronze, silver, gold and platinum level plans and, for those eligible,<sup>411</sup> catastrophic plans.

#### Minimum Essential Coverage and Employer Offer of Health Insurance Coverage

Generally, if an employee is offered minimum essential coverage in the group market, including employer-provided health insurance coverage, the individual is ineligible for the premium tax credit for health insurance purchased through a state exchange.

If an employee is offered unaffordable coverage by his or her employer or the plan's share of provided benefits is less than 60 percent, the employee can be eligible for the premium assistance tax credit, but only if the employee declines to enroll in the coverage and satisfies the conditions for receiving a tax credit through an exchange. Unaffordable is defined as coverage with a premium required to be paid by the employee that is 9.5 percent or more of the employee's household income, based on self-only coverage.<sup>412</sup> The percentage of income that is considered unaffordable is indexed in the same manner as the percentage of income is indexed for purposes of determining eligibility for the credit (as discussed above). The Secretary of the Treasury is informed of the name and employer identification number of every employer that has one or more employees receiving a premium assistance tax credit.

No later than five years after the date of the enactment of the provision the Comptroller General must conduct a study of whether the percentage of household income used for purposes of determining whether coverage is affordable is the appropriate level, and whether such level can be lowered without significantly increasing the costs to the Federal Government and reducing employer-provided health coverage. The Secretary reports the results of such study to the appropriate committees of Congress, including any recommendations for legislative changes.

#### Procedures for Determining Eligibility

For purposes of the premium assistance credit, exchange participants must provide information from their tax return from two years prior during the open enrollment period for coverage during

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<sup>410</sup> A similar rule applies to additional benefits that are offered in multi-state plans.

<sup>411</sup> Those eligible to purchase catastrophic plans either must have not reached the age of 30 before the beginning of the plan year, or have certification or an affordability or hardship exemption from the individual responsibility payment, as described in new IRC sections 5000A(e)(1) and 5000A(e)(5), respectively.

<sup>412</sup> The 9.5 percent amount is indexed for calendar years beginning after 2014.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

the next calendar year. For example, if an individual applies for a premium assistance credit for 2014, the individual must provide a tax return from 2012 during the 2103 open-enrollment period. The Internal Revenue Service ("IRS") is authorized to disclose to HHS limited tax return information to verify a taxpayer's income based on the most recent return information available to establish eligibility for the premium assistance credit. Existing privacy and safeguard requirements apply. Individuals who do not qualify for the premium assistance credit on the basis of their prior-year income may apply for the premium assistance credit based on specified changes in circumstances. For individuals and families who did not file a tax return in the prior tax year, the Secretary of HHS will establish alternative income documentation that may be provided to determine income eligibility for the premium assistance credit.

The Secretary of HHS must establish a program for determining whether or not individuals are eligible to: (1) enroll in an exchange-offered health plan; (2) claim a premium assistance credit; and (3) establish that their coverage under an employer-sponsored plan is unaffordable. The program must provide for the following: (1) the details of an individual's application process; (2) the details of how public entities are to make determinations of individuals' eligibility; (3) procedures for deeming individuals to be eligible; and (4) procedures for allowing individuals with limited English proficiency to have proper access to exchanges.

In applying for enrollment in an exchange-offered health plan, an individual applicant is required to provide individually identifiable information, including name, address, date of birth, and citizenship or immigration status. In the case of an individual claiming a premium assistance credit, the individual is required to submit to the exchange income and family size information and information regarding changes in marital or family status or income. Personal information provided to the exchange is submitted to the Secretary of HHS. In turn, the Secretary of HHS submits the applicable information to the Social Security Commissioner, Homeland Security Secretary, and Treasury Secretary for verification purposes. The Secretary of HHS is notified of the results following verification, and notifies the exchange of such results. The provision specifies actions to be undertaken if inconsistencies are found. The Secretary of HHS, in consultation with the Social Security Commissioner, the Secretary of Homeland Security, and the Treasury Secretary must establish procedures for appealing determinations resulting from the verification process, and redetermining eligibility on a periodic basis.

An employer must be notified if one of its employees is determined to be eligible for a premium assistance credit because the employer does not provide minimal essential coverage through an employer-sponsored plan, or the employer does offer such coverage but it is not affordable. The notice must include information about the employer's potential liability for payments under IRC section 4980H and that terminating or discriminating against an employee because he or she received a credit or subsidy is in violation of the Fair Labor Standards Act.<sup>413</sup> An employer is generally not entitled to information about its employees who qualify for the premium assistance credit. Employers may, however, be notified of the name of the employee and whether his or her income is above or below the threshold used to measure the affordability of the employer's health insurance coverage.

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<sup>413</sup> Public Law 75-718.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

Personal information submitted for verification may be used only to the extent necessary for verification purposes and may not be disclosed to anyone not identified in this provision. Any person, who submits false information due to negligence or disregard of any rule, and without reasonable cause, is subject to a civil penalty of not more than \$25,000. Any person who intentionally provides false information will be fined not more than \$250,000. Any person who knowingly and willfully uses or discloses confidential applicant information will be fined not more than \$25,000. Any fines imposed by this provision may not be collected through a lien or levy against property, and the section does not impose any criminal liability.

The provision requires the Secretary of HHS, in consultation with the Secretaries of the Treasury and Labor, to conduct a study to ensure that the procedures necessary to administer the determination of individuals' eligibility to participate in an exchange, to receive premium assistance credits, and to obtain an individual responsibility exemption, adequately protect employees' rights of privacy and employers' rights to due process. The results of the study must be reported by January 1, 2013, to the appropriate committees of Congress.

#### Reconciliation

If the premium assistance received through an advance payment exceeds the amount of credit to which the taxpayer is entitled, the excess advance payment is treated as an increase in tax. For persons whose household income is below 400 percent of the FPL, the amount of the increase in tax is limited to \$400. If the premium assistance received through an advance payment is less than the amount of the credit to which the taxpayer is entitled, the shortfall is treated as a reduction in tax.

The eligibility for and amount of premium assistance is determined in advance of the coverage year, on the basis of household income and family size from two years prior, and the monthly premiums for qualified health plans in the individual market in which the taxpayer, spouse and any dependent enroll in an exchange. Any advance premium assistance is paid during the year for which coverage is provided by the exchange. In the subsequent year, the amount of advance premium assistance is required to be reconciled with the allowable refundable credit for the year of coverage. Generally, this would be accomplished on the tax return filed for the year of coverage, based on that year's actual household income, family size, and premiums. Any adjustment to tax resulting from the difference between the advance premium assistance and the allowable refundable tax credit would be assessed as additional tax or a reduction in tax on the tax return.

Separately, the provision requires that the Exchange, or any person with whom it contracts to administer the insurance program, must report to the Secretary with respect to any taxpayer's participation in the health plan offered by the Exchange. The information to be reported is information necessary to determine whether a person has received excess advance payments, identifying information about the taxpayer (such as name, taxpayer identification number, months of coverage) and any other person covered by that policy; the level of coverage purchased by the taxpayer; the total premium charged for the coverage, as well as the aggregate advance payments credited to that taxpayer; and information provided to the Exchange for the purpose of establishing eligibility for the program, including changes of circumstances of the taxpayer since

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

first purchasing the coverage. Finally, the party submitting the report must provide a copy to the taxpayer whose information is the subject of the report.

Effective Date

The provision is effective for taxable years ending after December 31, 2013.

California Law (None)

California does not have a comparable tax credit. And, federal tax credits, including refundable credits, are not subject to California income or franchise tax.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
1414	Disclosures to Carry out Eligibility Requirements for Certain Programs

*Includes amendments made by:*

<u>Act/Section</u>	<u>Section Title</u>
HCERA section 1004	Income Definitions

Background

IRC section 6103 provides that returns and return information are confidential and may not be disclosed by the IRS, other federal employees, state employees, and certain others having access to such information except as provided in the Internal Revenue Code. IRC section 6103 contains a number of exceptions to the general rule of nondisclosure that authorize disclosure in specifically identified circumstances. For example, IRC section 6103 provides for the disclosure of certain return information for purposes of establishing the appropriate amount of any Medicare Part B premium subsidy adjustment.

IRC section 6103(p)(4) requires, as a condition of receiving returns and return information, that federal and state agencies (and certain other recipients) provide safeguards as prescribed by the Secretary of the Treasury by regulation to be necessary or appropriate to protect the confidentiality of returns or return information. Unauthorized disclosure of a return or return information is a felony punishable by a fine not exceeding \$5,000 or imprisonment of not more than five years, or both, together with the costs of prosecution.<sup>414</sup> The unauthorized inspection of

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<sup>414</sup> IRC section 7213.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

a return or return information is punishable by a fine not exceeding \$1,000 or imprisonment of not more than one year, or both, together with the costs of prosecution.<sup>415</sup> An action for civil damages also may be brought for unauthorized disclosure or inspection.<sup>416</sup>

New Federal Law (IRC sections 6103 and 7213)

Individuals will submit income information to an exchange as part of an application process in order to claim the cost-sharing reduction and the tax credit on an advance basis. The Department of HHS serves as the centralized verification agency for information submitted by individuals to the exchanges with respect to the reduction and the tax credit to the extent provided on an advance basis. The IRS is permitted to substantiate the accuracy of income information that has been provided to HHS for eligibility determination.

Specifically, upon written request of the Secretary of HHS, the IRS is permitted to disclose the following return information of any taxpayer whose income is relevant in determining the amount of the tax credit or cost-sharing reduction, or eligibility for participation in the specified state health subsidy programs (i.e., a state Medicaid program under title XIX of the Social Security Act, a state's children's health insurance program under title XXI of such Act, or a basic health program under section 2228 of such Act): (1) taxpayer identity; (2) the filing status of such taxpayer; (3) the modified adjusted gross income (as defined in new IRC section 36B) of such taxpayer, the taxpayer's spouse and of any dependants who are required to file a tax return; (4) such other information as is prescribed by Treasury regulation as might indicate whether such taxpayer is eligible for the credit or subsidy (and the amount thereof); and (5) the taxable year with respect to which the preceding information relates, or if applicable, the fact that such information is not available. HHS is permitted to disclose to an exchange or its contractors, or to the state agency administering the health subsidy programs referenced above (and their contractors) any inconsistency between the information submitted and IRS records.

The disclosed return information may be used only for the purposes of, and only to the extent necessary in, establishing eligibility for participation in the exchange, verifying the appropriate amount of the tax credit, and cost-sharing subsidy, or eligibility for the specified state health subsidy programs.

Recipients of the confidential return information are subject to the safeguard protections and civil and criminal penalties for unauthorized disclosure and inspection. Special rules apply to the disclosure of return information to contractors.

The IRS is required to make an accounting for all disclosures.

Effective Date

The provision is effective on March 23, 2010.

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<sup>415</sup> IRC section 7213A.

<sup>416</sup> IRC section 7431.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

California Law (R&TC sections 19542-19564)

The FTB receives certain information from the IRS, and is required to follow the federal rules under IRC section 6103, relating to confidentiality and disclosure of returns and return information. Additionally, California law provides specific disclosure rules and penalties for returns and other information provided to the Franchise Tax Board (FTB). Because this provision relates solely to disclosures between the IRS and the Secretary of HHS, it is not applicable under California law.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
1421	Credit for Employee Health Insurance Expenses of Small Businesses

*Includes amendments made by:*

<u>Act/Section</u>	<u>Section Title</u>
PPACA section 10105	Amendments to Subtitle E

Background

The IRC does not provide a tax credit for employers that provide health coverage for their employees. The cost to an employer of providing health coverage for its employees is generally deductible as an ordinary and necessary business expense for employee compensation.<sup>417</sup> In addition, the value of employer-provided health insurance is not subject to employer-paid Federal Insurance Contributions Act ("FICA") tax.

The IRC generally provides that employees are not taxed on the value of employer-provided health coverage under an accident or health plan.<sup>418</sup> That is, these benefits are excluded from gross income. In addition, medical care provided under an accident or health plan for employees, their spouses, and their dependents generally is excluded from gross income.<sup>419</sup> Active employees participating in a cafeteria plan may be able to pay their share of premiums on a pre-tax basis

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<sup>417</sup> IRC section 162. However, see special rules in IRC sections 419 and 419A for the deductibility of contributions to welfare benefit plans with respect to medical benefits for employees and their dependents.

<sup>418</sup> IRC section 106.

<sup>419</sup> IRC section 105(b).

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

through salary reduction.<sup>420</sup> Such salary-reduction contributions are treated as employer contributions and thus also are excluded from gross income.

New Federal Law (IRC sections 38, 45R, 196, and 280C)

Small Business Employers Eligible for the Credit

Under the provision, a tax credit is provided for a qualified small employer for nonelective contributions to purchase health insurance for its employees. A qualified small business employer for this purpose generally is an employer with no more than 25 full-time equivalent employees ("FTEs") employed during the employer's taxable year, and whose employees have annual full-time equivalent wages that average no more than \$50,000. However, the full amount of the credit is available only to an employer with ten or fewer FTEs and whose employees have average annual fulltime equivalent wages from the employer of not more than \$25,000. These wage limits are indexed to the Consumer Price Index for Urban Consumers ("CPI-U") for years beginning in 2014.

Under the provision, an employer's FTEs are calculated by dividing the total hours worked by all employees during the employer's tax year by 2080. For this purpose, the maximum number of hours that are counted for any single employee is 2080 (rounded down to the nearest whole number). Wages are defined in the same manner as under IRC section 3121(a) (as determined for purposes of FICA taxes but without regard to the dollar limit for covered wages) and the average wage is determined by dividing the total wages paid by the small employer by the number of FTEs (rounded down to the nearest \$1,000).

The number of hours of service worked by, and wages paid to, a seasonal worker of an employer is not taken into account in determining the full-time equivalent employees and average annual wages of the employer unless the worker works for the employer on more than 120 days during the taxable year. For purposes of the credit, the term 'seasonal worker' means a worker who performs labor or services on a seasonal basis as defined by the Secretary of Labor, including workers covered by 29 CFR sec. 500.20(s)(1) and retail workers employed exclusively during holiday seasons.

The contributions must be provided under an arrangement that requires the eligible small employer to make a nonelective contribution on behalf of each employee who enrolls in certain defined qualifying health insurance offered to employees by the employer equal to a uniform percentage (not less than 50 percent) of the premium cost of the qualifying health plan.

The credit is only available to offset actual tax liability and is claimed on the employer's tax return. The credit is not payable in advance to the taxpayer or refundable. Thus, the employer must pay the employees' premiums during the year and claim the credit at the end of the year on its income tax return. The credit is a general business credit, and can be carried back for one year and carried forward for 20 years. The credit is available for tax liability under the alternative minimum tax.

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<sup>420</sup> IRC section 125.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

### Years the Credit is Available

Under the provision, the credit is initially available for any taxable year beginning in 2010, 2011, 2012, or 2013. Qualifying health insurance for claiming the credit for this first phase of the credit is health insurance coverage within the meaning of IRC section 9832, which is generally health insurance coverage purchased from an insurance company licensed under state law.

For taxable years beginning in years after 2013, the credit is only available to a qualified small employer that purchases health insurance coverage for its employees through a state exchange and is only available for a maximum coverage period of two consecutive taxable years beginning with the first year in which the employer or any predecessor first offers one or more qualified plans to its employees through an exchange.

The maximum two-year coverage period does not take into account any taxable years beginning in years before 2014. Thus, a qualified small employer could potentially qualify for this credit for six taxable years, four years under the first phase and two years under the second phase.

### Calculation of Credit Amount

The credit is equal to the applicable percentage of the small business employer's contribution to the health insurance premium for each covered employee. Only nonelective contributions by the employer are taken into account in calculating the credit. Therefore, any amount contributed pursuant to a salary-reduction arrangement under a cafeteria plan within the meaning of IRC section 125 is not treated as an employer contribution for purposes of this credit. The credit is equal to the lesser of the following two amounts multiplied by an applicable tax credit percentage: (1) the amount of contributions the employer made on behalf of the employees during the taxable year for the qualifying health coverage and (2) the amount of contributions that the employer would have made during the taxable year if each employee had enrolled in coverage with a small business benchmark premium. To calculate such contributions under the second of these two amounts, the benchmark premium is multiplied by the number of employees enrolled in coverage, and then multiplied by the uniform percentage that applies for calculating the level of coverage selected by the employer. As discussed above, this tax credit is only available if this uniform percentage is at least 50 percent.

For the first phase of the credit (any taxable years beginning in 2010, 2011, 2012, or 2013), the applicable tax credit percentage is 35 percent. The benchmark premium is the average total premium cost in the small group market for employer-sponsored coverage in the employer's state. The premium and the benchmark premium vary based on the type of coverage provided to the employee (i.e., single, adult with child, family or two adults).

For taxable years beginning in years after 2013, the applicable tax credit percentage is 50 percent. The benchmark premium is the average total premium cost in the small group market for employer-sponsored coverage in the employer's state. The premium and the benchmark premium vary based on the type of coverage being provided to the employee (e.g. single or family).

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

The credit is reduced for an employer with between 10 and 25 FTEs. The amount of this reduction is equal to the amount of the credit (determined before any reduction) multiplied by a fraction, the numerator of which is the number of FTEs of the employer in excess of 10 and the denominator of which is 15. The amount of this reduction is equal to the amount of the credit (determined before any reduction) multiplied by a fraction, the numerator of which is the average annual wages of the employer in excess of \$25,000 and the denominator is \$25,000. For an employer with both more than ten FTEs and average annual wages in excess of \$25,000, the reduction is the sum of the amount of the two reductions.

#### Tax-Exempt Organizations as Qualified Small Employers

Any organization described in IRC section 501(c) which is exempt under IRC section 501(a) that otherwise qualifies for the small business tax credit is eligible to receive the credit. However, for tax-exempt organizations, the applicable percentage for the credit during the first phase of the credit (any taxable year beginning in 2010, 2011, 2012, or 2013) is limited to 25 percent and the applicable percentage for the credit during the second phase (taxable years beginning in years after 2013) is limited to 35 percent. The small business tax credit is otherwise calculated in the same manner for tax-exempt organizations that are qualified small employers as the tax credit is calculated for all other qualified small employers. However, for tax-exempt organizations, instead of being a general business credit, the small business tax credit is a refundable tax credit limited to the amount of the payroll taxes of the employer during the calendar year in which the taxable year begins. For this purpose, payroll taxes of an employer mean: (1) the amount of income tax required to be withheld from its employees' wages; (2) the amount of hospital insurance tax under IRC section 3101(b) required to be withheld from its employees' wages; and (3) the amount of the hospital insurance tax under IRC section 3111(b) imposed on the employer.

#### Special Rules

The employer is entitled to a deduction under IRC section 162 equal to the amount of the employer contribution minus the dollar amount of the credit. For example, if a qualified small employer pays 100 percent of the cost of its employees' health insurance coverage and the tax credit under this provision is 50 percent of that cost, the employer is able to claim an IRC section 162 deduction for the other 50 percent of the premium cost.

The employer is determined by applying the employer aggregations rules in IRC section 414(b), (c), and (m). In addition, the definition of employee includes a leased employee within the meaning of IRC section 414(n).<sup>421</sup>

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<sup>421</sup> IRC section 414(b) provides that, for specified employee benefit purposes, all employees of all corporations which are members of a controlled group of corporations are treated as employed by a single employer. There is a similar rule in IRC section 414(c) under which all employees of trades or businesses (whether or not incorporated) which are under common are treated under regulations as employed by a single employer, and, in IRC section 414(m), under which employees of an affiliated service group (as defined in that section) are treated as employed by a single employer. IRC section 414(n) provides that leased employees, as defined in that section, are treated as employees of the service recipient for specified purposes. IRC section 414(o) authorizes the Treasury to issue regulations to prevent avoidance of the certain requirement under IRC section 414(m) and 414(n).

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

Self-employed individuals, including partners and sole proprietors, two percent shareholders of an S corporation, and five percent owners of the employer (within the meaning of IRC section 416(i)(1)(B)(i)) are not treated as employees for purposes of this credit. Any employee with respect to a self employed individual is not an employee of the employer for purposes of this credit if the employee is not performing services in the trade or business of the employer. Thus, the credit is not available for a domestic employee of a sole proprietor of a business. There is also a special rule to prevent sole proprietorships from receiving the credit for the owner and their family members. Thus, no credit is available for any contribution to the purchase of health insurance for these individuals and the individual is not taken into account in determining the number of FTEs or average full-time equivalent wages.

The Secretary of is directed to prescribe such regulations as may be necessary to carry out the provisions of new IRC section 45R, including regulations to prevent the avoidance of the two-year limit on the credit period for the second phase of the credit through the use of successor entities and the use of the limit on the number of employees and the amount of average wages through the use of multiple entities. The Secretary of Treasury, in consultation with the Secretary of Labor, is directed to prescribe such regulations, rules, and guidance as may be necessary to determine the hours of service of an employee for purposes of determining FTEs, including rules for the employees who are not compensated on an hourly basis.

Effective Date

The provision is effective for taxable years beginning after December 31, 2009.

California Law (None)

California does not conform to the credit for employee health insurance expenses of small businesses.

Impact on California Revenue

Not applicable.

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PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

<u>Section</u>	<u>Section Title</u>
1501	Requirement to Maintain Minimum Essential Coverage

*Includes amendments made by:*

<u>Act/Section</u>	<u>Section Title</u>
PPACA section 10106	Amendments to Subtitle F
HCERA section 1002	Individual Responsibility

### Background

Federal law does not require individuals to have health insurance. Only the Commonwealth of Massachusetts, through its statewide program, requires that individuals have health insurance (although this policy has been considered in other states, such as California, Maryland, Maine, and Washington). All adult residents of Massachusetts are required to have health insurance that meets "minimum creditable coverage" standards if it is deemed "affordable" at their income level under a schedule set by the board of the Commonwealth Health Insurance Connector Authority ("Connector"). Individuals report their insurance status on state income tax forms. Individuals can file hardship exemptions from the mandate; persons for whom there are no affordable insurance options available are not subject to the requirement for insurance coverage.

For taxable year 2007, an individual without insurance and who was not exempt from the requirement did not qualify under Massachusetts law for a state income tax personal exemption. For taxable years beginning on or after January 1, 2008, a penalty is levied for each month an individual is without insurance. The penalty consists of an amount up to 50 percent of the lowest premium available to the individual through the Connector. The penalty is reported and paid by the individual with the individual's Massachusetts state income tax return at the same time and in the same manner as state income taxes. Failure to pay the penalty results in the same interest and penalties as apply to unpaid income tax.

### New Federal Law (IRC section 5000A)

#### Personal Responsibility Requirement

Beginning January, 2014, non-exempt U.S. citizens and legal residents are required to maintain minimum essential coverage. Minimum essential coverage includes government-sponsored programs, eligible employer-sponsored plans, plans in the individual market, grandfathered group health plans and other coverage as recognized by the Secretary of HHS in coordination with the Secretary of the Treasury. Government-sponsored programs include: Medicare; Medicaid; the Children's Health Insurance Program; coverage for members of the U.S. military;<sup>422</sup> veteran's health care;<sup>423</sup> and health care for Peace Corps volunteers.<sup>424</sup> Eligible employer-sponsored plans

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<sup>422</sup> 10 U.S.C. 55 and 38 U.S.C. 1781.

<sup>423</sup> 38 U.S.C. 17.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

include: governmental plans,<sup>425</sup> church plans,<sup>426</sup> grandfathered plans and other group health plans offered in the small or large group market within a state. Minimum essential coverage does not include coverage that consists of certain Health Insurance Portability and Accountability Act (HIPAA) excepted benefits.<sup>427</sup> Other HIPAA excepted benefits that do not constitute minimum essential coverage if offered under a separate policy, certificate or contract of insurance include long term care, limited scope dental and vision benefits, coverage for a disease or specified illness, hospital indemnity or other fixed-indemnity insurance or Medicare supplemental health insurance.<sup>428</sup>

Individuals are exempt from the requirement for months they are incarcerated, not legally present in the United States or maintain religious exemptions. Those who are exempt from the requirement due to religious reasons must be members of a recognized religious sect exempting them from self employment taxes<sup>429</sup> and adhere to tenets of the sect. Individuals residing<sup>430</sup> outside of the United States are deemed to maintain minimum essential coverage. If an individual is a dependent<sup>431</sup> of another taxpayer, the other taxpayer is liable for any penalty payment with respect to the individual.

#### Penalty

Individuals who fail to maintain minimum essential coverage in 2016 are subject to a penalty equal to the greater of: (1) 2.5 percent of household income in excess of the taxpayer's household income for the taxable year over the threshold amount of income required for income tax return filing for that taxpayer under IRC section 6012(a)(1);<sup>432</sup> or (2) \$695 per uninsured adult in the household. The fee for an uninsured individual under age 18 is one-half of the adult fee for an

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<sup>424</sup> 22 U.S.C. 2504(e).

<sup>425</sup> ERISA Section 3(32), U.S.C. 5: Chapter 89, except a plan described in paragraph (1)(A).

<sup>426</sup> ERISA section 3(33).

<sup>427</sup> U.S.C. 42 section 300gg-91(c)(1). HIPAA excepted benefits include: (1) coverage only for accident, or disability income insurance; (2) coverage issued as a supplement to liability insurance; (3) liability insurance, including general liability insurance and automobile liability insurance; (4) workers' compensation or similar insurance; (5) automobile medical payment insurance; (6) credit-only insurance; (7) coverage for on-site medical clinics; and (8) other similar insurance coverage, specified in regulations, under which benefits for medical care are secondary or incidental to other insurance benefits..

<sup>428</sup> 42 U.S.C. 300gg-91(c)(2-4).

<sup>429</sup> IRC section 1402(g)(1).

<sup>430</sup> IRC section 911(d)(1).

<sup>431</sup> IRC section 152.

<sup>432</sup> Generally, in 2010, the filing threshold is \$9,350 for a single person or a married person filing separately and is \$18,700 for married filing jointly. IR-2009-93, Oct. 15, 2009.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

adult. The total household penalty may not exceed 300 percent of the per-adult penalty (\$2,085). The total annual household payment may not exceed the national average annual premium for bronze level health plan offered through the Exchange that year for the household size.

This per-adult annual penalty is phased in as follows: \$95 for 2014; \$325 for 2015; and \$695 in 2016. For years after 2016, the \$695 amount is indexed to CPI-U, rounded to the next lowest \$50. The percentage of income is phased in as follows: one percent for 2014; two percent in 2015; and 2.5 percent beginning after 2015. If a taxpayer files a joint return, the individual and spouse are jointly liable for any penalty payment.

The penalty applies to any period the individual does not maintain minimum essential coverage and is determined monthly. The penalty is an excise tax that is assessed in the same manner as an assessable penalty under the enforcement provisions of subtitle F of the IRC.<sup>433</sup> As a result, it is assessable without regard to the restrictions of IRC section 6213(b). Although assessable and collectible under the IRC, the IRS authority to use certain collection methods is limited. Specifically, the filing of notices of liens and levies otherwise authorized for collection of taxes does not apply to the collection of this penalty. In addition, the statute waives criminal penalties for non-compliance with the requirement to maintain minimum essential coverage. However, the authority to offset refunds or credits is not limited by this provision.

Individuals who cannot afford coverage because their required contribution for employer-sponsored coverage or the lowest cost bronze plan in the local Exchange exceeds eight percent of household income for the year are exempt from the penalty.<sup>434</sup> In years after 2014, the eight-percent exemption is increased by the amount by which premium growth exceeds income growth. For employees, and individuals who are eligible for minimum essential coverage through an employer by reason of a relationship to an employee, the determination of whether coverage is affordable to the employee and any such individual is made by reference to the required contribution of the employee for self-only coverage. Individuals are liable for penalties imposed with respect to their dependents (as defined in IRC section 152). An individual filing a joint return with a spouse is jointly liable for any penalty imposed with respect to the spouse. Taxpayers with income below the income-tax filing threshold<sup>435</sup> shall also be exempt from the penalty for failure to maintain minimum essential coverage. All members of Indian tribes<sup>436</sup> are exempt from the penalty.

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<sup>433</sup> IRS authority to assess and collect taxes is generally provided in subtitle F, "Procedure and Administration" in the IRC. That subtitle establishes the rules governing both how taxpayers are required to report information to the IRS and pay their taxes as well as their rights. It also establishes the duties and authority of the IRS to enforce the IRC, including civil and criminal penalties.

<sup>434</sup> In the case of an individual participating in a salary-reduction arrangement, the taxpayer's household income is increased by any exclusion from gross income for any portion of the required contribution to the premium. The required contribution to the premium is the individual contribution to coverage through an employer or in the purchase of a bronze plan through the Exchange.

<sup>435</sup> Generally, in 2010, the filing threshold is \$9,350 for a single person or a married person filing separately and is \$18,700 for married filing jointly. IR-2009-93, Oct. 15, 2009.

<sup>436</sup> Tribal membership is defined in IRC section 45A(c)(6).

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

No penalty is assessed for individuals who do not maintain health insurance for a period of three months or less during the taxable year. If an individual exceeds the three-month maximum during the taxable year, the penalty for the full duration of the gap during the year is applied. If there are multiple gaps in coverage during a calendar year, the exemption from penalty applies only to the first such gap in coverage. The Secretary of the Treasury shall provide rules when a coverage gap includes months in multiple calendar years. Individuals may also apply to the Secretary of HHS for a hardship exemption due to hardship in obtaining coverage.<sup>437</sup> Residents of the possessions<sup>438</sup> of the United States are treated as being covered by acceptable coverage.

Family size is the number of individuals for whom the taxpayer is allowed a personal exemption. Household income is the sum of the modified adjusted gross incomes of the taxpayer and all individuals accounted for in the family size required to file a tax return for that year. Modified adjusted gross income means adjusted gross income increased by all tax-exempt interest and foreign earned income.<sup>439</sup>

Effective Date

The provision is effective for taxable years beginning after December 31, 2013.

California Law

The FTB does not administer excise taxes; thus, this provision that imposes an excise tax (referred to as a “penalty”) for the failure to maintain minimum essential coverage is deferred to the Board of Equalization (BOE).

Impact on California Revenue

Defer to the BOE.

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<sup>437</sup> IRC section 1311(d)(4)(H).

<sup>438</sup> IRC section 937(a).

<sup>439</sup> IRC section 911.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

<u>Section</u>	<u>Section Title</u>
1502	Reporting of Health Insurance Coverage

Background

Present law imposes a variety of information reporting requirements on participants in certain transactions.<sup>440</sup> These requirements are intended to assist taxpayers in preparing their income tax returns and help the IRS determine whether such returns are correct and complete. Failure to comply with the information reporting requirements may result in penalties, including: a penalty for failure to file the information return,<sup>441</sup> a penalty for failure to furnish payee statements,<sup>442</sup> and a penalty for failure to comply with various other reporting requirements.<sup>443</sup>

The penalty for failure to file an information return generally is \$50 for each return for which such failure occurs. The total penalty imposed on a person for all failures during a calendar year cannot exceed \$250,000. Additionally, special rules apply to reduce the per-failure and maximum penalty where the failure is corrected within a specified period.

The penalty for failure to provide a correct payee statement is \$50 for each statement with respect to which such failure occurs, with the total penalty for a calendar year not to exceed \$100,000. Special rules apply that increase the per-statement and total penalties where there is intentional disregard of the requirement to furnish a payee statement.

New Federal Law (IRC sections 6055 and 6724)

Under the provision, insurers (including employers who self-insure) that provide minimum essential coverage<sup>444</sup> to any individual during a calendar year must report certain health insurance coverage information to both the covered individual and to the IRS. In the case of coverage provided by a governmental unit, or any agency or instrumentality thereof, the reporting requirement applies to the person or employee who enters into the agreement to provide the health insurance coverage (or their designee).

The information required to be reported includes: (1) the name, address, and taxpayer identification number of the primary insured, and the name and taxpayer identification number of each other individual obtaining coverage under the policy; (2) the dates during which the individual was covered under the policy during the calendar year; (3) whether the coverage is a

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<sup>440</sup> IRC sections 6031 through 6060.

<sup>441</sup> IRC section 6721.

<sup>442</sup> IRC section 6722.

<sup>443</sup> IRC section 6723. The penalty for failure to comply timely with a specified information reporting requirement is \$50 per failure, not to exceed \$100,000 for a calendar year.

<sup>444</sup> As defined in IRC section 5000A.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

qualified health plan offered through an exchange; (4) the amount of any premium tax credit or cost-sharing reduction received by the individual with respect to such coverage; and (5) such other information as the Secretary may require.

To the extent health insurance coverage is through an employer-provided group health plan, the insurer is also required to report the name, address and employer identification number of the employer, the portion of the premium, if any, required to be paid by the employer, and any other information the Secretary may require to administer the new tax credit for eligible small employers.

The insurer is required to report the above information, along with the name, address and contact information of the reporting insurer, to the covered individual on or before January 31 of the year following the calendar year for which the information is required to be reported to the IRS.

The provision amends the information reporting provisions of the IRC to provide that an insurer who fails to comply with these new reporting requirements is subject to the penalties for failure to file an information return and failure to furnish payee statements, respectively.

The IRS is required, not later than June 30 of each year, in consultation with the Secretary of HHS, to provide annual notice to each individual who files an income tax return and who fails to enroll in minimum essential coverage. The notice is required to include information on the services available through the exchange operating in the individual's state of residence.

#### Effective Date

The provision is effective for calendar years beginning after 2013.

#### California Law (R&TC section 18631)

The FTB may request a copy of any information return that is added, on or after January 1, 2009, to Part III of Subchapter A of Chapter 61 of the IRC as a newly-required information return required to be filed with the Secretary of the Treasury.

#### Impact on California Revenue

Baseline.

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PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

<u>Section</u>	<u>Section Title</u>
1513	Shared Responsibility for Employers

*Includes amendments made by:*

<u>Act/Section</u>	<u>Section Title</u>
PPACA section 10106	Amendments to Subtitle F
HCERA section 1003	Employer Responsibility

### Background

Currently, there is no federal requirement that employers offer health insurance coverage to employees or their families. However, as with other compensation, the cost of employer-provided health coverage is a deductible business expense under IRC section 162.<sup>445</sup> In addition, employer-provided health insurance coverage is generally not included in an employee's gross income.<sup>446</sup>

Employees participating in a cafeteria plan may be able to pay the portion of premiums for health insurance coverage not otherwise paid for by their employers on a pre-tax basis through salary reduction.<sup>447</sup> Such salary-reduction contributions are treated as employer contributions for purposes of the IRC, and are thus excluded from gross income.

One way that employers can offer employer-provided health insurance coverage for purposes of the tax exclusion is to offer to reimburse employees for the premiums for health insurance purchased by employees in the individual health insurance market. The payment or reimbursement of employees' substantiated individual health insurance premiums is excludible from employees' gross income.<sup>448</sup> This reimbursement for individual health insurance premiums can also be paid through salary reduction under a cafeteria plan.<sup>449</sup> However, this offer to reimburse individual health insurance premiums constitutes a group health plan.

The Employee Retirement Income Security Act of 1974 ("ERISA")<sup>450</sup> preempts state law relating to certain employee benefit plans, including employer-sponsored health plans. While ERISA specifically provides that its preemption rule does not exempt or relieve any person from any state

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<sup>445</sup> IRC section 162. However see special rules in IRC sections 419 and 419A for the deductibility of contributions to welfare benefit plans with respect to medical benefits for employees and their dependents.

<sup>446</sup> IRC section 106.

<sup>447</sup> IRC section 125.

<sup>448</sup> Rev. Rul. 61-146 (1961-2 CB 25).

<sup>449</sup> Proposed Treas. Reg. section 1.125-1(m).

<sup>450</sup> Public Law 93-406.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

law which regulates insurance, ERISA also provides that an employee benefit plan is not deemed to be engaged in the business of insurance for purposes of any state law regulating insurance companies or insurance contracts. As a result of this ERISA preemption, self-insured employer-sponsored health plans need not provide benefits that are mandated under state insurance law.

While ERISA does not require an employer to offer health benefits, it does require compliance if an employer chooses to offer health benefits, such as compliance with plan fiduciary standards, reporting and disclosure requirements, and procedures for appealing denied benefit claims. There are other federal requirements for health plans which include, for example, rules for health care continuation coverage.<sup>451</sup> The IRC imposes an excise tax on group health plans that fail to meet these other requirements.<sup>452</sup> The excise tax generally is equal to \$100 per day per failure during the period of noncompliance and is imposed on the employer sponsoring the plan.

Under Medicaid, states may establish "premium assistance" programs, which pay a Medicaid beneficiary's share of premiums for employer-sponsored health coverage. Besides being available to the beneficiary through his or her employer, the coverage must be comprehensive and cost-effective for the state. An individual's enrollment in an employer plan is considered cost-effective if paying the premiums, deductibles, coinsurance and other cost-sharing obligations of the employer plan is less expensive than the state's expected cost of directly providing Medicaid-covered services. States are also required to provide coverage for those Medicaid-covered services that are not included in the private plans. A 2007 analysis showed that 12 states had Medicaid premium assistance programs as authorized under current law.

#### New Federal Law (IRC section 4980H)

An applicable large employer that does not offer coverage for all its full-time employees, offers minimum essential coverage that is unaffordable, or offers minimum essential coverage that consists of a plan under which the plan's share of the total allowed cost of benefits is less than 60 percent, is required to pay a penalty if any full-time employee is certified to the employer as having purchased health insurance through a state exchange with respect to which a tax credit or cost-sharing reduction is allowed or paid to the employee.

#### Applicable Large Employer

An employer is an applicable large employer with respect to any calendar year if it employed an average of at least 50 full-time employees during the preceding calendar year. For purposes of the provision, "employer" includes any predecessor employer. An employer is not treated as employing more than 50 full-time employees if the employer's workforce exceeds 50 full-time employees for 120 days or fewer during the calendar year and the employees that cause the employer's workforce to exceed 50 full-time employees are seasonal workers. A seasonal worker is a worker who performs labor or services on a seasonal basis (as defined by the Secretary of

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<sup>451</sup> These rules were added to ERISA and the IRC by the Consolidated Omnibus Budget Reconciliation Act of 1985 (Public Law 99-272).

<sup>452</sup> IRC section 4980B.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

Labor), including retail workers employed exclusively during the holiday season and workers whose employment is, ordinarily, the kind exclusively performed at certain seasons or periods of the year and which, from its nature, may not be continuous or carried on throughout the year.<sup>453</sup>

In counting the number of employees for purposes of determining whether an employer is an applicable large employer, a full-time employee (meaning, for any month, an employee working an average of at least 30 hours or more each week) is counted as one employee and all other employees are counted on a pro-rated basis in accordance with regulations prescribed by the Secretary. The number of full-time equivalent employees that must be taken into account for purposes of determining whether the employer exceeds the threshold is equal to the aggregate number of hours worked by non-full-time employees for the month, divided by 120 (or such other number based on an average of 30 hours of service each week as the Secretary may prescribe in regulations).

The Secretary, in consultation with the Secretary of Labor, is directed to issue, as necessary, rules, regulations and guidance to determine an employee's hours of service, including rules that apply to employees who are not compensated on an hourly basis.

In determining whether an employer is an applicable large employer, the aggregation rules of IRC sections 414(b), (c), (m), and (o) apply. The determination of whether an employer that was not in existence during the preceding calendar year is an applicable large employer is made based on the average number of employees that it is reasonably expected to employ on business days in the current calendar year.

#### Penalty for Employers Not Offering Coverage

An applicable large employer who fails to offer its full-time employees and their dependents the opportunity to enroll in minimum essential coverage under an employer-sponsored plan for any month is subject to a penalty if at least one of its full-time employees is certified to the employer as having enrolled in health insurance coverage purchased through a state exchange with respect to which a premium tax credit or cost-sharing reduction is allowed or paid to such employee or employees. The penalty for any month is an excise tax equal to the number of full-time employees over a 30-employee threshold during the applicable month (regardless of how many employees are receiving a premium tax credit or cost-sharing reduction) multiplied by one-twelfth of \$2,000. In the case of persons treated as a single employer under the provision, the 30-employee reduction in full-time employees is made from the total number of full-time employees employed by such persons (i.e., only one 30-person reduction is permitted per controlled group of employers) and is allocated among such persons in relation to the number of full-time employees employed by each such person.

For example, in 2014, Employer A fails to offer minimum essential coverage and has 100 full-time employees, ten of whom receive a tax credit for the year for enrolling in a state exchange-offered

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<sup>453</sup> Section 500.20(s)(1) of title 29, Code of Federal Regulations. Under section 5000.20(s)(1), a worker who moves from one seasonal activity to another, while employed in agriculture or performing agricultural labor, is employed on a seasonal basis even though he may continue to be employed during a major portion of the year.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

plan. For each employee over the 30-employee threshold, the employer owes \$2,000, for a total penalty of \$140,000 (\$2,000 multiplied by 70 ((100-30))). This penalty is assessed on a monthly basis.

For calendar years after 2014, the \$2,000 dollar amount is increased by the percentage (if any) by which the average per capita premium for health insurance coverage in the United States for the preceding calendar year (as estimated by the Secretary of HHS no later than October 1 of the preceding calendar year) exceeds the average per capita premium for 2013 (as determined by the Secretary of HHS), rounded down to the nearest \$10.

#### Penalty for Employees Receiving Premium Credits

An applicable large employer who offers, for any month, its full-time employees and their dependents the opportunity to enroll in minimum essential coverage under an employer-sponsored plan is subject to a penalty if any full-time employee is certified to the employer as having enrolled in health insurance coverage purchased through a state exchange with respect to which a premium tax credit or cost-sharing reduction is allowed or paid to such employee or employees.

The penalty is an excise tax that is imposed for each employee who receives a premium tax credit or cost-sharing reduction for health insurance purchased through a state exchange. For each full-time employee receiving a premium tax credit or cost-sharing subsidy through a state exchange for any month, the employer is required to pay an amount equal to one-twelfth of \$3,000. The penalty for each employer for any month is capped at an amount equal to the number of full-time employees during the month (regardless of how many employees are receiving a premium tax credit or cost-sharing reduction) in excess of 30, multiplied by one-twelfth of \$2,000. In the case of persons treated as a single employer under the provision, the 30-employee reduction in full-time employees for purposes of calculating the maximum penalty is made from the total number of full-time employees employed by such persons (i.e., only one 30-person reduction is permitted per controlled group of employers) and is allocated among such persons in relation to the number of full-time employees employed by each such person.

For example, in 2014, Employer A offers health coverage and has 100 full-time employees, 20 of whom receive a tax credit for the year for enrolling in a state exchange offered plan. For each employee receiving a tax credit, the employer owes \$3,000, for a total penalty of \$60,000. The maximum penalty for this employer is capped at the amount of the penalty that it would have been assessed for a failure to provide coverage, or \$140,000 (\$2,000 multiplied by 70 ((100-30))). Since the calculated penalty of \$60,000 is less than the maximum amount, Employer A pays the \$60,000 calculated penalty. This penalty is assessed on a monthly basis.

For calendar years after 2014, the \$3,000 and \$2,000 dollar amounts are increased by the percentage (if any) by which the average per capita premium for health insurance coverage in the United States for the preceding calendar year (as estimated by the Secretary of HHS no later than October 1 of the preceding calendar year) exceeds the average per capita premium for 2013 (as determined by the Secretary of HHS), rounded down to the nearest \$10.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

Time for Payment, Deductibility of Excise Taxes, Restrictions on Assessment

The excise taxes imposed under this provision are payable on an annual, monthly or other periodic basis as the Secretary of Treasury may prescribe. The excise taxes imposed under this provision for employees receiving premium tax credits are not deductible under IRC section 162 as a business expense. The restrictions on assessment under IRC section 6213 are not applicable to the excise taxes imposed under the provision.

Employer Offer of Health Insurance Coverage

Under the provision, as under current law, an employer is not required to offer health insurance coverage. If an employee is offered health insurance coverage by his or her employer and chooses to enroll in the coverage, the employer-provided portion of the coverage is excluded from gross income. The tax treatment is the same whether the employer offers coverage outside of a state exchange or the employer offers a coverage option through a state exchange.

*Definition of coverage*

As a general matter, if an employee is offered affordable minimum essential coverage under an employer-sponsored plan, the individual is ineligible for a premium tax credit and cost-sharing reductions for health insurance purchased through a state exchange.

*Unaffordable coverage*

If an employee is offered minimum essential coverage by their employer that is either unaffordable or that consists of a plan under which the plan's share of the total allowed cost of benefits is less than 60 percent, however, the employee is eligible for a premium tax credit and cost-sharing reductions, but only if the employee declines to enroll in the coverage and purchases coverage through the exchange instead. Unaffordable is defined as coverage with a premium required to be paid by the employee that is more than 9.5 percent of the employee's household income (as defined for purposes of the premium tax credits). This percentage of the employee's income is indexed to the per capita growth in premiums for the insured market as determined by the Secretary of HHS. The employee must seek an affordability waiver from the state exchange and provide information as to family income and the lowest cost employer option offered to them. The state exchange then provides the waiver to the employee. The employer penalty applies for any employee(s) receiving an affordability waiver.

For purposes of determining if coverage is unaffordable, required salary-reduction contributions are treated as payments required to be made by the employee. However, if an employee is reimbursed by the employer for any portion of the premium for health insurance coverage purchased through the exchange, including any reimbursement through salary-reduction contributions under a cafeteria plan, the coverage is employer-provided and the employee is not eligible for premium tax credits or cost-sharing reductions. Thus, an individual is not permitted to purchase coverage through the exchange, apply for the premium tax credit, and pay for the individual's portion of the premium using salary-reduction contributions under the cafeteria plan of the individual's employer.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

An employer must be notified if one of its employees is determined to be eligible for a premium assistance credit or a cost-sharing reduction because the employer does not provide minimal essential coverage through an employer-sponsored plan, or the employer does offer such coverage but it is not affordable or the plan's share of the total allowed cost of benefits is less than 60 percent. The notice must include information about the employer's potential liability for payments under IRC section 4980H. The employer must also receive notification of the appeals process established for employers notified of potential liability for payments under IRC section 4980H. An employer is generally not entitled to information about its employees who qualify for the premium assistance credit or cost-sharing reductions; however, the appeals process must provide an employer the opportunity to access the data used to make the determination of an employee's eligibility for a premium assistance credit or cost-sharing reduction, to the extent allowable by law.

The Secretary is required to prescribe rules, regulations or guidance for the repayment of any assessable payment (including interest) if the payment is based on the allowance or payment of a premium tax credit or cost-sharing reduction with respect to an employee that is subsequently disallowed and with respect to which the assessable payment would not have been required to have been made in the absence of the allowance or payment.

*Effect of Medicaid enrollment*

A Medicaid-eligible individual can always choose to leave the employer's coverage and enroll in Medicaid, and an employer is not required to pay a penalty for any employees enrolled in Medicaid.

Study and Reporting on Employer Responsibility Requirements

The Secretary of Labor is required to study whether employee wages are reduced by reason of the application of the employer responsibility requirements, using the National Compensation Survey published by the Bureau of Labor Statistics. The Secretary of Labor is to report the results of this study to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate.

Effective Date

The provision is effective for months beginning after December 31, 2013.

California Law

The FTB does not administer excise taxes. Defer to the Board of Equalization (BOE).

Impact on California Revenue

Defer to the BOE.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

<u>Section</u>	<u>Section Title</u>
1514	Reporting of Employer Health Insurance Coverage

Background

Penalties for Failure to Comply with Information Reporting Requirements

Present law imposes a variety of information reporting requirements on participants in certain transactions.<sup>454</sup> These requirements are intended to assist taxpayers in preparing their income tax returns and help the IRS determine whether such returns are correct and complete. Failure to comply with the information reporting requirements may result in penalties, including: a penalty for failure to file the information return,<sup>455</sup> a penalty for failure to furnish payee statements,<sup>456</sup> and a penalty for failure to comply with various other reporting requirements.<sup>457</sup>

The penalty for failure to file an information return generally is \$50 for each return for which such failure occurs. The total penalty imposed on a person for all failures during a calendar year cannot exceed \$250,000. Additionally, special rules apply to reduce the per-failure and maximum penalty where the failure is corrected within a specified period.

The penalty for failure to provide a correct payee statement is \$50 for each statement with respect to which such failure occurs, with the total penalty for a calendar year not to exceed \$100,000. Special rules apply that increase the per-statement and total penalties where there is intentional disregard of the requirement to furnish a payee statement.

New Federal Law (IRC sections 6056 and 6724)

Under the provision, each applicable large employer subject to the employer-responsibility provisions of new IRC section 4980H and each "offering employer" must report certain health insurance coverage information to both its full-time employees and to the IRS. An offering employer is any employer who offers minimum essential coverage<sup>458</sup> to its employees under an eligible employer-sponsored plan and who pays any portion of the costs of such plan, but only if the required employer contribution of any employee exceeds eight percent of the wages paid by the employer to the employee. In the case of years after 2014, the eight percent is indexed to reflect the rate of premium growth over income growth between 2013 and the preceding calendar year. In the case of coverage provided by a governmental unit, or any agency or instrumentality

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<sup>454</sup> IRC sections 6031 through 6060.

<sup>455</sup> IRC section 6721.

<sup>456</sup> IRC section 6722.

<sup>457</sup> IRC section 6723. The penalty for failure to comply timely with a specified information reporting requirement is \$50 per failure, not to exceed \$100,000 for a calendar year.

<sup>458</sup> As defined in IRC section 5000A.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

thereof, the reporting requirement applies to the person or employee appropriately designated for purposes of making the returns and statements required by the provision.

The information required to be reported includes: (1) the name, address and employer identification number of the employer; (2) a certification as to whether the employer offers its full-time employees and their dependents the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan; (3) the number of full-time employees of the employer for each month during the calendar year; (4) the name, address and taxpayer identification number of each full-time employee employed by the employer during the calendar year and the number of months, if any, during which the employee (and any dependents) was covered under a plan sponsored by the employer during the calendar year; and (5) such other information as the Secretary may require.

Employers who offer the opportunity to enroll in minimum essential coverage must also report: (1) in the case of an applicable large employer, the length of any waiting period with respect to such coverage; (2) the months during the calendar year during which the coverage was available; (3) the monthly premium for the lowest cost option in each of the enrollment categories under the plan; (4) the employer's share of the total allowed costs of benefits under the plan; and (5), in the case of an offering employer, the option for which the employer pays the largest position of the cost of the plan and the portion of the cost paid by the employer in each of the enrollment categories under each option.

The employer is required to report to each full-time employee the above information required to be reported with respect to that employee, along with the name, address and contact information of the reporting employer, on or before January 31 of the year following the calendar year for which the information is required to be reported to the IRS.

The provision amends the information reporting provisions of the IRC to provide that an employer who fails to comply with these new reporting requirements is subject to the penalties for failure to file an information return and failure to furnish payee statements, respectively.

To the maximum extent feasible, the Secretary may provide that any information return or payee statement required to be provided under the provision may be provided as part of any return or statement required under new IRC sections 6051<sup>459</sup> or 6055<sup>460</sup> and, in the case of an applicable large employer or offering employer offering health insurance coverage of a health insurance issuer, the employer may enter into an agreement with the issuer to include the information required by the provision with the information return and payee statement required under new IRC section 6055.

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<sup>459</sup> For additional information on new IRC section 6051, see the explanation of Act section 9002, "Inclusion of Employer-Sponsored Health Coverage on W-2."

<sup>460</sup> For additional information on new IRC section 6055, see the explanation of Act section 1502, "Reporting of Health Insurance Coverage."

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

The Secretary has the authority, in coordination with the Secretary of Labor, to review the accuracy of the information reported by the employer, including the employer's share of the total allowed costs of benefits under the plan.

Effective Date

The provision is effective for periods beginning after December 31, 2013.

California Law (R&TC section 18631)

The FTB may request a copy of any information return that is added, on or after January 1, 2009, to Part III of Subchapter A of Chapter 61 of the IRC as a newly-required information return required to be filed with the Secretary of the Treasury.

Impact on California Revenue

Baseline.

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<u>Section</u>	<u>Section Title</u>
1515	Offering of Exchange-Participating Qualified Health Plans through Cafeteria Plans

Background

Currently, there is no federal requirement that employers offer health insurance coverage to employees or their families. However, as with other compensation, the cost of employer-provided health coverage is a deductible business expense under IRC section 162.<sup>461</sup> In addition, employer-provided health insurance coverage is generally not included in an employee's gross income.<sup>462</sup>

Definition of a Cafeteria Plan

If an employee receives a qualified benefit (as defined below) based on the employee's election between the qualified benefit and a taxable benefit under a cafeteria plan, the qualified benefit generally is not includable in gross income.<sup>463</sup> However, if a plan offering an employee an election between taxable benefits (including cash) and nontaxable qualified benefits does not meet the requirements for being a cafeteria plan, the election between taxable and nontaxable benefits

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<sup>461</sup> IRC section 162. However, see special rules in IRC sections 419 and 419A for the deductibility of contributions to welfare benefit plans with respect to medical benefits for employees and their dependents.

<sup>462</sup> IRC section 106.

<sup>463</sup> IRC section 125(a).

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

results in gross income to the employee, regardless of what benefit is elected and when the election is made.<sup>464</sup> A cafeteria plan is a separate written plan under which all participants are employees, and participants are permitted to choose among at least one permitted taxable benefit (for example, current cash compensation) and at least one qualified benefit. Finally, a cafeteria plan must not provide for deferral of compensation, except as specifically permitted in IRC sections 125(d)(2)(B), (C), or (D).

### Qualified Benefits

Qualified benefits under a cafeteria plan are generally employer-provided benefits that are not includable in gross income under an express provision of the IRC. Examples of qualified benefits include employer-provided health insurance coverage, group term life insurance coverage not in excess of \$50,000, and benefits under a dependent care assistance program. In order to be excludable, any qualified benefit elected under a cafeteria plan must independently satisfy any requirements under the IRC section that provides the exclusion. However, some employer-provided benefits that are not includable in gross income under an express provision of the IRC are explicitly not allowed in a cafeteria plan. These benefits are generally referred to as nonqualified benefits. Examples of nonqualified benefits include scholarships;<sup>465</sup> employer-provided meals and lodging;<sup>466</sup> educational assistance;<sup>467</sup> and fringe benefits.<sup>468</sup> A plan offering any nonqualified benefit is not a cafeteria plan.<sup>469</sup>

### Payment of Health Insurance Premiums through a Cafeteria Plan

Employees participating in a cafeteria plan may be able to pay the portion of premiums for health insurance coverage not otherwise paid for by their employers on a pre-tax basis through salary reduction.<sup>470</sup> Such salary-reduction contributions are treated as employer contributions for purposes of the IRC, and are thus excluded from gross income.

One way that employers can offer employer-provided health insurance coverage for purposes of the tax exclusion is to offer to reimburse employees for the premiums for health insurance purchased by employees in the individual health insurance market. The payment or

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<sup>464</sup> Proposed Treas. Reg. section 1.125-1(b).

<sup>465</sup> IRC section 117.

<sup>466</sup> IRC section 119.

<sup>467</sup> IRC section 127.

<sup>468</sup> IRC section 132.

<sup>469</sup> Proposed Treas. Reg. section 1.125-1(q). Long-term care services, contributions to Archer Medical Savings Accounts, group term life insurance for an employee's spouse, child or dependent, and elective deferrals to IRC section 403(b) plans are also nonqualified benefits.

<sup>470</sup> IRC section 125.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

reimbursement of employees' substantiated individual health insurance premiums is excludible from employees' gross income.<sup>471</sup> This reimbursement for individual health insurance premiums can also be paid for through salary reduction under a cafeteria plan.<sup>472</sup> This offer to reimburse individual health insurance premiums constitutes a group health plan.

New Federal Law (IRC section 125)

Under the provision, reimbursement (or direct payment) for the premiums for coverage under any qualified health plan (as defined in section 1301(a) of this Act) offered through an Exchange established under section 1311 of this Act is a qualified benefit under a cafeteria plan if the employer is a qualified employer. Under section 1312(f)(2) of this Act, a qualified employer is generally a small employer that elects to make all its full-time employees eligible for one or more qualified plans offered in the small group market through an Exchange.<sup>473</sup> Otherwise, reimbursement (or direct payment) for the premiums for coverage under any qualified health plan offered through an Exchange is not a qualified benefit under a cafeteria plan. Thus, an employer that is not a qualified employer cannot offer to reimburse an employee for the premium for a qualified plan that the employee purchases through the individual market in an Exchange as a health insurance coverage option under its cafeteria plan.

Effective Date

This provision applies to taxable years beginning after December 31, 2013.

California Law (R&TC sections 17131 and 17131.5)

For taxable years beginning on or after January 1, 2010, California conforms by reference to IRC section 125, relating to cafeteria plans, in R&TC section 17131 as of the "specified date" of January 1, 2009, with modifications. Thus, California does not conform to this provision.

Impact on California Revenue

Negligible—the Joint Committee on Taxation estimates that this provision will result in negligible revenue losses; thus, California revenue losses as a result of conforming to this provision would also be negligible.

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<sup>471</sup> Rev. Rul. 61-146 (1961-2 CB 25).

<sup>472</sup> Proposed Treas. Reg. section 1.125-1(m).

<sup>473</sup> Beginning in 2017, each state may allow issuers of health insurance coverage in the large group market in a state to offer qualified plans in the large group market. In that event, a qualified employer includes a small employer that elects to make all its full-time employees eligible for one or more qualified plans offered in the large group market through an Exchange.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

<u>Section</u>	<u>Section Title</u>
1562	Conforming Amendments

Background

The Health Insurance Portability and Accountability Act of 1996 ("HIPAA")<sup>474</sup> imposes a number of requirements with respect to group health coverage that are designed to provide protections to health plan participants. These protections include limitations on exclusions from coverage based on pre-existing conditions; the prohibition of discrimination on the basis of health status; guaranteed renewability in multiemployer plans and certain employer welfare arrangements; standards relating to benefits for mother and newborns; parity in the application of certain limits to mental health benefits; and coverage of dependent students on medically necessary leave of absence. The requirements are enforced through the IRC, ERISA,<sup>475</sup> and PHSА.<sup>476</sup> The HIPAA requirements in the IRC are in chapter 100 of Subtitle K, Group Health Plan Requirements.

A group health plan is defined as a plan (including a self-insured plan) of, or contributed to by, an employer (including a self-employed person) or employee organization to provide health care (directly or otherwise) to the employees, former employees, the employer, others associated or formerly associated with the employer in a business relationship, or their families.<sup>477</sup>

The IRC imposes an excise tax on group health plans which fail to meet the HIPAA requirements.<sup>478</sup> 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: (1) 10 percent of the employer's group health plan expenses for the prior year; or (2) \$500,000. No tax is imposed if the Secretary of the Treasury 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 9815)

The provision adds new IRC section 9815 that provides that the provisions of part A of title XXVII of the PHSА (as amended by this Act) apply to group health plans, and health insurance issuers providing health insurance coverage in connection with group health plans, as if included in the HIPAA provisions of the IRC. To the extent that any HIPAA provision of the IRC conflicts with a

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<sup>474</sup> Public Law 104-191.

<sup>475</sup> Public Law 93-406.

<sup>476</sup> 42 U.S.C. 6A.

<sup>477</sup> The requirements do not apply to any governmental plan or any group health plan that has fewer than two participants who are current employees.

<sup>478</sup> IRC section 4980D.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

provision of part A of title XXVII of the PHSA with respect to group health plans, or health insurance issuers providing health insurance coverage in connection with group health plans, the provisions of such part A generally apply.

The provisions of part A of title XXVII of the PHSA added by section 1001 of this Act that are incorporated by reference in new IRC section 9815 include the following: section 2711 (No lifetime or annual limits); section 2712 (Prohibition on rescissions); section 2713 (Coverage of preventive health services); section 2714 (Extension of dependent coverage); section 2715 (Development and utilization of uniform explanation of coverage documents and standardized definitions); section 2716 (Prohibition of discrimination based on salary); section 2717 (Ensuring the quality of care); section 2718 (Bringing down the cost of health care coverage); and section 2719 (Appeals process). These new sections of the PHSA, which relate to individual and group market reforms, are effective six months after March 23, 2010.

The provisions of part A of title XXVII of the PHSA added by section 1201 of this Act that are incorporated by reference in new IRC section 9815 include the following: section 2704 (Prohibition of preexisting condition exclusions or other discrimination based on health status); section 2701 (Fair health insurance premiums); section 2702 (Guaranteed availability of coverage) section 2703 (Guaranteed renewability of coverage); section 2705 (Prohibiting discrimination against individual participants and beneficiaries based on health status); section 2706 (Non-discrimination in health care); section 2707 (Comprehensive health insurance coverage); and section 2708 (Prohibition on excessive waiting periods). These new sections of the PHSA, which relate to general health insurance reforms, are effective for plan years beginning on or after January 1, 2014.

New IRC section 9815 specifies that section 2716 (Prohibition of discrimination based on salary) and 2718 (Bringing down the cost of health coverage) of title XXVII of the PHSA (as amended by this Act) do not apply under the IRC provisions of HIPAA with respect to self-insured group health plans.

As a result of incorporating these HIPAA provision by reference, the excise tax that applies in the event of a violation of present law HIPAA requirements also applies in the event of a violation of these new requirements.

#### Effective Date

This provision is effective on March 23, 2010.

#### California Law

The FTB does not administer excise taxes. Defer to the Board of Equalization (BOE).

#### Impact on California Revenue

Defer to the BOE.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

<u>Section</u>	<u>Section Title</u>
3308	Reducing Part D Premium Subsidy for High-Income Beneficiaries

Background

IRC section 6103 provides that returns and return information are confidential and may not be disclosed by the IRS, other federal employees, state employees, and certain others having access to such information except as provided in the IRC. IRC section 6103 contains a number of exceptions to the general rule of nondisclosure that authorize disclosure in specifically identified circumstances. For example, IRC section 6103 provides for the disclosure of certain return information for purposes of establishing the appropriate amount of any Medicare Part B premium subsidy adjustment.

Specifically, upon written request from the Commissioner of Social Security, the IRS may disclose the following limited return information of a taxpayer whose premium, according to the records of the Secretary, may be subject to adjustment under section 1839(i) of the Social Security Act (relating to Medicare Part B):

- Taxpayer identity information with respect to such taxpayer;
- The filing status of the taxpayer;
- The adjusted gross income of such taxpayer;
- The amounts excluded from such taxpayer's gross income under IRC sections 135 and 911 to the extent such information is available;
- The interest received or accrued during the taxable year which is exempt from the tax imposed by chapter 1 of the IRC to the extent such information is available;
- The amounts excluded from such taxpayer's gross income by IRC sections 931 and 933 to the extent such information is available;
- Such other information relating to the liability of the taxpayer as is prescribed by the Secretary by regulation as might indicate that the amount of the premium of the taxpayer may be subject to an adjustment and the amount of such adjustment; and
- The taxable year with respect to which the preceding information relates.

This return information may be used by officers, employees, and contractors of the Social Security Administration only for the purposes of, and to the extent necessary in, establishing the appropriate amount of any Medicare Part B premium subsidy adjustment.

IRC section 6103(p)(4) requires, as a condition of receiving returns and return information, that federal and state agencies (and certain other recipients) provide safeguards as prescribed by the

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

Secretary by regulation to be necessary or appropriate to protect the confidentiality of returns or return information. Unauthorized disclosure of a return or return information is a felony punishable by a fine not exceeding \$5,000 or imprisonment of not more than five years, or both, together with the costs of prosecution.<sup>479</sup> The unauthorized inspection of a return or return information is punishable by a fine not exceeding \$1,000 or imprisonment of not more than one year, or both, together with the costs of prosecution.<sup>480</sup> An action for civil damages also may be brought for unauthorized disclosure or inspection.<sup>481</sup>

New Federal Law (IRC section 6103)

Upon written request from the Commissioner of Social Security, the IRS may disclose the following limited return information of a taxpayer whose Medicare Part D premium subsidy, according to the records of the Secretary, may be subject to adjustment:

- Taxpayer identity information with respect to such taxpayer;
- The filing status of the taxpayer;
- The adjusted gross income of such taxpayer;
- The amounts excluded from such taxpayer's gross income under IRC sections 135 and 911 to the extent such information is available;
- The interest received or accrued during the taxable year which is exempt from the tax imposed by chapter 1 of the IRC to the extent such information is available;
- The amounts excluded from such taxpayer's gross income by IRC sections 931 and 933 to the extent such information is available;
- Such other information relating to the liability of the taxpayer as is prescribed by the Secretary by regulation as might indicate that the amount of the Part D premium of the taxpayer may be subject to an adjustment and the amount of such adjustment; and
- The taxable year with respect to which the preceding information relates.

This return information may be used by officers, employees, and contractors of the Social Security Administration only for the purposes of, and to the extent necessary in, establishing the appropriate amount of any Medicare Part D premium subsidy adjustment.

For purposes of both the Medicare Part B premium subsidy adjustment and the Medicare Part D premium subsidy adjustment, the provision provides that the Social Security Administration may

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<sup>479</sup> IRC section 7213.

<sup>480</sup> IRC section 7213A.

<sup>481</sup> IRC section 7431.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

re-disclose only taxpayer identity and the amount of premium subsidy adjustment to officers and employees and contractors of the Centers for Medicare and Medicaid Services, and officers and employees of the Office of Personnel Management and the Railroad Retirement Board. This re-disclosure is permitted only to the extent necessary for the collection of the premium subsidy amount from the taxpayers under the jurisdiction of the respective agencies.

Further, the Social Security Administration may re-disclose the return information received under this provision to officers and employees of the Department of HHS to the extent necessary to resolve administrative appeals of the Part B and Part D subsidy adjustments and to officers and employees of the Department of Justice to the extent necessary for use in judicial proceedings related to establishing and collecting the appropriate amount of any Medicare Part B or Medicare Part D premium subsidy adjustments.

Effective Date

The provision is effective on March 23, 2010.

California Law (R&TC sections 19542 - 19564)

The FTB receives certain information from the IRS, and is required to follow the federal rules under IRC section 6103, relating to confidentiality and disclosure of returns and return information. Additionally, California law provides specific disclosure rules and penalties for returns and other information provided to the FTB. Because this provision relates solely to disclosures between the IRS and other federal agencies, it is not applicable under California law.

Impact on California Revenue

Not applicable.

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PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

<u>Section</u>	<u>Section Title</u>
6301	Patient-Centered Outcomes Research

Background

None.

New Federal Law (IRC sections 501, 4001, 4371, 4375, 4376, 4377, 9501, and 9511)

Patient-Centered Outcomes Research Trust Fund

Under new IRC section 9511, there is established in the Treasury of the United States a trust fund, the Patient Centered Outcomes Research Trust Fund ("PCORTF"), to carry out the provisions in this Act relating to comparative effectiveness research. The PCORTF is funded in part from fees imposed on health plans under new IRC sections 4375 through 4377.

Fee on Insured and Self-Insured Health Plans

*Insured plans*

Under new IRC section 4375, a fee is imposed on each specified health insurance policy. The fee is equal to two dollars (one dollar in the case of policy years ending during fiscal year 2013) multiplied by the average number of lives covered under the policy. For any policy year beginning after September 30, 2014, the dollar amount is equal to the sum of: (1) the dollar amount for policy years ending in the preceding fiscal year; plus (2) an amount equal to the product of (a) the dollar amount for policy years ending in the preceding fiscal year, multiplied by (b) the percentage increase in the projected per capita amount of National Health Expenditures, as most recently published by the Secretary before the beginning of the fiscal year. The issuer of the policy is liable for payment of the fee. A specified health insurance policy includes any accident or health insurance policy<sup>482</sup> issued with respect to individuals residing in the United States.<sup>483</sup> An arrangement under which fixed payments of premiums are received as consideration for a person's agreement to provide, or arrange for the provision of, accident or health coverage to residents of the United States, regardless of how such coverage is provided or arranged to be provided, is treated as a specified health insurance policy. The person agreeing to provide or arrange for the provision of coverage is treated as the issuer.

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<sup>482</sup> A specified health insurance policy does not include insurance if substantially all of the coverage provided under such policy consists of excepted benefits described in IRC section 9832(c). Examples of excepted benefits described in IRC section 9832(c) are coverage for only accident, or disability insurance, or any combination thereof; liability insurance, including general liability insurance and automobile liability insurance; workers' compensation or similar insurance; automobile medical payment insurance; coverage for on-site medical clinics; limited scope dental or vision benefits; benefits for long term care, nursing home care, community based care, or any combination thereof; coverage only for a specified disease or illness; hospital indemnity or other fixed indemnity insurance; and Medicare supplemental coverage.

<sup>483</sup> Under the provision, the United States includes any possession of the United States.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

*Self-insured plans*

In the case of an applicable self-insured health plan, new IRC section 4376 imposes a fee equal to two dollars (one dollar in the case of policy years ending during fiscal year 2013) multiplied by the average number of lives covered under the plan. For any policy year beginning after September 30, 2014, the dollar amount is equal to the sum of: (1) the dollar amount for policy years ending in the preceding fiscal year; plus (2) an amount equal to the product of (a) the dollar amount for policy years ending in the preceding fiscal year, multiplied by (b) the percentage increase in the projected per capita amount of National Health Expenditures, as most recently published by the Secretary before the beginning of the fiscal year. The plan sponsor is liable for payment of the fee. For purposes of the provision, the plan sponsor is: (1) the employer in the case of a plan established or maintained by a single employer; or (2) the employee organization in the case of a plan established or maintained by an employee organization. In the case of a plan established or maintained by two or more employers or jointly by one or more employers and one or more employee organizations, a multiple employer welfare arrangement, or a voluntary employees' beneficiary association described in IRC section 501(c)(9) ("VEBA"), the plan sponsor is the association, committee, joint board of trustees, or other similar group of representatives of the parties who establish or maintain the plan. In the case of a rural electric cooperative or a rural telephone cooperative, the plan sponsor is the cooperative or association.

Under the provision, an applicable self-insured health plan is any plan providing accident or health coverage if any portion of such coverage is provided other than through an insurance policy and such plan is established or maintained: (1) by one or more employers for the benefit of their employees or former employees; (2) by one or more employee organizations for the benefit of their members or former members; (3) jointly by one or more employers and one or more employee organizations for the benefit of employees or former employees; (4) by a VEBA; (5) by any organization described in IRC section 501(c)(6); or (6) in the case of a plan not previously described, by a multiple employer welfare arrangement (as defined in section 3(40) of ERISA, a rural electric cooperative (as defined in section 3(40)(B)(iv) of ERISA), or a rural telephone cooperative association (as defined in section 3(40)(B)(v) of ERISA).

*Other special rules*

Governmental entities are generally not exempt from the fees imposed under the provision. There is an exception for exempt governmental programs including, Medicare, Medicaid, SCHIP, and any program established by federal law for providing medical care (other than through insurance policies) to members of the Armed Forces, veterans, or members of Indian tribes.

No amount collected from the fee on health insurance and self-insured plans is covered over to any possession of the United States. For purposes of the IRC's procedure and administration rules, the fee imposed under the provision is treated as a tax. The fees imposed under new IRC sections 4375 and 4376 do not apply to plan years ending after September 31, 2019.

Effective Date

The fee on health insurance and self-insured plans is effective with respect to policies and plans for portions of policy or plan years beginning on or after October 1, 2012.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

California Law

Changes to IRC section 501

The provision amends IRC section 501 to provide tax-exempt status to the Patient Centered Outcomes Research Institute. California does not conform to IRC section 501, but instead has stand-alone law that provides rules for tax-exempt organizations. Generally, to obtain California tax-exempt status, an organization is required to file an exempt application<sup>484</sup> with the FTB 90 calendar days before the exemption is needed. An organization obtains tax-exempt status upon receiving a letter from the FTB exempting the organization from tax.

Fee on Insured and Self-Insured Health Plans

The FTB does not administer excise taxes. Defer to the Board of Equalization (BOE).

Impact on California Revenue

Defer to the BOE.

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<u>Section</u>	<u>Section Title</u>
9001	Excise Tax on High-Cost Employer-Sponsored Health Coverage

*Includes amendments made by:*

<u>Act/Section</u>	<u>Section Title</u>
PPACA section 10901	Modifications to Excise Tax on High-Cost Employer-Sponsored Health Coverage
HCERA section 1401	High-Cost Plan Excise Tax

Background

Taxation of Insurance Companies

Current law provides special rules for determining the taxable income of insurance companies (Subchapter L of the IRC). Separate sets of rules apply to life insurance companies and to property and casualty insurance companies. Insurance companies generally are subject to federal income tax at regular corporate income tax rates.

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<sup>484</sup> Form FTB 3500, Exemption Application, or form FTB 3500A, Submission of Exemption Request.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

An insurance company that provides health insurance is subject to federal income tax as either a life insurance company or as a property insurance company, depending on its mix of lines of business and on the resulting portion of its reserves that are treated as life insurance reserves. For federal income tax purposes, an insurance company is treated as a life insurance company if the sum of its (a) life insurance reserves and (b) unearned premiums and unpaid losses on noncancellable life, accident or health contracts not included in life insurance reserves, comprise more than 50 percent of its total reserves.<sup>485</sup>

Some insurance providers may be exempt from federal income tax under IRC section 501(a) if specific requirements are satisfied. IRC section 501(c)(8), for example, describes certain fraternal beneficiary societies, orders, or associations operating under the lodge system or for the exclusive benefit of their members that provide for the payment of life, sick, accident, or other benefits to the members or their dependents. IRC section 501(c)(9) describes certain voluntary employees' beneficiary associations that provide for the payment of life, sick, accident, or other benefits to the members of the association or their dependents or designated beneficiaries. IRC section 501(c)(12)(A) describes certain benevolent life insurance associations of a purely local character. IRC section 501(c)(15) describes certain small non-life insurance companies with annual gross receipts of no more than \$600,000 (\$150,000 in the case of a mutual insurance company). IRC section 501(c)(26) describes certain membership organizations established to provide health insurance to certain high-risk individuals. IRC section 501(c)(27) describes certain organizations established to provide workmen's compensation insurance. A health maintenance organization that is tax-exempt under IRC section 501(c)(3) or (4) is not treated as providing prohibited<sup>486</sup> commercial-type insurance, in the case of incidental health insurance provided by the health maintenance organization that is of a kind customarily provided by such organizations.

#### Treatment of Employer-Sponsored Health Coverage

As with other compensation, the cost of employer-provided health coverage is a deductible business expense under IRC section 162.<sup>487</sup> Employer-provided health insurance coverage is generally not included in an employee's gross income.

In addition, employees participating in a cafeteria plan may be able to pay the portion of premiums for health insurance coverage not otherwise paid for by their employers on a pre-tax basis through salary reduction.<sup>488</sup> Such salary-reduction contributions are treated as employer contributions for federal income purposes, and are thus excluded from gross income.

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<sup>485</sup> IRC section 816(a).

<sup>486</sup> IRC section 501(m).

<sup>487</sup> IRC section 162. However see special rules in IRC sections 419 and 419A for the deductibility of contributions to welfare benefit plans with respect to medical benefits for employees and their dependents.

<sup>488</sup> IRC section 125.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

Employers may agree to reimburse medical expenses of their employees (and their spouses and dependents), not covered by a health insurance plan, through flexible spending arrangements which allow reimbursement not in excess of a specified dollar amount (either elected by an employee under a cafeteria plan or otherwise specified by the employer). Reimbursements under these arrangements are also excludible from gross income as employer-provided health coverage.

A flexible spending arrangement for medical expenses under a cafeteria plan ("Health FSA") is an unfunded arrangement under which employees are given the option to reduce their current cash compensation and instead have the amount made available for use in reimbursing the employee for his or her medical expenses.<sup>489</sup> Health FSAs that are funded on a salary-reduction basis are subject to the requirements for cafeteria plans, including a requirement that amounts remaining under a Health FSA at the end of a plan year must be forfeited by the employee (referred to as the "use-it-or-lose-it rule").<sup>490</sup>

Alternatively, the employer may specify a dollar amount that is available for medical expense reimbursement. These arrangements are commonly called Health Reimbursement Arrangements ("HRAs"). Some of the rules applicable to HRAs and Health FSAs are similar (e.g., the amounts in the arrangements can only be used to reimburse medical expenses and not for other purposes), but the rules are not identical. In particular, HRAs cannot be funded on a salary-reduction basis and the use-it-or-lose-it rule does not apply. Thus, amounts remaining at the end of the year may be carried forward to be used to reimburse medical expenses in following years.<sup>491</sup>

Current law provides that individuals with a high-deductible health plan (and generally no other health plan) may establish and make tax-deductible contributions to a health savings account ("HSA"). An HSA is subject to a condition that the individual is covered under a high-deductible health plan (purchased either through the individual market or through an employer). Subject to certain limitations,<sup>492</sup> contributions made to an HSA by an employer, including contributions made through a cafeteria plan through salary reduction, are excluded from income (and from wages for payroll tax purposes). Contributions made by individuals are deductible for income tax purposes, regardless of whether the individuals itemize. Like an HSA, an Archer MSA is a tax-exempt trust or custodial account to which tax-deductible contributions may be made by individuals with a high-

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<sup>489</sup> IRC section 125. Prop. Treas. Reg. section 1.125-5 provides rules for Health FSAs. There is a similar type of flexible spending arrangement for dependent care expenses.

<sup>490</sup> IRC section 125(d)(2). A cafeteria plan is permitted to allow a grace period not to exceed two and one-half months immediately following the end of the plan year during which unused amounts may be used. Notice 2005-42, 2005-1 C.B. 1204.

<sup>491</sup> Guidance with respect to HRAs, including the interaction of FSAs and HRAs in the case of an individual covered under both, is provided in Notice 2002-45, 2002-2 C.B. 93.

<sup>492</sup> For 2010, the maximum aggregate annual contribution that can be made to an HSA is \$3,050 in the case of self-only coverage and \$6,150 in the case of family coverage. The annual contribution limits are increased for individuals who have attained age 55 by the end of the taxable year (referred to as "catch-up contributions"). In the case of policyholders and covered spouses who are age 55 or older, the HSA annual contribution limit is greater than the otherwise applicable limit by \$1,000 in 2009 and thereafter. Contributions, including catch-up contributions, cannot be made once an individual is enrolled in Medicare.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

deductible health plan; however, only self-employed individuals and employees of small employers are eligible to have an Archer MSA. Archer MSAs provide tax benefits similar to, but generally not as favorable as, those provided by HSAs for individuals covered by high-deductible health plans.<sup>493</sup>

ERISA<sup>494</sup> preempts state law relating to certain employee benefit plans, including employer-sponsored health plans. While ERISA specifically provides that its preemption rule does not exempt or relieve any person from any state law which regulates insurance, ERISA also provides that an employee benefit plan is not deemed to be engaged in the business of insurance for purposes of any state law regulating insurance companies or insurance contracts. As a result of this ERISA preemption, self-insured employer-sponsored health plans need not provide benefits that are mandated under state insurance law.

While ERISA does not require an employer to offer health benefits, it does require compliance if an employer chooses to offer health benefits, such as compliance with plan fiduciary standards, reporting and disclosure requirements, and procedures for appealing denied benefit claims. ERISA was amended (as well as the PHSA and the IRC) by COBRA<sup>495</sup> and HIPAA,<sup>496</sup> which added other federal requirements for health plans, including rules for health care continuation coverage, limitations on exclusions from coverage based on preexisting conditions, and a few benefit requirements such as minimum hospital stay requirements for mothers following the birth of a child.

COBRA requires that a group health plan offer continuation coverage to qualified beneficiaries in the case of a qualifying event (such as a loss of employment).<sup>497</sup> A plan may require payment of a premium for any period of continuation coverage. The amount of such premium generally may not exceed 102 percent of the "applicable premium" for such period and the premium must be payable, at the election of the payor, in monthly installments. The applicable premium for any period of continuation coverage means the cost to the plan for such period of coverage for similarly situated non-COBRA beneficiaries with respect to whom a qualifying event has not occurred, and is determined without regard to whether the cost is paid by the employer or employee. There are special rules for determining the applicable premium in the case of self-

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<sup>493</sup> In addition to being limited to self-employed individuals and employees of small employers, the definition of a high-deductible health plan for an Archer MSA differs from that for an HSA. After 2007, no new contributions can be made to Archer MSAs except by or on behalf of individuals who previously had made Archer MSA contributions and employees who are employed by a participating employer.

<sup>494</sup> Public Law 93-406.

<sup>495</sup> Public Law 99-272.

<sup>496</sup> Public Law 104-191.

<sup>497</sup> A group health plan is defined as a plan (including a self-insured plan) of, or contributed to by, an employer (including a self-employed person) or employee organization to provide health care (directly or otherwise) to the employees, former employees, the employer, others associated or formerly associated with the employer in a business relationship, or their families. The COBRA requirements are enforced through the IRC, ERISA, and the PHSA.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

insured plans. Under the special rules for self-insured plans, the applicable premium generally is equal to a reasonable estimate of the cost of providing coverage for similarly situated beneficiaries which is determined on an actuarial basis and takes into account such other factors as the Secretary of Treasury may prescribe in regulations.

Current law imposes an excise tax on group health plans that fail to meet HIPAA and COBRA requirements.<sup>498</sup> The excise tax generally is equal to \$100 per day per failure during the period of noncompliance and is imposed on the employer sponsoring the plan.

#### Deduction for Health Insurance Costs of Self-Employed Individuals

Under current law, self-employed individuals may deduct the cost of health insurance for themselves and their spouses and dependents.<sup>499</sup> The deduction is not available for any month in which the self-employed individual is eligible to participate in an employer-subsidized health plan. Moreover, the deduction may not exceed the individual's earned income from self-employment. The deduction applies only to the cost of insurance (i.e., it does not apply to out-of-pocket expenses that are not reimbursed by insurance). The deduction does not apply for self-employment tax purposes. For purposes of the deduction, a more-than-two-percent-shareholder-employee of an S corporation is treated the same as a self-employed individual. Thus, the exclusion for employer provided health care coverage does not apply to such individuals, but they are entitled to the deduction for health insurance costs as if they were self-employed.

#### Deductibility of Excise Taxes

In general, excise taxes may be deductible under IRC section 162 if such taxes are paid or incurred in carrying on a trade or business, and are not within the scope of the disallowance of deductions for certain taxes enumerated in IRC section 275.

#### New Federal Law (IRC section 4980I)

The provision imposes an excise tax on insurers if the aggregate value of employer-sponsored health insurance coverage for an employee (including, for purposes of the provision, any former employee, surviving spouse and any other primary insured individual) exceeds a threshold amount. The tax is equal to 40 percent of the aggregate value that exceeds the threshold amount. For 2018, the threshold amount is \$10,200 for individual coverage and \$27,500 for family coverage, multiplied by the health cost adjustment percentage (as defined below) and increased by the age and gender adjusted excess premium amount (as defined below).

The health cost adjustment percentage is designed to increase the thresholds in the event that the actual growth in the cost of U.S. health care between 2010 and 2018 exceeds the projected growth for that period. The health cost adjustment percentage is equal to 100 percent plus the excess, if any, of the percentage by which the per employee cost of coverage under the Blue

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<sup>498</sup> IRC sections 4980B and 4980D.

<sup>499</sup> IRC section 162(l).

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

Cross/Blue Shield standard benefit option under the Federal Employees Health Benefits Plan ("standard FEHBP coverage")<sup>500</sup> for plan year 2018 (as determined using the benefit package for standard FEHBP coverage for plan year 2010) exceeds the per employee cost of standard FEHBP coverage for plan year 2010, over 55 percent. In 2019, the threshold amounts, after application of the health cost adjustment percentage in 2018, if any, are indexed to the CPI-U, as determined by the Department of Labor, plus one percentage point, rounded to the nearest \$50. In 2020 and thereafter, the threshold amounts are indexed to the CPI-U as determined by the Department of Labor, rounded to the nearest \$50.

For each employee (other than for certain retirees and employees in high-risk professions, whose thresholds are adjusted under rules described below), the age and gender adjusted excess premium amount is equal to the excess, if any, of the premium cost of standard FEHBP coverage for the type of coverage provided to the individual if priced for the age and gender characteristics of all employees of the individual's employer, over the premium cost, determined under procedures proscribed by the Secretary, for that coverage if priced for the age and gender characteristics of the national workforce.

For example, if the growth in the cost of health care during the period between 2010 and 2018, calculated by reference to the growth in the per employee cost of standard FEHBP coverage during that period (holding benefits under the standard FEHBP plan constant during the period) is 57 percent, the threshold amounts for 2018 will be \$10,200 for individual coverage and \$27,500 for family coverage, multiplied by 102 percent (100 percent plus the excess of 57 percent over 55 percent), or \$10,404 for individual coverage and \$28,050 for family coverage. In 2019, the new threshold amounts of \$10,404 for individual coverage and \$28,050 for family coverage are indexed for CPI-U, plus one percentage point, rounded to the nearest \$50. Beginning in 2020, the threshold amounts are indexed to the CPI-U, rounded to the nearest \$50.

The new threshold amounts (as indexed) are then increased for any employee by the age and gender adjusted excess premium amount, if any. For an employee with individual coverage in 2019, if standard FEHBP coverage priced for the age and gender characteristics of the workforce of the employee's employer is \$11,400 and the Secretary estimates that the premium cost for individual standard FEHBP coverage priced for the age and gender characteristics of the national workforce is \$10,500, the threshold for that employee is increased by \$900 (\$11,400 less \$10,500) to \$11,304 (\$10,404 plus \$900).

The excise tax is imposed pro rata on the issuers of the insurance. In the case of a self-insured group health plan, a Health FSA or an HRA, the excise tax is paid by the entity that administers benefits under the plan or arrangement ("plan administrator"). Where the employer acts as plan administrator to a self-insured group health plan, a Health FSA or an HRA, the excise tax is paid by the employer. Where an employer contributes to an HSA or an Archer MSA, the employer is responsible for payment of the excise tax, as the insurer.

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<sup>500</sup> For purposes of determining the health cost adjustment percentage in 2018 and the age and gender adjusted excess premium amount in any year, in the event the standard Blue Cross/Blue Shield option is not available under the Federal Employees Health Benefit Plan for such year, the Secretary will determine the health cost adjustment percentage by reference to a substantially similar option available under the Federal Employees Health Benefit Plan for that year.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

Employer-sponsored health insurance coverage is health coverage under any group health plan offered by an employer to an employee without regard to whether the employer provides the coverage (and thus the coverage is excludable from the employee's gross income) or the employee pays for the coverage with after-tax dollars. Employer-sponsored health insurance coverage includes coverage under any group health plan established and maintained primarily for the civilian employees of the federal government or any of its agencies or instrumentalities and, except as provided below, of any state government or political subdivision thereof or by any of agencies or instrumentalities of such government or subdivision.

Employer-sponsored health insurance coverage includes both fully-insured and self-insured health coverage excludable from the employee's gross income, including, in the self-insured context, on-site medical clinics that offer more than a de minimis amount of medical care to employees and executive physical programs. In the case of a self-employed individual, employer-sponsored health insurance coverage is coverage for any portion of which a deduction is allowable to the self-employed individual under IRC section 162(l).

In determining the amount by which the value of employer-sponsored health insurance coverage exceeds the threshold amount, the aggregate value of all employer-sponsored health insurance coverage is taken into account, including coverage in the form of reimbursements under a Health FSA or an HRA, contributions to an HSA or Archer MSA, and, except as provided below, other supplementary health insurance coverage. The value of employer-sponsored coverage for long term care and the following benefits described in IRC section 9832(c)(1) that are excepted from the portability, access and renewability requirements of HIPAA are not taken into account in the determination of whether the value of health coverage exceeds the threshold amount:

(1) coverage only for accident or disability income insurance, or any combination of these coverages; (2) coverage issued as a supplement to liability insurance; (3) liability insurance, including general liability insurance and automobile liability insurance; (4) workers' compensation or similar insurance; (5) automobile medical payment insurance; (5) credit-only insurance; and (6) other similar insurance coverage, specified in regulations, under which benefits for medical care are secondary or incidental to other insurance benefits.

The value of employer-sponsored health insurance coverage does not include the value of independent, non-coordinated coverage described in IRC section 9832(c)(3) as excepted from the portability, access and renewability requirements of HIPAA if that coverage is purchased exclusively by the employee with after-tax dollars (or, in the case of a self-employed individual, for which a deduction under IRC section 162(l) is not allowable). The value of employer-sponsored health insurance coverage does include the value of such coverage if any portion of the coverage is employer-provided (or, in the case of a self-employed individual, if a deduction is allowable for any portion of the payment for the coverage). Coverage described in IRC section 9832(c)(3) is coverage only for a specified disease or illness or for hospital or other fixed indemnity health coverage. Fixed indemnity health coverage pays fixed dollar amounts based on the occurrence of qualifying events, including but not limited to the diagnosis of a specific disease, an accidental injury or a hospitalization, provided that the coverage is not coordinated with other health coverage.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

Finally, the value of employer-sponsored health insurance coverage does not include any coverage under a separate policy, certificate, or contract of insurance which provides benefits substantially all of which are for treatment of the mouth (including any organ or structure within the mouth) or for treatment of the eye.

#### Calculation and Proration of Excise Tax and Reporting Requirements

##### *Applicable threshold*

In general, the individual threshold applies to any employee covered by employer-sponsored health insurance coverage. The family threshold applies to an employee only if such individual and at least one other beneficiary are enrolled in coverage other than self-only coverage under an employer-sponsored health insurance plan that provides minimum essential coverage (as determined for purposes of the individual responsibility requirements) and under which the benefits provided do not vary based on whether the covered individual is the employee or other beneficiary.

For all employees covered by a multiemployer plan, the family threshold applies regardless of whether the individual maintains individual or family coverage under the plan. For purposes of the provision, a multiemployer plan is an employee health benefit plan to which more than one employer is required to contribute, which is maintained pursuant to one or more collective bargaining agreements between one or more employee organizations and more than one employer.

##### *Amount of applicable premium*

Under the provision, the aggregate value of all employer-sponsored health insurance coverage, including any supplementary health insurance coverage not excluded from the value of employer-sponsored health insurance, is generally calculated in the same manner as the applicable premiums for the taxable year for the employee determined under the rules for COBRA continuation coverage, but without regard to the excise tax. If the plan provides for the same COBRA continuation coverage premium for both individual coverage and family coverage, the plan is required to calculate separate individual and family premiums for this purpose. In determining the coverage value for retirees, employers may elect to treat pre-65 retirees together with post-65 retirees.

##### *Value of coverage in the form of Health FSA reimbursements*

In the case of a Health FSA from which reimbursements are limited to the amount of the salary reduction, the value of employer-sponsored health insurance coverage is equal to the dollar amount of the aggregate salary-reduction contributions for the year. To the extent that the Health FSA provides for employer contributions in excess of the amount of the employee's salary reduction, the value of the coverage generally is determined in the same manner as the applicable premium for COBRA continuation coverage. If the plan provides for the same COBRA continuation coverage premium for both individual coverage and family coverage, the plan is required to calculate separate individual and family premiums for this purpose.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

*Amount subject to the excise tax and reporting requirement*

The amount subject to the excise tax on high cost employer-sponsored health insurance coverage for each employee is the sum of the aggregate premiums for health insurance coverage, the amount of any salary-reduction contributions to a Health FSA for the taxable year, and the dollar amount of employer contributions to an HSA or an Archer MSA, minus the dollar amount of the threshold. The aggregate premiums for health insurance coverage include all employer-sponsored health insurance coverage including coverage for any supplementary health insurance coverage. The applicable premium for health coverage provided through an HRA is also included in this aggregate amount.

Under a separate rule,<sup>501</sup> an employer is required to disclose the aggregate premiums for health insurance coverage for each employee on his or her annual Form W-2.

Under the provision, the excise tax is allocated pro rata among the insurers, with each insurer responsible for payment of the excise tax on an amount equal to the amount subject to the total excise tax multiplied by a fraction, the numerator of which is the amount of employer-sponsored health insurance coverage provided by that insurer to the employee and the denominator of which is the aggregate value of all employer-sponsored health insurance coverage provided to the employee. In the case of a self-insured group health plan, a Health FSA or an HRA, the excise tax is allocated to the plan administrator. If an employer contributes to an HSA or an Archer MSA, the employer is responsible for payment of the excise tax, as the insurer. The employer is responsible for calculating the amount subject to the excise tax allocable to each insurer and plan administrator and for reporting these amounts to each insurer, plan administrator and the Secretary, in such form and at such time as the Secretary may prescribe. Each insurer and plan administrator is then responsible for calculating, reporting and paying the excise tax to the IRS on such forms and at such time as the Secretary may prescribe.

For example, if in 2018 an employee elects family coverage under a fully-insured health care policy covering major medical and dental with a value of \$31,000, the health cost adjustment percentage for that year is 100 percent, and the age and gender adjusted excess premium amount for the employee is \$600, the amount subject to the excise tax is \$2,900 (\$31,000 less the threshold of \$28,100 (\$27,500 multiplied by 100 percent and increased by \$600)). The employer reports \$2,900 as taxable to the insurer, which calculates and remits the excise tax to the IRS.

Alternatively, if in 2018 an employee elects family coverage under a fully-insured major medical policy with a value of \$28,500 and contributes \$2,500 to a Health FSA, the employee has an aggregate health insurance coverage value of \$31,000. If the health cost adjustment percentage for that year is 100 percent and the age and gender adjusted excess premium amount for the employee is \$600, the amount subject to the excise tax is \$2,900 (\$31,000 less the threshold of \$28,100 (\$27,500 multiplied by 100 percent and increased by \$600)). The employer reports \$2,666 ( $\$2,900 \times \$28,500 / \$31,000$ ) as taxable to the major medical insurer which then

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<sup>501</sup> See the explanation of section 9002 of this Act, "Inclusion of Cost of Employer Sponsored Health Coverage on W-2."

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

calculates and remits the excise tax to the IRS. If the employer uses a third-party administrator for the Health FSA, the employer reports \$234 ( $\$2,900 \times \$2,500/\$31,000$ ) to the administrator and the administrator calculates and remits the excise tax to the IRS. If the employer is acting as the plan administrator of the Health FSA, the employer is responsible for calculating and remitting the excise tax on the \$234 to the IRS.

#### Penalty for Underreporting Liability for Tax to Insurers

If the employer reports to insurers, plan administrators and the IRS a lower amount of insurance cost subject to the excise tax than required, the employer is subject to a penalty equal to the sum of any additional excise tax that each such insurer and administrator would have owed if the employer had reported correctly and interest attributable to that additional excise tax as determined under IRC section 6621 from the date that the tax was otherwise due to the date paid by the employer. This may occur, for example, if the employer undervalues the aggregate premium and thereby lowers the amount subject to the excise tax for all insurers and plan administrators (including the employer, when acting as plan administrator of a self-insured plan).

The penalty will not apply if it is established to the satisfaction of the Secretary that the employer neither knew, nor, exercising reasonable diligence, would have known, that the failure existed. In addition, no penalty will be imposed on any failure corrected within the 30-day period beginning on the first date that the employer knew, or exercising reasonable diligence, would have known, that the failure existed, so long as the failure is due to reasonable cause and not to willful neglect. All or part of the penalty may be waived by the Secretary in the case of any failure due to reasonable cause and not to willful neglect, to the extent that the payment of the penalty would be excessive or otherwise inequitable relative to the failure involved.

The penalty is in addition to the amount of excise tax owed, which may not be waived.

#### Increased Thresholds for Certain Retirees and Individuals in High-Risk Professions

The threshold amounts are increased for an individual who has attained age of 55 who is non-Medicare eligible and receiving employer-sponsored retiree health coverage or who is covered by a plan sponsored by an employer the majority of whose employees covered by the plan are engaged in a high-risk profession or employed to repair or install electrical and telecommunications lines. For these individuals, the threshold amount in 2018 is increased by: (1) \$1,650 for individual coverage or \$3,450 for family coverage; and (2) the age and gender adjusted excess premium amount (as defined above). In 2019, the additional \$1,650 and \$3,450 amounts are indexed to the CPI-U, plus one percentage point, rounded to the nearest \$50. In 2020 and thereafter, the additional threshold amounts are indexed to the CPI-U, rounded to the nearest \$50.

For purposes of this rule, employees considered to be engaged in a high-risk profession are law enforcement officers, employees who engage in fire protection activities, individuals who provide out-of-hospital emergency medical care (including emergency medical technicians, paramedics, and first-responders), individuals whose primary work is longshore work, and individuals engaged in the construction, mining, agriculture (not including food processing), forestry, and fishing

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

industries. A retiree with at least 20 years of employment in a high-risk profession is also eligible for the increased threshold.

Under this provision, an individual's threshold cannot be increased by more than \$1,650 for individual coverage or \$3,450 for family coverage (indexed as described above) and the age and gender adjusted excess premium amount, even if the individual would qualify for an increased threshold both on account of his or her status as a retiree over age 55 and as a participant in a plan that covers employees in a high-risk profession.

#### Deductibility of Excise Tax

Under the provision, the amount of the excise tax imposed is not deductible for federal income tax purposes.

#### Regulatory Authority

The Secretary is directed to prescribe such regulations as may be necessary to carry out the provision.

#### Effective Date

The provision is effective for taxable years beginning after December 31, 2017.

#### California Law

The FTB does not administer excise taxes. Defer to the Board of Equalization (BOE).

#### Impact on California Revenue

Defer to the BOE.

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#### Section

#### Section Title

9002

Inclusion of Cost of Employer-Sponsored Health Coverage on W-2

#### Background

In many cases, an employer pays for all or a portion of its employees' health insurance coverage as an employee benefit. This benefit often includes premiums for major medical, dental, and other supplementary health insurance coverage. Under present law, the value of employer-provided health coverage is not required to be reported to the IRS or any other federal agency.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

The value of the employer contribution to health coverage is excludible from an employee's income.<sup>502</sup>

Under current law, every employer is required to furnish each employee and the federal government with a statement of compensation information, including wages, paid by the employer to the employee, and the taxes withheld from such wages during the calendar year. The statement, made on federal Form W-2, must be provided to each employee by January 31 of the succeeding year. There is no requirement that the employer report the total value of employer-sponsored health insurance coverage on federal Form W-2,<sup>503</sup> although some employers voluntarily report the amount of salary reduction under a cafeteria plan resulting in tax-free employee benefits in box 14.

New Federal Law (IRC section 6051)

Under the provision, an employer is required to disclose on each employee's annual federal Form W-2 the value of the employee's health insurance coverage sponsored by the employer. If an employee enrolls in employer-sponsored health insurance coverage under multiple plans, the employer must disclose the aggregate value of all such health coverage (excluding the value of a health flexible spending arrangement). For example, if an employee enrolls in employer-sponsored health insurance coverage under a major medical plan, a dental plan, and a vision plan, the employer is required to report the total value of the combination of all of these health related insurance policies. For this purpose, employers generally use the same value for all similarly situated employees receiving the same category of coverage (such as single or family health insurance coverage).

To determine the value of employer-sponsored health insurance coverage, the employer calculates the applicable premiums for the taxable year for the employee under the rules for COBRA continuation coverage under IRC section 4980B(f)(4) (and accompanying Treasury regulations), including the special rule for self-insured plans. The value that the employer is required to report is the portion of the aggregate premium. If the plan provides for the same COBRA continuation coverage premium for both individual coverage and family coverage, the plan would be required to calculate separate individual and family premiums for this purpose.

Effective Date

The provision is effective for taxable years beginning after December 31, 2010.

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<sup>502</sup> IRC section 106.

<sup>503</sup> Any portion of employer sponsored coverage that is paid for by the employee with after-tax contributions is included as wages on the federal Form W-2.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

California Law (R&TC section 18631)

The FTB may request a copy of any information return that is added, on or after January 1, 2009, to Part III of Subchapter A of Chapter 61 of the IRC as a newly-required information return required to be filed with the Secretary of the Treasury.

Impact on California Revenue

Baseline.

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<u>Section</u>	<u>Section Title</u>
9003	Distributions for Medicine Qualified Only if for Prescribed Drug or Insulin

Background

Individual Deduction for Medical Expenses

Expenses for medical care, not compensated for by insurance or otherwise, are deductible by an individual under the rules relating to itemized deductions to the extent the expenses exceed 7.5 percent of adjusted gross income ("AGI").<sup>504</sup> Medical care generally is defined broadly as amounts paid for diagnoses, cure, mitigation, treatment or prevention of disease, or for the purpose of affecting any structure of the body.<sup>505</sup> However, any amount paid during a taxable year for medicine or drugs is explicitly deductible as a medical expense only if the medicine or drug is a prescribed drug or is insulin.<sup>506</sup> Thus, any amount paid for medicine available without a prescription ("over-the-counter medicine") is not deductible as a medical expense, including any medicine recommended by a physician.<sup>507</sup>

Exclusion for Employer-Provided Health Care

The IRC generally provides that employees are not taxed on (that is, may exclude from gross income) the value of employer-provided health coverage under an accident or health plan.<sup>508</sup>

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<sup>504</sup> IRC section 213(a).

<sup>505</sup> IRC section 213(d). There are certain limitations on the general definition including a rule that cosmetic surgery or similar procedures are generally not medical care.

<sup>506</sup> IRC section 213(b).

<sup>507</sup> Rev. Rul. 2003-58, 2003-1 CB 959.

<sup>508</sup> IRC section 106.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

In addition, any reimbursements under an accident or health plan for medical care expenses for employees, their spouses, and their dependents generally are excluded from gross income.<sup>509</sup> An employer may agree to reimburse expenses for medical care of its employees (and their spouses and dependents), not covered by a health insurance plan, through a flexible spending arrangement ("FSA") which allows reimbursement not in excess of a specified dollar amount. Such dollar amount is either elected by an employee under a cafeteria plan ("Health FSA") or otherwise specified by the employer under an HRA. Reimbursements under these arrangements are also excludible from gross income as employer-provided health coverage. The general definition of medical care without the explicit limitation on medicine applies for purposes of the exclusion for employer-provided health coverage and medical care.<sup>510</sup> Thus, under an HRA or under a Health FSA, amounts paid for prescription and over-the-counter medicine are treated as medical expenses, and reimbursements for such amounts are excludible from gross income.

### Medical Savings Arrangements

Present law provides that individuals with a high-deductible health plan (and generally no other health plan) purchased either through the individual market or through an employer may establish and make tax-deductible contributions to a health savings account ("HSA").<sup>511</sup> Subject to certain limitations,<sup>512</sup> contributions made to an HSA by an employer, including contributions made through a cafeteria plan through salary reduction, are excluded from income (and from wages for payroll tax purposes). Contributions made by individuals are deductible for income tax purposes, regardless of whether the individuals itemize. Distributions from an HSA that are used for qualified medical expenses are excludible from gross income.<sup>513</sup> The general definition of medical care without the explicit limitation on medicine also applies for purposes of this exclusion.<sup>514</sup> Similar rules apply for another type of medical savings arrangement called an Archer MSA.<sup>515</sup> Thus, a distribution from a HSA or an Archer MSA used to purchase over-the-counter medicine also is excludible as an amount used for qualified medical expenses.

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<sup>509</sup> IRC section 105(b).

<sup>510</sup> IRC section 105(b) provides that reimbursements for medical care within the meaning of IRC section 213(d) pursuant to employer-provided health coverage are excludible from gross income. The definition of medical care in IRC section 213(d) does not include the prescription drug limitation in IRC section 213(b).

<sup>511</sup> IRC section 223.

<sup>512</sup> For 2009, the maximum aggregate annual contribution that can be made to an HSA is \$3,000 in the case of self-only coverage and \$5,950 in the case of family coverage (\$3,050 and \$6,150 for 2010). The annual contribution limits are increased for individuals who have attained age 55 by the end of the taxable year (referred to as "catch-up contributions"). In the case of policyholders and covered spouses who are age 55 or older, the HSA annual contribution limit is greater than the otherwise applicable limit by \$1,000 in 2009 and thereafter. Contributions, including catch-up contributions, cannot be made once an individual is enrolled in Medicare.

<sup>513</sup> IRC section 223(f).

<sup>514</sup> IRC section 223(d)(2).

<sup>515</sup> IRC section 220.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

New Federal Law (IRC sections 106, 220, and 223)

Under the provision, with respect to medicines, the definition of medical expense for purposes of employer-provided health coverage (including HRAs and Health FSAs), HSAs, and Archer MSAs, is conformed to the definition for purposes of the itemized deduction for medical expenses, except that prescribed drug is determined without regard to whether the drug is available without a prescription. Thus, under the provision, the cost of over-the-counter medicines may not be reimbursed with excludible income through a Health FSA, HRA, HSA, or Archer MSA, unless the medicine is prescribed by a physician.

Effective Date

The provision is effective for expenses incurred after December 31, 2010.

California Law (R&TC sections 17085, 17131, 17131.4, 17201, 17215, 17215.1, and 17215.4)

Flexible Spending Arrangements (FSAs)

For taxable years beginning on or after January 1, 2010, California conforms to FSAs as of the “specified date” of January 1, 2009. Thus, California does not conform to this federal limitation on excludable FSA distributions for medicines.

Archer Medical Savings Accounts (MSAs)

For taxable years beginning on or after January 1, 2010, California conforms to Archer MSAs as of the “specified date” of January 1, 2009, with modifications. California law allows an Archer MSA contribution deduction equal to the amount deducted on the federal return for the same taxable year; however, because California conforms to the federal amount of qualified medical expenses as of the “specified date,” California does not conform to this federal limitation on excludable MSA distributions for medicines.

Health Savings Accounts (HSAs)

*In general*

California does not conform to any of the federal HSA provisions. Thus, contributions to an HSA are not excludable or deductible under California law.

*Rollover from an MSA to an HSA*

Because a tax-free rollover from an MSA to an HSA is not allowed under California law, any distribution from an MSA that is rolled into an HSA must be added to adjusted gross income on the taxpayer’s California return; and, as that MSA distribution is not treated as being made for qualified medical expenses, it would be subject to the MSA 10-percent additional tax.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

*Distribution from an IRA to an HSA*

Under California law, any distribution from an IRA to an HSA is includable in California income, and is subject to a two and one-half percent additional tax under the rules for premature distributions.

*One-time contribution to an HSA from an Individual Retirement Arrangement (IRA)*

Federal law allows a one-time contribution to an HSA of amounts distributed from an individual IRA. The contribution must be made in a direct trustee-to-trustee transfer. Amounts distributed from an IRA under these rules are not includable in federal gross income to the extent that the distribution would otherwise be includable. Additionally, such distributions are not subject to the 10-percent additional tax on early distributions.

Any contribution from an IRA to fund an HSA is not excludable from California income because California specifically does not conform to IRC section 223, relating to HSAs, even though California conforms to IRC section 408, relating to IRAs. Under California law, any distribution from an IRA to an HSA is includable in California gross income and is subject to a two and one-half percent additional tax under the rules for premature distributions.

Impact on California Revenue

Flexible Spending Arrangements (FSAs)

Baseline—FSAs are expected to comply with the new federal rules; thus, baseline gains are estimated to be \$30,000,000 in 2011-12, and \$19,000,000 in subsequent fiscal years. Estimates are based on a proration of federal estimates developed by the Joint Committee on Taxation.

Archer Medical Savings Accounts (MSAs)

Baseline.

Health Savings Accounts (HSAs)

Not applicable.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

<u>Section</u>	<u>Section Title</u>
9004	Increase in Additional Tax on Distributions from HSAs and Archer MSAs Not Used for Qualified Medical Expenses

Background

Health Savings Account (HSA)

Present law provides that individuals with a high-deductible health plan (and generally no other health plan) may establish and make tax-deductible contributions to a health savings account ("HSA").<sup>516</sup> An HSA is a tax-exempt account held by a trustee or custodian for the benefit of the individual. An HSA is subject to a condition that the individual is covered under a high-deductible health plan (purchased either through the individual market or through an employer). The decision to create and fund an HSA is made on an individual-by-individual basis and does not require any action on the part of the employer.

Subject to certain limitations, contributions made to an HSA by an employer, including contributions made through a cafeteria plan through salary reduction, are excluded from income (and from wages for payroll tax purposes). Contributions made by individuals are deductible for income tax purposes, regardless of whether the individuals itemize their deductions on their tax return (rather than claiming the standard deduction). Income from investments made in HSAs is not taxable and the overall income is not taxable upon disbursement for medical expenses.

For 2010, the maximum aggregate annual contribution that can be made to an HSA is \$3,050 in the case of self-only coverage and \$6,150 in the case of family coverage. The annual contribution limits are increased for individuals who have attained age 55 by the end of the taxable year (referred to as "catch-up contributions"). In the case of policyholders and covered spouses who are age 55 or older, the HSA annual contribution limit is greater than the otherwise applicable limit by \$1,000 in 2010 and thereafter. Contributions, including catch-up contributions, cannot be made once an individual is enrolled in Medicare.

A high-deductible health plan is a health plan that has an annual deductible that is at least \$1,200 for self-only coverage or \$2,400 for family coverage for 2010 and that limits the sum of the annual deductible and other payments that the individual must make with respect to covered benefits to no more than \$5,950 in the case of self-only coverage and \$11,900 in the case of family coverage for 2010.

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<sup>516</sup> An individual with other coverage in addition to a high-deductible health plan is still eligible for an HSA if such other coverage is "permitted insurance" or "permitted coverage." Permitted insurance is: (1) insurance if substantially all of the coverage provided under such insurance relates to (a) liabilities incurred under worker's compensation law, (b) tort liabilities, (c) liabilities relating to ownership or use of property (e.g., auto insurance), or (d) such other similar liabilities as the Secretary may prescribe by regulations; (2) insurance for a specified disease or illness; and (3) insurance that provides a fixed payment for hospitalization. Permitted coverage is coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care. With respect to coverage for years beginning after December 31, 2006, certain coverage under a Health FSA is disregarded in determining eligibility for an HSA.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

Distributions from an HSA that are used for qualified medical expenses are excludible from gross income. Distributions from an HSA that are not used for qualified medical expenses are includible in gross income. An additional 10 percent tax is added for all HSA disbursements not made for qualified medical expenses. The additional 10-percent tax does not apply, however, if the distribution is made after death, disability, or attainment of age of Medicare eligibility (currently, age 65). Unlike reimbursements from a flexible spending arrangement or health reimbursement arrangement, distributions from an HSA are not required to be substantiated by the employer or a third party for the distributions to be excludible from income.

As in the case of individual retirement arrangements,<sup>517</sup> the individual is the beneficial owner of his or her HSA, and thus the individual is required to maintain books and records with respect to the expense and claim the exclusion for a distribution from the HSA on their tax return. The determination of whether the distribution is for a qualified medical expense is subject to individual self-reporting and IRS enforcement.

#### Archer Medical Savings Account (MSA)

An Archer MSA is also a tax-exempt trust or custodial account to which tax-deductible contributions may be made by individuals with a high-deductible health plan.<sup>518</sup> Archer MSAs provide tax benefits similar to, but generally not as favorable as, those provided by HSAs for individuals covered by high-deductible health plans. The main differences include: (1) only self-employed individuals and employees of small employers are eligible to have an Archer MSA; (2) for Archer MSA purposes, a high-deductible health plan is a health plan with (a) an annual deductible for 2010 of at least \$2,000 and no more than \$3,000 in the case of self-only coverage and at least \$4,050 and no more than \$6,050 in the case of family coverage and (b) maximum out-of-pocket expenses for 2010 of no more than \$4,050 in the case of self-only coverage and no more than \$7,400 in the case of family coverage; and (3) the additional tax on distributions not used for medical expenses is 15 percent rather than 10 percent. After 2007, no new contributions can be made to Archer MSAs except by or on behalf of individuals who previously had made Archer MSA contributions and employees who are employed by a participating employer.

#### New Federal Law

The additional tax on distributions from an HSA or an Archer MSA that are not used for qualified medical expenses is increased to 20 percent of the disbursed amount.

#### Effective Date

The change is effective for disbursements made during tax years starting after December 31, 2010.

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<sup>517</sup> IRC section 408.

<sup>518</sup> IRC section 220.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

California Law (R&TC sections 17131, 17131.4, 17201, 17215, 17215.1, and 17215.4)

Archer MSAs

California conforms to Archer MSAs, with modifications. California law allows an Archer MSA deduction equal to the amount deducted on the federal return for the same taxable year.

For taxable years beginning on or after January 1, 2010, California conforms to IRC section 220(f)(4), relating to additional tax on distributions not used for qualified medical expenses, as of the specified date of January 1, 2009; however, California modifies the federal 15-percent additional tax on nonqualified distributions to 10-percent additional tax on such distributions. Because California's modified conformity to the MSA additional tax is as of the specified date of January 1, 2009, California does not conform to the federal increase to the additional-tax percentage.

HSA's

California does not conform to any of the federal HSA provisions. Thus, contributions to an HSA are not excludable or deductible under California law, and there are no additional taxes on HSA distributions, regardless of whether or not the distributions are nonqualified for federal purposes.

Impact on California Revenue

Archer MSAs

Estimated Revenue Impact of Increase in Additional Tax on Distributions from Archer MSAs Not Used for Qualified Medical Expenses For Distributions Made On or After January 1, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
\$200,000	\$150,000	\$150,000

Estimates are based on a proration of federal estimates developed by the Joint Committee on Taxation, adjusted to reflect California differences.

HSA's

Not applicable.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

<u>Section</u>	<u>Section Title</u>
9005	Limitation on Health Flexible Spending Arrangements under Cafeteria Plans

*Includes amendments made by:*

<u>Act/Section</u>	<u>Section Title</u>
PPACA section 10902	Inflation Adjustment of Limitation on Health Flexible Spending Arrangements under Cafeteria Plans
HCERA section 1403	Delay of Limitation on Health Flexible Spending Arrangements under Cafeteria Plans

### Background

#### Exclusion from Income for Employer-Provided Health Coverage

The IRC generally provides that the value of employer-provided health coverage under an accident or health plan is excludable from gross income.<sup>519</sup> In addition, any reimbursements under an accident or health plan for medical care expenses for employees, their spouses, and their dependents generally are excluded from gross income.<sup>520</sup> The exclusion applies both to health coverage in the case in which an employer absorbs the cost of employees' medical expenses not covered by insurance (i.e., a self-insured plan) as well as in the case in which the employer purchases health insurance coverage for its employees. There is no limit on the amount of employer-provided health coverage that is excludable. A similar rule excludes employer-provided health insurance coverage from the employees' wages for payroll tax purposes.<sup>521</sup>

Employers may also provide health coverage in the form of an agreement to reimburse medical expenses of their employees (and their spouses and dependents), not reimbursed by a health insurance plan, through flexible spending arrangements which allow reimbursement for medical care not in excess of a specified dollar amount (either elected by an employee under a cafeteria plan or otherwise specified by the employer). Health coverage provided in the form of one of these arrangements is also excludable from gross income as employer-provided health coverage under an accident or health plan.<sup>522</sup>

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<sup>519</sup> IRC section 106. Health coverage provided to active members of the uniformed services, military retirees, and their dependents are excludable under IRC section 134. That section provides an exclusion for "qualified military benefits," defined as benefits received by reason of status or service as a member of the uniformed services and which were excludable from gross income on September 9, 1986, under any provision of law, regulation, or administrative practice then in effect.

<sup>520</sup> IRC section 105(b).

<sup>521</sup> IRC sections 3121(a)(2), and 3306(a)(2). See also IRC section 3231(e)(1) for a similar rule with respect to compensation for purposes of Railroad Retirement Tax.

<sup>522</sup> IRC section 106.

## Qualified Benefits

Qualified benefits under a cafeteria plan are generally employer-provided benefits that are not includable in gross income under an express provision of the IRC. Examples of qualified benefits include employer-provided health coverage, group term life insurance coverage not in excess of 50,000, and benefits under a dependent care assistance program. In order to be excludable, any qualified benefit elected under a cafeteria plan must independently satisfy any requirements under the IRC section that provides the exclusion. However, some employer-provided benefits that are not includable in gross income under an express provision of the IRC are explicitly not allowed in a cafeteria plan. These benefits are generally referred to as nonqualified benefits. Examples of nonqualified benefits include scholarships;<sup>523</sup> employer-provided meals and lodging;<sup>524</sup> educational assistance;<sup>525</sup> and fringe benefits.<sup>526</sup> A plan offering any nonqualified benefit is not a cafeteria plan.<sup>527</sup>

## Flexible Spending Arrangement under a Cafeteria Plan

A flexible spending arrangement for medical expenses under a cafeteria plan ("Health FSA") is health coverage in the form of an unfunded arrangement under which employees are given the option to reduce their current cash compensation and instead have the amount of the salary-reduction contributions made available for use in reimbursing the employee for his or her medical expenses. Health FSAs are subject to the general requirements for cafeteria plans, including a requirement that amounts remaining under a Health FSA at the end of a plan year must be forfeited by the employee (referred to as the "use-it-or-lose-it rule").<sup>528</sup> A Health FSA is permitted to allow a grace period not to exceed two and one-half months immediately following the end of the plan year during which unused amounts may be used.<sup>529</sup> A Health FSA can also include employer flex-credits which are non-elective employer contributions that the employer makes for every employee eligible to participate in the employer's cafeteria plan, to be used only for one or more tax excludible qualified benefits (but not as cash or a taxable benefit).<sup>530</sup>

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<sup>523</sup> IRC section 117.

<sup>524</sup> IRC section 119.

<sup>525</sup> IRC section 127.

<sup>526</sup> IRC section 132.

<sup>527</sup> Proposed Treas. Reg. section 1.125-1(q). Long-term care services, contributions to Archer Medical Savings Accounts, group term life insurance for an employee's spouse, child or dependent, and elective deferrals to IRC section 403(b) plans are also nonqualified benefits.

<sup>528</sup> IRC section 125(d)(2) and proposed Treas. Reg. section 1.125-5(c).

<sup>529</sup> Notice 2005-42, 2005-1 C.B. 1204, and proposed Treas. Reg. section 1.125-1(e).

<sup>530</sup> Proposed Treas. Reg. section 1-125-5(b).

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

A flexible spending arrangement including a Health FSA (under a cafeteria plan) is generally distinguishable from other employer-provided health coverage by the relationship between the value of the coverage for a year and the maximum amount of reimbursement reasonably available during the same period. A flexible spending arrangement for health coverage generally is defined as a benefit program which provides employees with coverage under which specific incurred medical care expenses may be reimbursed (subject to reimbursement maximums and other conditions) and the maximum amount of reimbursement reasonably available is less than 500 percent of the value of such coverage.<sup>531</sup>

#### Health Reimbursement Arrangement

Rather than offering a Health FSA through a cafeteria plan, an employer may specify a dollar amount that is available for medical expense reimbursement. These arrangements are commonly called HRAs. Some of the rules applicable to HRAs and Health FSAs are similar (e.g., the amounts in the arrangements can only be used to reimburse medical expenses and not for other purposes), but the rules are not identical. In particular, HRAs cannot be funded on a salary-reduction basis and the use-it-or-lose-it rule does not apply. Thus, amounts remaining at the end of the year may be carried forward to be used to reimburse medical expenses in following years.<sup>532</sup>

#### New Federal Law (IRC section 125)

Under the provision, in order for a Health FSA to be a qualified benefit under a cafeteria plan, the maximum amount available for reimbursement of incurred medical expenses of an employee, the employee's dependents, and any other eligible beneficiaries with respect to the employee, under the Health FSA for a plan year (or other 12-month coverage period) must not exceed \$2,500.<sup>533</sup> The \$2,500 limitation is indexed to CPI-U, with any increase that is not a multiple of 50 rounded to the next lowest multiple of 50 for years beginning after December 31, 2013.

A cafeteria plan that does not include this limitation on the maximum amount available for reimbursement under any FSA is not a cafeteria plan within the meaning of IRC section 125. Thus, when an employee is given the option under a cafeteria plan maintained by an employer to reduce his or her current cash compensation and instead have the amount of the salary reduction be made available for use in reimbursing the employee for his or her medical expenses under a Health FSA, the amount of the reduction in cash compensation pursuant to a salary-reduction election must be limited to \$2,500 for a plan year.

It is intended that regulations would require all cafeteria plans of an employer to be aggregated for purposes of applying this limit. The employer for this purpose is determined after applying the

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<sup>531</sup> Sec. 106(c)(2) and proposed Treas. Reg. sec. 1.125-5(a).

<sup>532</sup> Guidance with respect to HRAs, including the interaction of FSAs and HRAs in the case of an individual covered under both, is provided in Notice 2002-45, 2002-2 C.B. 93.

<sup>533</sup> The provision does not change the present law treatment as described in proposed Treas. Reg. section 1.125-5 for dependent care flexible spending arrangements or adoption assistance flexible spending arrangements.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

employer aggregation rules in IRC section 414(b), (c), (m), and (o).<sup>534</sup> In the event of a plan year or coverage period that is less than 12 months, it is intended that the limit be required to be prorated.

The provision does not limit the amount permitted to be available for reimbursement under employer-provided health coverage offered through an HRA, including a flexible spending arrangement within the meaning of IRC section 106(c)(2), that is not part of a cafeteria plan.

Effective Date

The provision is effective for taxable year beginning after December 31, 2012.

California Law (R&TC sections 17131 and 17131.5)

For taxable years beginning on or after January 1, 2010, California conforms to IRC section 125, relating to cafeteria plans, in R&TC section 17131 as of the “specified date” of January 1, 2009, with modifications. Thus, California does not conform to this provision.

Impact on California Revenue

Baseline—health FSAs are expected to follow the new federal rules; thus, based on a proration of federal estimates developed by the Joint Committee on Taxation, it is estimated that this provision will result in baseline revenue gains of \$42 million in 2012-13 and \$70 million in subsequent fiscal years.

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<u>Section</u>	<u>Section Title</u>
9006	Expansion of Information Reporting Requirements

Background

Present law imposes a variety of information reporting requirements on participants in certain transactions.<sup>535</sup> These requirements are intended to assist taxpayers in preparing their income tax returns and to help the IRS determine whether such returns are correct and complete.

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<sup>534</sup> IRC section 414(b) provides that, for specified employee benefit purposes, all employees of all corporations which are members of a controlled group of corporations are treated as employed by a single employer. There is a similar rule in IRC section 414(c) under which all employees of trades or businesses (whether or not incorporated) which are under common control are treated under regulations as employed by a single employer, and, in IRC section 414(m), under which employees of an affiliated service group (as defined in that section) are treated as employed by a single employer. IRC section 414(o) authorizes the Treasury to issue regulations to prevent avoidance of the requirements under IRC section 414(m). IRC section 125(g)(4) applies this rule to cafeteria plans.

<sup>535</sup> IRC sections 6031 through 6060.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

The primary provision governing information reporting by payors requires an information return by every person engaged in a trade or business who makes payments aggregating \$600 or more in any taxable year to a single payee in the course of that payor's trade or business.<sup>536</sup> Payments subject to reporting include fixed or determinable income or compensation, but do not include payments for goods or certain enumerated types of payments that are subject to other specific reporting requirements.<sup>537</sup> The payor is required to provide the recipient of the payment with an annual statement showing the aggregate payments made and contact information for the payor.<sup>538</sup> The regulations generally except from reporting, payments to corporations, exempt organizations, governmental entities, international organizations, or retirement plans.<sup>539</sup> However, the following types of payments to corporations must be reported: Medical and healthcare payments;<sup>540</sup> fish purchases for cash;<sup>541</sup> attorney's fees;<sup>542</sup> gross proceeds paid to an attorney;<sup>543</sup> substitute payments in lieu of dividends or tax-exempt interest;<sup>544</sup> and payments by a federal executive agency for services.<sup>545</sup>

Failure to comply with the information reporting requirements results in penalties, which may include a penalty for failure to file the information return,<sup>546</sup> and a penalty for failure to furnish payee statements<sup>547</sup> or failure to comply with other various reporting requirements.<sup>548</sup>

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<sup>536</sup> IRC section 6041(a). The information return is generally submitted electronically as a Form-1099 or Form-1096, although certain payments to beneficiaries or employees may require use of Forms W-3 or W-2, respectively. Treas. Reg. section 1.6041-1(a)(2).

<sup>537</sup> IRC section 6041(a) requires reporting as to "other fixed or determinable gains, profits, and income (other than payments to which IRC section 6042(a)(1), 6044(a)(1), 6047(c), 6049(a) or 6050N(a) applies and other than payments with respect to which a statement is required under authority of IRC section 6042(a), 6044(a)(2), or 6045).]" These excepted payments include most interest, royalties, and dividends.

<sup>538</sup> IRC section 6041(d).

<sup>539</sup> Treas. Reg. section 1.6041-3(p). Certain for-profit health provider corporations are not covered by this general exception, including those organizations providing billing services for such companies.

<sup>540</sup> IRC section 6050T.

<sup>541</sup> IRC section 6050R.

<sup>542</sup> IRC section 6045(f)(1) and (2); Treas. Reg. sections. 1.6041-1(d)(2) and 1.6045-5(d)(5).

<sup>543</sup> IRC section 6045(f)(1) and (2); Treas. Reg. sections. 1.6041-1(d)(2) and 1.6045-5(d)(5).

<sup>544</sup> IRC section 6045(d).

<sup>545</sup> IRC section 6041(d)(3).

<sup>546</sup> IRC section 6721. The penalty for the failure to file an information return generally is \$50 for each return for which such failure occurs. The total penalty imposed on a person for all failures during a calendar year cannot exceed \$250,000. Additionally, special rules apply to reduce the per-failure and maximum penalty where the failure is corrected within a specified period.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

Detailed rules are provided for the reporting of various types of investment income, including interest, dividends, and gross proceeds from brokered transactions (such as a sale of stock).<sup>549</sup> In general, the requirement to file Form 1099 applies with respect to amounts paid to U.S. persons and is linked to the backup withholding rules of IRC section 3406. Thus, a payor of interest, dividends or gross proceeds generally must request that a U.S. payee (other than certain exempt recipients) furnish a Form W-9 providing that person's name and taxpayer identification number.<sup>550</sup> That information is then used to complete the Form 1099.

New Federal Law (IRC section 6041)

Under the provision, a business is required to file an information return for all payments aggregating \$600 or more in a calendar year to a single payee (other than a payee that is a tax-exempt corporation), notwithstanding any regulation promulgated under IRC section 6041 prior to March 23, 2010. The payments to be reported include gross proceeds paid in consideration for property or services. However, the provision does not override specific provisions elsewhere in the IRC that except certain payments from reporting, such as securities or broker transactions as defined under IRC section 6045(a) and the regulations thereunder.

Effective Date

The provision is effective for payments made after December 31, 2011.

California Law (R&TC section 18631)

The FTB may request a copy of any information return that is added, on or after January 1, 2009, to Part III of Subchapter A of Chapter 61 of the IRC as a newly-required information return required to be filed with the Secretary of the Treasury.

Impact on California Revenue

Baseline—this federal provision is expected to result in an increase in self compliance; as a result, baseline revenue gains are estimated to be \$12 million in 2011-12, \$56 million in 2012-13, and \$73 million in 2013-14.

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<sup>547</sup> IRC section 6722. The penalty for failure to provide a correct payee statement is \$50 for each statement with respect to which such failure occurs, with the total penalty for a calendar year not to exceed \$100,000. Special rules apply that increase the per-statement and total penalties where there is intentional disregard of the requirement to furnish a payee statement.

<sup>548</sup> IRC section 6723. The penalty for failure to timely comply with a specified information reporting requirement is \$50 per failure, not to exceed \$100,000 for a calendar year.

<sup>549</sup> IRC sections 6042 (dividends), 6045 (broker reporting) and 6049 (interest) and the Treasury regulations thereunder.

<sup>550</sup> See Treas. Reg. section 31.3406(h)-3.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

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<u>Section</u>	<u>Section Title</u>
9007	Additional Requirements for Charitable Hospitals

*Includes amendments made by:*

<u>Act/Section</u>	<u>Section Title</u>
PPACA section 10903	Modifications of Limitation on Charge by Charitable Hospitals

### Background

#### Tax Exemption

Charitable organizations, i.e., organizations described in IRC section 501(c)(3), generally are exempt from federal income tax, are eligible to receive tax deductible contributions,<sup>551</sup> have access to tax-exempt financing through state and local governments (described in more detail below),<sup>552</sup> and generally are exempt from state and local taxes. A charitable organization must operate primarily in pursuit of one or more tax-exempt purposes constituting the basis of its tax exemption.<sup>553</sup> The IRC specifies such purposes as religious, charitable, scientific, educational, literary, testing for public safety, to foster international amateur sports competition, or for the prevention of cruelty to children or animals. In general, an organization is organized and operated for charitable purposes if it provides relief for the poor and distressed or the underprivileged.<sup>554</sup>

The IRC does not provide a per se exemption for hospitals. Rather, a hospital qualifies for exemption if it is organized and operated for a charitable purpose and otherwise meets the requirements of IRC section 501(c)(3).<sup>555</sup> The promotion of health has been recognized by the IRS as a charitable purpose that is beneficial to the community as a whole.<sup>556</sup> It includes not only

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<sup>551</sup> IRC section 170.

<sup>552</sup> IRC section 145.

<sup>553</sup> Treas. Reg. section 1.501(c)(3)-1(c)(1).

<sup>554</sup> Treas. Reg. section 1.501(c)(3)-1(d)(2).

<sup>555</sup> Although nonprofit hospitals generally are recognized as tax exempt by virtue of being "charitable" organizations, some might qualify for exemption as educational or scientific organizations because they are organized and operated primarily for medical education and research purposes.

<sup>556</sup> Rev. Rul. 69-545, 1969-2 C.B. 117; see also Restatement (Second) of Trusts sections 368, 372 (1959); see Bruce R. Hopkins, *The Law of Tax-Exempt Organizations*, section 6.3 (8th ed. 2003) (discussing various forms of health-care providers that may qualify for exemption under IRC section 501(c)(3)).

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

the establishment or maintenance of charitable hospitals, but clinics, homes for the aged, and other providers of health care.

Since 1969, the IRS has applied a "community-benefit" standard for determining whether a hospital is charitable.<sup>557</sup> According to Revenue Ruling 69-545, community benefit can include, for example: maintaining an emergency room open to all persons regardless of ability to pay; having an independent board of trustees composed of representatives of the community; operating with an open medical staff policy, with privileges available to all qualifying physicians; providing charity care; and utilizing surplus funds to improve the quality of patient care, expand facilities, and advance medical training, education and research. Beginning in 2009, hospitals generally are required to submit information on community benefit on their annual information returns filed with the IRS.<sup>558</sup> Present law does not include sanctions short of revocation of tax-exempt status for hospitals that fail to satisfy the community-benefit standard.

Although IRC section 501(c)(3) hospitals generally are exempt from federal tax on their net income, such organizations 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.<sup>559</sup> In general, interest, rents, royalties, and annuities are excluded from the unrelated business income of tax-exempt organizations.<sup>560</sup>

#### Charitable Contributions

In general, a deduction is permitted for charitable contributions, including charitable contributions to tax-exempt hospitals, 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.<sup>561</sup>

#### Tax-Exempt Financing

In addition to issuing tax-exempt bonds for government operations and services, state and local governments may issue tax-exempt bonds to finance the activities of charitable organizations described in IRC section 501(c)(3). Because interest income on tax-exempt bonds is excluded

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<sup>557</sup> Rev. Rul. 69-545, 1969-2 C.B. 117. From 1956 until 1969, the IRS applied a "financial-ability" standard, requiring that a charitable hospital be "operated to the extent of its financial ability for those not able to pay for the services rendered and not exclusively for those who are able and expected to pay." Rev. Rul. 56-185, 1956-1 C.B. 202.

<sup>558</sup> Federal Form 990, Schedule H.

<sup>559</sup> IRC sections 511-514.

<sup>560</sup> IRC section 512(b).

<sup>561</sup> IRC sections 170, 2055, and 2522, respectively.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

from gross income, investors generally are willing to accept a lower pre-tax rate of return on such bonds than they might otherwise accept on a taxable investment. This, in turn, lowers the cost of capital for the users of such financing. Both capital expenditures and limited working capital expenditures of charitable organizations described in IRC section 501(c)(3) generally may be financed with tax-exempt bonds. Private, nonprofit hospitals frequently are the beneficiaries of this type of financing.

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 (e.g., private businesses or individuals). For these purposes, the term "nongovernmental person" generally includes the federal government and all other individuals and entities other than states or local governments, including IRC section 501(c)(3) organizations. 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.

#### Reporting and Disclosure Requirements

Exempt organizations are required to file an annual information return, stating specifically the items of gross income, receipts, disbursements, and such other information as the Secretary may prescribe.<sup>562</sup> IRC section 501(c)(3) organizations that are classified as public charities must file federal Form 990 (Return of Organization Exempt From Income Tax),<sup>563</sup> including Schedule A, which requests information specific to IRC section 501(c)(3) organizations. Additionally, an organization that operates at least one facility that is, or is required to be, licensed, registered, or similarly recognized by a state as a hospital must complete Schedule H (federal Form 990), which requests information regarding charity care, community benefits, bad-debt expense, and certain management company and joint-venture arrangements of a hospital.

An organization described in IRC section 501(c) or (d) generally is also required to make available for public inspection for a period of three years a copy of its annual information return (federal Form 990) and exemption application materials.<sup>564</sup> This requirement is satisfied if the organization has made the annual return and exemption application widely available (e.g., by posting such information on its website).<sup>565</sup>

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<sup>562</sup> IRC section 6033(a). An organization that has not received a determination of its tax-exempt status, but that claims tax-exempt status under IRC section 501(a), is subject to the same annual reporting requirements and exceptions as organizations that have received a tax-exemption determination.

<sup>563</sup> Social welfare organizations, labor organizations, agricultural organizations, horticultural organizations, and business leagues are subject to the generally applicable Form 990, Form 990-EZ, and Form 990-T annual filing requirements.

<sup>564</sup> IRC section 6104(d).

<sup>565</sup> IRC section 6104(d)(4); Treas. Reg. section 301.6104(d)-2(b).

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

New Federal Law (IRC sections 501, 4959, and 6033)

Additional Requirements for IRC section 501(c)(3) Hospitals<sup>566</sup>

*In general*

The provision establishes new requirements applicable to IRC section 501(c)(3) hospitals. The new requirements are in addition to, and not in lieu of, the requirements otherwise applicable to an organization described in IRC section 501(c)(3). The requirements generally apply to any IRC section 501(c)(3) organization that operates at least one hospital facility. For purposes of the provision, a hospital facility generally includes: (1) any facility that is, or is required to be, licensed, registered, or similarly recognized by a state as a hospital; and (2) any other facility or organization the Secretary of the Treasury (the "Secretary"), in consultation with the Secretary of HHS and after public comment, determines has the provision of hospital care as its principal purpose. To qualify for tax exemption under IRC section 501(c)(3), an organization subject to the provision is required to comply with the following requirements with respect to each hospital facility operated by such organization.

*Community health needs assessment*

Each hospital facility is required to conduct a community health needs assessment at least once every three taxable years and adopt an implementation strategy to meet the community needs identified through such assessment. The assessment may be based on current information collected by a public health agency or non-profit organizations and may be conducted together with one or more other organizations, including related organizations. The assessment process must take into account input from persons who represent the broad interests of the community served by the hospital facility, including those with special knowledge or expertise of public health issues. The hospital must disclose in its annual information report to the IRS (i.e., federal Form 990 and related schedules) how it is addressing the needs identified in the assessment and, if all identified needs are not addressed, the reasons why (e.g., lack of financial or human resources). Each hospital facility is required to make the assessment widely available. Failure to complete a community health needs assessment in any applicable three-year period results in a penalty on the organization equal to \$50,000. For example, if a facility does not complete a community health needs assessment in taxable years one, two or three, it is subject to the penalty in year three. If it then fails to complete a community health needs assessment in year four, it is subject to another penalty in year four (for failing to satisfy the requirement during the three-year period beginning with taxable year two and ending with taxable year four). An organization that fails to disclose how it is meeting needs identified in the assessment is subject to existing incomplete return penalties.<sup>567</sup>

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<sup>566</sup> No inference is intended regarding whether an organization satisfies the present-law community-benefit standard.

<sup>567</sup> IRC section 6652.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

*Financial assistance policy*

Each hospital facility is required to adopt, implement, and widely publicize a written financial assistance policy. The financial assistance policy must indicate the eligibility criteria for financial assistance and whether such assistance includes free or discounted care. For those eligible for discounted care, the policy must indicate the basis for calculating the amounts that will be billed to such patients. The policy must also indicate how to apply for such assistance. If a hospital does not have a separate billing and collections policy, the financial assistance policy must also indicate what actions the hospital may take in the event of non-response or non-payment, including collections action and reporting to credit rating agencies. Each hospital facility also is required to adopt and implement a policy to provide emergency medical treatment to individuals. The policy must prevent discrimination in the provision of emergency medical treatment, including denial of service, against those eligible for financial assistance under the facility's financial assistance policy or those eligible for government assistance.

*Limitation on charges*

Each hospital facility is permitted to bill for emergency or other medically necessary care provided to individuals who qualify for financial assistance under the facility's financial assistance policy no more than the amounts generally billed to individuals who have insurance covering such care. A hospital facility may not use gross charges (i.e., "chargemaster" rates) when billing individuals who qualify for financial assistance. It is intended that amounts billed to those who qualify for financial assistance may be based on either the best, or an average of the three best, negotiated commercial rates, or Medicare rates.

*Collection processes*

Under the provision, a hospital facility (or its affiliates) may not undertake extraordinary collection actions (even if otherwise permitted by law) against an individual without first making reasonable efforts to determine whether the individual is eligible for assistance under the hospital's financial assistance policy. Such extraordinary collection actions include lawsuits, liens on residences, arrests, body attachments, or other similar collection processes. The Secretary is directed to issue guidance concerning what constitutes reasonable efforts to determine eligibility. It is intended that for this purpose, "reasonable efforts" includes notification by the hospital of its financial assistance policy upon admission and in written and oral communications with the patient regarding the patient's bill, including invoices and telephone calls, before collection action or reporting to credit rating agencies is initiated.

**Reporting and Disclosure Requirements**

The provision includes new reporting and disclosure requirements. Under the provision, the Secretary or the Secretary's delegate is required to review information about a hospital's community benefit activities (currently reported on federal Form 990, Schedule H) at least once every three years. The provision also requires each organization to which the provision applies to file with its annual information return (i.e., federal Form 990) a copy of its audited financial statements (or, in the case of an organization the financial statements of which are included in a

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

consolidated financial statement with other organizations, such consolidated financial statements).

The provision requires the Secretary, in consultation with the Secretary of HHS, to submit annually a report to Congress with information regarding the levels of charity care, bad-debt expenses, unreimbursed costs of means-tested government programs, and unreimbursed costs of non-means tested government programs incurred by private tax-exempt, taxable, and governmental hospitals, as well as the costs incurred by private tax-exempt hospitals for community-benefit activities. In addition, the Secretary, in consultation with the Secretary of HHS, must conduct a study of the trends in these amounts, and submit a report on such study to Congress not later than five years from March 23, 2010.

#### Effective Date

Except as provided below, the provision is effective for taxable years beginning after March 23, 2010. The community health needs assessment requirement is effective for taxable years beginning after March 23, 2012.<sup>568</sup> The excise tax on failures to satisfy the community health needs assessment requirement is effective for failures occurring after March 23, 2010.

#### California Law (R&TC sections 18631, 23701, and 23701d)

##### Changes to IRC section 501

##### *In general*

California does not conform to IRC section 501, but instead has stand-alone law that provides rules for tax-exempt organizations. Generally, to obtain California tax-exempt status, an organization is required to file an exempt application<sup>569</sup> with the FTB 90 calendar days before the exemption is needed. An organization obtains tax-exempt status upon receiving a letter from the FTB exempting the organization from tax.

##### *Special rule for IRC section 501(c)(3) organizations*

An organization that is exempt from federal tax under IRC section 501(c)(3) can obtain California tax-exempt status by submitting to the FTB a copy of their federal determination letter of exemption under IRC section 501(c)(3).<sup>570</sup> Thus, the additional federal requirements under this provision would automatically have to be met for a hospital to obtain tax-exempt status under California law on the basis of a federal exemption under IRC section 501(c)(3).

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<sup>568</sup> For example, the enactment date is March 23, 2010. A calendar-year taxpayer would test whether it meets the community health needs assessment requirement in the taxable year ending December 31, 2013. To avoid the penalty, the taxpayer must have satisfied the community health needs assessment requirements in 2011, 2012, or 2013.

<sup>569</sup> Form FTB 3500, Exemption Application.

<sup>570</sup> R&TC section 23701d.



PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

Security benefits, and interest paid on the U.S. Treasury securities held in the HI trust fund. For the SMI trust fund, transfers from the general fund of the Treasury represent the largest source of revenue, but additional revenues include monthly premiums paid by beneficiaries, and interest paid on the U.S. Treasury securities held in the SMI trust fund.

Present law does not impose a fee creditable to the Medicare trust funds on companies that manufacture or import prescription drugs for sale in the United States.

New Federal Law (Uncodified Act section 9008 affecting Subtitle D of the IRC)

The provision imposes a fee on each covered entity engaged in the business of manufacturing or importing branded prescription drugs for sale to any specified government program or pursuant to coverage under any such program for each calendar year beginning after 2010. Fees collected under the provision are credited to the Medicare Part B trust fund.

The aggregate annual fee for all covered entities is the applicable amount. The applicable amount is \$2.5 billion for calendar year 2011, \$2.8 billion for calendar years 2012 and 2013, \$3 billion for calendar years 2014 through 2016, \$4 billion for calendar year 2017, \$4.1 billion for calendar year 2018, and \$2.8 billion for calendar year 2019 and thereafter.

The aggregate fee is apportioned among the covered entities each year based on such entity's relative share of branded prescription drug sales taken into account during the previous calendar year. The Secretary of the Treasury will establish an annual payment date that will be no later than September 30 of each calendar year.

The Secretary of the Treasury will calculate the amount of each covered entity's fee for each calendar year by determining the relative market share for each covered entity. A covered entity's relative market share for a calendar year is the covered entity's branded prescription drug sales taken into account during the preceding calendar year as a percentage of the aggregate branded prescription drug sales of all covered entities taken into account during the preceding calendar year. The branded prescription drug sales taken into account during any calendar year with respect to any covered entity is: (1) zero percent of sales not more than \$5 million; (2) 10 percent of sales over \$5 million but not more than \$125 million; (3) 40 percent of sales over \$125 million but not more than \$225 million; (4) 75 percent of sales over \$225 million but not more than \$400 million; and (5) 100 percent of sales over \$400 million.

For purposes of the provision, a covered entity is any manufacturer or importer with gross receipts from branded prescription drug sales. All persons treated as a single employer under IRC section 52(a) or (b) or under IRC section 414(m) or 414(o) will be treated as a single covered entity for purposes of the provision. In applying the single employer rules under IRC section 52(a) and (b), foreign corporations will not be excluded. If more than one person is liable for payment of the fee imposed by this provision, all such persons are jointly and severally liable for payment of such fee. It is anticipated that the Secretary may require each covered entity to identify each member of the group that is treated as a single covered entity under the provision.

Under the provision, branded prescription drug sales are sales of branded prescriptions drugs made to any specified government program or pursuant to coverage under any such program.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

The term branded prescription drugs includes any drug which is subject to section 503(b) of the Federal Food, Drug, and Cosmetic Act and for which an application was submitted under section 505(b) of such Act, and any biological product for which an application was submitted under section 351(a) of such Act. Branded prescription drug sales, as defined under the provision, does not include sales of any drug or biological product with respect to which an orphan drug tax credit was allowed for any taxable year under IRC section 45C. The exception for orphan drug sales does not apply to any drug or biological product after such drug or biological product is approved by the Food and Drug Administration for marketing for any indication other than the rare disease or condition with respect to which the IRC section 45C credit was allowed.

Specified government programs under the provision include: (1) the Medicare Part D program under part D of title XVIII of the Social Security Act; (2) the Medicare Part B program under part B of title XVIII of the Social Security Act; (3) the Medicaid program under title XIX of the Social Security Act; (4) any program under which branded prescription drugs are procured by the Department of Veterans Affairs; (5) any program under which branded prescription drugs are procured by the Department of Defense; or (6) the TRICARE retail pharmacy program under section 1074g of title 10, United States Code.

The Secretary of HHS, the Secretary of Veterans Affairs, and the Secretary of Defense will report to the Secretary of the Treasury, at a time and in such a manner as the Secretary of the Treasury prescribes, the total branded prescription drug sales for each covered entity with respect to each specified government program under such Secretary's jurisdiction. The provision includes specific information to be included in the reports by the respective Secretaries for each specified government program.

The fees imposed under the provision are treated as excise taxes with respect to which only civil actions for refunds under the provisions of subtitle F will apply. Thus, the fees may be assessed and collected using the procedures in subtitle F without regard to the restrictions on assessment in IRC section 6213.

The Secretary of the Treasury has authority to publish guidance as necessary to carry out the purposes of this provision. It is anticipated that the Secretary of the Treasury will publish guidance related to the determination of the fee under this section. For example, the Secretary may publish initial determinations, allow a notice and comment period, and then provide notice and demand for payment of the fee. It is also anticipated that the Secretary of the Treasury will provide guidance as to the determination of the fee in situations involving mergers, acquisitions, business divisions, bankruptcy, or any other situations where guidance is necessary to account for sales taken into account for determining the fee for any calendar year.

The fees imposed under the provision are not deductible for U.S. income tax purposes.

Effective Date

The provision is effective for calendar years beginning after December 31, 2010.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

California Law (R&TC sections 17201 and 24345)

Fee on Branded Prescription Pharmaceutical Manufacturers and Importers

The FTB does not administer excise taxes similar to the fee on branded prescription pharmaceutical manufacturers and importers. Defer to the BOE.

Deductibility of Fee on Branded Prescription Pharmaceutical Manufacturers and Importers

For federal purposes, the fee is considered a nondeductible tax described in IRC section 275(a)(6).<sup>572</sup> For taxable years beginning on and after January 1, 2010, the PITL conforms to IRC section 275 as of the “specified date” of January 1, 2009.<sup>573</sup> Because this provision was enacted after the “specified date,” the fee imposed under this section is deductible under the PITL.

And under the CTL, the fee imposed under this section is deductible.<sup>574</sup>

Impact on California Revenue

Fee on Branded Prescription Pharmaceutical Manufacturers and Importers

Defer to the BOE.

Deductibility of the Fee on Branded Prescription Pharmaceutical Manufacturers and Importers

Estimated Revenue Impact of Denying a Deduction for the Annual Fee on Branded Prescription Pharmaceutical Manufacturers and Importers For Calendar Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
\$17,000,000	\$15,000,000	\$15,000,000

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<sup>572</sup> Section 9008(f)(2) of the Patient Protection and Affordable Care Act.

<sup>573</sup> R&TC section 17201.

<sup>574</sup> R&TC section 24345.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

<u>Section</u>	<u>Section Title</u>
9009	Imposition of Annual Fee on Medical Device Manufacturers and Importers

Background

The provision imposing an annual fee on manufactures and importers of medical devices is repealed, and replaced with Act section 1405(d) of the Health Care and Education Reconciliation Act of 2010 (Public Law 111-152, March 30, 2010.)

Effective Date

The repeal is effective as of March 30, 2010.

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<u>Section</u>	<u>Section Title</u>
9010	Imposition of Annual Fee on Health Insurance Providers

*Includes amendments made by:*

<u>Act/Section</u>	<u>Section Title</u>
PPACA section 10905	Modification of Annual Fee on Health Insurance Providers
HCERA section 1406	Health Insurance Providers

Background

Present law provides special rules for determining the taxable income of insurance companies (Subchapter L of the IRC). Separate sets of rules apply to life insurance companies and to property and casualty insurance companies. Insurance companies are subject to federal income tax at regular corporate income tax rates.

An insurance company that provides health insurance is subject to federal income tax as either a life insurance company or as a property insurance company, depending on its mix of lines of business and on the resulting portion of its reserves that are treated as life insurance reserves. For federal income tax purposes, an insurance company is treated as a life insurance company if the sum of its (a) life insurance reserves and (b) unearned premiums and unpaid losses on non-cancellable life, accident or health contracts not included in life insurance reserves, comprise more than 50 percent of its total reserves.<sup>575</sup>

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<sup>575</sup> IRC section 816(a).

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

Some insurance providers may be exempt from federal income tax under IRC section 501(a) if specific requirements are satisfied. IRC section 501(c)(8), for example, describes certain fraternal beneficiary societies, orders, or associations operating under the lodge system or for the exclusive benefit of their members that provide for the payment of life, sick, accident, or other benefits to the members or their dependents. IRC section 501(c)(9) describes certain voluntary employees' beneficiary associations that provide for the payment of life, sick, accident, or other benefits to the members of the association or their dependents or designated beneficiaries. IRC section 501(c)(12)(A) describes certain benevolent life insurance associations of a purely local character. IRC section 501(c)(15) describes certain small non-life insurance companies with annual gross receipts of no more than \$600,000 (\$150,000 in the case of a mutual insurance company). IRC section 501(c)(26) describes certain membership organizations established to provide health insurance to certain high-risk individuals. IRC section 501(c)(27) describes certain organizations established to provide workmen's compensation insurance.

An excise tax applies to premiums paid to foreign insurers and reinsurers covering U.S. risks.<sup>576</sup> The excise tax is imposed on a gross basis at the rate of one percent on reinsurance and life insurance premiums, and at the rate of four percent on property and casualty insurance premiums. The excise tax does not apply to premiums that are effectively connected with the conduct of a U.S. trade or business or that are exempted from the excise tax under an applicable income tax treaty. The excise tax paid by one party cannot be credited if, for example, the risk is reinsured with a second party in a transaction that is also subject to the excise tax.

IRS authority to assess and collect taxes is generally provided in subtitle F of the IRC (sections 6001 -7874), relating to procedure and administration. That subtitle establishes the rules governing both how taxpayers are required to report information to the IRS and to pay their taxes, as well as their rights. It also establishes the duties and authority of the IRS to enforce the federal tax law, and sets forth rules relating to judicial proceedings involving federal tax.

New Federal Law (Uncodified Act section 9010 affecting Subtitle D of the IRC)

Under the provision, an annual fee applies to any covered entity engaged in the business of providing health insurance with respect to United States health risks. The fee applies for calendar years beginning after 2013. The aggregate annual fee for all covered entities is the applicable amount. The applicable amount is \$8 billion for calendar year 2014, \$11.3 billion for calendar years 2015 and 2016, \$13.9 billion for calendar year 2017, and \$14.3 billion for calendar year 2018. For calendar years after 2018, the applicable amount is indexed to the rate of premium growth.

The annual payment date for a calendar year is determined by the Secretary of the Treasury, but in no event may be later than September 30 of that year.

Under the provision, the aggregate annual fee is apportioned among the providers based on a ratio designed to reflect relative market share of U.S. health insurance business. For each covered entity, the fee for a calendar year is an amount that bears the same ratio to the applicable amount as the covered entity's net premiums written during the preceding calendar

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<sup>576</sup> IRC sections 4371-4374.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

year with respect to health insurance for any United States health risk, bears to the aggregate net written premiums of all covered entities during such preceding calendar year with respect to such health insurance.

The provision requires the Secretary of the Treasury to calculate the amount of each covered entity's fee for the calendar year, determining the covered entity's net written premiums for the preceding calendar year with respect to health insurance for any United States health risk on the basis of reports submitted by the covered entity and through the use of any other source of information available to the Treasury Department. It is intended that the Treasury Department be able to rely on published aggregate annual statement data to the extent necessary, and may use annual statement data and filed annual statements that are publicly available to verify or supplement the reports submitted by covered entities.

“Net written premiums” is intended to mean premiums written, including reinsurance premiums written, reduced by reinsurance ceded, and reduced by ceding commissions. Net written premiums do not include amounts arising under arrangements that are not treated as insurance (i.e., in the absence of sufficient risk shifting and risk distribution for the arrangement to constitute insurance).<sup>577</sup>

The amount of net premiums written that are taken into account for purposes of determining a covered entity's market share is subject to dollar thresholds. A covered entity's net premiums written during the calendar year that are not more than \$25 million are not taken into account for this purpose. With respect to a covered entity's net premiums written during the calendar year that are more than \$25 million but not more than \$50 million, 50 percent are taken into account, and 100 percent of net premiums written in excess of \$50 million are taken into account.

After application of the above dollar thresholds, a special rule provides an exclusion, for purposes of determining an otherwise covered entity's market share, of 50 percent of net premiums written that are attributable to the exempt activities<sup>578</sup> of a health insurance organization that is exempt from federal income tax<sup>579</sup> by reason of being described in IRC section 501(c)(3) (generally, a public charity), IRC section 501(c)(4) (generally, a social welfare organization), IRC section 501(c)(26) (generally, a high-risk health insurance pool), or IRC section 501(c)(29) (a consumer operated and oriented plan ("CO-OP") health insurance issuer).

A covered entity generally is an entity that provides health insurance with respect to United States health risks during the calendar year in which the fee under this section is due. Thus for example, an insurance company subject to tax under Part I or II of IRC Subchapter L, an organization

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<sup>577</sup> See *Helvering v. Le Gierse*, 312 U.S. 531 (1941).

<sup>578</sup> The exempt activities for this purpose are activities other than activities of an unrelated trade or business defined in IRC section 513.

<sup>579</sup> IRC section 501(m) provides that an organization described in IRC section 501(c)(3) or (4) is exempt from federal income tax only if no substantial part of its activities consists of providing commercial-type insurance. Thus, an organization otherwise described in IRC section 501(c)(3) or (4) that is taxable (under the federal income tax rules) by reason of IRC section 501(m) is not eligible for the 50-percent exclusion under the insurance fee.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

exempt from tax under IRC section 501(a), a foreign insurer that provides health insurance with respect to United States health risks, or an insurer that provides health insurance with respect to United States health risks under Medicare Advantage, Medicare Part D, or Medicaid, is a covered entity under the provision except as provided in specific exceptions.

Specific exceptions are provided to the definition of a covered entity. A covered entity does not include an employer to the extent that the employer self-insures the health risks of its employees. For example, a manufacturer that enters into a self-insurance arrangement with respect to the health risks of its employees is not treated as a covered entity. As a further example, an insurer that sells health insurance and that also enters into a self-insurance arrangement with respect to the health risks of its own employees is treated as a covered entity with respect to its health insurance business, but is not treated as a covered entity to the extent of the self-insurance of its own employees' health risks.

A covered entity does not include any governmental entity. For this purpose, it is intended that a governmental entity includes a county organized health system entity that is an independent public agency organized as a nonprofit under state law and that contracts with a state to administer state Medicaid benefits through local care providers or HMOs.

A covered entity does not include an entity that: (1) qualifies as nonprofit under applicable state law; (2) meets the private inurement and limitation on lobbying provisions described in IRC section 501(c)(3); and (3) receives more than 80 percent of its gross revenue from government programs that target low-income, elderly, or disabled populations (including Medicare, Medicaid, the State Children's Health Insurance Plan ("SCHIP"), and dual-eligible plans).

A covered entity does not include an organization that qualifies as a VEBA under IRC section 501(c)(9) that is established by an entity other than the employer (i.e., a union) for the purpose of providing health care benefits. This exclusion does not apply to multi-employer welfare arrangements ("MEWAs").

For purposes of the provision, all persons treated as a single employer under IRC section 52(a) or (b) or IRC section 414(m) or (o) are treated as a single covered entity (or as a single employer, for purposes of the rule relating to employers that self-insure the health risks of employees), and otherwise applicable exclusion of foreign corporations under those rules is disregarded. However, the exceptions to the definition of a covered entity are applied on a separate-entity basis, not taking into account this rule. If more than one person is liable for payment of the fee by reason of being treated as a single covered entity, all such persons are jointly and severally liable for payment of the fee.

A United States health risk means the health risk of an individual who is a U.S. citizen, is a U.S. resident within the meaning of IRC section 7701(b)(1)(A) (whether or not located in the United States), or is located in the United States, with respect to the period that the individual is located there. In general, it is intended that risks in the following lines of business reported on the annual statement as prescribed by the National Association of Insurance Commissioners and as filed with the insurance commissioners of the states in which insurers are licensed to do business constitute health risks for this purpose: comprehensive (hospital and medical), vision, dental, Federal Employees Health Benefit plan, title XVIII Medicare, title XIX Medicaid, and other health.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

For purposes of the provision, health insurance does not include coverage only for accident, or disability income insurance, or a combination thereof. Health insurance does not include coverage only for a specified disease or illness, nor does health insurance include hospital indemnity or other fixed-indemnity insurance. Health insurance does not include any insurance for long-term care or any Medicare supplemental health insurance (as defined in section 1882(g)(1) of the Social Security Act).

For purposes of procedure and administration under the rules of Subtitle F of the IRC, the fee under this provision is treated as an excise tax with respect to which only civil actions for refund under Subtitle F apply. The Secretary of the Treasury may redetermine the amount of a covered entity's fee under the provision for any calendar year for which the statute of limitations remains open.

For purposes of IRC section 275, relating to the nondeductibility of specified taxes, the fee is considered to be a nondeductible tax described in IRC section 275(a)(6).

A reporting rule applies under the provision. A covered entity is required to report to the Secretary of the Treasury the amount of its net premiums written during any calendar year with respect to health insurance for any United States health risk.

A penalty applies for failure to report, unless it is shown that the failure is due to reasonable cause. The amount of the penalty is \$10,000 plus the lesser of: (1) \$1,000 per day while the failure continues; or (2) the amount of the fee imposed for which the report was required. The penalty is treated as a penalty for purposes of subtitle F of the IRC, must be paid on notice and demand by the Treasury Department and in the same manner as tax, and with respect to which only civil actions for refund under procedures of subtitle F. The reported information is not treated as taxpayer information under IRC section 6103.

An accuracy-related penalty applies in the case of any understatement of a covered entity's net premiums written. For this purpose, an understatement is the difference between the amount of net premiums written as reported on the return filed by the covered entity and the amount of net premiums written that should have been reported on the return. The penalty is equal to the amount of the fee that should have been paid in the absence of an understatement over the amount of the fee determined based on the understatement. The accuracy-related penalty is subject to the provisions of subtitle F of the IRC that apply to assessable penalties imposed under Chapter 68.

The provision provides authority for the Secretary of the Treasury to publish guidance necessary to carry out the purposes of the provision and to prescribe regulations necessary or appropriate to prevent avoidance of the purposes of the provision, including inappropriate actions taken to qualify as an exempt entity under the provision.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

Effective Date

The annual fee is required to be paid in each calendar year beginning after December 31, 2013. The fee under the provision is determined with respect to net premiums written after December 31, 2012, with respect to health insurance for any United States health risk.

California Law (R&TC sections 13201–13222 and Section 28 of Article XIII of the California Constitution)

Insurance Companies in General

Insurance companies must be admitted to do business in California. Once admitted, those insurance companies pay the gross premiums tax that is administered by the Board of Equalization (BOE). Insurance companies are not subject to tax under the PITL or the CTL.

Nonadmitted Insurance Policyholders

The FTB administers the tax on nonadmitted insurance policyholders. Policyholders who purchase or renew an insurance contract during the calendar quarter from an insurance company that is not authorized to transact business in California must pay a “nonadmitted insurance tax.” The tax is 3 percent on all premiums paid or to be paid to nonadmitted insurers on contracts covering risks located in California, and is imposed on any corporation, partnership, limited liability company, individual society, association, organization, governmental or quasi-governmental entity, joint-stock company, estate or trust, receiver, trustee, assignee, referee, or any other person acting in a fiduciary capacity.<sup>580</sup>

Policyholders subject to the tax must file Form 570, Nonadmitted Insurance Tax Return, to the FTB on or before the first day of the third month following the close of any calendar quarter during which a nonadmitted insurance contract took effect or was renewed.

Impact on California Revenue

Defer to the BOE.

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<sup>580</sup> R&TC sections 13201–13222.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

<u>Section</u>	<u>Section Title</u>
9012	Elimination of Deduction for Expenses Allocable to Medicare Part D Subsidy

*Includes amendments made by:*

<u>Act/Section</u>	<u>Section Title</u>
HCERA section 1407	Delay of Elimination of Deduction for Expenses Allocable to Medicare Part D Subsidy

## Background

### In General

Sponsors<sup>581</sup> of qualified retiree prescription drug plans are eligible for subsidy payments from the Secretary of HHS with respect to a portion of each qualified covered retiree's gross covered prescription drug costs ("qualified retiree prescription drug plan subsidy").<sup>582</sup> A qualified retiree prescription drug plan is employment-based retiree health coverage<sup>583</sup> that has an actuarial value at least as great as the Medicare Part D standard plan for the risk pool and that meets certain other disclosure and recordkeeping requirements.<sup>584</sup> These qualified retiree prescription drug plan subsidies are excludable from the plan sponsor's gross income for the purposes of regular income tax and alternative minimum tax (including the adjustment for adjusted current earnings).<sup>585</sup>

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<sup>581</sup> The identity of the plan sponsor is determined in accordance with section 16(B) of ERISA, except that for cases where a plan is maintained jointly by one employer and an employee organization, the employer is the primary source of financing, and the employer is the plan sponsor.

<sup>582</sup> Sec. 1860D-22 of the Social Security Act (SSA), 42 USC Sec. 1395w-132.

<sup>583</sup> Employment-based retiree health coverage is health insurance coverage or other coverage of health care costs (whether provided by voluntary insurance coverage or pursuant to statutory or contractual obligation) for Medicare Part D eligible individuals (their spouses and dependents) under group health plans based on their status as retired participants in such plans. For purposes of the subsidy, group health plans generally include employee welfare benefit plans (as defined in section 607(1) of ERISA) that provide medical care (as defined in IRC section 213(d)), federal and state governmental plans, collectively bargained plans, and church plans.

<sup>584</sup> In addition to meeting the actuarial value standard, the plan sponsor must also maintain and provide the Secretary of HHS access to records that meet the Secretary of HHS's requirements for purposes of audits and other oversight activities necessary to ensure the adequacy of prescription drug coverage and the accuracy of payments made to eligible individuals under the plan. In addition, the plan sponsor must disclose to the Secretary of HHS whether the plan meets the actuarial equivalence requirement and if it does not, must disclose to retirees the limitations of their ability to enroll in Medicare Part D and that non-creditable coverage enrollment is subject to penalties such as fees for late enrollment. 42 U.S.C. 1395w-132(a)(2).

<sup>585</sup> IRC section 139A.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

## Subsidy Amounts

For each qualifying covered retiree enrolled for a coverage year in a qualified retiree prescription drug plan, the qualified retiree prescription drug plan subsidy is equal to 28 percent of the portion of the allowable retiree costs paid by the plan sponsor on behalf of the retiree that exceed the cost threshold but do not exceed the cost limit. A "qualifying covered retiree" is an individual who is eligible for Medicare but not enrolled in either a Medicare Part D prescription drug plan or a Medicare Advantage-Prescription Drug plan, but who is covered under a qualified retiree prescription drug plan. In general, allowable retiree costs are, with respect to prescription drug costs under a qualified retiree prescription drug plan, the part of the actual costs paid by the plan sponsor on behalf of a qualifying covered retiree under the plan.<sup>586</sup> Both the threshold and limit are indexed to the percentage increase in Medicare per capita prescription drug costs; the cost threshold was \$250 in 2006 (\$310 in 2010) and the cost limit was \$5,000 in 2006 (\$6,300 in 2010).<sup>587</sup>

## Expenses Relating to Tax-Exempt Income

In general, no deduction is allowed under any provision of the IRC for any expense or amount which would otherwise be allowable as a deduction if such expense or amount is allocable to a class or classes of exempt income.<sup>588</sup> Thus, expenses or amount paid or incurred with respect to the subsidies excluded from income under section 139A would generally not be deductible. However, a provision under IRC section 139A specifies that the exclusion of the qualified retiree prescription drug plan subsidy from income is not taken into account in determining whether any deduction is allowable with respect to covered retiree prescription drug expenses that are taken into account in determining the subsidy payment. Therefore, under present law, a taxpayer may claim a business deduction for covered retiree prescription drug expenses incurred notwithstanding that the taxpayer excludes from income qualified retiree prescription drug plan subsidies allocable to such expenses.

## New Federal Law (IRC section 139A)

The provision eliminates the rule that the exclusion for subsidy payments is not taken into account for purposes of determining whether a deduction is allowable with respect to retiree prescription drug expenses. Thus, under the provision, the amount otherwise allowable as a deduction for retiree prescription drug expenses is reduced by the amount of the excludable subsidy payments received.

For example, assume a company receives a subsidy of \$28 with respect to eligible drug expenses of \$100. The \$28 is excludable from income under IRC section 139A, and the amount otherwise

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<sup>586</sup> For purposes of calculating allowable retiree costs, actual costs paid are net of discounts, chargebacks, and average percentage rebates, and exclude administrative costs.

<sup>587</sup> <http://www.cms.hhs.gov/MedicareAdvtgSpecRateStats/Downloads/Announcement2010.pdf>. Retrieved on March 19, 2010.

<sup>588</sup> IRC section 265(a) and Treas. Reg. section 1.265-1(a).

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

allowable as a deduction is reduced by the \$28. Thus, if the company otherwise meets the requirements of IRC section 162 with respect to its eligible drug expenses, it would be entitled to an ordinary business expense deduction of \$72.

Effective Date

The provision is effective for taxable years beginning after December 31, 2012.

California Law (R&TC section 17139.6)

The PITL specifically does not conform to IRC section 139A; thus, California law does not allow an exclusion from gross income for federal subsidies for prescription drug plans, and taxpayers may claim a business deduction for covered retiree prescription drug expenses incurred.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
9013	Modification of Itemized Deduction for Medical Expenses

Background

Regular Income Tax

For regular income tax purposes, individuals are allowed an itemized deduction for unreimbursed medical expenses, but only to the extent that such expenses exceed 7.5 percent of AGI.<sup>589</sup>

This deduction is available both to insured and uninsured individuals; thus, for example, an individual with employer-provided health insurance (or certain other forms of tax-subsidized health benefits) may also claim the itemized deduction for the individual's medical expenses not covered by that insurance if the 7.5 percent AGI threshold is met. The medical deduction encompasses health insurance premiums to the extent they have not been excluded from taxable income through the employer exclusion or self-insured deduction.

Alternative Minimum Tax

For purposes of the alternative minimum tax ("AMT"), medical expenses are deductible only to the extent that they exceed 10 percent of AGI.

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<sup>589</sup> IRC section 213.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

New Federal Law (IRC sections 56 and 213)

This provision increases the threshold for the itemized deduction for unreimbursed medical expenses from 7.5 percent of AGI to 10 percent of AGI for regular income tax purposes. However, for the years 2013, 2014, 2015 and 2016, if either the taxpayer or the taxpayer's spouse turns 65 before the end of the taxable year, the increased threshold does not apply and the threshold remains at 7.5 percent of AGI. The provision does not change the AMT treatment of the itemized deduction for medical expenses.

Effective Date

The provision is effective for taxable years beginning after December 31, 2012.

California Law (R&TC sections 17062 and 17201)

Regular Income Tax

For taxable years beginning on or after January 1, 2010, California conforms to IRC section 213, relating to the itemized deduction for unreimbursed medical expenses in excess of 7.5 percent of AGI, as of the "specified date" of January 1, 2009. Because this provision was enacted after the "specified date," California does not conform to it.

Alternative Minimum Tax (AMT)

For taxable years beginning on or after January 1, 2010, California conforms to IRC section 56, providing that medical expenses are deductible for AMT purposes only to the extent that they exceed 10 percent of AGI, as of the "specified date" of January 1, 2009. However, the AMT change made by this provision is not applicable because it did not change the AMT 10-percent-of-AGI threshold; instead, it only made conforming amendments to IRC section 56 to reflect the changes made to IRC section 213.

Impact on California Revenue

Regular Income Tax

Estimated Revenue Impact of Modification of Itemized Deduction for Medical Expenses For Taxable Years Beginning on Or After January 1, 2013 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
\$0	\$25,000,000	\$44,000,000

Conforming to this provision would result in a partial year of revenues for fiscal year 2012-13, as the federal provision is not operative until January 1, 2013. Additionally, when this provision

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

affects the deductibility threshold for individuals who are age 65 or over in 2017, there would be a corresponding increase to the state's annual revenue gain.

Alternative Minimum Tax (AMT)

Not applicable.

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<u>Section</u>	<u>Section Title</u>
9014	Limitation on Excessive Remuneration Paid by Certain Health Insurance Providers

Background

An employer generally may deduct reasonable compensation for personal services as an ordinary and necessary business expense. IRC section 162(m) provides 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<sup>590</sup> is limited to no more than \$1 million per year.<sup>591</sup> 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

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<sup>590</sup> 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.

<sup>591</sup> IRC section 162(m). This deduction limitation applies for purposes of the regular income tax and the alternative minimum tax.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

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 IRS issued updated guidance on identifying which employees are covered by IRC section 162(m).<sup>592</sup>

*Remuneration subject to the limit*

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<sup>593</sup>); and (5) any remuneration payable under a written binding contract which was in effect on February 17, 1993.

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.

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<sup>592</sup> Notice 2007-49, 2007-25 I.R.B. 1429.

<sup>593</sup> IRC section 132.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

Executive Compensation of Employers Participating in the Troubled Assets Relief Program

*In general*

Under IRC section 162(m)(5), the deduction 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 Emergency Stabilization Act of 2008<sup>594</sup> ("EESA") 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 EESA 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.

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<sup>594</sup> Public Law 110-343.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

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).<sup>595</sup>

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<sup>595</sup> 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. 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).

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

*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 \$500,000 limit. In addition, the \$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 \$500,000 limit.

Taxation of Insurance Companies

Present law provides special rules for determining the taxable income of insurance companies (Subchapter L of the IRC). Separate sets of rules apply to life insurance companies and to property and casualty insurance companies. Insurance companies are subject to federal income tax at regular corporate income tax rates. An insurance company generally may deduct compensation paid in the course of its trade or business.

New Federal Law (IRC section 162)

Under the provision, no deduction is allowed for remuneration which is attributable to services performed by an applicable individual for a covered health insurance provider during an applicable taxable year to the extent that such remuneration exceeds \$500,000. As under IRC section 162(m)(5) for remuneration from TARP participants, the exceptions for performance based remuneration, commissions, or remuneration under existing binding contracts do not apply. This \$500,000 deduction limitation applies without regard to whether such remuneration is paid during the taxable year or a subsequent taxable year. In applying this rule, rules similar to those in IRC section 162(m)(5)(A)(ii) apply. Thus, in the case of remuneration that relates to services that an applicable individual performs during a taxable year but that is not deductible until a later year, such as nonqualified deferred compensation, the unused portion (if any) of the \$500,000 limit for the 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.

In determining whether the remuneration of an applicable individual for a year exceeds \$500,000, all remuneration from all members of any controlled group of corporations (within the meaning of IRC section 414(b)), other businesses under common control (within the meaning of IRC section 414(c)), or affiliated service group (within the meaning of IRC sections 414(m) and (o)) are aggregated.

Covered Health Insurance Provider and Applicable Taxable Year

An insurance provider is a covered health insurance provider if at least 25 percent of the insurance provider's gross premium income from health business is derived from health insurance plans that meet the minimum creditable coverage requirements in the bill ("covered health insurance provider"). A taxable year is an applicable taxable year for an insurance provider

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

if an insurance provider is a covered insurance provider for any portion of the taxable year. Employers with self-insured plans are excluded from the definition of covered health insurance provider.

#### Applicable Individual

Applicable individuals include all officers, employees, directors, and other workers or service providers (such as consultants) performing services for or on behalf of a covered health insurance provider. Thus, in contrast to the general rules under IRC section 162(m) and the special rules executive compensation of employers participating in the TARP program, the limitation on the deductibility of remuneration from a covered health insurance provided is not limited to a small group of officers and covered executives but generally applies to remuneration of all employees and service providers. If an individual is an applicable individual with respect to a covered health insurance provider for any taxable year, the individual is treated as an applicable individual for all subsequent taxable years (and is treated as an applicable individual for purposes of any subsequent taxable year for purposes of the special rule for deferred remuneration).

#### Effective Date

The provision is effective for remuneration paid in taxable years beginning after 2012 with respect to services performed after 2009.

#### California Law (R&TC sections 13201–13222 and Section 28 of Article XIII of the California Constitution)

For taxable years beginning on or after January 1, 2010, California conforms to IRC section 162 as of the “specified date” of January 1, 2009. However, insurance companies are not subject to tax under the PITL or the CTL.

#### Insurance Companies in General

Insurance companies must be admitted to do business in California. Once admitted, those insurance companies pay the gross premiums tax that is administered by the Board of Equalization (BOE).

#### Nonadmitted Insurance Policyholders

The FTB administers the tax on nonadmitted insurance policyholders. Policyholders who purchase or renew an insurance contract during the calendar quarter from an insurance company that is not authorized to transact business in California must pay a “nonadmitted insurance tax.” The tax is 3 percent on all premiums paid or to be paid to nonadmitted insurers on contracts covering risks located in California, and is imposed on any corporation, partnership, limited liability company, individual society, association, organization, governmental or quasi-governmental entity, joint-stock company, estate or trust, receiver, trustee, assignee, referee, or any other person acting in a fiduciary capacity.<sup>596</sup>

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<sup>596</sup> R&TC sections 13201–13222.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

Policyholders subject to the tax must file Form 570, Nonadmitted Insurance Tax Return, to the FTB on or before the first day of the third month following the close of any calendar quarter during which a nonadmitted insurance contract took effect or was renewed.

Impact on California Revenue

Defer to the BOE.

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<u>Section</u>	<u>Section Title</u>
9015	Additional Hospital Insurance Tax on High-Income Taxpayers

*Includes amendments made by:*

<u>Act/Section</u>	<u>Section Title</u>
PPACA section 10906	Modification to Additional Hospital Insurance Tax on High-Income Taxpayers

Background

Federal Insurance Contributions Act Tax

The Federal Insurance Contributions Act (FICA) imposes tax on employers based on the amount of wages paid to an employee during the year. The tax imposed is composed of two parts: (1) the old age, survivors, and disability insurance ("OASDI") tax equal to 6.2 percent of covered wages up to the taxable wage base (\$106,800 in 2010); and (2) the hospital insurance (HI) tax amount equal to 1.45 percent of covered wages. Generally, covered wages means all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash. Certain exceptions from covered wages are also provided. In addition to the tax on employers, each employee is subject to FICA taxes equal to the amount of tax imposed on the employer.

The employee portion of the FICA tax generally must be withheld and remitted to the federal government by the employer.<sup>597</sup> The employer generally is liable for the amount of this tax whether or not the employer withholds the amount from the employee's wages.<sup>598</sup> In the event that the employer fails to withhold from an employee, the employee generally is not liable to the

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<sup>597</sup> IRC section 3102(a).

<sup>598</sup> IRC section 3102(b).

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

IRS for the amount of the tax. However, if the employer pays its liability for the amount of the tax not withheld, the employer generally has a right to collect that amount from the employee. Further, if the employer deducts and pays the tax the employer is indemnified against the claims and demands of any person for the amount of any payment of the tax made by the employer.<sup>599</sup>

#### Self-Employment Contributions Act Tax

As a parallel to FICA taxes, the Self-Employment Contributions Act (SECA) imposes taxes on the net income from self employment of self-employed individuals. The rate of the OASDI portion of SECA taxes is equal to the combined employee and employer OASDI FICA tax rates and applies to self employment income up to the FICA taxable wage base. Similarly, the rate of the HI portion is the same as the combined employer and employee HI rates and there is no cap on the amount of self employment income to which the rate applies.<sup>600</sup>

For purposes of computing net earnings from self employment, taxpayers are permitted a deduction equal to the product of the taxpayer's earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent); i.e., 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas the self-employed individual's net earnings are economically equivalent to an employee's wages plus the employer share of FICA taxes.

#### New Federal Law (IRC sections 164, 1401, 1402, 3101, and 3102)

##### Additional HI Tax on Employee Portion of HI Tax

###### *Calculation of additional tax*

The employee portion of the HI tax is increased by an additional tax of 0.9 percent on wages<sup>601</sup> received in excess of the threshold amount. However, unlike the general 1.45 percent HI tax on wages, this additional tax is on the combined wages of the employee and the employee's spouse, in the case of a joint return. The threshold amount is \$250,000 in the case of a joint return or surviving spouse, \$125,000 in the case of a married individual filing a separate return, and \$200,000 in any other case.

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<sup>599</sup> IRC section 3102(b).

<sup>600</sup> For purposes of computing net earnings from self employment, taxpayers are permitted a deduction equal to the product of the taxpayer's earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent); i.e., 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas the self-employed individual's net earnings are economically equivalent to an employee's wages plus the employer share of FICA taxes.

<sup>601</sup> IRC section 3121(a).

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

*Liability for the additional HI tax on wages*

As under present law, the employer is required to withhold the additional HI tax on wages but is liable for the tax if the employer fails to withhold the amount of the tax from wages, or collect the tax from the employee if the employer fails to withhold. However, in determining the employer's requirement to withhold and liability for the tax, only wages that the employee receives from the employer in excess of \$200,000 for a year are taken into account and the employer must disregard the amount of wages received by the employee's spouse. Thus, the employer is only required to withhold on wages in excess of \$200,000 for the year, even though the tax may apply to a portion of the employee's wages at or below \$200,000, if the employee's spouse also has wages for the year, they are filing a joint return, and their total combined wages for the year exceed \$250,000.

For example, if a taxpayer's spouse has wages in excess of \$250,000 and the taxpayer has wages of \$100,000, the employer of the taxpayer is not required to withhold any portion of the additional tax, even though the combined wages of the taxpayer and the taxpayer's spouse are over the \$250,000 threshold. In this instance, the employer of the taxpayer's spouse is obligated to withhold the additional 0.9-percent HI tax with respect to the \$50,000 above the threshold with respect to the wages of \$250,000 for the taxpayer's spouse.

In contrast to the employee portion of the general HI tax of 1.45 percent of wages for which the employee generally has no direct liability to the IRS to pay the tax, the employee is also liable for this additional 0.9-percent HI tax to the extent the tax is not withheld by the employer. The amount of this tax not withheld by an employer must also be taken into account in determining a taxpayer's liability for estimated tax.

**Additional HI for Self-Employed Individuals**

This same additional HI tax applies to the HI portion of SECA tax on self-employment income in excess of the threshold amount. Thus, an additional tax of 0.9 percent is imposed on every self-employed individual on self-employment income<sup>602</sup> in excess of the threshold amount.

As in the case of the additional HI tax on wages, the threshold amount for the additional SECA HI tax is \$250,000 in the case of a joint return or surviving spouse, \$125,000 in the case of a married individual filing a separate return, and \$200,000 in any other case. The threshold amount is reduced (but not below zero) by the amount of wages taken into account in determining the FICA tax with respect to the taxpayer. No deduction is allowed under IRC section 164(f) for the additional SECA tax, and the deduction under IRC section 1402(a)(12) is determined without regard to the additional SECA tax rate.

Effective Date

The provision applies to remuneration received and taxable years beginning after December 31, 2012.

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<sup>602</sup> IRC section 1402(b).

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

California Law (R&TC section 17201)

Changes to Employment Taxes (IRC sections 1401, 1402, 3101, and 3102)

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

Changes to the Deductibility of Self-Employment Taxes for Income Tax Purposes (IRC section 164)

For taxable years beginning on or after January 1, 2010, the PITL conforms to IRC section 164, relating to deductible taxes, as of the “specified date” of January 1, 2009. Because this provision was enacted after the “specified date,” California does not conform to it. However, because the additional HI self-employment tax is not deductible under current California law, there is no impact of conforming to this provision (that denies a deduction under IRC section 164 for such additional tax).

Impact on California Revenue

Changes to Employment Taxes (IRC sections 1401, 1402, 3101, and 3102)

Defer to the EDD.

Changes to the Deductibility of Self-Employment Taxes for Income Tax Purposes (IRC section 164)

No impact.

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<u>Section</u>	<u>Section Title</u>
9016	Modification of Section 833 Treatment of Certain Health Organizations

Background

A property and casualty insurance company is subject to tax on its taxable income, generally defined as its gross income less allowable deductions (IRC section 832). For this purpose, gross income includes underwriting income and investment income, as well as other items. Underwriting income is the premiums earned on insurance contracts during the year, less losses incurred and expenses incurred. The amount of losses incurred is determined by taking into account the discounted unpaid losses. Premiums earned during the year is determined taking into account a 20-percent reduction in the otherwise allowable deduction, intended to represent the allocable portion of expenses incurred in generating the unearned premiums (IRC section 832(b)(4)(B)).

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

Present law provides that an organization described in IRC sections 501(c)(3) and (4) is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance (IRC section 501(m)). When this rule was enacted in 1986,<sup>603</sup> special rules were provided under IRC section 833 for Blue Cross and Blue Shield organizations providing health insurance that: (1) were in existence on August 16, 1986; (2) were determined at any time to be tax-exempt under a determination that had not been revoked; and (3) were tax-exempt for the last taxable year beginning before January 1, 1987 (when the present-law rule became effective), provided that no material change occurred in the structure or operations of the organizations after August 16, 1986, and before the close of 1986 or any subsequent taxable year. Any other organization is eligible for IRC section 833 treatment if it meets six requirements set forth in IRC section 833(c): (1) substantially all of its activities involve providing health insurance; (2) at least 10 percent of its health insurance is provided to individuals and small groups (not taking into account Medicare supplemental coverage); (3) it provides continuous full-year open enrollment for individuals and small groups; (4) for individuals, it provides full coverage of pre-existing conditions of high-risk individuals and coverage without regard to age, income, or employment of individuals under age 65; (5) at least 35 percent of its premiums are community rated; and (6) no part of its net earnings inures to the benefit of any private shareholder or individual.

IRC section 833 provides a deduction with respect to health business of such organizations. The deduction is equal to 25 percent of the sum of: (1) claims incurred, and liabilities incurred under cost-plus contracts, for the taxable year; and (2) expenses incurred in connection with administration, adjustment, or settlement of claims or in connection with administration of cost-plus contracts during the taxable year, to the extent this sum exceeds the adjusted surplus at the beginning of the taxable year. Only health-related items are taken into account.

IRC section 833 provides an exception for such an organization from the application of the 20-percent reduction in the deduction for increases in unearned premiums that applies generally to property and casualty companies.

IRC section 833 provides that such an organization is taxable as a stock property and casualty insurer under the federal income tax rules applicable to property and casualty insurers.

New Federal Law (IRC section 833)

The provision limits eligibility for the rules of IRC section 833 to those organizations meeting a medical loss ratio standard of 85 percent for the taxable year. Thus, under the provision, an organization that does not meet the 85-percent standard is not allowed the 25-percent deduction and the exception from the 20-percent reduction in the unearned premium reserve deduction under IRC section 833.

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<sup>603</sup> See H. Rep. 99-426, Tax Reform Act of 1985, (December 7, 1985) at 664. The Committee stated, "[T]he availability of tax-exempt status under [then-]present law has allowed some large insurance entities to compete directly with commercial insurance companies. For example, the Blue Cross/Blue Shield organizations historically have been treated as tax-exempt organizations described in IRC sections 501(c)(3) or (4). This group of organizations is now among the largest health care insurers in the United States." See also Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, JCS-10-87 (May 4, 1987) at 583-592.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

For this purpose, an organization's medical loss ratio is determined as the percentage of total premium revenue expended on reimbursement for clinical services that are provided to enrollees under the organization's policies during the taxable year, as reported under section 2718 of the PHSA.

It is intended that the medical loss ratio under this provision be determined on an organization-by-organization basis, not on an affiliated or other group basis, and that Treasury Department guidance be promulgated promptly to carry out the purposes of the provision.

Effective Date

The provision is effective for taxable years beginning after December 31, 2009.

California Law (R&TC sections 13201–13222 and Section 28 of Article XIII of the California Constitution)

Insurance Companies in General

Insurance companies must be admitted to do business in California. Once admitted, those insurance companies pay the gross premiums tax that is administered by the Board of Equalization (BOE). Insurance companies are not subject to tax under the PITL or the CTL.

Nonadmitted Insurance Policyholders

The FTB administers the tax on nonadmitted insurance policyholders. Policyholders who purchase or renew an insurance contract during the calendar quarter from an insurance company that is not authorized to transact business in California must pay a “nonadmitted insurance tax.” The tax is 3 percent on all premiums paid or to be paid to nonadmitted insurers on contracts covering risks located in California, and is imposed on any corporation, partnership, limited liability company, individual society, association, organization, governmental or quasi-governmental entity, joint-stock company, estate or trust, receiver, trustee, assignee, referee, or any other person acting in a fiduciary capacity.<sup>604</sup>

Policyholders subject to the tax must file Form 570, Nonadmitted Insurance Tax Return, to the FTB on or before the first day of the third month following the close of any calendar quarter during which a nonadmitted insurance contract took effect or was renewed.

Impact on California Revenue

Defer to the BOE.

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<sup>604</sup> R&TC sections 13201–13222.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

<u>Section</u>	<u>Section Title</u>
9017	Excise Tax on Elective Cosmetic Medical Procedures
10907	Excise Tax on Indoor Tanning Services in Lieu of Elective Cosmetic Medical Procedures

Section 9017 is deemed null and void, and has no effect. Section 10907 provides the following:

Background

There is no tax on indoor tanning services under present law.

New Federal Law (IRC sections 4001 and 5000B)

In General

The provision imposes a tax on each individual on whom indoor tanning services are performed. The tax is equal to 10 percent of the amount paid for indoor tanning services.

For purposes of the provision, indoor tanning services are services employing any electronic product designed to induce skin tanning and which incorporate one or more ultraviolet lamps and intended for the irradiation of an individual by ultraviolet radiation, with wavelengths in air between 200 and 400 nanometers. Indoor tanning services do not include any phototherapy service performed by a licensed medical professional.

Payment of Tax

The tax is paid by the individual on whom the indoor tanning services are performed. The tax is collected by each person receiving a payment for tanning services on which a tax is imposed. If the tax is not paid by the person receiving the indoor tanning services at the time the payment for the service is received, the person performing the procedure pays the tax.

Payment of the tax is remitted quarterly to the Secretary by the person collecting the tax. The Secretary is given discretion over the manner of the payment.

Effective Date

The provision applies to services performed on or after July 1, 2010.

California Law

The FTB does not administer excise taxes. Defer to the BOE.

Impact on California Revenue

Defer to the BOE.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

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<u>Section</u>	<u>Section Title</u>
9021	Exclusion of Health Benefits Provided by Indian Tribal Governments

Background

Present law generally provides that gross income includes all income from whatever source derived.<sup>605</sup> Exclusions from income are provided, however, for certain health care benefits.

Exclusion from Income for Employer-Provided Health Coverage

Employees generally are not taxed on (that is, may "exclude" from gross income) the value of employer-provided health coverage under an accident or health plan.<sup>606</sup> In addition, any reimbursements under an accident or health plan for medical care expenses for employees, their spouses, and their dependents generally are excluded from gross income.<sup>607</sup> As with cash or other compensation, the amount paid by employers for employer-provided health coverage is a deductible business expense. Unlike other forms of compensation, however, if an employer contributes to a plan providing health coverage for employees (and the employees' spouses and dependents), the value of the coverage and all benefits (including reimbursements) in the form of medical care under the plan are excludable from the employees' income for income tax purposes.<sup>608</sup> The exclusion applies both to health coverage in the case in which an employer absorbs the cost of employees' medical expenses not covered by insurance (i.e., a self-insured plan) as well as in the case in which the employer purchases health insurance coverage for its employees. There is no limit on the amount of employer-provided health coverage that is excludable.

In addition, employees participating in a cafeteria plan may be able to pay the portion of premiums for health insurance coverage not otherwise paid for by their employers on a pre-tax basis through salary reduction.<sup>609</sup> Such salary-reduction contributions are treated as employer contributions and thus also are excluded from gross income.

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<sup>605</sup> IRC section 61.

<sup>606</sup> IRC section 106.

<sup>607</sup> IRC section 105(b).

<sup>608</sup> IRC sections 104, 105, 106, and 125. A similar rule excludes employer provided health insurance coverage and reimbursements for medical expenses from the employees' wages for payroll tax purposes under IRC sections 3121(a)(2), and 3306(a)(2). Health coverage provided to active members of the uniformed services, military retirees, and their dependents are excludable under IRC section 134. That section provides an exclusion for "qualified military benefits," defined as benefits received by reason of status or service as a member of the uniformed services and which were excludable from gross income on September 9, 1986, under any provision of law, regulation, or administrative practice then in effect.

<sup>609</sup> IRC section 125.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

Employers may agree to reimburse medical expenses of their employees (and their spouses and dependents), not covered by a health insurance plan, through flexible spending arrangements which allow reimbursement not in excess of a specified dollar amount (either elected by an employee under a cafeteria plan or otherwise specified by the employer). Reimbursements under these arrangements are also excludible from gross income as employer-provided health coverage.

#### The General Welfare Exclusion

Under the general welfare exclusion doctrine, certain payments made to individuals are excluded from gross income. The exclusion has been interpreted to cover payments by governmental units under legislatively provided social benefit programs for the promotion of the general welfare.<sup>610</sup>

The general welfare exclusion generally applies if the payments: (1) are made from a governmental fund; (2) are for the promotion of general welfare (on the basis of the need of the recipient); and (3) do not represent compensation for services.<sup>611</sup> A representative of the IRS recently expressed the view that the general welfare exclusion does not apply to persons with significant income or assets, and that any such extension would represent a departure from well-established administrative practice.<sup>612</sup> The representative further expressed the view that application of the general welfare exclusion to an Indian tribal government providing coverage or

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<sup>610</sup> See, e.g., Rev. Rul. 78-170, 1978-1 C.B. 24 (government payments to assist low-income persons with utility costs are not income); Rev. Rul. 76-395, 1976-2 C.B. 16, 17 (government grants to assist low-income city inhabitants to refurbish homes are not income); Rev. Rul. 76-144, 1976-1 C.B. 17 (government grants to persons eligible for relief under the Disaster Relief Act of 1974 are not income); Rev. Rul. 74-153, 1974-1 C.B. 20 (government payments to assist adoptive parents with support and maintenance of adoptive children are not income); Rev. Rul. 74-205, 1974-1 C.B. 20 (replacement housing payments received by individuals under the Housing and Urban Development Act of 1968 are not includible in gross income); Gen. Couns. Mem. 34506 (May 26, 1971) (federal mortgage assistance payments excluded from income under general welfare exception); Rev. Rul. 57-102, 1957-1 C.B. 26 (government benefits paid to blind persons are not income). The courts have also acknowledged the existence of this doctrine. See, e.g., *Bailey v. Commissioner*, 88 T.C. 1293, 1299-1301 (1987) (new building façade paid for by urban renewal agency on taxpayer's property under facade grant program not considered payments under general welfare doctrine because awarded without regard to any need of the recipients); *Graff v. Commissioner*, 74 TC 743, 753-754 (1980) (court acknowledged that rental subsidies under Housing Act were excludable under general welfare doctrine but found that payments at issue made by HUD on taxpayer landlord's behalf were taxable income to him), *affd. per curiam* 673 F.2d 784 (5th Cir. 1982).

<sup>611</sup> See Rev. Rul. 98-19, 1998-1 C.B. 840 (excluding relocation payments made by local governments to those whose homes were damaged by floods). Recent guidance as to whether the need of the recipient (taken into account under the second requirement of the general welfare exclusion) must be based solely on financial means or whether the need can be based on a variety of other considerations including health, educational background, or employment status, has been mixed. Chief Couns. Adv. 200021036 (May 25, 2000) (excluding state adoption assistant payments made to individuals adopting special needs children without regard to financial means of parents; the children were considered to be the recipients); Priv. Ltr. Rul. 200632005 (April 13, 2006) (excluding payments made by Tribe to members based on multiple factors of need pursuant to housing assistance program); Chief Couns. Adv. 200648027 (Jul 25, 2006) (excluding subsidy payments based on financial need of recipient made by state to certain participants in state health insurance program to reduce cost of health insurance premiums).

<sup>612</sup> Testimony of Sarah H. Ingram, Commissioner, Tax Exempt and Government Entities, Internal Revenue Service, before the Senate Committee on Indian Affairs, *Oversight Hearing to Examine the Federal Tax Treatment of Health Care Benefits Provided by Tribal Governments to Their Citizens*, September 17, 2009.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

benefits to tribal members is dependent upon the structure and administration of the particular program.

New Federal Law (IRC section 139D)

The provision allows an exclusion from gross income for the value of specified Indian tribe health care benefits. The exclusion applies to the value of: (1) health services or benefits provided or purchased by the Indian Health Service ("IHS"), either directly or indirectly, through a grant to or a contract or compact with an Indian tribe or tribal organization or through programs of third parties funded by the IHS;<sup>613</sup> (2) medical care (in the form of provided or purchased medical care services, accident or health insurance or an arrangement having the same effect, or amounts paid directly or indirectly, to reimburse the member for expenses incurred for medical care) provided by an Indian tribe or tribal organization to a member of an Indian tribe, including the member's spouse or dependents;<sup>614</sup> (3) accident or health plan coverage (or an arrangement having the same effect) provided by an Indian tribe or tribal organization for medical care to a member of an Indian tribe, including the member's spouse or dependents; and (4) any other medical care provided by an Indian tribe or tribal organization that supplements, replaces, or substitutes for the programs and services provided by the federal government to Indian tribes or Indians.

This provision does not apply to any amount which is deducted or excluded from gross income under another provision of the IRC.

No change made by the provision is intended to create an inference with respect to the exclusion from gross income of benefits provided prior to the date of enactment. Additionally, no inference is intended with respect to the tax treatment of other benefits provided by an Indian tribe or tribal organization not covered by this provision.

Effective Date

The provision applies to benefits and coverage provided after March 23, 2010.

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<sup>613</sup> The term "Indian tribe" means any Indian tribe, band, nation, pueblo, or other organized group or community, including any Alaska Native village, or regional or village corporation, as defined by, or established pursuant to, the Alaska Native Claims Settlement Act (43 U.S.C. 1601 et. seq.), which is recognized as eligible for the special programs and services provided by the United States to Indians because of their status as Indians. The term "tribal organization" has the same meaning as such term in section 4(l) of the Indian Self-Determination and Education Assistance Act (25 U.S.C. 450b(1)).

<sup>614</sup> The terms "accident or health insurance" and "accident or health plan" have the same meaning as when used in IRC section 105. The term "medical care" is the same as the definition under IRC section 213. For purposes of the provision, dependents are determined under IRC section 152, but without regard to subsections (b)(1), (b)(2), and (d)(1)(B). IRC section 152(b)(1) generally provides that if an individual is a dependent of another taxpayer during a taxable year such individual is treated as having no dependents for such taxable year. IRC section 152(b)(2) provides that a married individual filing a joint return with his or her spouse is not treated as a dependent of a taxpayer. IRC section 152(d)(1)(B) provides that a "qualifying relative" (i.e., a relative that qualifies as a dependent) does not include a person whose gross income for the calendar year in which the taxable year begins equals or exceeds the exempt amount (as defined under IRC section 151).

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

California Law (IRC section 17131)

State Taxation of Indian Tribe Members

Income received by an Indian tribal member who lives in that tribe's Indian country (i.e. a reservation, a dependent Indian community, or an Indian trust allotment) is exempt from California income tax if such income is sourced in the tribal member's Indian country. The exemption of income with respect to Indian tribal members does not apply to income earned outside the reservation; thus, Indian tribal members living, working or deriving income outside their reservations are subject to the normal state income tax laws.

Exclusion from Gross Income for the Value of Specified Indian Tribe Health Care Benefits

For taxable years beginning on or after January 1, 2010, California conforms to Part III of Subchapter B of Chapter 1 of Subtitle A of the IRC, relating to the computation of taxable income, as of the "specified date" of January 1, 2009. Because this provision (to exclude from gross income for the value of specified Indian tribe health care benefits) was enacted after the "specified date," California does not conform to it.

Impact on California Revenue

Estimated Revenue Impact of Exclusion of Health Benefits Provided by Indian Tribal Governments For Taxable Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
-\$150,000	-\$80,000	-\$80,000

Estimates are based on a proration of federal estimates developed by the Joint Committee on Taxation.

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<u>Section</u>	<u>Section Title</u>
9022	Establishment of Simple Cafeteria Plans for Small Businesses

Background

Definition of a Cafeteria Plan

If an employee receives a qualified benefit (as defined below) based on the employee's election between the qualified benefit and a taxable benefit under a cafeteria plan, the qualified benefit

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

generally is not includable in gross income.<sup>615</sup> However, if a plan offering an employee an election between taxable benefits (including cash) and nontaxable qualified benefits does not meet the requirements for being a cafeteria plan, the election between taxable and nontaxable benefits results in gross income to the employee, regardless of what benefit is elected and when the election is made.<sup>616</sup> A cafeteria plan is a separate written plan under which all participants are employees, and participants are permitted to choose among at least one permitted taxable benefit (for example, current cash compensation) and at least one qualified benefit. Finally, a cafeteria plan must not provide for deferral of compensation, except as specifically permitted in IRC sections 125(d)(2)(B), (C), or (D).

### Qualified Benefits

Qualified benefits under a cafeteria plan are generally employer-provided benefits that are not includable in gross income under an express provision of the IRC. Examples of qualified benefits include employer-provided health insurance coverage, group term life insurance coverage not in excess of \$50,000, and benefits under a dependent care assistance program. In order to be excludable, any qualified benefit elected under a cafeteria plan must independently satisfy any requirements under the IRC section that provides the exclusion. However, some employer-provided benefits that are not includable in gross income under an express provision of the IRC are explicitly not allowed in a cafeteria plan. These benefits are generally referred to as nonqualified benefits. Examples of nonqualified benefits include scholarships;<sup>617</sup> employer-provided meals and lodging;<sup>618</sup> educational assistance;<sup>619</sup> and fringe benefits.<sup>620</sup> A plan offering any nonqualified benefit is not a cafeteria plan.<sup>621</sup>

### Employer Contributions through Salary Reduction

Employees electing a qualified benefit through salary reduction are electing to forego salary and instead to receive a benefit that is excludable from gross income because it is provided by employer contributions. IRC section 125 provides that the employee is treated as receiving the qualified benefit from the employer in lieu of the taxable benefit. For example, active employees

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<sup>615</sup> IRC section 125(a).

<sup>616</sup> Proposed Treas. Reg. section 1.125-1(b).

<sup>617</sup> IRC section 117.

<sup>618</sup> IRC section 119.

<sup>619</sup> IRC section 127.

<sup>620</sup> IRC section 132.

<sup>621</sup> Proposed Treas. Reg. section 1.125-1(q). Long-term care services, contributions to Archer Medical Savings Accounts, group term life insurance for an employee's spouse, child or dependent, and elective deferrals to IRC section 403(b) plans are also nonqualified benefits.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

participating in a cafeteria plan may be able to pay their share of premiums for employer-provided health insurance on a pre-tax basis through salary reduction.<sup>622</sup>

### Nondiscrimination Requirements

Cafeteria plans and certain qualified benefits (including group term life insurance, self-insured medical reimbursement plans, and dependent care assistance programs) are subject to nondiscrimination requirements to prevent discrimination in favor of highly-compensated individuals generally as to eligibility for benefits and as to actual contributions and benefits provided. There are also rules to prevent the provision of disproportionate benefits to key employees (within the meaning of IRC section 416(i)) through a cafeteria plan.<sup>623</sup> Although the basic purpose of each of the nondiscrimination rules is the same, the specific rules for satisfying the relevant nondiscrimination requirements, including the definition of highly-compensated individual,<sup>624</sup> vary for cafeteria plans generally and for each qualified benefit. An employer maintaining a cafeteria plan in which any highly-compensated individual participates must make sure that both the cafeteria plan and each qualified benefit satisfies the relevant nondiscrimination requirements, as a failure to satisfy the nondiscrimination rules generally results in a loss of the tax exclusion by the highly-compensated individuals.

### New Federal Law (IRC section 125)

Under the provision, an eligible small employer is provided with a safe harbor from the nondiscrimination requirements for cafeteria plans as well as from the nondiscrimination requirements for specified qualified benefits offered under a cafeteria plan, including group term life insurance, benefits under a self insured medical expense reimbursement plan, and benefits under a dependent care assistance program. Under the safe harbor, a cafeteria plan and the specified qualified benefits are treated as meeting the specified nondiscrimination rules if the

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<sup>622</sup> IRC section 125.

<sup>623</sup> A key employee generally is an employee who, at any time during the year is (1) a five-percent owner of the employer, or (2) a one-percent owner with compensation of more than \$150,000 (not indexed for inflation), or (3) an officer with compensation more than \$160,000 (for 2010). A special rule limits the number of officers treated as key employees. If the employer is a corporation, a five-percent owner is a person who owns more than five percent of the outstanding stock or stock possessing more than five percent of the total combined voting power of all stock. If the employer is not a corporation, a five-percent owner is a person who owns more than five percent of the capital or profits interest. A one-percent owner is determined by substituting one percent for five percent in the preceding definitions. For purposes of determining employee ownership in the employer, certain attribution rules apply.

<sup>624</sup> For cafeteria plan purposes, a "highly-compensated individual" is: (1) an officer; (2) a five-percent shareholder; (3) an individual who is highly compensated; or (4) the spouse or dependent of any of the preceding categories. A "highly-compensated participant" is a participant who falls in any of those categories. "Highly compensated" is not defined for this purpose. Under IRC section 105(h), a self-insured medical expense reimbursement plan must not discriminate in favor of a "highly-compensated individual," defined as: (1) one of the five highest paid officers; (2) a 10-percent shareholder; or (3) an individual among the highest paid 25 percent of all employees. Under IRC section 129 for a dependent care assistance program, eligibility for benefits, and the benefits and contributions provided, generally must not discriminate in favor of highly-compensated employees within the meaning of IRC section 414(q).

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

cafeteria plan satisfies minimum eligibility and participation requirements and minimum contribution requirements.

#### Eligibility Requirement

The eligibility requirement is met only if all employees (other than excludable employees) are eligible to participate, and each employee eligible to participate is able to elect any benefit available under the plan (subject to the terms and conditions applicable to all participants). However, a cafeteria plan will not fail to satisfy this eligibility requirement merely because the plan excludes employees who: (1) have not attained the age of 21 (or a younger age provided in the plan) before the close of a plan year; (2) have fewer than 1,000 hours of service for the preceding plan year; (3) have not completed one year of service with the employer as of any day during the plan year; (4) are covered under an agreement that the Secretary of Labor finds to be a collective bargaining agreement if there is evidence that the benefits covered under the cafeteria plan were the subject of good faith bargaining between employee representatives and the employer; or (5) are described in IRC section 410(b)(3)(C) (relating to nonresident aliens working outside the United States). An employer may have a shorter age and service requirement but only if such shorter service or younger age applies to all employees.

#### Minimum Contribution Requirement

The minimum contribution requirement is met if the employer provides a minimum contribution for each nonhighly-compensated employee (employee who is not a highly-compensated employee<sup>625</sup> or a key employee (within the meaning of IRC section 416(i))) in addition to any salary-reduction contributions made by the employee. The minimum must be available for application toward the cost of any qualified benefit (other than a taxable benefit) offered under the plan. The minimum contribution is permitted to be calculated under either the nonelective contribution method or the matching contribution method, but the same method must be used for calculating the minimum contribution for all nonhighly-compensated employees. The minimum contribution under the nonelective contribution method is an amount equal to a uniform percentage (not less than two percent) of each eligible employee's compensation for the plan year, determined without regard to whether the employee makes any salary-reduction contribution under the cafeteria plan. The minimum matching contribution is the lesser of 100 percent of the amount of the salary-reduction contribution elected to be made by the employee for the plan year or (2) six percent of the employee's compensation for the plan year. Compensation for purposes of this minimum contribution requirement is compensation with the meaning of IRC section 414(s).

A simple cafeteria plan is permitted to provide for the matching contributions in addition to the minimum required, but only if matching contributions with respect to salary-reduction contributions for any highly-compensated employee or key employee are not made at a greater

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<sup>625</sup> IRC section 414(q) generally defines a highly-compensated employee as an employee: (1) who was a five-percent owner during the year or the preceding year; or (2) who had compensation of \$110,000 (for 2010) or more for the preceding year. An employer may elect to limit the employees treated as highly-compensated employees based upon their compensation in the preceding year to the highest paid 20 percent of employees in the preceding year. Five-percent owner is defined by cross-reference to the definition of key employee in IRC section 416(i).

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

rate than the matching contributions for any nonhighly-compensated employee. Nothing in this provision prohibits an employer from providing qualified benefits under the plan in addition to the required contributions.

#### Eligible Employer

An eligible small employer under the provision is, with respect to any year, an employer who employed an average of 100 or fewer employees on business days during either of the two preceding years. For purposes of the provision, a year may only be taken into account if the employer was in existence throughout the year. If an employer was not in existence throughout the preceding year, the determination is based on the average number of employees that it is reasonably expected such employer will employ on business days in the current year. If an employer was an eligible employer for any year and maintained a simple cafeteria plan for its employees for such year, then, for each subsequent year during which the employer continues, without interruption, to maintain the cafeteria plan, the employer is deemed to be an eligible small employer until the employer employs an average of 200 or more employees on business days during any year preceding any such subsequent year.

The determination of whether an employer is an eligible small employer is determined by applying the controlled group rules of IRC sections 52(a) and (b) under which all members of the controlled group are treated as a single employer. In addition, the definition of employee includes leased employees within the meaning of IRC sections 414(n) and (o).<sup>626</sup>

#### Effective Date

The provision is effective for taxable years beginning after December 31, 2010.

#### California Law (R&TC sections 17131 and 17131.5)

For taxable years beginning on or after January 1, 2010, California conforms by reference to IRC section 125, relating to cafeteria plans, in R&TC section 17131 as of the “specified date” of January 1, 2009, with modifications. Because this provision was enacted after the “specified date,” California does not conform to it.

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<sup>626</sup> IRC section 52(b) provides that, for specified purposes, all employees of all corporations which are members of a controlled group of corporations are treated as employed by a single employer. However, IRC section 52(b) provides certain modifications to the control group rules including substituting 50 percent ownership for 80 percent ownership as the measure of control. There is a similar rule in IRC section 52(c) under which all employees of trades or businesses (whether or not incorporated) which are under common control are treated under regulations as employed by a single employer. IRC section 414(n) provides rules for specified purposes when leased employees are treated as employed by the service recipient and IRC section 414(o) authorizes the Treasury to issue regulations to prevent avoidance of the requirements of IRC section 414(n).

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

Impact on California Revenue

Negligible—the Joint Committee on Taxation estimates that this provision will result in negligible revenue losses; thus, the California revenue losses as a result of conforming to this provision would also be negligible.

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<u>Section</u>	<u>Section Title</u>
9023	Qualifying Therapeutic Discovery Project Credit

Background

Present law provides for a research credit equal to 20 percent (14 percent in the case of the alternative simplified credit) of the amount by which the taxpayer's qualified research expenses for a taxable year exceed its base amount for that year.<sup>627</sup> Thus, the research credit is generally available with respect to incremental increases in qualified research.

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."<sup>628</sup>

Finally, 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.

The research credit, including the university basic research credit and the energy research credit, expired for amounts paid or incurred after December 31, 2009.<sup>629</sup>

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

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<sup>627</sup> IRC section 41.

<sup>628</sup> IRC section 41(e).

<sup>629</sup> IRC section 41(h).

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

(so-called contract research expenses).<sup>630</sup> 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.

Present law also provides a 50-percent credit<sup>631</sup> for expenses related to human clinical testing of drugs for the treatment of certain rare diseases and conditions, generally those that afflict less than 200,000 persons in the United States. Qualifying expenses are those paid or incurred by the taxpayer after the date on which the drug is designated as a potential treatment for a rare disease or disorder by the Food and Drug Administration ("FDA") in accordance with section 526 of the Federal Food, Drug, and Cosmetic Act.

Present law does not provide a credit specifically designed to encourage investment in new therapies relating to diseases.

New Federal Law (IRC sections 46, 48D, 49, and 280C)

In General

The provision establishes a 50- percent nonrefundable investment tax credit for qualified investments in qualifying therapeutic discovery projects. The provision allocates \$1 billion during the two-year period 2009 through 2010 for the program. The Secretary, in consultation with the Secretary of HHS, will award certifications for qualified investments. The credit is available only to companies having 250 or fewer employees.<sup>632</sup>

A "qualifying therapeutic discovery project" is a project which is designed to develop a product, process, or therapy to diagnose, treat, or prevent diseases and afflictions by: (1) conducting pre-clinical activities, clinical trials, clinical studies, and research protocols; or (2) by developing technology or products designed to diagnose diseases and conditions, including molecular and companion drugs and diagnostics, or to further the delivery or administration of therapeutics.

The qualified investment for any taxable year is the aggregate amount of the costs paid or incurred in such year for expenses necessary for and directly related to the conduct of a qualifying therapeutic discovery project. The qualified investment for any taxable year with respect to any

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<sup>630</sup> 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 of 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).

<sup>631</sup> IRC section 45C.

<sup>632</sup> The number of employees is determined taking into account all businesses of the taxpayer at the time it submits an application, and is determined taking into account the rules for determining a single employer under IRC section 52(a) or (b) or IRC section 414(m) or (o).

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

qualifying therapeutic discovery project does not include any cost for: (1) remuneration for an employee described in IRC section 162(m)(3), (2) interest expense, (3) facility maintenance expenses, (4) a service cost identified under Treas. Reg. section 1.263A-1(e)(4), or (5) any other expenditure as determined by the Secretary as appropriate to carry out the purposes of the provision.

Companies must apply to the Secretary to obtain certification for qualifying investments.<sup>633</sup> The Secretary, in determining qualifying projects, will consider only those projects that show reasonable potential to: (1) result in new therapies to treat areas of unmet medical need or to prevent, detect, or treat chronic or acute disease and conditions; (2) reduce long-term health care costs in the United States; or (3) significantly advance the goal of curing cancer within a 30-year period. Additionally, the Secretary will take into consideration which projects would have the greatest potential to: (1) create and sustain (directly or indirectly) high quality, high paying jobs in the United States; and (2) advance the United States' competitiveness in the fields of life, biological, and medical sciences.

Qualified therapeutic discovery project expenditures do not qualify for the research credit, orphan drug credit, or bonus depreciation.<sup>634</sup> If a credit is allowed for an expenditure related to property subject to depreciation, the basis of the property is reduced by the amount of the credit. Additionally, expenditures taken into account in determining the credit are nondeductible to the extent of the credit claimed that is attributable to such expenditures.

#### Election to Receive Grant in Lieu of Tax Credit

Taxpayers may elect to receive credits that have been allocated to them in the form of Treasury grants equal to 50 percent of the qualifying investment. Any such grant is not includible in the taxpayer's gross income.

In making grants under this section, the Secretary of the Treasury is to apply rules similar to the rules of IRC section 50. In applying such rules, if an investment ceases to be a qualified investment, the Secretary of the Treasury shall provide for the recapture of the appropriate percentage of the grant amount in such manner as the Secretary of the Treasury determines appropriate. The Secretary of the Treasury shall not make any grant under this section to: (1) any federal, state, or local government (or any political subdivision, agency, or instrumentality thereof); (2) any organization described in IRC section 501(c) and exempt from tax under IRC section 501(a); (3) any entity referred to in paragraph (4) of IRC section 54(j); or (4) any partnership or other pass-thru entity any partner (or other holder of an equity or profits interest) of which is described in paragraph (1), (2) or (3).

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<sup>633</sup> The Secretary must take action to approve or deny an application within 30 days of the submission of such application.

<sup>634</sup> Any expenses for the taxable year that are qualified research expenses under IRC section 41(b) are taken into account in determining base period research expenses for purposes of computing the research credit under IRC section 41 for subsequent taxable years.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

Effective Date

The provision applies to expenditures paid or incurred after December 31, 2008, in taxable years beginning after December 31, 2008.

California Law

Therapeutic Discovery Project Credit

California does not conform to IRC section 48D, relating to the therapeutic discovery project credit, and has no comparable credit.

Election to Receive Grant in Lieu of Tax Credit / Exclusion from Gross Income

The exclusion of the grant from federal income and the corresponding fifty-percent basis reduction are provided under IRC section 48D. California does not conform to IRC section 48D; thus, the grant is includible in a taxpayer's California gross income and there is no California basis reduction.

Impact on California Revenue

Therapeutic Discovery Project Credit

Not applicable.

Election to Receive Grant in Lieu of Tax Credit / Exclusion from Gross Income

Estimated Revenue Impact of Exclusion of Qualifying Therapeutic Discovery Project Grants For Taxable Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
-\$2,600,000	-\$1,700,000	-\$800,000

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

<u>Section</u>	<u>Section Title</u>
10105	Amendments to Subtitle E

Background

None.

New Federal Law (IRC sections 36B, 38, 45R, 280C, and 6211)

This provision amends sections 1401 and 1421 of this Act.

Additionally, this provision instructs the Secretary of Health and Human Services (HHS) to conduct a study on the feasibility and implication of adjusting the application of the federal poverty level (FPL) under the provisions enacted in the bill for different geographical areas so as to reflect disparities in the cost of living among different areas in the United States, including the territories. If the Secretary deems such an adjustment feasible, then the study should include a methodology for implementing the adjustment. The Secretary is required to report the results of the study to Congress no later than January 1, 2013. The provision requires that special attention be paid to the impact of disparities between the poverty levels and the cost of living in the territories and the impact of this disparity on the expansion of health coverage in the territories. The territories are the Commonwealth of Puerto Rico, the U.S. Virgin Islands, Guam, the Commonwealth of the Northern Mariana Islands, American Samoa, and any other territory or possession of the United States. The provision also makes technical amendments to several IRC sections that are added or amended by this Act.

Effective Date

The provision is effective on March 23, 2010.

California Law (None)

This provision is not applicable under California law.

Impact on California Revenue

Not applicable.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

<u>Section</u>	<u>Section Title</u>
10108	Free Choice Vouchers

Background

None.

New Federal Law (IRC sections 36B, 101, 139D, 162, and 4980H)

Provision of Vouchers

Employers offering minimum essential coverage through an eligible employer-sponsored plan and paying a portion of that coverage must provide qualified employees with a voucher whose value can be applied to purchase of a health plan through the Exchange. Qualified employees are employees whose required contribution for employer-sponsored minimum essential coverage exceeds 8 percent, but does not exceed 9.8 percent of the employee's household income for the taxable year and the employee's total household income does not exceed 400 percent of the poverty line for the family. In addition, the employee must not participate in the employer's health plan.

The value of the voucher is equal to the dollar value of the employer contribution to the employer-offered health plan. If multiple plans are offered by the employer, the value of the voucher is the dollar amount that would be paid if the employee chose the plan for which the employer would pay the largest percentage of the premium cost.<sup>635</sup> The value of the voucher is for self-only coverage unless the individual purchases family coverage in the Exchange. Under the provision, for purposes of calculating the dollar value of the employer contribution, the premium for any health plan is determined under the rules of section 2204 of PHS, except that the amount is adjusted for age and category of enrollment in accordance with regulations established by the Secretary.

In the case of years after 2014, the eight percent and the 9.8 percent are indexed to the excess of premium growth over income growth for the preceding calendar year.

Use of Vouchers

Vouchers can be used in the Exchange towards the monthly premium of any qualified health plan in the Exchange. The value of the voucher to the extent it is used for the purchase of a health

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<sup>635</sup> For example, if an employer offering the same plans for \$200 and \$300 offers a flat \$180 contribution for all plans, a contribution of 90 percent for the \$200 plan and a contribution of 60 percent for the \$300 plan, and the value of the voucher would equal the value of the contribution to the \$200 since it received a 90 percent contribution, a value of \$180. However, if the firm offers a \$150 contribution to the \$200 plan (75 percent) and a \$200 contribution to the \$300 plan (67 percent), the value of the voucher is based on the plan receiving the greater percentage paid by the employer and would be \$150. If a firm offers health plans with monthly premiums of \$200 and \$300 and provides a payment of 60 percent of any plan purchased, the value of the voucher will be 60 percent the higher premium plan, in this case, 60 percent of \$300 or \$180.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

plan is not includable in gross income. If the value of the voucher exceeds the premium of the health plan chosen by the employee, the employee is paid the excess value of the voucher. The excess amount received by the employee is includable in the employee's gross income.

If an individual receives a voucher the individual is disqualified from receiving any tax credit or cost sharing credit for the purchase of a plan in the Exchange. Similarly, if any employee receives a free choice voucher, the employer is not be assessed a shared responsibility payment on behalf of that employee.

#### Definition of Terms

The terms used for this provision have the same meaning as any term used in the provision for the requirement to maintain minimum essential coverage (section 1501 of this Act and new IRC section 5000A). For example, the terms "household income," "poverty line," "required contribution," and "eligible employer-sponsored plan" have the same meaning for both provisions. Thus, the required contribution includes the amount of any salary-reduction contribution.

#### Effective Date

The provision is effective after December 31, 2013.

#### California Law (R&TC sections 17131, 17201, and 24343)

#### Gross Income Exclusion under IRC section 139D

IRC section 139D was added to Part III of Subchapter B of Chapter 1 of Subtitle A of the IRC to provide the gross-income exclusion for the value of the free choice voucher to the extent it is used for the purchase of a health plan. For taxable years beginning on or after January 1, 2010, California conforms by reference in the PITL to Part III of Subchapter B of Chapter 1 of Subtitle A of the IRC, relating to items specifically excluded from gross income, as of the "specified date" of January 1, 2009. Because this provision was enacted after the "specified date," California does not conform to the gross income exclusion under IRC section 139D.

#### Employer Deduction under IRC section 162

IRC section 162 was amended to provide that the amount of a free choice voucher is treated as a deductible employer expense for personal services actually rendered. For taxable years beginning on or after January 1, 2010, under both the PITL and the Corporation Tax Law (CTL), California conforms to IRC section 162 as of the "specified date" of January 1, 2009. Because this provision was enacted after the "specified date," California does not conform to this federal change to IRC section 162.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

Impact on California Revenue

Estimated Revenue Impact of Free Choice Voucher Exclusion and Deduction For Taxable Years Beginning On or After January 1, 2014 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
No Impact	No Impact	-\$55,000,000

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<u>Section</u>	<u>Section Title</u>
10908	Exclusion for Assistance Provided to Participants in State Student Loan Repayment Programs for Certain Health Professionals

Background

Gross income generally includes the discharge of indebtedness of the taxpayer. Under an exception to this general rule, gross income does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers.

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

In addition, an individual's gross income does not include amounts from the forgiveness of loans made by educational organizations (and certain tax-exempt organizations in the case of refinancing loans) out of private, nongovernmental funds if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance any outstanding student loans (not just loans made by educational organizations) and the student is not employed by the lender organization. In the case of such loans made or refinanced by educational organizations (or refinancing loans made by certain tax-exempt organizations), cancellation of the student loan must be contingent upon the student working in an occupation or area with unmet needs and

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

such work must be performed for, or under the direction of, a tax-exempt charitable organization or a governmental entity.

Finally, an individual's gross income does not include any loan repayment amount received under the National Health Service Corps loan repayment program or certain state loan repayment programs.

New Federal Law (IRC section 108)

The provision modifies the gross income exclusion for amounts received under the National Health Service Corps loan repayment program or certain state loan repayment programs to include any amount received by an individual under any state loan repayment or loan forgiveness program that is intended to provide for the increased availability of health care services in underserved or health professional shortage areas (as determined by the state).

Effective Date

The provision is effective for amounts received by an individual in taxable years beginning after December 31, 2008.

California Law (R&TC section 17131)

For taxable years beginning on or after January 1, 2010, California conforms to IRC section 108 as of the "specified date" of January 1, 2009. Because this provision was enacted after the "specified date," California does not conform to it.

Impact on California Revenue

Estimated Revenue Impact of Exclusion for Assistance Provided to Participants in State Student Loan Repayment Programs for Certain Health Professionals For Taxable Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
-\$500,000	-\$350,000	-\$350,000

Estimates are based on a proration of federal estimates developed by the Joint Committee on Taxation.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

<u>Section</u>	<u>Section Title</u>
10909	Expansion of Adoption Credit and Adoption Assistance Programs

Background

Tax Credit

*Non-special needs adoptions*

Generally, a nonrefundable tax credit is allowed for qualified adoption expenses paid or incurred by a taxpayer, subject to the maximum credit. The maximum credit is \$12,170 per eligible child for taxable years beginning in 2010. An eligible child is an individual who: (1) has not attained age 18; or (2) is physically or mentally incapable of caring for himself or herself. The maximum credit is applied per child rather than per year. Therefore, while qualified adoption expenses may be incurred in one or more taxable years, the tax credit per adoption of an eligible child may not exceed the maximum credit.

*Special needs adoptions*

In the case of a special-needs adoption finalized during a taxable year, the taxpayer may claim as an adoption credit the amount of the maximum credit minus the aggregate qualified adoption expenses with respect to that adoption for all prior taxable years. A special-needs child is an eligible child who is a citizen or resident of the United States whom a state has determined: (1) cannot or should not be returned to the home of the birth parents; and (2) has a specific factor or condition (such as the child's ethnic background, age, or membership in a minority or sibling group, or the presence of factors such as medical conditions, or physical, mental, or emotional handicaps) because of which the child cannot be placed with adoptive parents without adoption assistance.

*Qualified adoption expenses*

Qualified adoption expenses are reasonable and necessary adoption fees, court costs, attorneys fees, and other expenses that are: (1) directly related to, and the principal purpose of which is for, the legal adoption of an eligible child by the taxpayer; (2) not incurred in violation of state or federal law, or in carrying out any surrogate parenting arrangement; (3) not for the adoption of the child of the taxpayer's spouse; and (4) not reimbursed (e.g., by an employer).

*Phase-out for higher-income individuals*

The adoption credit is phased out ratably for taxpayers with modified adjusted gross income between \$182,520 and \$222,520 for taxable years beginning in 2010. Under present law, modified adjusted gross income is the sum of the taxpayer's adjusted gross income plus amounts excluded from income under IRC sections 911, 931, and 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands; and residents of Puerto Rico, respectively).

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

*EGTRRA sunset*<sup>636</sup>

For taxable years after 2010, the adoption credit will be reduced to a maximum credit of \$6,000 for special-needs adoptions and no tax credit for non-special-needs adoptions. Also, the credit phase-out range will revert to the pre-EGTRRA levels (i.e., a ratable phase-out between modified adjusted gross income between \$75,000 and \$115,000). Finally, the adoption credit will be allowed only to the extent the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum foreign tax credit.

Exclusion for Employer-Provided Adoption Assistance

An exclusion from the gross income of an employee is allowed for qualified adoption expenses paid or reimbursed by an employer under an adoption assistance program. For 2010, the maximum exclusion is \$12,170. Also for 2010, the exclusion is phased out ratably for taxpayers with modified adjusted gross income between \$182,520 and \$222,520. Modified adjusted gross income is the sum of the taxpayer's adjusted gross income plus amounts excluded from income under IRC sections 911, 931, and 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands; and residents of Puerto Rico, respectively). For purposes of this exclusion, modified adjusted gross income also includes all employer payments and reimbursements for adoption expenses whether or not they are taxable to the employee.

Adoption expenses paid or reimbursed by the employer under an adoption assistance program are not eligible for the adoption credit. A taxpayer may be eligible for the adoption credit (with respect to qualified adoption expenses he or she incurs) and also for the exclusion (with respect to different qualified adoption expenses paid or reimbursed by his or her employer).

Because of the EGTRRA sunset, the EGTRRA modifications to the exclusion for employer-provided adoption assistance do not apply to amounts paid or incurred after December 31, 2010.

New Federal Law (IRC sections 1, 21, 23, 24, 25, 25A, 25B, 26, 30, 30B, 30C, 30D, 31, 36C, 137, 904, 1016, 1400C, and 6211)

Tax Credit

For 2010, the maximum credit is increased to \$13,170 per eligible child (a \$1,000 increase). This increase applies to both non-special-needs adoptions and special-needs adoptions. Also, the adoption credit is made refundable.

The new dollar limit and phase-out of the adoption credit are adjusted for inflation in taxable years beginning after December 31, 2010.

The EGTRRA sunset is delayed for one year (i.e., the sunset becomes effective for taxable years beginning after December 31, 2011).

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<sup>636</sup> "EGTRRA" refers to the Economic Growth and Tax Relief Reconciliation Act of 2001.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

Adoption Assistance Program

The maximum exclusion is increased to \$13,170 per eligible child (a \$1,000 increase).

The new dollar limit and income limitations of the employer-provided adoption assistance exclusion are adjusted for inflation in taxable years beginning after December 31, 2010.

The EGTRRA sunset is delayed for one year (i.e., the sunset becomes effective for taxable years beginning after December 31, 2011).

Effective Date

The provisions generally are effective for taxable years beginning after December 31, 2009.

California Law (R&TC sections 17052.25 and 17131)

Tax Credit

California does not conform to the federal adoption credit; instead, California provides its own credit for adoption costs.

For taxable years beginning on or after January 1, 1994, California allows a credit equal to 50 percent of the cost of adopting a minor child who is an American citizen and is in the custody of a California public agency or a political subdivision of California. The credit is claimed in the taxable year in which the decree or order of adoption is entered, although qualifying costs paid or incurred in prior years can qualify for the credit.

Costs eligible for the credit include: (1) fees for required services of either the Department of Social Services or a licensed adoption agency; (2) travel and related expenses for the adoptive family that are directly related to the adoption process; and (3) medical fees and expenses that are not reimbursed by insurance and are directly related to the adoption process.

The maximum allowable credit cannot exceed \$2,500 per minor child. California's credit cannot reduce regular tax below tentative minimum tax for alternative minimum tax purposes; however, credit amounts subject to this limitation may be carried over to succeeding taxable years until exhausted.

Adoption Assistance Program

For taxable years beginning on or after January 1, 2010, California conforms to the employee gross income exclusion as of the "specified date" of January 1, 2009. Because the federal changes to this exclusion were enacted after the "specified date," California does not conform to the \$1,000 increase to the adoption assistance gross income exclusion. Thus, for California

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)  
Public Law 111-148, March 23, 2010

purposes, the maximum exclusion for 2010 is \$12,170 per eligible child. However, California automatically conforms to the one-year delay to the EGTRRA sunset.<sup>637</sup>

Impact on California Revenue

Tax Credit

Not applicable.

Adoptions Assistance Program

Estimated Revenue Impact of Adoption Assistance Program Exclusion Increase For Taxable Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
-\$1,200,000	No Impact	No Impact

Estimates are based on a proration of federal estimates developed by the Joint Committee on Taxation.

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<sup>637</sup> R&TC section 17024.5(a)(2)(B).

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010 (HCERA)  
Public Law 111-152, March 30, 2010

<u>Section</u>	<u>Section Title</u>
1004	Income Definitions

Background

Definition of Dependent for Exclusion for Employer-Provided Health Coverage

The IRC generally provides that employees are not taxed on (that is, may "exclude" from gross income) the value of employer-provided health coverage under an accident or health plan.<sup>638</sup> This exclusion applies to coverage for personal injuries or sickness for employees (including retirees), their spouses and their dependents.<sup>639</sup> In addition, any reimbursements under an accident or health plan for medical care expenses for employees (including retirees), their spouses, and their dependents (as defined in IRC section 152) generally are excluded from gross income.<sup>640</sup> IRC section 152 defines a dependent as a qualifying child or qualifying relative.

Under IRC section 152(c), a child generally is a qualifying child of a taxpayer if the child satisfies each of five tests for the taxable year: (1) the child has the same principal place of abode as the taxpayer for more than one-half of the taxable year; (2) the child has a specified relationship to the taxpayer; (3) the child has not yet attained a specified age; (4) the child has not provided over one-half of their own support for the calendar year in which the taxable year of the taxpayer begins; and (5) the qualifying child has not filed a joint return (other than for a claim of refund) with their spouse for the taxable year beginning in the calendar year in which the taxable year of the taxpayer begins. A tie-breaking rule applies if more than one taxpayer claims a child as a qualifying child. The specified relationship is that the child is the taxpayer's son, daughter, stepson, stepdaughter, brother, sister, stepbrother, stepsister, or a descendant of any such individual. With respect to the specified age, a child must be under age 19 (or under age 24 in the case of a full-time student). However, no age limit applies with respect to individuals who are totally and permanently disabled within the meaning of IRC section 22(e)(3) at any time during the calendar year. Other rules may apply.

Under IRC section 152(d), a qualifying relative means an individual that satisfies three tests for the taxable year: (1) the individual bears a specified relationship to the taxpayer; (2) the taxpayer provides more than one-half the individual's support for the calendar year in which the taxable year begins; and (3) the individual is not a qualifying child of the taxpayer or any other taxpayer for any taxable year beginning in the calendar year in which such taxable year begins. The specified relationship test for qualifying relative is satisfied if that individual is the taxpayer's: (1) child or

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<sup>638</sup> IRC section 106.

<sup>639</sup> Treas. Reg. section 1.106-1.

<sup>640</sup> IRC section 105(b).

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

descendant of a child; (2) brother, sister, stepbrother or stepsister; (3) father, mother or ancestor of either; (4) stepfather or stepmother; (5) niece or nephew; (6) aunt or uncle; (7) in-law; or (8) certain other individuals, who for the taxable year of the taxpayer, have the same principal place of abode as the taxpayer and are members of the taxpayer's household.<sup>641</sup>

Employers may agree to reimburse medical expenses of their employees (and their spouses and dependents), not covered by a health insurance plan, through flexible spending arrangements which allow reimbursement not in excess of a specified dollar amount (either elected by an employee under a cafeteria plan or otherwise specified by the employer). Reimbursements under these arrangements are also excludible from gross income as employer-provided health coverage. The same definition of dependents applies for purposes of flexible spending arrangements.

#### Deduction for Health Insurance Premiums of Self-Employed Individuals

Under present law, self-employed individuals may deduct the cost of health insurance for themselves and their spouses and dependents. The deduction is not available for any month in which the self-employed individual is eligible to participate in an employer-subsidized health plan. Moreover, the deduction may not exceed the individual's self-employment income. The deduction applies only to the cost of insurance (i.e., it does not apply to out-of-pocket expenses that are not reimbursed by insurance). The deduction does not apply for self-employment tax purposes. For purposes of the deduction, a more than two percent shareholder-employee of an S corporation is treated the same as a self-employed individual. Thus, the exclusion for employer-provided health care coverage does not apply to such individuals, but they are entitled to the deduction for health insurance costs as if they were self-employed.

#### Voluntary Employees' Beneficiary Associations (VEBA)

A VEBA is a tax-exempt entity that is a part of a plan for providing life, sick or accident benefits to its members or their dependents or designated beneficiaries.<sup>642</sup> No part of the net earnings of the association inures (other than through the payment of life, sick, accident or other benefits) to the benefit of any private shareholder or individual. A VEBA may be funded with employer contributions or employee contributions or a combination of employer contributions and employee contributions. The same definition of dependent applies for purposes of receipt of medical benefits through a VEBA.

#### Qualified Plans Providing Retiree Health Benefits

A qualified pension or annuity plan can establish and maintain a separate account to provide for the payment of sickness, accident, hospitalization, and medical expenses for retired employees, their spouses and their dependents ("401(h) account"). An employer's contributions to a 401(h) account must be reasonable and ascertainable, and retiree health benefits must be subordinate

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<sup>641</sup> Generally, same-sex partners do not qualify as dependents under IRC section 152. In addition, same-sex partners are not recognized as spouses for purposes of the IRC. Defense of Marriage Act, Public Law 104-199.

<sup>642</sup> IRC sections 419(e) and 501(c)(9).

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

to the retirement benefits provided by the plan. In addition, it must be impossible, at any time prior to the satisfaction of all retiree health liabilities under the plan, for any part of the corpus or income of the 401(h) account to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than providing retiree health benefits and, upon satisfaction of all retiree health liabilities, the plan must provide that any amount remaining in the 401(h) account be returned to the employer.

New Federal Law (IRC sections 36B, 105, 162, 401, 501, and 5000A)

The provision amends IRC section 105(b) to extend the general exclusion for reimbursements for medical care expenses under an employer-provided accident or health plan to any child of an employee who has not attained age 27 as of the end of the taxable year. This change is also intended to apply to the exclusion for employer-provided coverage under an accident or health plan for injuries or sickness for such a child. A parallel change is made for VEBA and 401(h) accounts.

The provision similarly amends IRC section 162(l) to permit self-employed individuals to take a deduction for any child of the taxpayer who has not attained age 27 as of the end of the taxable year.

For purposes of the provision, "child" means an individual who is a son, daughter, stepson, stepdaughter or eligible foster child of the taxpayer.<sup>643</sup> An eligible foster child means an individual who is placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction.

Effective Date

The provision is effective as of March 30, 2010.

California Law (R&TC sections 17131, 17201, 17501, 23701, 23701i, 24343, and 24601)

Changes to IRC sections 36B and 5000A

California does not conform to IRC sections 36B and 5000A; thus, these federal changes are not applicable.

Changes to IRC section 105

The PITL conforms to the IRC section 105(b) general exclusion for reimbursements for medical care expenses under an employer-provided accident or health plan to any child of an employee who has not attained age 27 as of the end of the taxable year.<sup>644</sup>

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<sup>643</sup> IRC section 152(f)(1). Under IRC section 152(f)(1), a legally adopted child of the taxpayer or an individual who is lawfully placed with the taxpayer for legal adoption by the taxpayer is treated as a child of the taxpayer by blood.

<sup>644</sup> R&TC section 17131, as amended by chapter 17 of the Statutes of 2011. The California exclusion applies in the same manner and to the same periods as the federal exclusion.

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

Changes to IRC section 162

The PITL conforms to the federal self-employment medical care insurance deduction for any child who has not attained the age of 27 by the end of the taxable year.<sup>645</sup>

Changes to IRC section 401

California automatically conforms to the federal change that allows plans providing retiree health benefits to retired employees, their spouses, and their dependents, to include within the meaning of “dependent” any child of a retired employee who has not attained age 27 as of the end of the calendar year.<sup>646</sup>

Changes to IRC section 501

*In general*

California does not conform to IRC section 501, but instead has stand-alone law that provides rules for tax-exempt organizations. Generally, to obtain California tax-exempt status, an organization is required to file an exempt application<sup>647</sup> with the FTB 90 calendar days before the exemption is needed. An organization obtains tax-exempt status upon receiving a letter from the FTB exempting the organization from tax.

*Voluntary Employees' Beneficiary Associations (VEBA)*

California conforms to the federal change to the definition of VEBA dependents to include any child of a member who has not attained the age of 27 by the end of the calendar year.<sup>648</sup>

Impact on California Revenue

Changes to IRC sections 36B and 5000A

Not applicable.

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<sup>645</sup> R&TC section 17201.1, as amended by chapter 17 of the Statutes of 2011. The California deduction applies in the same manner and to the same periods as the federal deduction.

<sup>646</sup> Under R&TC sections 17501 and 24601, California conforms to Part I of Subchapter D of Chapter 1 of Subtitle A of the IRC (IRC sections 401 through 420), relating to pension, profit-sharing, and stock-bonus plans, etc., without regard to taxable year.

<sup>647</sup> Form FTB 3500, Exemption Application.

<sup>648</sup> R&TC section 23701i, as amended by chapter 17 of the Statutes of 2011. The California change to the definition of VEBA dependents applies in the same manner and to the same periods as the federal change.

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

Changes to IRC sections 105, 162, and 501

California conformed to these provisions with chapter 17 of the Statutes of 2011; see the analysis of AB 36 (2010/11) at: [http://www.ftb.ca.gov/law/legis/11\\_12bills/ab36\\_final.pdf](http://www.ftb.ca.gov/law/legis/11_12bills/ab36_final.pdf).

Changes to IRC section 401

Baseline—based federal information from the Department of Health and Human Services, baseline revenue losses are estimated to be \$1,600,000 in 2011-12, \$1,500,000 in 2012-13, and \$1,700,000 in 2013-14.

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<u>Section</u>	<u>Section Title</u>
1402	Unearned Income Medicare Contribution

Background

Social security benefits and certain Medicare benefits are financed primarily by payroll taxes on covered wages. FICA imposes tax on employers based on the amount of wages paid to an employee during the year. The tax imposed is composed of two parts: (1) the OASDI tax equal to 6.2 percent of covered wages up to the taxable wage base (\$106,800 in 2010); and (2) the Medicare hospital insurance ("HI") tax amount equal to 1.45 percent of covered wages. In addition to the tax on employers, each employee is subject to FICA taxes equal to the amount of tax imposed on the employer. The employee-level tax generally must be withheld and remitted to the federal government by the employer.

As a parallel to FICA taxes, SECA imposes taxes on the net income from self employment of self employed individuals. The rate of the OASDI portion of SECA taxes is equal to the combined employee and employer OASDI FICA tax rates and applies to self-employment income up to the FICA taxable wage base. Similarly, the rate of the HI portion is the same as the combined employer and employee HI rates and there is no cap on the amount of self-employment income to which the rate applies.<sup>649</sup>

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<sup>649</sup> For purposes of computing net earnings from self employment, taxpayers are permitted a deduction equal to the product of the taxpayer's earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent); i.e., 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas the self-employed individual's net earnings are economically equivalent to an employee's wages plus the employer share of FICA taxes.

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

New Federal Law (IRC sections 1, 1401, 1411, 3101, and 6654)

In General

In the case of an individual, estate, or trust an unearned income Medicare contribution tax is imposed.

In the case of an individual, the tax is the 3.8 percent of the lesser of net investment income or the excess of modified adjusted gross income over the threshold amount.

The threshold amount is \$250,000 in the case of a joint return or surviving spouse, \$125,000 in the case of a married individual filing a separate return, and \$200,000 in any other case.

Modified adjusted gross income is adjusted gross income increased by the amount excluded from income as foreign earned income under IRC section 911(a)(1) (net of the deductions and exclusions disallowed with respect to the foreign earned income).

In the case of an estate or trust, the tax is 3.8 percent of the lesser of undistributed net investment income or the excess of adjusted gross income (as defined in IRC section 67(e)) over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins.

The tax does not apply to a non-resident alien or to a trust all the unexpired interests in which are devoted to charitable purposes. The tax also does not apply to a trust that is exempt from tax under IRC section 501 or a charitable remainder trust exempt from tax under IRC section 664.

The tax is subject to the individual estimated tax provisions. The tax is not deductible in computing any tax imposed by subtitle A of the Internal Revenue Code (relating to income taxes).

Net Investment Income

Net investment income is investment income reduced by the deductions properly allocable to such income.

Investment income is the sum of (i) gross income from interest, dividends, annuities, royalties, and rents (other than income derived from any trade or business to which the tax does not apply), (ii) other gross income derived from any business to which the tax applies, and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply.<sup>650</sup>

In the case of a trade or business, the tax applies if the trade or business is a passive activity with respect to the taxpayer or the trade or business consists of trading financial instruments or commodities (as defined in IRC section 475(e)(2)). The tax does not apply to other trades or businesses conducted by a sole proprietor, partnership, or S corporation.

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<sup>650</sup> Gross income does not include items, such as interest on tax-exempt bonds, veterans' benefits, and excluded gain from the sale of a principal residence, which are excluded from gross income under the income tax.

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

In the case of the disposition of a partnership interest or stock in an S corporation, gain or loss is taken into account only to the extent gain or loss would be taken into account by the partner or shareholder if the entity had sold all its properties for fair market value immediately before the disposition. Thus, only net gain or loss attributable to property held by the entity which is not property attributable to an active trade or business is taken into account.<sup>651</sup>

Income, gain, or loss on working capital is not treated as derived from a trade or business. Investment income does not include distributions from a qualified retirement plan or amounts subject to SECA tax.

Effective Date

The provision applies to taxable years beginning after December 31, 2012.

California Law

California has no equivalent to FICA, SECA, or the new unearned income Medicare contribution tax.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
1405	Excise Tax on Medical Device Manufacturers

Background

Chapter 32 of Subtitle A of the IRC imposes excise taxes on sales by manufacturers of certain products. Terms and procedures related to the imposition, payment, and reporting of these excise taxes are included in various provisions within the IRC.

Certain sales are exempt from the excise tax imposed on manufacturers. Exempt sales include sales: (1) for use by the purchaser for further manufacture, or for resale to a second purchaser in further manufacture; (2) for export or for resale to a second purchaser for export; (3) for use by the purchaser as supplies for vessels or aircraft; (4) to a state or local government for the exclusive use of a state or local government; (5) to a nonprofit educational organization for its exclusive use; or (6) to a qualified blood collector organization for such organization's exclusive

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<sup>651</sup> For this purpose, a business of trading financial instruments or commodities is not treated as an active trade or business.

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

use in the collection, storage, or transportation of blood.<sup>652</sup> If an article is sold free of tax for resale to a second purchaser for further manufacture or for export, the exemption will not apply unless, within the six-month period beginning on the date of sale by the manufacturer, the manufacturer receives proof that the article has been exported or resold for the use in further manufacturing.<sup>653</sup> In general, the exemptions will not apply unless the manufacturer, the first purchaser, and the second purchaser are registered with the Secretary of the Treasury.

The lease of an article is generally considered to be a sale of such article.<sup>654</sup> Special rules apply for the imposition of tax to each lease payment. Rules are also imposed that treat the use of articles subject to tax by manufacturers, producers, or importers of such articles, as sales for the purpose of imposition of certain excise taxes.<sup>655</sup>

There are also rules for determining the price of an article on which excise tax is imposed.<sup>656</sup> These rules provide for: (1) the inclusion of containers, packaging, and certain transportation charges in the price; (2) determining a constructive sales price if an article is sold for less than the fair market price; and (3) determining the tax due in the case of partial payments or installment sales.

A credit or refund is generally allowed for overpayments of manufacturers excise taxes.<sup>657</sup> Overpayments may occur when tax-paid articles are sold for export and for certain specified uses and resales—when there are price adjustments—and where tax paid articles are subject to further manufacture. Generally, no credit or refund of any overpayment of tax is allowed or made unless the person who paid the tax establishes one of four prerequisites: (1) the tax was not included in the price of the article or otherwise collected from the person who purchased the article; (2) the tax was repaid to the ultimate purchaser of the article; (3) for overpayments due to specified uses and resales, the tax has been repaid to the ultimate vendor or the person has obtained the written consent of such ultimate vendor; or (4) the person has filed with the Secretary of the Treasury the written consent of the ultimate purchaser of the article to the allowance of the credit or making of the refund.<sup>658</sup>

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<sup>652</sup> IRC section 4221(a).

<sup>653</sup> IRC section 4221(b).

<sup>654</sup> IRC section 4217(a).

<sup>655</sup> IRC section 4218.

<sup>656</sup> IRC section 4216.

<sup>657</sup> IRC section 6416.

<sup>658</sup> IRC section 6416(a).

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

New Federal Law (IRC sections 4001, 4061, 4191, 4221, and 6416)

Under the provision, a tax equal to 2.3 percent of the sale price is imposed on the sale of any taxable medical device by the manufacturer, producer, or importer of such device. A taxable medical device is any device, defined in section 201(h) of the Federal Food, Drug, and Cosmetic Act,<sup>659</sup> intended for humans. The excise tax does not apply to eyeglasses, contact lenses, hearing aids, and any other medical device determined by the Secretary to be of a type that is generally purchased by the general public at retail for individual use. The Secretary may determine that a specific medical device is exempt under the provision if the device is generally sold at retail establishments (including over the internet) to individuals for their personal use. The exemption for such items is not limited by device class as defined in section 513 of the Federal Food, Drug, and Cosmetic Act. For example, items purchased by the general public at retail for individual use could include Class I items such as certain bandages and tipped applicators, Class II items such as certain pregnancy test kits and diabetes testing supplies, and Class III items such as certain denture adhesives and snake bite kits. Such items would only be exempt if they are generally designed and sold for individual use. It is anticipated that the Secretary will publish a list of medical device classifications<sup>660</sup> that are of a type generally purchased by the general public at retail for individual use.

The present law manufacturers excise tax exemptions for further manufacture and for export apply to tax imposed under this provision; however exemptions for use as supplies for vessels or aircraft, and for sales to state or local governments, nonprofit educational organizations, and qualified blood collector organizations are not applicable.

The provision repeals section 9009 of the Patient Protection and Affordable Care Act of 2010 (relating to an annual fee on medical device manufacturers and importers).

Effective Date

The provision applies to sales after December 31, 2012.

California Law

Excise taxes are administered by the Board of Equalization (BOE). Defer to the BOE.

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<sup>659</sup> 21 U.S.C. 321. IRC section 201(h) defines device as an instrument, apparatus, implement, machine, contrivance, implant, in vitro reagent, or other similar or related article, including any component, part, or accessory, which is: (1) recognized in the official National Formulary, or the United States Pharmacopeia, or any supplement to them; (2) intended for use in the diagnosis of disease or other conditions, or in the cure, mitigation, treatment, or prevention of disease, in man or other animals; or (3) intended to affect the structure or any function of the body of man or other animals, and which does not achieve its primary intended purposes through chemical action within or on the body of man or other animals and which is not dependent upon being metabolized for the achievement of its primary intended purposes.

<sup>660</sup> Medical device classifications are found in Title 21 of the Code of Federal Regulations, Parts 862-892.

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

Impact on California Revenue

Defer to the BOE.

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<u>Section</u>	<u>Section Title</u>
1408	Elimination of Unintended Application of Cellulosic Biofuel Producer Credit

Background

The "cellulosic biofuel producer 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 is generally \$1.01 per gallon.<sup>661</sup>

"Qualified cellulosic biofuel production" is any cellulosic biofuel which is produced by the taxpayer and which is: (1) sold by the taxpayer to another person (a) for use by such other person in the production of a qualified cellulosic biofuel 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 cellulosic biofuel at retail to another person and places such cellulosic biofuel in the fuel tank of such other person; or (2) used by the producer for any purpose described in (1)(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; (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 ("EPA") under section 211 of the Clean Air Act. The cellulosic biofuel producer credit cannot be claimed unless the taxpayer is registered by the IRS as a producer of cellulosic biofuel.

Cellulosic biofuel eligible for the IRC section 40 credit is precluded from qualifying as biodiesel, renewable diesel, or alternative fuel for purposes of the applicable income tax credit, excise tax credit, or payment provisions relating to those fuels.<sup>662</sup>

Because it is a credit under IRC section 40(a), the cellulosic biofuel producer credit is part of the general business credits in IRC section 38. However, the credit can only be carried forward three taxable years after the termination of the credit. The credit is also allowable against the alternative minimum tax. Under IRC section 87, the credit is included in gross income. The cellulosic biofuel producer credit terminates on December 31, 2012.

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<sup>661</sup> In the case of cellulosic biofuel that is alcohol, the \$1.01 credit amount is reduced by the credit amount of the alcohol mixture credit, and for ethanol, the credit amount for small ethanol producers, as in effect at the time the cellulosic biofuel fuel is produced.

<sup>662</sup> See IRC sections 40A(d)(1), 40A(f)(3), and 6426(h).

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

The kraft process for making paper produces a byproduct called black liquor, which has been used for decades by paper manufacturers as a fuel in the papermaking process. Black liquor is composed of water, lignin, and the spent chemicals used to break down the wood. The amount of the biomass in black liquor varies. The portion of the black liquor that is not consumed as a fuel source for the paper mills is recycled back into the papermaking process. Black liquor has ash content (mineral and other inorganic matter) significantly above that of other fuels.

In an informal Chief Counsel Advice ("CCA"), the IRS has concluded that black liquor is a liquid fuel from biomass and may qualify for the cellulosic biofuel producer credit, as well as the refundable alternative fuel mixture credit.<sup>663</sup> A taxpayer cannot claim both the alternative fuel mixture credit and the cellulosic biofuel producer credit. The alternative fuel credits and payment provisions expired December 31, 2009.

New Federal Law (IRC section 40)

The provision modifies the cellulosic biofuel producer credit to exclude fuels with significant water, sediment, or ash content, such as black liquor. Consequently, credits will cease to be available for these fuels. Specifically, the provision excludes from the definition of cellulosic biofuel any fuels that (1) are more than four percent (determined by weight) water and sediment in any combination, or (2) have an ash content of more than one percent (determined by weight). Water content (including both free water and water in solution with dissolved solids) is determined by distillation, using for example ASTM method D95 or a similar method suitable to the specific fuel being tested. Sediment consists of solid particles that are dispersed in the liquid fuel and is determined by centrifuge or extraction using, for example, ASTM method D1796 or D473 or similar method that reports sediment content in weight percent. Ash is the residue remaining after combustion of the sample using a specified method, such as ASTM D3174 or a similar method suitable for the fuel being tested.

Effective Date

The provision is effective for fuels sold or used on or after January 1, 2010.

California Law (None)

California does not conform to the cellulosic biofuel credit.

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<sup>663</sup> IRS C.C.A. 200941011, 2009 W.L. 3239569 (June 30, 2009). The IRC provides for a tax credit of 50 cents for each gallon of alternative fuel used to produce an alternative fuel mixture that is used or sold for use as a fuel (IRC section 6426(e)). Under Notice 2006-92, an alternative fuel mixture is a mixture of alternative fuel and a taxable fuel (such as diesel) that contains at least 0.1 percent taxable fuel. Liquid fuel derived from biomass is an alternative fuel (IRC section 6426(d)(2)(G)). Diesel fuel has been added to black liquor to qualify for the alternative mixture credit and the mixture is burned in a recovery boiler as fuel. Persons that have an alternative fuel mixture credit amount in excess of their taxable fuel excise tax liability may make a claim for payment from the Treasury in the amount of the excess.

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
1409	Codification of Economic Substance Doctrine and Penalties

Background

In General

The IRC provides detailed rules specifying the computation of taxable income, including the amount, timing, source, and character of items of income, gain, loss, and deduction. These rules permit both taxpayers and the government to compute taxable income with reasonable accuracy and predictability. Taxpayers generally may plan their transactions in reliance on these rules to determine the federal income tax consequences arising from the transactions.

In addition to the statutory provisions, courts have developed several doctrines that can be applied to deny the tax benefits of a tax-motivated transaction, notwithstanding that the transaction may satisfy the literal requirements of a specific tax provision. These common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts, the IRS, and litigants. Although these doctrines serve an important role in the administration of the tax system, they can be seen as at odds with an objective "rule-based" system of taxation.

One common-law doctrine applied over the years is the "economic substance" doctrine. In general, this doctrine denies tax benefits arising from transactions that do not result in a meaningful change to the taxpayer's economic position other than a purported reduction in federal income tax.<sup>664</sup>

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<sup>664</sup> See, e.g., *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff'g* 73 T.C.M. (CCH) 2189 (1997), *cert. denied* 526 U.S. 1017 (1999); *Klamath Strategic Investment Fund, LLC v. United States*, 472 F. Supp. 2d 885 (E.D. Texas 2007), *aff'd* 568 F.3d 537 (5th Cir. 2009); *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *vacating and remanding* 62 Fed. Cl. 716 (2004) (slip opinion at 123-124, 128); *cert. denied*, 127 S. Ct. 1261 (Mem.) (2007).

Closely related doctrines also applied by the courts (sometimes interchangeable with the economic substance doctrine) include the "sham transaction doctrine" and the "business purpose doctrine." See, e.g., *Knetsch v. United States*, 364 U.S. 361 (1960) (denying interest deductions on a "sham transaction" that lacked "commercial economic substance"). Certain "substance over form" cases involving tax-indifferent parties, in which courts have found that the substance of the transaction did not comport with the form asserted by the taxpayer, have also involved examination of whether the change in economic position that occurred, if any, was consistent with the form asserted, and whether the claimed business purpose supported the particular tax benefits that were claimed. See, e.g., *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006); *BB&T Corporation v. United States*, 2007-1 USTC P 50,130 (M.D.N.C. 2007), *aff'd* 523 F.3d 461 (4th Cir. 2008). Although the Second Circuit found for the government in *TIFD III-E, Inc.*, on

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

*Economic substance doctrine*

Courts generally deny claimed tax benefits if the transaction that gives rise to those benefits lacks economic substance independent of U.S. federal income tax considerations—notwithstanding that the purported activity actually occurred. The Tax Court has described the doctrine as follows:

The tax law ... requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.<sup>665</sup>

*Business purpose doctrine*

A common law doctrine that often is considered together with the economic substance doctrine is the business purpose doctrine. The business purpose doctrine involves an inquiry into the subjective motives of the taxpayer; that is, whether the taxpayer intended the transaction to serve some useful non-tax purpose. In making this determination, some courts have bifurcated a transaction in which activities with non-tax objectives have been combined with unrelated activities having only tax-avoidance objectives, in order to disallow the tax benefits of the overall transaction.<sup>666</sup>

Application by the Courts

*Elements of the doctrine*

There is a lack of uniformity regarding the proper application of the economic substance doctrine.<sup>667</sup> Some courts apply a conjunctive test that requires a taxpayer to establish the presence of both economic substance (i.e., the objective component) and business purpose (i.e., the subjective component) in order for the transaction to survive judicial scrutiny.<sup>668</sup> A narrower

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remand to consider issues under IRC section 704(e), the District Court found for the taxpayer. See, *TIFD III-E Inc. v. United States*, No. 3:01-cv-01839, 2009 WL 3208650 (D. Conn. Oct. 23, 2009).

<sup>665</sup> *ACM Partnership v. Commissioner*, 73 T.C.M. at 2215.

<sup>666</sup> See, *ACM Partnership v. Commissioner*, 157 F.3d at 256 n.48.

<sup>667</sup> "The casebooks are glutted with [economic substance] tests. Many such tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify." *Collins v. Commissioner*, 857 F.2d 1383, 1386 (9th Cir. 1988).

<sup>668</sup> See, e.g., *Pasternak v. Commissioner*, 990 F.2d 893, 898 (6th Cir. 1993) ("The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction."). See also, *Klamath Strategic Investment Fund v. United States*, 568 F.3d 537, (5th Cir. 2009) (even if taxpayers may have had a profit motive, a transaction was disregarded where it did not in fact have any realistic possibility of profit and funding was never at risk).

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

approach used by some courts is to conclude that either a business purpose or economic substance is sufficient to respect the transaction.<sup>669</sup> A third approach regards economic substance and business purpose as "simply more precise factors to consider" in determining whether a transaction has any practical economic effects other than the creation of tax benefits.<sup>670</sup>

One decision by the Court of Federal Claims questioned the continuing viability of the doctrine. That court also stated that "the use of the 'economic substance' doctrine to trump 'mere compliance with the [IRC]' would violate the separation of powers" though that court also found that the particular transaction at issue in the case did not lack economic substance. The Court of Appeals for the Federal Circuit ("Federal Circuit Court") overruled the Court of Federal Claims decision, reiterating the viability of the economic substance doctrine and concluding that the transaction in question violated that doctrine.<sup>671</sup> The Federal Circuit Court stated that "[w]hile the doctrine may well also apply if the taxpayer's sole subjective motivation is tax avoidance even if the transaction has economic substance, [footnote omitted], a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance."<sup>672</sup>

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<sup>669</sup> See, e.g., *Rice's Toyota World v. Commissioner*, 752 F.2d 89, 91-92 (4th Cir. 1985) ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and, second, that the transaction has no economic substance because no reasonable possibility of a profit exists."); *IES Industries v. United States*, 253 F.3d 350, 358 (8th Cir. 2001) ("In determining whether a transaction is a sham for tax purposes [under the Eighth Circuit test], a transaction will be characterized as a sham if it is not motivated by any economic purpose outside of tax considerations (the business purpose test), and if it is without economic substance because no real potential for profit exists (the economic substance test)."). As noted earlier, the economic substance doctrine and the sham transaction doctrine are similar and sometimes are applied interchangeably. For a more detailed discussion of the sham transaction doctrine, see, e.g., Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including Provisions Relating to Corporate Tax Shelters)* (JCS-3-99) at 182.

<sup>670</sup> See, e.g., *ACM Partnership v. Commissioner*, 157 F.3d at 247; *James v. Commissioner*, 899 F.2d 905, 908 (10th Cir. 1995); *Sacks v. Commissioner*, 69 F.3d 982, 985 (9th Cir. 1995) ("Instead, the consideration of business purpose and economic substance are simply more precise factors to consider ... We have repeatedly and carefully noted that this formulation cannot be used as a 'rigid two-step analysis'.")

<sup>671</sup> *Coltec Industries, Inc. v. United States*, 62 Fed. Cl. 716 (2004) (slip opinion at 123-124, 128); *vacated and remanded*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied*, 127 S. Ct. 1261 (Mem.) (2007).

<sup>672</sup> The Federal Circuit Court stated that "when the taxpayer claims a deduction, it is the taxpayer who bears the burden of proving that the transaction has economic substance." The Federal Circuit Court quoted a decision of its predecessor court, stating that "*Gregory v. Helvering* requires that a taxpayer carry an unusually heavy burden when he attempts to demonstrate that Congress intended to give favorable tax treatment to the kind of transaction that would never occur absent the motive of tax avoidance." The Court also stated that "while the taxpayer's subjective motivation may be pertinent to the existence of a tax-avoidance purpose, all courts have looked to the objective reality of a transaction in assessing its economic substance." *Coltec Industries, Inc. v. United States*, 454 F.3d at 1355, 1356.

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

*Nontax economic benefits*

There also is a lack of uniformity regarding the type of non-tax economic benefit a taxpayer must establish in order to demonstrate that a transaction has economic substance. Some courts have denied tax benefits on the grounds that a stated business benefit of a particular structure was not in fact obtained by that structure.<sup>673</sup> Several courts have denied tax benefits on the grounds that the subject transactions lacked profit potential.<sup>674</sup> In addition, some courts have applied the economic substance doctrine to disallow tax benefits in transactions in which a taxpayer was exposed to risk and the transaction had a profit potential, but the court concluded that the economic risks and profit potential were insignificant when compared to the tax benefits.<sup>675</sup> Under this analysis, the taxpayer's profit potential must be more than nominal. Conversely, other courts view the application of the economic substance doctrine as requiring an objective determination of whether a "reasonable possibility of profit" from the transaction existed apart from the tax benefits.<sup>676</sup> In these cases, in assessing whether a reasonable possibility of profit exists, it may be sufficient if there is a nominal amount of pre-tax profit as measured against expected tax benefits.

*Financial accounting benefits*

In determining whether a taxpayer had a valid business purpose for entering into a transaction, at least two courts have concluded that financial accounting benefits arising from tax savings do not qualify as a non-tax business purpose.<sup>677</sup> However, based on court decisions that recognize the

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<sup>673</sup> See, e.g., *Coltec Industries v. United States*, 454 F.3d 1340 (Fed. Cir. 2006). The court analyzed the transfer to a subsidiary of a note purporting to provide high stock basis in exchange for a purported assumption of liabilities, and held these transactions unnecessary to accomplish any business purpose of using a subsidiary to manage asbestos liabilities. The court also held that the purported business purpose of adding a barrier to veil-piercing claims by third parties was not accomplished by the transaction. 454 F.3d at 1358-1360 (Fed. Cir. 2006).

<sup>674</sup> See, e.g., *Knetsch*, 364 U.S. at 361; *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966) (holding that an unprofitable, leveraged acquisition of Treasury bills, and accompanying prepaid interest deduction, lacked economic substance).

<sup>675</sup> See, e.g., *Goldstein v. Commissioner*, 364 F.2d at 739-40 (disallowing deduction even though taxpayer had a possibility of small gain or loss by owning Treasury bills); *Sheldon v. Commissioner*, 94 T.C. 738, 768 (1990) (stating that "potential for gain ... is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions").

<sup>676</sup> See, e.g., *Rice's Toyota World v. Commissioner*, 752 F. 2d 89, 94 (4th Cir. 1985) (the economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits); *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778, 781 (5th Cir. 2001) (applied the same test, citing *Rice's Toyota World*); *IES Industries v. United States*, 253 F.3d 350, 354 (8th Cir. 2001); *Wells Fargo & Company v. United States*, No. 06-628T, 2010 WL 94544, at \*57-58 (Fed. Cl. Jan. 8, 2010).

<sup>677</sup> See *American Electric Power, Inc. v. United States*, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio 2001), *aff'd*, 326 F.3d 737 (6th Cir. 2003) and *Wells Fargo & Company v. United States*, No. 06-628T, 2010 WL 94544, at \*59 (Fed. Cl. Jan. 8, 2010).

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

importance of financial accounting treatment, taxpayers have asserted that financial accounting benefits arising from tax savings can satisfy the business purpose test.<sup>678</sup>

*Tax-indifferent parties*

A number of cases have involved transactions structured to allocate income for federal tax purposes to a tax-indifferent party, with a corresponding deduction, or favorable basis result, to a taxable person. The income allocated to the tax-indifferent party for tax purposes was structured to exceed any actual economic income to be received by the tax-indifferent party from the transaction. Courts have sometimes concluded that this particular type of transaction did not satisfy the economic substance doctrine.<sup>679</sup> In other cases, courts have indicated that the substance of a transaction did not support the form of income allocations asserted by the taxpayer and have questioned whether asserted business purpose or other standards were met.<sup>680</sup>

Penalty Regime

*General accuracy-related penalty*

An accuracy-related penalty under IRC section 6662 applies to the portion of any underpayment that is attributable to: (1) negligence; (2) any substantial understatement of income tax; (3) any substantial valuation misstatement; (4) any substantial overstatement of pension liabilities; or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or \$5,000 (or, in the case of corporations, by the lesser of (a) 10 percent of the correct tax (or \$10,000 if greater) or (b) \$10 million), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.<sup>681</sup> The IRC section 6662 penalty is increased to 40 percent in the case of gross valuation misstatements as defined in IRC section 6662(h). Except in the case of tax shelters,<sup>682</sup>

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<sup>678</sup> See, e.g., Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JSC-3-03) February, 2003 ("Enron Report"), Volume III at C-93, 289. Enron Corporation relied on *Frank Lyon Co. v. United States*, 435 U.S. 561, 577-78 (1978), and *Newman v. Commissioner*, 902 F.2d 159, 163 (2d Cir. 1990), to argue that financial accounting benefits arising from tax savings constitute a good business purpose.

<sup>679</sup> See, e.g., *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff'g* 73 T.C.M. (CCH) 2189 (1997), *cert. denied* 526 U.S. 1017 (1999).

<sup>680</sup> See, e.g., *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006). Although the Second Circuit found for the government in *TIFD III-E, Inc.*, on remand to consider issues under section 704(e), the District Court found for the taxpayer. See, *TIFD III-E Inc. v. United States*, No. 3:01-cv-01839, 2009 WL 3208650 (Oct. 23, 2009).

<sup>681</sup> IRC section 6662.

<sup>682</sup> A tax shelter is defined for this purpose as a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, other entity, plan, or arrangement is the avoidance or evasion of federal income tax. IRC section 6662(d)(2)(C).

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

the amount of any understatement is reduced by any portion attributable to an item if the treatment of the item is supported by substantial authority, or if the facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment. The Treasury Secretary may prescribe a list of positions which the Secretary believes do not meet the requirements for substantial authority under this provision.

The IRC section 6662 penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.<sup>683</sup> The relevant regulations for a tax shelter provide that reasonable cause exists where the taxpayer "reasonably relies in good faith on an opinion based on a professional tax advisor's analysis of the pertinent facts and authorities [that] ... unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.<sup>684</sup> For transactions other than tax shelters, the relevant regulations provide a facts and circumstances test, the most important factor generally being the extent of the taxpayer's effort to assess the proper tax liability. If a taxpayer relies on an opinion, reliance is not reasonable if the taxpayer knows or should have known that the advisor lacked knowledge in the relevant aspects of federal tax law, or if the taxpayer fails to disclose a fact that it knows or should have known is relevant. Certain additional requirements apply with respect to the advice.<sup>685</sup>

*Listed transactions and reportable avoidance transactions*

*In general*

A separate accuracy-related penalty under IRC section 6662A applies to any "listed transaction" and to any other "reportable transaction" that is not a listed transaction, if a significant purpose of such transaction is the avoidance or evasion of federal income tax<sup>686</sup> (hereinafter referred to as a "reportable avoidance transaction"). The penalty rate and defenses available to avoid the penalty vary depending on whether the transaction was adequately disclosed.

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<sup>683</sup> IRC section 6664(c).

<sup>684</sup> Treas. Reg. section 1.6662-4(g)(4)(i)(B) and Treas. Reg. section 1.6664-4(c).

<sup>685</sup> See Treas. Reg. section 1.6664-4(c). In addition to the requirements applicable to taxpayers under the regulations, advisors may be subject to potential penalties under IRC section 6694 (applicable to return preparers), and to monetary penalties and other sanctions under Circular 230 (which provides rules governing persons practicing before the IRS). Under Circular 230, if a transaction is a "covered transaction" (a term that includes listed transactions and certain non-listed reportable transactions) a "more-likely-than-not" confidence level is required for written tax advice that may be relied upon by a taxpayer for the purpose of avoiding penalties, and certain other standards must also be met. Treasury Dept. Circular 230 (Rev. 4-2008) Sec. 10.35. For other tax advice, Circular 230 generally requires a lower "realistic possibility" confidence level or a "non-frivolous" confidence level coupled with advising the client of any opportunity to avoid the accuracy-related penalty under IRC section 6662 by adequate disclosure. Treasury Dept. Circular 230 (Rev. 4-2008) Sec. 10.34.

<sup>686</sup> IRC section 6662A(b)(2).

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

Both listed transactions and other reportable transactions are allowed to be described by the Treasury department under IRC section 6011 as transactions that must be reported, and IRC section 6707A(c) imposes a penalty for failure adequately to report such transactions under IRC section 6011. A reportable transaction is defined as one that the Treasury Secretary determines is required to be disclosed because it is determined to have a potential for tax avoidance or evasion.<sup>687</sup> A listed transaction is defined as a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of the reporting disclosure requirements.<sup>688</sup>

*Disclosed transactions*

In general, a 20-percent accuracy-related penalty is imposed on any understatement attributable to an adequately disclosed listed transaction or reportable avoidance transaction.<sup>689</sup> The only exception to the penalty is if the taxpayer satisfies a more stringent reasonable cause and good faith exception (hereinafter referred to as the "strengthened reasonable cause exception"), which is described below. The strengthened reasonable cause exception is available only if the relevant facts affecting the tax treatment were adequately disclosed, there is or was substantial authority for the claimed tax treatment, and the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment. A "reasonable belief" must be based on the facts and law as they exist at the time that the return in question is filed, and not take into account the possibility that a return would not be audited. Moreover, reliance on professional advice may support a "reasonable belief" only in certain circumstances.<sup>690</sup>

*Undisclosed transactions*

If the taxpayer does not adequately disclose the transaction, the strengthened reasonable cause exception is not available (i.e., a strict liability penalty generally applies), and the taxpayer is subject to an increased penalty equal to 30 percent of the understatement.<sup>691</sup> However, a taxpayer will be treated as having adequately disclosed a transaction for this purpose if the IRS Commissioner has separately rescinded the separate penalty under IRC section 6707A for failure to disclose a reportable transaction.<sup>692</sup> The IRS Commissioner is authorized to do this only if the failure does not relate to a listed transaction and only if rescinding the penalty would promote compliance and effective tax administration.<sup>693</sup>

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<sup>687</sup> IRC section 6707A(c)(1).

<sup>688</sup> IRC section 6707A(c)(2).

<sup>689</sup> IRC section 6662A(a).

<sup>690</sup> IRC section 6664(d)(3)(B) does not allow a reasonable belief to be based on a "disqualified opinion" or on an opinion from a "disqualified tax advisor."

<sup>691</sup> IRC section 6662A(c).

<sup>692</sup> IRC section 6664(d).

<sup>693</sup> IRC section 6707A(d).

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

A public entity that is required to pay a penalty for an undisclosed listed or reportable transaction must disclose the imposition of the penalty in reports to the SEC for such periods as the Secretary specifies. The disclosure to the SEC applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).<sup>694</sup>

*Determination of the understatement amount*

The penalty is applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. For purposes of this provision, the amount of the understatement is determined as the sum of: (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return);<sup>695</sup> and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item.

Except as provided in regulations, a taxpayer's treatment of an item will not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of when the taxpayer is first contacted regarding an examination of the return or such other date as specified by the Secretary.<sup>696</sup>

*Strengthened reasonable cause exception*

A penalty is not imposed under IRC section 6662A with respect to any portion of an understatement if it is shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires: (1) adequate disclosure of the facts affecting the transaction in accordance with the regulations under IRC section 6011;<sup>697</sup> (2) that there is or was substantial authority for such treatment; and (3) that the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. For this purpose, a taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief: (1) is based on the facts and law that exist at the time the tax return (that includes the

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<sup>694</sup> IRC section 6707A(e).

<sup>695</sup> For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses which would (without regard to IRC section 1211) be allowed for such year, will be treated as an increase in taxable income. IRC section 6662A(b).

<sup>696</sup> IRC section 6662A(e)(3).

<sup>697</sup> See the previous discussion regarding the penalty for failing to disclose a reportable transaction.

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

item) is filed; and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised.<sup>698</sup>

A taxpayer may (but is not required to) rely on an opinion of a tax advisor in establishing its reasonable belief with respect to the tax treatment of the item. However, a taxpayer may not rely on an opinion of a tax advisor for this purpose if the opinion is provided by a "disqualified tax advisor," or is a "disqualified opinion."

*Disqualified tax advisor*

A disqualified tax advisor is any advisor who: (1) is a material advisor<sup>699</sup> and who participates in the organization, management, promotion, or sale of the transaction or is related (within the meaning of IRC section 267(b) or 707(b)(1)) to any person who so participates; (2) is compensated directly or indirectly<sup>700</sup> by a material advisor with respect to the transaction; (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained; or (4) as determined under regulations prescribed by the Secretary, has a disqualifying financial interest with respect to the transaction.

A material advisor is considered as participating in the "organization" of a transaction if the advisor performs acts relating to the development of the transaction. This may include, for example, preparing documents: (1) establishing a structure used in connection with the transaction (such as a partnership agreement); (2) describing the transaction (such as an offering memorandum or other statement describing the transaction); or (3) relating to the registration of the transaction with any federal, state, or local government body.<sup>701</sup> Participation in the "management" of a transaction means involvement in the decision-making process regarding any business activity with respect to the transaction. Participation in the "promotion or sale" of a transaction means any involvement in marketing or soliciting the transaction to others. Thus, an

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<sup>698</sup> IRC section 6664(d).

<sup>699</sup> The term "material advisor" means any person who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, or carrying out any reportable transaction, and who derives gross income in excess of \$50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons (\$250,000 in any other case). IRC section 6111(b)(1).

<sup>700</sup> This situation could arise, for example, when an advisor has an arrangement or understanding (oral or written) with an organizer, manager, or promoter of a reportable transaction that such party will recommend or refer potential participants to the advisor for an opinion regarding the tax treatment of the transaction.

<sup>701</sup> An advisor should not be treated as participating in the organization of a transaction if the advisor's only involvement with respect to the organization of the transaction is the rendering of an opinion regarding the tax consequences of such transaction. However, such an advisor may be a "disqualified tax advisor" with respect to the transaction if the advisor participates in the management, promotion, or sale of the transaction (or if the advisor is compensated by a material advisor, has a fee arrangement that is contingent on the tax benefits of the transaction, or as determined by the Secretary, has a continuing financial interest with respect to the transaction). See Notice 2005-12, 2005-1 C.B. 494, regarding disqualified compensation arrangements.

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

*Disqualified opinion*

An opinion may not be relied upon if the opinion: (1) is based on unreasonable factual or legal assumptions (including assumptions as to future events); (2) unreasonably relies upon representations, statements, findings or agreements of the taxpayer or any other person; (3) does not identify and consider all relevant facts; or (4) fails to meet any other requirement prescribed by the Secretary.

*Coordination with other penalties*

Any understatement upon which a penalty is imposed under IRC section 6662A is not subject to the accuracy-related penalty for underpayments under IRC section 6662.<sup>702</sup> However, that understatement is included for purposes of determining whether any understatement (as defined in IRC section 6662(d)(2)) is a substantial understatement under IRC section 6662(d)(1).<sup>703</sup> Thus, in the case of an understatement (as defined in IRC section 6662(d)(2)), the amount of the understatement (determined without regard to IRC section 6662A(e)(1)(A)) is increased by the aggregate amount of reportable transaction understatements for purposes of determining whether the understatement is a substantial understatement. The IRC section 6662(a) penalty applies only to the excess of the amount of the substantial understatement (if any) after IRC section 6662A(e)(1)(A) is applied over the aggregate amount of reportable transaction understatements.<sup>704</sup> Accordingly, every understatement is penalized, but only under one penalty provision.

The penalty imposed under IRC section 6662A does not apply to any portion of an understatement to which a fraud penalty applies under IRC section 6663 or to which the 40-percent penalty for gross valuation misstatements under IRC section 6662(h) applies.<sup>705</sup>

*Baseless claim for refund or credit*

If a claim for refund or credit with respect to income tax (other than a claim relating to the earned income tax credit) is made for an excessive amount, unless it is shown that the claim for such excessive amount has a reasonable basis, the person making such claim is subject to a penalty in an amount equal to 20 percent of the excessive amount.<sup>706</sup>

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<sup>702</sup> IRC section 6662(b)(flush language). In addition, IRC section 6662(b) provides that IRC section 6662 does not apply to any portion of an underpayment on which a fraud penalty is imposed under IRC section 6663.

<sup>703</sup> IRC section 6662A(e)(1).

<sup>704</sup> IRC section 6662(d)(2)(A)(flush language).

<sup>705</sup> IRC section 6662A(e)(2).

<sup>706</sup> IRC section 6676.

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

The term "excessive amount" means the amount by which the amount of the claim for refund for any taxable year exceeds the amount of such claim allowable for the taxable year.

This penalty does not apply to any portion of the excessive amount of a claim for refund or credit which is subject to a penalty imposed under the accuracy-related or fraud penalty provisions (including the general accuracy-related penalty, or the penalty with respect to listed and reportable transactions, described above).

New Federal Law (IRC sections 6662, 6662A, 6664, 6676, and 7701)

The provision clarifies and enhances the application of the economic substance doctrine. Under the provision, new IRC section 7701(o) provides that in the case of any transaction<sup>707</sup> to which the economic substance doctrine is relevant, such transaction is treated as having economic substance only if: (1) the transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position; and (2) the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into such transaction. The provision provides a uniform definition of economic substance, but does not alter the flexibility of the courts in other respects.

The determination of whether the economic substance doctrine is relevant to a transaction is made in the same manner as if the provision had never been enacted. Thus, the provision does not change present-law standards in determining when to utilize an economic-substance analysis.<sup>708</sup>

The provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Among<sup>709</sup> these basic transactions are: (1) the choice between capitalizing a

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<sup>707</sup> The term "transaction" includes a series of transactions.

<sup>708</sup> If the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed. See, e.g., Treas. Reg. sec. 1.269-2, stating that characteristic of circumstances in which an amount otherwise constituting a deduction, credit, or other allowance is not available are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by the Congress to effectuate. Thus, for example, it is not intended that a tax credit (e.g., IRC section 42 (low-income housing credit), IRC section 45 (production tax credit), IRC section 45D (new markets tax credit), IRC section 47 (rehabilitation credit), IRC section 48 (energy credit), etc.) be disallowed in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage.

<sup>709</sup> The examples are illustrative and not exclusive.

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

business enterprise with debt or equity;<sup>710</sup> (2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment;<sup>711</sup> (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under Subchapter C of the IRC;<sup>712</sup> and (4) the choice to utilize a related-party entity in a transaction, provided that the arm's-length standard of IRC section 482 and other applicable concepts are satisfied.<sup>713</sup> Leasing transactions, like all other types of transactions, will continue to be analyzed in light of all the facts and circumstances.<sup>714</sup> As under present law, whether a particular transaction meets the requirements for specific treatment under any of these provisions is a question of facts and circumstances. Also, the fact that a transaction meets the requirements for specific treatment under any provision of the IRC is not determinative of whether a transaction or series of transactions of which it is a part has economic substance.<sup>715</sup>

The provision does not alter the court's ability to aggregate, disaggregate, or otherwise re-characterize a transaction when applying the doctrine. For example, the provision reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities with

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<sup>710</sup> See, e.g., *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946) (respecting debt characterization in one case and not in the other, based on all the facts and circumstances).

<sup>711</sup> See, e.g., *Sam Siegel v. Commissioner*, 45 T.C. 566 (1966), acq. 1966-2 C.B. 3. But see *Commissioner v. Bollinger*, 485 U.S. 340 (1988) (agency principles applied to title-holding corporation under the facts and circumstances).

<sup>712</sup> See, e.g., *Rev. Proc. 2010-3 2010-1 I.R.B. 110, Secs. 3.01(38), (39),(40,) and (42)* (IRS will not rule on certain matters relating to incorporations or reorganizations unless there is a "significant issue"); compare *Gregory v. Helvering*, 293 U.S. 465 (1935).

<sup>713</sup> See, e.g., *National Carbide v. Commissioner*, 336 U.S. 422 (1949), *Moline Properties v. Commissioner*, 319 U.S. 435 (1943); compare, e.g. *Aiken Industries, Inc. v. Commissioner*, 56 T.C. 925 (1971), acq., 1972-2 C.B. 1; *Commissioner v. Bollinger*, 485 U.S. 340 (1988); see also sec. 7701(l).

<sup>714</sup> See, e.g., *Frank Lyon Co. v. Commissioner*, 435 U.S. 561 (1978); *Hilton v. Commissioner*, 74 T.C. 305, *aff'd*, 671 F. 2d 316 (9th Cir. 1982), *cert. denied*, 459 U.S. 907 (1982); *Coltec Industries v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied*, 127 S. Ct. 1261 (Mem) (2007); *BB&T Corporation v. United States*, 2007-1 USTC P 50,130 (M.D.N.C. 2007), *aff'd*, 523 F.3d 461 (4th Cir. 2008); *Wells Fargo & Company v. United States*, No. 06-628T, 2010 WL 94544, at \*60 (Fed. Cl. Jan. 8, 2010) (distinguishing leasing case *Consolidated Edison Company of New York*, No. 06-305T, 2009 WL 3418533 (Fed. Cl. Oct. 21, 2009) by observing that "considerations of economic substance are factually specific to the transaction involved").

<sup>715</sup> As examples of cases in which courts have found that a transaction does not meet the requirements for the treatment claimed by the taxpayer under the IRC, or does not have economic substance, see e.g., *BB&T Corporation v. United States*, 2007-1 USTC P 50,130 (M.D.N.C. 2007) *aff'd*, 523 F.3d 461 (4th Cir. 2008); *Tribune Company and Subsidiaries v. Commissioner*, 125 T.C. 110 (2005); *H.J. Heinz Company and Subsidiaries v. United States*, 76 Fed. Cl. 570 (2007); *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied* 127 S. Ct. 1261 (Mem.) (2007); *Long Term Capital Holdings LP v. United States*, 330 F. Supp. 2d 122 (D. Conn. 2004), *aff'd*, 150 Fed. Appx. 40 (2d Cir. 2005); *Klamath Strategic Investment Fund, LLC v. United States*, 472 F. Supp. 2d 885 (E.D. Texas 2007); *aff'd*, 568 F. 3d 537 (5th Cir. 2009); *Santa Monica Pictures LLC v. Commissioner*, 89 T.C.M. 1157 (2005).

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow those tax-motivated benefits.<sup>716</sup>

### Conjunctive Analysis

The provision clarifies that the economic substance doctrine involves a conjunctive analysis - there must be an inquiry regarding the objective effects of the transaction on the taxpayer's economic position as well as an inquiry regarding the taxpayer's subjective motives for engaging in the transaction. Under the provision, a transaction must satisfy both tests, i.e., the transaction must change in a meaningful way (apart from federal income tax effects) the taxpayer's economic position and the taxpayer must have a substantial non-federal-income-tax purpose for entering into such transaction, in order for a transaction to be treated as having economic substance. This clarification eliminates the disparity that exists among the federal circuit courts regarding the application of the doctrine, and modifies its application in those circuits in which either a change in economic position or a non-tax business purpose (without having both) is sufficient to satisfy the economic substance doctrine.<sup>717</sup>

### Non-Federal-Income-Tax Business Purpose

Under the provision, a taxpayer's non-federal-income-tax purpose<sup>718</sup> for entering into a transaction (the second prong in the analysis) must be "substantial." For purposes of this analysis, any state or local income tax effect which is related to a federal income tax effect is treated in the same manner as a federal income tax effect. Also, a purpose of achieving a favorable accounting

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<sup>716</sup> See, e.g., *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), cert. denied 127 S. Ct. 1261 (Mem.) (2007) ("the first asserted business purpose focuses on the wrong transaction—the creation of Garrison as a separate subsidiary to manage asbestos liabilities... . [W]e must focus on the transaction that gave the taxpayer a high basis in the stock and thus gave rise to the alleged benefit upon sale...") 454 F.3d 1340, 1358 (Fed. Cir. 2006). See also *ACM Partnership v. Commissioner*, 157 F.3d at 256 n.48; *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938) ("A given result at the end of a straight path is not made a different result because reached by following a devious path.").

<sup>717</sup> The provision defines "economic substance doctrine" as the common law doctrine under which tax benefits under subtitle A of the IRC with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose. Thus, the definition includes any doctrine that denies tax benefits for lack of economic substance, for lack of business purpose, or for lack of both.

<sup>718</sup> See, e.g., Treas. Reg. section 1.269-2(b) (stating that a distortion of tax liability indicating the principal purpose of tax evasion or avoidance might be evidenced by the fact that "the transaction was not undertaken for reasons germane to the conduct of the business of the taxpayer"). Similarly, in *ACM Partnership v. Commissioner*, 73 T.C.M. (CCH) 2189 (1997), the court stated: Key to [the determination of whether a transaction has economic substance] is that the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs. [citations omitted]

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

treatment for financial reporting purposes is not taken into account as a non-federal-income-tax purpose if the origin of the financial accounting benefit is a reduction of federal income tax.<sup>719</sup>

#### Profit Potential

Under the provision, a taxpayer may rely on factors other than profit potential to demonstrate that a transaction results in a meaningful change in the taxpayer's economic position or that the taxpayer has a substantial non-federal-income-tax purpose for entering into such transaction. The provision does not require or establish a minimum return that will satisfy the profit-potential test. However, if a taxpayer relies on a profit potential, the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.<sup>720</sup> Fees and other transaction expenses are taken into account as expenses in determining pre-tax profit. In addition, the Secretary is to issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases.<sup>721</sup>

#### Personal Transactions of Individuals

In the case of an individual, the provision applies only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

#### Other Rules

No inference is intended as to the proper application of the economic substance doctrine under present law. The provision is not intended to alter or supplant any other rule of law, including any common-law doctrine or provision of the IRC or regulations or other guidance thereunder; and it is intended the provision be construed as being additive to any such other rule of law.

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<sup>719</sup> Claiming that a financial accounting benefit constitutes a substantial non-tax purpose fails to consider the origin of the accounting benefit (i.e., reduction of taxes) and significantly diminishes the purpose for having a substantial non-tax purpose requirement. See, e.g., *American Electric Power, Inc. v. United States*, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio 2001) ("AEP's intended use of the cash flows generated by the [corporate-owned life insurance] plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings 'were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed,") (citing *Winn-Dixie v. Commissioner*, 113 T.C. 254, 287 (1999)); *aff'd*, 326 F3d 737 (6<sup>th</sup> Cir. 2003).

<sup>720</sup> See, e.g., *Rice's Toyota World v. Commissioner*, 752 F.2d at 94 (the economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits); *Compaq Computer Corp. v. Commissioner*, 277 F.3d at 781 (applied the same test, citing *Rice's Toyota World*); *IES Industries v. United States*, 253 F.3d at 354 (the application of the objective economic substance test involves determining whether there was a "reasonable possibility of profit ... apart from tax benefits.").

<sup>721</sup> There is no intention to restrict the ability of the courts to consider the appropriate treatment of foreign taxes in particular cases, as under present law.

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

As with other provisions in the IRC, the Secretary has general authority to prescribe rules and regulations necessary for the enforcement of the provision.<sup>722</sup>

#### Penalty for Underpayments Attributable to Transactions Lacking Economic Substance

The provision imposes a new strict-liability penalty under IRC section 6662 for an underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance, as defined in new IRC section 7701(o), or failing to meet the requirements of any similar rule of law.<sup>723</sup> The penalty rate is 20 percent (increased to 40 percent if the taxpayer does not adequately disclose the relevant facts affecting the tax treatment in the return or a statement attached to the return). An amended return or supplement to a return is not taken into account if filed after the taxpayer has been contacted for audit or such other date as is specified by the Secretary. No exceptions (including the reasonable cause rules) to the penalty are available. Thus, under the provision, outside opinions or in-house analysis would not protect a taxpayer from imposition of a penalty if it is determined that the transaction lacks economic substance or fails to meet the requirements of any similar rule of law. Similarly, a claim for refund or credit that is excessive under IRC section 6676 due to a claim that is lacking in economic substance or failing to meet the requirements of any similar rule of law is subject to the 20-percent penalty under that section; and, the reasonable-basis exception is not available.

The penalty does not apply to any portion of an underpayment on which a fraud penalty is imposed.<sup>724</sup> The new 40-percent penalty for non-disclosed transactions is added to the penalties to which IRC section 6662A will not also apply.<sup>725</sup>

As described above, under the provision, the reasonable cause and good faith exception of present-law IRC section 6664(c)(1) does not apply to any portion of an underpayment which is attributable to a transaction lacking economic substance, as defined in IRC section 7701(o), or failing to meet the requirements of any similar rule of law. Likewise, the reasonable cause and good faith exception of present-law IRC section 6664(d)(1) does not apply to any portion of a reportable transaction understatement which is attributable to a transaction lacking economic substance, as defined in IRC section 7701(o), or failing to meet the requirements of any similar rule of law.

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<sup>722</sup> IRC section 7805(a).

<sup>723</sup> It is intended that the penalty would apply to a transaction the tax benefits of which are disallowed as a result of the application of the similar factors and analysis that is required under the provision for an economic substance analysis, even if a different term is used to describe the doctrine.

<sup>724</sup> As under present law, the penalties under IRC section 6662 (including the new penalty) do not apply to any portion of an underpayment on which a fraud penalty is imposed.

<sup>725</sup> As revised by the provision, new IRC section 6662A(e)(2)(b) provides that IRC section 6662A will not apply to any portion of an understatement due to gross valuation misstatement under IRC section 6662(h) or non-disclosed noneconomic substance transactions under new IRC section 6662(i).

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

Effective Date

The provision applies to transactions entered into after March 30, 2010, and to underpayments, understatements, and refunds and credits attributable to transactions entered into after such date.

California Law (R&TC sections 19164, 19164.5, and 19774)

General Accuracy-Related Penalty

The new federal penalty for underpayments and understatements attributable to transactions lacking economic substance is under IRC section 6662, relating to the accuracy-related penalty. For taxable years beginning on or after January 1, 2010, California conforms by reference<sup>726</sup> to IRC section 6662 as of the “specified date” of January 1, 2009, with modifications. Because this provision was enacted after the “specified date,” California does not conform to this provision’s change to the general accuracy-related penalty.

Separate Accuracy-Related Penalty on Listed Transactions and Reportable Avoidance Transactions

For taxable years beginning on or after January 1, 2010, California conforms by reference<sup>727</sup> to the federal separate accuracy-related penalty under IRC section 6662A, as of the “specified date” of January 1, 2009, that applies to any "listed transaction" and to any other "reportable transaction" that is not a listed transaction if a significant purpose of such transaction is the avoidance or evasion of state income tax.

Baseless Claim for Refund or Credit

California does not conform to the federal penalty on baseless refund claims under IRC section 6676.

Noneconomic Substance Transaction Understatement (NEST) Penalty

California does not conform to the separate federal accuracy-related penalty on underpayments that result from transactions lacking economic substance, but instead has its own noneconomic substance transaction understatement (NEST) penalty. The California NEST penalty is imposed on any noneconomic substance transaction understatement.<sup>728</sup> A “noneconomic substance transaction understatement” is an understatement resulting from the disallowance of any loss,

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<sup>726</sup> For taxable years beginning on or after January 1, 2010, R&TC section 19164 conforms to IRC section 6662, relating to imposition of accuracy-related penalty on underpayments, as of the “specified date” of January 1, 2009.

<sup>727</sup> For taxable years beginning on or after January 1, 2010, R&TC section 19164.5 conforms to IRC section 6662A, relating to imposition of accuracy-related penalty on understatements with respect to reportable transactions, as of the “specified date” of January 1, 2009.

<sup>728</sup> R&TC section 19774.

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

deduction or credit, or addition to income that is attributable to a transaction that lacks economic substance. A transaction is treated as lacking economic substance if the taxpayer lacks a valid nontax California business purpose for entering into the transaction. The NEST penalty is 20 percent of the understatement if the transaction is adequately disclosed and 40 percent of the understatement if it is not. Reasonable-cause and adequate-disclosure exceptions do not apply, and the penalty may only be relieved by the Chief Counsel of the FTB.

#### Penalty Coordination

Similar to federal law, California law provides coordination among penalties to provide that every understatement subject to a penalty under any of the above-mentioned applicable penalties is only penalized under one penalty provision (i.e., the general accuracy-related penalty, the separate accuracy-related penalty on certain reportable transactions, or the NEST penalty). For example, an understatement upon which a penalty is imposed under the separate accuracy-related penalty on listed transactions and reportable avoidance transactions<sup>729</sup> is not subject to the general accuracy-related penalty<sup>730</sup> or to the noneconomic substance transaction understatement penalty.<sup>731</sup> However, that understatement is included for purposes of determining whether any understatement<sup>732</sup> is a substantial understatement under the general accuracy-related penalty.

#### Impact on California Revenue

Baseline—based on a proration of the federal estimate developed by the Joint Committee on Taxation, baseline revenue gains are estimated to be \$5.7 million in 2011-12, \$5.5 million in 2012-13, and \$5.2 million in 2013-14.

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<u>Section</u>	<u>Section Title</u>
1410	Time for Payment of Corporate Estimated Taxes

#### Background

In general, corporations are required to make quarterly estimated tax payments of their income tax liability.<sup>733</sup> For a corporation whose taxable year is a calendar year, these estimated tax

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<sup>729</sup> R&TC section 19164.5.

<sup>730</sup> For underpayments under R&TC section 19164.

<sup>731</sup> R&TC section 19774.

<sup>732</sup> As defined in IRC section 6662(d)(2), as conformed to under R&TC section 19164(a)(1)(A), modified by R&TC section 19164(a)(4).

<sup>733</sup> IRC section 6655.

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

payments must be made by April 15, June 15, September 15, and December 15. In the case of a corporation with assets of at least \$1 billion (determined as of the end of the preceding taxable year), payments due in July, August, or September, 2014, are increased to 157.75 percent of the payment otherwise due and the next required payment is reduced accordingly.<sup>734</sup>

New Federal Law (IRC section 6665)

The provision increases the required payment of estimated tax otherwise due in July, August, or September, 2014, by 15.75 percentage points.

Effective Date

The provision is effective on March 30, 2010.

California Law (R&TC section 19025)

California law does not conform to IRC section 6655, and instead has its own rules for estimated tax payments.

For taxable years beginning on or after January 1, 2010, required estimated payments are required in the following percentages:

Quarter Installment	Percent of Estimated Tax
1 <sup>st</sup>	30
2 <sup>nd</sup>	40
3 <sup>rd</sup>	0
4 <sup>th</sup>	30

Corporate taxpayers who are not required to make an estimate payment installment in the first quarter are required to make the following installment payments in subsequent quarters:

Quarter Installment	Percent of Estimated Tax
2 <sup>nd</sup>	60
3 <sup>rd</sup>	0
4 <sup>th</sup>	40

Corporate taxpayers who are not required to make an estimate payment installment in the first two quarters are required to make the following installment payments in subsequent quarters:

Quarter Installment	Percent of Estimated Tax
3 <sup>rd</sup>	70
4 <sup>th</sup>	30

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<sup>734</sup> The Hiring Incentives to Restore Employment ("HIRE") Act, Sec.561; Public Law 111-124, Sec. 4; Public Law 111-92, Sec. 18; Public Law 111-42, Sec. 202(b)(1).

HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010  
Public Law 111-152, March 30, 2010

Corporate taxpayers who are not required to make an estimate payment installment in the first three quarters are required to pay 100 percent in the fourth quarter.

Impact on California Revenue

Not applicable.

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CONTINUING EXTENSION ACT OF 2010  
Public Law 111-157, April 12, 2010

<u>Section</u>	<u>Section Title</u>
2	Extension of Unemployment Insurance Provisions

Background

The 2008 Supplemental Appropriations Act<sup>735</sup> added an uncodified provision providing payments to states having agreements for the payment of emergency unemployment compensation, with the eligibility period ending on March 31, 2009.

The 2010 Department of Defense Appropriations Act<sup>736</sup> extended the eligibility period for emergency unemployment compensation provided in the 2008 Supplemental Appropriations Act to February 28, 2010.

The Temporary Extension Act of 2010<sup>737</sup> extended eligibility period for emergency unemployment compensation provided in the 2008 Supplemental Appropriations Act to April 5, 2010.

New Federal Law (IRC section 3304)

This provision extends the eligibility period for emergency unemployment compensation provided in the 2008 Supplemental Appropriations Act to April 5, 2010.

Effective Date

This provision is effective March 2, 2010 (as if included in the enactment of the Temporary Extension Act of 2010).

California Law

Defer to the Employment Development Department (EDD).

Impact on California Revenue

Defer to the EDD.

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<sup>735</sup> Section 4007 of Public Law 110-252.

<sup>736</sup> Section 1009 of Public Law 111-118.

<sup>737</sup> Section 2 of Public Law 111-144.

CONTINUING EXTENSION ACT OF 2010  
Public Law 111-157, April 12, 2010

<u>Section</u>	<u>Section Title</u>
3	Extension and Improvement of Premium Assistance for COBRA Benefits

Background

See [Section 3](#) of Public Law 111-144, on page 3 of this report.

New Federal Law (IRC section 6432)

This provision extends the eligibility period for COBRA continuation coverage and premium assistance to May 31, 2010.

The provision also provides that all COBRA continuation coverage provisions, including state continuation coverage programs, shall apply to an individual who experiences a qualifying event related to a termination of employment on or after April 1, 2010, and before April 15, 2010.

Effective Date

This provision is effective March 2, 2010 (as if included in the enactment of the Temporary Extension Act of 2010).

***A. IRC section 139C Provision***

California Law (R&TC section 17131)

The Personal Income Tax Law (PITL) conforms to the federal rules relating to items that are specifically excluded from gross income as of the “specified date” of January 1, 2009,<sup>738</sup> and as a result does not conform to this provision (that establishes that an AEI’s premium reduction is excludable from gross income).

However, the premium reduction provision is treated as a part of ERISA. As a result, any state taxation of the premium reduction is prohibited by the ERISA preemption of state law.

Impact on California Revenue

Baseline.

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<sup>738</sup> For taxable years beginning on or after January 1, 2010, R&TC section 17131 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, 2009.

CONTINUING EXTENSION ACT OF 2010  
Public Law 111-157, April 12, 2010

***B. IRC section 6432 Provision***

California Law

The Franchise Tax Board does not administer payroll taxes. Defer to the Employment Development Department (EDD).

Impact on California Revenue

Defer to the EDD.

***C. IRC section 6720C Provision***

California Law (None)

California law has no comparable provision similar to IRC section 6720C.

Impact on California Revenue

Not applicable.

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

<u>Section</u>	<u>Section Title</u>
103	Establish a CMS-IRS Data Match to Identify Fraudulent Providers

Background

In General

IRC section 6103 provides that returns and return information are confidential and may not be disclosed by the IRS, other federal employees, state employees, and certain others having access to such information except as provided in the Internal Revenue Code (IRC). IRC section 6103 contains a number of exceptions to the general rule of nondisclosure that authorize disclosure in specifically identified circumstances. For example, IRC section 6103 provides for the disclosure of certain return information for purposes of establishing the appropriate amount of any Medicare Part B premium-subsidy adjustment.

IRC section 6103(p)(4) requires, as a condition of receiving returns and return information, that federal and state agencies (and certain other recipients) provide safeguards as prescribed by the Secretary of the Treasury by regulation to be necessary or appropriate to protect the confidentiality of returns or return information. Unauthorized disclosure of a return or return information is a felony punishable by a fine not exceeding \$5,000 or imprisonment of not more than five years, or both, together with the costs of prosecution.<sup>739</sup> The unauthorized inspection of a return or return information is punishable by a fine not exceeding \$1,000 or imprisonment of not more than one year, or both, together with the costs of prosecution.<sup>740</sup> An action for civil damages also may be brought for unauthorized disclosure or inspection.<sup>741</sup>

Disclosure Provisions of the Patient Protection and Affordable Care Act (as Amended by the Health Care and Education Reconciliation Act of 2010)

Individuals will submit income information to an exchange as part of an application process in order to claim the cost-sharing reduction and the tax credit on an advance basis. The Department of Health and Human Services (HHS) serves as the centralized verification agency for information submitted by individuals to the exchanges with respect to the reduction and the tax credit to the extent provided on an advance basis. The IRS is permitted to substantiate the accuracy of income information that has been provided to HHS for eligibility determination.

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<sup>739</sup> IRC section 7213.

<sup>740</sup> IRC section 7213A.

<sup>741</sup> IRC section 7431.

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

Specifically, upon written request of the Secretary of HHS, the IRS is permitted to disclose the following return information of any taxpayer whose income is relevant in determining the amount of the tax credit or cost-sharing reduction, or eligibility for participation in the specified state health subsidy programs (i.e., a state Medicaid program under title XIX of the Social Security Act, a state's children's health insurance program under title XXI of such Act, or a basic health program under section 2228 of such Act): (1) taxpayer identity; (2) the filing status of such taxpayer; (3) the modified adjusted gross income (as defined in new IRC section 36B) of such taxpayer, the taxpayer's spouse and of any dependants who are required to file a tax return; (4) such other information as is prescribed by Treasury regulation as might indicate whether such taxpayer is eligible for the credit or subsidy (and the amount thereof); and (5) the taxable year with respect to which the preceding information relates, or if applicable, the fact that such information is not available. HHS is permitted to disclose to an exchange or its contractors, or to the state agency administering the health subsidy programs referenced above (and their contractors) any inconsistency between the information submitted and IRS records.

The disclosed return information may be used only for the purposes of, and only to the extent necessary in, establishing eligibility for participation in the exchange, verifying the appropriate amount of the tax credit, and cost-sharing subsidy, or eligibility for the specified state health subsidy programs.

Recipients of the confidential return information are subject to the safeguard protections and civil and criminal penalties for unauthorized disclosure and inspection. Special rules apply to the disclosure of return information to contractors.

The IRS is required to make an accounting for all disclosures.

New Federal Law (IRC section 6103)

This provision authorizes the Secretary of the Treasury to disclose to HHS officers and employees tax-return information regarding delinquent tax debt with respect to taxpayers who apply to enroll or reenroll as Medicare service providers or suppliers. The HHS Secretary is required to take this information into account in determining whether to deny such an application or to apply enhanced oversight to a service provider or supplier who owes such a debt.

Effective Date

This provision is effective July 25, 2010.

California Law (R&TC sections 19542-19564)

The FTB receives certain information from the IRS, and is required to follow the federal rules under IRC section 6103, relating to confidentiality and disclosure of returns and return information. Additionally, California law provides specific disclosure rules and penalties for returns and other information provided to the FTB. Because this provision relates solely to disclosures between the IRS and the Secretary of HHS, it is not applicable to California.

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
201	Extended Period for Single-Employer Defined Benefit Plans to Amortize Certain Shortfall Amortization Bases

Background

Minimum Funding Rules

*In general*

Defined benefit pension plans generally are subject to minimum funding rules that require the sponsoring employer to periodically make contributions to fund plan benefits.<sup>742</sup> The minimum funding rules for single-employer defined benefit pension plans were substantially revised by the Pension Protection Act of 2006 (“PPA”)<sup>743</sup> The PPA also revised the funding rules that apply to multiemployer defined benefit pension plans. The Worker, Retiree, and Employer Recovery Act of 2008 (“WRERA”)<sup>744</sup> made a number of technical corrections to the PPA. In addition, WRERA made certain amendments to the PPA minimum funding rules to provide funding relief to defined benefit plans affected by the decline in global financial markets during 2008.

The PPA minimum funding rules are generally effective for plan years beginning after December 31, 2007. Delayed effective dates apply to single-employer plans sponsored by certain large

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<sup>742</sup> IRC section 412. Similar rules apply to defined benefit pension plans under the Labor Code provisions of the Employee Retirement Income Security Act of 1974 (“ERISA”). A number of exceptions to the minimum funding rules apply. For example, governmental and church plans are not subject to the minimum funding rules. Under IRC section 414(d), a governmental plan is generally a plan established and maintained for its employees by the federal government, a state government or political subdivision, or an agency or instrumentality of the foregoing. A governmental plan also includes any plan to which the Railroad Retirement Act of 1935 or 1937 applies and that is financed by contributions required under that Act and any plan of an international organization that is exempt from taxation by reason of the International Organizations Immunities Act. A governmental plan includes a plan established and maintained by an Indian tribal government (as defined in IRC section 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with IRC section 7871(d)), or an agency or instrumentality of either, so long as all participants are employees of such entity, substantially all of whose services as employees are in the performance of essential governmental functions but not in the performance of commercial activities (whether or not an essential government function). Under IRC section 414(e), a church plan is a plan established and maintained for its employee by a church or by a convention or association of churches which is exempt from tax under IRC section 501. A church plan may elect to be subject to the minimum funding rules.

<sup>743</sup> Public Law 109-280.

<sup>744</sup> Public Law 110-458.

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

defense contractors, multiple employer plans of some rural cooperatives, and single-employer plans affected by settlement agreements with the Pension Benefit Guaranty Corporation (“PBGC”).<sup>745</sup>

The minimum funding rules for single-employer and multiemployer plans are different. A single-employer plan is a plan that is not a multiemployer plan. A multiemployer plan is generally a plan to which more than one employer is required to contribute and which is maintained pursuant to a collective bargaining agreement. There are also multiple employer plans, which are plans maintained by more than one employer and to which more than one employer is required to contribute, but that are not maintained pursuant to a collective bargaining agreement. The single-employer plan funding rules generally apply to multiple employer plans.

The purpose of the minimum funding rules is to ensure that the sponsoring employer of a defined benefit pension plan makes periodic minimum contributions that will adequately fund benefits promised under the plan. The rules permit an employer to fund the plan over a period of time. Thus, it is possible that a plan may be terminated at a time when plan assets are not sufficient to provide all benefits accrued by employees under the plan.

The due date for the payment of a minimum required contribution for a plan year is generally eight and one-half months after the end of the plan year.<sup>746</sup> If unpaid minimum funding contributions for a single-employer plan exceed \$1,000,000, a lien arises in favor of the plan upon all property and rights to property (real or personal) belonging to the sponsoring employer (or member of the sponsoring employer’s controlled group) in an amount equal to the unpaid minimum contributions.<sup>747</sup> Notice must be given to the PBGC<sup>748</sup> of a funding failure that gives rise to a lien, and generally the lien is enforceable by the PBGC.

In the event of a failure to comply with the minimum funding rules, the IRC imposes a two-level excise tax on the plan sponsor.<sup>749</sup> The initial tax is 10 percent of aggregate unpaid contributions

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<sup>745</sup> The PPA funding rules do not apply to eligible government contractor plans for plan years beginning before the earliest of: (1) the first plan year for which the plan ceases to be an eligible government contractor plan; (2) the effective date of the Cost Accounting Standards Pension Harmonization Rule; or (3) January 1, 2011. The new funding rules do not apply to eligible rural cooperative plans for plan years beginning before the earlier of: (1) the first plan year for which the plan ceases to be an eligible cooperative plan; or (2) January 1, 2017. The new funding rules do not apply to eligible PBGC settlement plans for plan years beginning before January 1, 2014.

<sup>746</sup> IRC section 430(j).

<sup>747</sup> IRC section 430(k).

<sup>748</sup> The PBGC was established for the purpose of ensuring that benefits promised under a defined benefit pension plan are paid (up to specified annual limits) if the sponsoring employer is not able to fulfill its obligation to adequately fund the plan and the plan is terminated when it is underfunded (ERISA section 4002(a)). The benefit-protection function of the PBGC is carried out through an insurance program that applies to defined benefit pension plans. Sponsors of plans that are subject to the insurance program are liable to the PBGC for premium payments. PBGC termination insurance serves as a backstop to the minimum funding rules.

<sup>749</sup> IRC section 4971.

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

for single-employer plans and five percent of the plan's accumulated funding deficiency (as defined below) for multiemployer plans. An additional tax is imposed if the failure is not corrected before the date that a notice of deficiency with respect to the initial tax is mailed to the employer by the Internal Revenue Service (IRS) or the date of assessment of the initial tax. The additional tax is equal to 100 percent of the unpaid contribution or the accumulated funding deficiency, whichever is applicable. Before issuing a notice of deficiency with respect to the excise tax, the Secretary must notify the Secretary of Labor and provide the Secretary of Labor with a reasonable opportunity to require the employer responsible for contributing to, or under, the plan to correct the deficiency or comment on the imposition of the tax.

*Funding target and shortfall amortization charges*

The minimum required contribution for a plan year for single-employer defined benefit plans generally depends on a comparison of the value of the plan's assets with the plan's funding target and target normal cost.<sup>750</sup> 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 to be earned during the plan year. WRERA clarified 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.<sup>751</sup>

A shortfall amortization base is determined for a plan year based on the plan's funding shortfall for the plan year.<sup>752</sup> 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. The shortfall amortization base for a plan year is the plan's funding shortfall minus the present value, determined using the segment interest rates (discussed below), of the aggregate total of the shortfall amortization installments that have been determined for the plan year and any succeeding plan year with respect to any

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<sup>750</sup> IRC section 430.

<sup>751</sup> This clarification is effective for plan years beginning after December 31, 2008, and is elective for the preceding plan year. Final regulations issued under IRC section 430 reserve the issue of the definition of "plan-related expenses." The definition of the term is expected to be the subject of future proposed regulations. Treas. Reg. section 1.430(d)-1(b)(2)(iii)(B).

<sup>752</sup> 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 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) was 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 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 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. While the PPA provided that the transition rule did 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), WRERA amended the PPA rules to extend the transition rule to plan years beginning after 2008 even if, for each preceding plan year after 2007, the plan's shortfall amortization base was not zero.

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

shortfall amortization bases for preceding plan years. As a result, in any given plan year, a plan may have a number of shortfall amortization installments that relate to the current or prior years. The aggregate of these installments is referred to as the shortfall amortization charge. In the case of a plan with a funding shortfall for a plan year, the minimum required contribution is generally equal to the sum of the plan's target normal cost and the shortfall amortization charge for that year.

A shortfall amortization base may be positive or negative, depending on whether the present value of remaining installments with respect to prior year amortization bases is more or less than the plan's funding shortfall. In either case, the shortfall amortization base is amortized over a seven-year period beginning with the current plan year. Shortfall amortization installments for a particular plan year with respect to positive and negative shortfall amortization bases are netted in determining the shortfall amortization charge for the plan year, but the resulting shortfall amortization charge cannot be less than zero (i.e., negative amortization installments may not offset normal cost).

If the value of the plan's assets exceeds the plan's funding target for a plan year, then the minimum required contribution is generally equal to the plan's target normal cost for the year. Target normal cost for this purpose is reduced (but not below zero) by the amount by which the value of the plan's assets exceed the plan's funding target.

*Actuarial assumptions*

The minimum funding rules for single-employer defined benefit pension plans specify the interest rates and other actuarial assumptions that must be used in determining a plan's target normal cost and funding target. Under the rules, present value is determined using three interest rates ("segment" rates), each of which applies to benefit payments expected to be made from the plan during a certain period. The first segment rate applies to benefits reasonably determined to be payable during the five-year period beginning on the first day of the plan year; the second segment rate applies to benefits reasonably determined to be payable during the 15-year period following the initial five-year period; and the third segment rate applies to benefits reasonably determined to be payable at the end of the 15-year period. Each segment rate is a single interest rate determined monthly by the Secretary 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 corporate bond yield curve used for this purpose reflects the average, for the 24-month period ending with the preceding month, of yields on investment grade corporate bonds with varying maturities and that are in the top three quality levels available.

The present value of liabilities under a plan is determined using the segment rates for the "applicable month" for the plan year. The applicable month is the month that includes the plan's valuation date for the plan year, or, at the election of the plan sponsor, any of the four months preceding the month that includes the valuation date. An election of a preceding month applies to the plan year for which it is made and all succeeding plan years unless revoked with the consent of the Secretary.

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

Solely for purposes of determining minimum required contributions, in lieu of the segment rates described above, a plan sponsor may elect to use interest rates on a yield curve based on the yields on investment grade corporate bonds for the month preceding the month in which the plan year begins (i.e., without regard to the 24-month averaging described above) (“spot” rates). In general, such an election may be revoked only with approval of the Secretary. However, Treasury regulations provide automatic approval for plan sponsors to make a new choice of interest rates for 2009 and 2010 (regardless of what choices were made for earlier years).<sup>753</sup> In addition, for 2009, the IRS has indicated that it will allow plan sponsors to use the spot rate for the month that includes the plan’s valuation date for the 2009 plan year, or, at the election of the plan sponsor, any of the four months preceding the month that includes the valuation date (rather than only for the month preceding the valuation date).<sup>754</sup>

New Federal Law (IRC section 430)

Election of Extended Amortization Period

The provision permits the plan sponsor of a single-employer defined benefit pension plan to elect to determine the shortfall amortization installments with respect to the shortfall amortization base for not more than two eligible plan years under two alternative extended amortization schedules.

Under the provision, the sponsor of a single-employer defined benefit plan may elect to amortize the shortfall amortization base for an eligible plan year over a nine-year period beginning with the election year (“two plus seven amortization schedule”). The shortfall amortization installments for the first two plan years in the nine-year period are equal to the interest on the shortfall amortization base for the election year, determined by using the effective interest rate for the election year.<sup>755</sup> The shortfall amortization installments for the last seven plan years in the nine-year period are equal to the amounts necessary to amortize the remaining balance of the shortfall amortization base for the election year in level annual installments over the seven-year period, determined by using the segment rates for the election year.

Alternatively, the sponsor of a single-employer defined benefit plan may elect to amortize the shortfall amortization base for an election year in level annual installments over a fifteen-year period beginning with the election year (“fifteen-year amortization schedule”).

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<sup>753</sup> Treas. Reg. section 1.430(h)(2)-1(h)(3). Final regulations under IRC sections 430(d), 430(f), 430(g), 430(h)(2), 430(i) and 436 were issued on October 7, 2009 and published in the Federal Register on October 15, 2009. 74 F.R. 53004 (October 15, 2009). The regulations are effective for plan years beginning on or after January 1, 2010, except for plans to which a delayed effective date applies. For plan years beginning before January 1, 2010, plans are permitted to rely on the final regulations or the proposed regulations (72 F.R. 74215) for purposes of satisfying the requirements of IRC sections 430 and 436.

<sup>754</sup> Internal Revenue Service, Employee Plans News, March 2009 Special Edition.

<sup>755</sup> The effective interest rate with respect to a plan for a plan year is the single rate of interest that, if used to determine the present value of the benefits taken into account in determining the plan’s funding target for the year, would result in an amount equal to the plan’s funding target (as determined using the first, second, and third segment rates). IRC section 430(h)(2)(A).

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

For purposes of the provision, an eligible plan year is a plan year beginning in 2008, 2009, 2010, or 2011, but only if the due date for the payment of the minimum required contribution for the plan year occurs on or after June 25, 2010. A plan sponsor is not required to elect to use an extended amortization schedule for more than one eligible plan year or to make such election for consecutive eligible plan years; however, a plan sponsor who does make an election for two eligible plan years is required to elect the same extended amortization schedule for each year. For example, a plan sponsor who elects to use the fifteen-year amortization schedule for the plan year beginning in 2009 can make an election to use that same extended amortization schedule for the plan year beginning in 2010 or 2011; however, the plan sponsor is not permitted to elect the two plus seven amortization schedule for either of those subsequent eligible plan years.

Multiple employer plans of rural cooperatives that are not yet subject to the PPA minimum funding rules may only elect an extended amortization schedule for the plan year beginning in 2011.

An election to use an extended amortization schedule may be revoked only with the consent of the Secretary. Prior to granting a revocation request the Secretary must provide the PBGC an opportunity to comment on the conditions applicable to the treatment of any portion of the election year shortfall amortization base that remains unamortized as of the revocation date.

#### Increase in Required Installments for Certain Plans

##### *In general*

Under the provision, any plan year in a restriction period is a year in which the shortfall amortization installment otherwise determined and payable for that year pursuant to an election to use an extended amortization period may be increased, subject to certain limits described below, by an "installment acceleration amount." The length of the restriction period following an election to use an extended amortization schedule depends on the extended amortization schedule elected by the plan sponsor for the eligible plan year. For a plan sponsor who elects to use the two plus seven amortization schedule for an eligible plan year, the restriction period is the three year period beginning with the election year or, if later, the first plan year beginning after December 31, 2009. For a plan sponsor who elects to use the fifteen-year amortization schedule for an eligible plan year, the restriction period is the five year period beginning with the election year or, if later, the first plan year beginning after December 31, 2009.

For example, for a plan sponsor who elects to use the two plus seven amortization schedule for the plan year beginning in 2009, the restriction period with respect to that election is the three year period during the 2010, 2011, and 2012 plan years. If the same plan sponsor then elects to use the two plus seven amortization schedule for the plan year beginning in 2011, the separate restriction period with respect to that election is the three year period during the 2011, 2012, and 2013 plan years.

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

*Installment acceleration amount*

The “installment acceleration amount” with respect to any plan year in a restriction period is the aggregate amount of excess employee compensation with respect to all employees for the plan year and the aggregate amount of extraordinary dividends and redemptions for the plan year. For purposes of the provision, “plan sponsor” includes any member of the plan sponsor’s controlled group (as determined for purposes of the minimum funding rules).

*Excess employee compensation*

Excess employee compensation is compensation (as defined below) with respect to any employee (including a self-employed individual treated as an employee under IRC section 401(c)) for any plan year in excess of \$1,000,000. Beginning in 2011, the \$1,000,000 threshold is indexed to the Consumer Price Index for Urban Consumers, rounded to the next lowest \$1,000.

For purposes of determining excess employee compensation, “compensation” includes all amounts attributable to services performed by an employee for a plan sponsor after February 28, 2010, that are includable in the employee’s income as remuneration during the calendar year in which the plan year begins, regardless of whether the services were performed during such calendar year. Compensation for any employee during a calendar year also includes any amount that the plan sponsor directly or indirectly sets aside or reserves in, or transfers to, a trust (or other arrangement specified by the Secretary) during the calendar year for purposes of paying deferred compensation to the employee under a nonqualified deferred compensation plan (as defined in IRC section 409A) of the plan sponsor, unless such amount is otherwise includable in income as remuneration by the employee in that calendar year. To the extent that an amount is taken into account when set aside, reserved or transferred to a trust or other arrangement, that amount is not taken into account in calculating the excess employee compensation with respect to the employee in any subsequent calendar year. The rule for amounts set aside, reserved or transferred to a trust or other arrangement applies without regard to whether the related compensation is attributable to services performed by an employee for a plan sponsor before or after February 28, 2010.

Compensation does not include any amount otherwise includable in the employee’s income with respect to the granting of service recipient stock (as defined for purposes of IRC section 409A) after February 28, 2010, that is, at the time of grant, subject to a substantial risk of forfeiture (within the meaning of IRC section 83(c)(1)) for at least five years following the date of grant. A grant would not fail to satisfy this requirement if the grant were vested upon death, disability, or involuntary termination of employment before the end of the five-year period. Under the provision, the Secretary may provide for the application of this exception for restricted service recipient stock to persons other than corporations. In addition, compensation does not include any remuneration payable to an employee on a commission basis solely on account of income directly generated by that employee’s individual performance. Finally, compensation does not include any remuneration consisting of nonqualified deferred compensation, restricted stock, restricted stock units, stock options, or stock appreciation rights payable or granted under a binding written contract in effect on March 1, 2010 and not modified in any material respect before the remuneration is paid.

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

*Extraordinary dividends and redemptions*

The aggregate amount of extraordinary dividends and redemptions for a plan year is equal to the amount by which the sum of the dividends declared during the plan year by the plan sponsor and the aggregate amount paid for the redemption of stock of the plan sponsor redeemed during the plan year exceeds the greater of: (1) the plan sponsor's adjusted net income (within the meaning of section 4043 of ERISA) for the preceding plan year, determined without regard for any reduction by reason of interest, taxes, depreciation or amortization; or (2) for a plan sponsor who determined and declared dividends in the same manner for at least five consecutive years immediately preceding the plan year, the aggregate amount of dividends determined and declared for the plan year in that manner. It is intended that dividends would be deemed to be determined in the same manner for the prior five years if they are at the same level or rate as dividends in the previous five consecutive years. For purposes of the provision, only dividends declared and redemptions occurring after February 28, 2010 are taken into account in determining the amount of dividends and redemptions for a plan year.

In calculating the dividends declared and amounts paid for the redemption of stock during the plan year, the following amounts are disregarded: (1) dividends paid by one member of the plan sponsor's controlled group to another member of the controlled group; (2) redemptions made pursuant to an employee benefit plan or that are made on account of the death, disability or termination of employment of an employee or shareholder; and (3) dividends and redemptions with respect to applicable preferred stock on which dividends accrue at a specified rate in all events and without regard to the plan sponsor's income and with respect to which interest accrues on any unpaid dividends. Applicable preferred stock is preferred stock originally issued before March 1, 2010 (including any preferred stock originally issued prior to that date that is subsequently reissued with otherwise identical terms) and preferred stock issued after March 1, 2010 that is held by an employee benefit plan subject to Title I of ERISA.

Limitations on Installment Acceleration Amounts

*Annual limitation*

Under the provision, the installment acceleration amount for a plan year is limited to the aggregate amount of funding relief received by the plan sponsor in prior years as a result of an election to use an extended amortization period for an eligible plan year. To the extent that an installment acceleration amount is limited by application of this rule, the excess installment acceleration amount is generally carried over to the succeeding plan year.

Thus, under the provision, the installment acceleration amount for any plan year may not exceed the excess (if any) of the sum of the shortfall amortization installments for that plan year and all prior plan years in the nine or fifteen year amortization period, as elected, with respect to the shortfall amortization base for the election year, that would have been determined and payable by the plan sponsor with respect to that shortfall amortization base in the absence of an election to use an extended amortization period, over the sum of the shortfall amortization installments for such plan years, determined under the two and seven or fifteen year amortization schedule, as

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

elected by the plan sponsor, including any installment acceleration amount from a preceding plan year (“annual limit”).

To the extent that a carryover of excess installment acceleration amounts from a preceding plan year, when added to other installment acceleration amounts for a plan year (as determined prior to application of the annual limit on installment acceleration amounts) would cause the shortfall amortization installment for the plan year to exceed the annual limit, the excess is similarly carried over to the next succeeding plan year. Under the provision, the following ordering rule applies in applying the annual limit for a plan year: the installment acceleration amounts for the plan year, determined prior to the addition of any carryover installment acceleration amount from a preceding year, is applied first against the annual limit and then any installment acceleration amounts carried over to the plan year are applied against the annual limit on a first-in, first-out basis.

The carryover rules apply during the restriction period with respect to an election year and for a limited number of years following the expiration of the restriction period with respect to an election year. Under the provision, no amount is carried over to a plan year that begins after the first plan year following the last plan year in the restriction period applicable to a two plus seven amortization schedule and no amount is carried over to a plan year that begins after the second plan year following the last plan year in the restriction period applicable to a fifteen year amortization schedule.

*Total installments limited to the present value of the shortfall amortization base*

Two additional rules (subject to rules prescribed by the Secretary) apply under the provision to insure that the addition of an installment acceleration amount to a shortfall amortization installment for a plan year results only in an acceleration of the payment of amounts that would otherwise be included in subsequent shortfall amortization installments with respect to the shortfall amortization base for the election year and not in the amortization of an amount in excess of that shortfall amortization base.

Under the first rule, if the shortfall amortization installment with respect to the shortfall amortization base for an election year is required to be increased by any installment acceleration amount, the remaining shortfall amortization installments with respect to that shortfall amortization base are reduced, in reverse order of the otherwise required installments, to the extent necessary to limit the present value of the remaining installments to the present value of the remaining unamortized shortfall amortization base. Under the second rule, the increase for any plan year is limited to the amount that does not cause the amount of the installment to exceed the present value of the installment and all succeeding installments with respect to the shortfall amortization base for the election year (determined without regard to the installment acceleration amount, but after application of the first rule reducing the remaining shortfall amortization installments to reflect any installment acceleration amount).

Under the provision, any installment acceleration amount is disregarded for purposes of determining a plan’s quarterly contributions.

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

### Reporting Requirement

The provision requires a plan sponsor who elects to use an extended amortization schedule is required to give notice of the election to participants and beneficiaries of the plan and to inform the PBGC of the election in such form and manner as the Director of the PBGC may require.

### Regulations and Guidance

The Secretary is directed to provide rules for the application of the provisions governing installment acceleration amounts to plan sponsors who elect an extended amortization schedule for two or more plans, including rules for the ratable allocation of any installment acceleration amount among electing plans on the basis of each plan's relative reduction in its shortfall amortization installment for the first plan year in the extended amortization period. The Secretary is also directed to provide rules for the application of those provisions and the provisions governing the election of an extended amortization schedule in any case where there is a merger or acquisition involving an electing plan sponsor.

### Effective Date

This provision is effective for plan years beginning after December 31, 2007.

### California Law (R&TC section 17501)

#### IRC Automatic Conformity

California automatically conforms to the federal single-employer defined benefit plan rules to the same extent as applicable for federal income tax purposes.<sup>756</sup>

#### ERISA Preemption

Additionally, federal ERISA provisions specifically preempt state laws relating to certain employee benefit plans in California.

### Impact on California Revenue

Baseline.

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<sup>756</sup> R&TC section 17501 conforms to Part III of Subchapter D of Chapter 1 of Subtitle A of the IRC, without regard to the "specified date" contained in R&TC 17024.5.

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

<u>Section</u>	<u>Section Title</u>
202	Application of Extended Amortization Period to Plans Subject to Prior Law Funding Rules

Background

In General

Defined benefit pension plans generally are subject to minimum funding requirements under ERISA and the IRC.<sup>757</sup> The Pension Protection Act of 2006 (PPA) made significant changes to the minimum funding requirements for single-employer plans. Generally, those modifications became effective for plan years beginning after December 31, 2007. As discussed below, however, there are delayed effective dates for certain plans including multiple employer plans of certain cooperatives, certain Pension Benefit Guarantee Corporation (PBGC) settlement plans, and plans of certain government contractors.

*Multiple employer plans of certain cooperatives*

Section 104 of PPA provides a delayed effective date for the PPA's single-employer plan funding rules for any plan that was in existence on July 26, 2005, and was an eligible cooperative plan for the plan year including that date. A plan is treated as an eligible cooperative plan for a plan year if it is maintained by more than one employer and at least 85 percent of the employers are: (1) certain rural cooperatives;<sup>758</sup> or (2) certain cooperative organizations that are more than 50-percent owned by agricultural producers or by cooperatives owned by agricultural producers, or organizations that are more than 50-percent owned, or controlled by, one or more such cooperative organizations. A plan is also treated as an eligible cooperative plan for any plan year for which it is maintained by more than one employer and is maintained by a rural telephone cooperative association.

The PPA's funding rules do not apply with respect to an eligible cooperative plan for plan years beginning before the earlier of: (1) the first plan year for which the plan ceases to be an eligible cooperative plan; or (2) January 1, 2017. In addition, in applying the pre-PPA funding rules to an eligible cooperative plan to such a plan for plan years beginning after December 31, 2007, and before the first plan year for which the PPA funding rules apply, the interest rate used is the interest rate applicable under the PPA funding rules with respect to payments expected to be

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<sup>757</sup> IRC section 412 and section 302 of ERISA. Multiemployer defined benefit pension plans are also subject to the minimum funding requirements, but the rules for multiemployer plans differ in various respects from the rules applicable to single-employer plans. Governmental plans and church plans are generally exempt from the minimum funding requirements.

<sup>758</sup> This is as defined in IRC section 401(k)(7)(B) without regard to (iv) thereof and includes: (1) organizations engaged primarily in providing electric service on a mutual or cooperative basis, or engaged primarily in providing electric service to the public in its service area and which is exempt from tax or which is a state or local government, other than a municipality; (2) certain civic leagues and business leagues exempt from tax 80 percent of the members of which are described in (1); (3) certain cooperative telephone companies; and (4) any organization that is a national association of organizations described above.

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

made from the plan after the 20-year period beginning on the first day of the plan year (i.e., the third segment rate under the PPA funding rules).<sup>759</sup>

*Certain PBGC settlement plans*

The PPA provides a delayed effective date for its single-employer plan funding rules for any plan that was in existence on July 26, 2005, and was a “PBGC settlement plan” as of that date. The term “PBGC settlement plan” means a single-employer defined benefit plan: (1) that was sponsored by an employer in bankruptcy proceedings giving rise to a claim by the PBGC of not greater than \$150 million, and the sponsorship of which was assumed by another employer (not a member of the same controlled group as the bankrupt sponsor) and the PBGC’s claim was settled or withdrawn in connection with the assumption of the sponsorship; or (2) that, by agreement with the PBGC, was spun off from a plan subsequently terminated by the PBGC in an involuntary termination.

The PPA’s funding rules do not apply with respect to a PBGC settlement plan for plan years beginning before January 1, 2014. In addition, in applying the pre-PPA funding rules to such a plan for plan years beginning after December 31, 2007, and before January 1, 2014, the interest rate used is the third segment rate under the PPA funding rules.

*Plans of certain government contractors*

The PPA provides a delayed effective date for its single-employer plan funding rules for any eligible government contractor plan. A plan is treated as an eligible government contractor plan if it is maintained by a corporation (or member of the same affiliated group): (1) whose primary source of revenue is derived from business performed under contracts with the United States that are subject to the Federal Acquisition Regulations<sup>760</sup> and also to the Defense Federal Acquisition Regulation Supplement;<sup>761</sup> (2) whose revenue derived from such business in the previous fiscal year exceeded \$5 billion; and (3) whose pension plan costs that are assignable under those contracts are subject to certain provisions of the Cost Accounting Standards.<sup>762</sup>

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<sup>759</sup> The PPA specifies the interest rates that must be used in determining a plan’s target normal cost and funding target. Present value is determined using three interest rates (“segment” rates), each of which applies to benefit payments expected to be made from the plan during a certain period. The first segment rate applies to benefits reasonably determined to be payable during the five-year period beginning on the first day of the plan year; the second segment rate applies to benefits reasonably determined to be payable during the 15-year period following the initial five-year period; and the third segment rate applies to benefits reasonably determined to be payable the end of the 15-year period. Each segment rate is a single interest rate determined monthly 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.

<sup>760</sup> Chapter 1 of Title 48, C.F.R.

<sup>761</sup> Chapter 2 of Title 48, C.F.R.

<sup>762</sup> 48 C.F.R. 9904.412 and 9904.413.

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

The PPA funding rules do not apply with respect to such a plan for plan years beginning before the earliest of: (1) the first plan year for which the plan ceases to be an eligible government contractor plan; (2) the effective date of the Cost Accounting Standards Pension Harmonization Rule;<sup>763</sup> and (3) the first plan year beginning after December 31, 2010. In addition, in applying the pre-PPA funding rules to such a plan for plan years beginning after December 31, 2007, and before the first plan year for which the PPA funding rules apply, the interest rate used is the third segment rate under the PPA funding rules.

#### General Minimum Funding Rules for Plans with Delayed PPA Effective Dates

##### *Funding standard account*

As an administrative aid in the application of the pre-PPA funding requirements, a defined benefit pension plan is required to maintain a special account called a “funding standard account” to which specified charges and credits are made for each plan year, including a charge for normal cost and credits for contributions to the plan. Other charges or credits may apply as a result of decreases or increases in past service liability as a result of plan amendments, experience gains or losses, gains or losses resulting from a change in actuarial assumptions, or a waiver of minimum required contributions.

In determining plan funding under an actuarial cost method, a plan’s actuary generally makes certain assumptions regarding the future experience of a plan. These assumptions typically involve rates of interest, mortality, disability, salary increases, and other factors affecting the value of assets and liabilities. If the plan’s actual unfunded liabilities are less than those anticipated by the actuary on the basis of these assumptions, then the excess is an experience gain. If the actual unfunded liabilities are greater than those anticipated, then the difference is an experience loss. Experience gains and losses for a year are generally amortized as credits or charges to the funding standard account over five years.

If the actuarial assumptions used for funding a plan are revised and, under the new assumptions, the accrued liability of a plan is less than the accrued liability computed under the previous assumptions, the decrease is a gain from changes in actuarial assumptions. If the new assumptions result in an increase in the plan’s accrued liability, the plan has a loss from changes in actuarial assumptions. The accrued liability of a plan is the actuarial present value of projected pension benefits under the plan that will not be funded by future contributions to meet normal cost or future employee contributions. The gain or loss for a year from changes in actuarial assumptions is amortized as credits or charges to the funding standard account over ten years.

If minimum required contributions are waived, the waived amount (referred to as a “waived funding deficiency”) is credited to the funding standard account. The waived funding deficiency is

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<sup>763</sup> Section 106(d) of PPA requires the Cost Accounting Standards Board to review and revise sections 412 and 413 of the Cost Accounting Standards (48 C.F.R. 9904.412 and 9904.413) to harmonize the minimum required contributions under ERISA of eligible government contractor plans and government reimbursable pension plan costs, not later than Jan. 1, 2010. Any final rule adopted by the Cost Accounting Standards Board will be considered the Cost Accounting Standards Pension Harmonization Rule.

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

then amortized over a period of five years, beginning with the year following the year in which the waiver is granted. Each year, the funding standard account is charged with the amortization amount for that year unless the plan becomes fully funded.

If, as of the close of a plan year, the funding standard account reflects credits at least equal to charges, the plan is generally treated as meeting the minimum funding standard for the year. If, as of the close of the plan year, charges to the funding standard account exceed credits to the account, then the excess is referred to as an “accumulated funding deficiency.” Thus, as a general rule, the minimum contribution for a plan year is determined as the amount by which the charges to the funding standard account would exceed credits to the account if no contribution were made to the plan. For example, if the balance of charges to the funding standard account of a plan for a year would be \$200,000 without any contributions, then a minimum contribution equal to that amount would be required to meet the minimum funding standard for the year to prevent an accumulated funding deficiency.

*Funding methods and general concepts*

A defined benefit pension plan is required to use an acceptable actuarial cost method to determine the elements included in its funding standard account for a year. Generally, an actuarial cost method breaks up the cost of benefits under the plan into annual charges consisting of two elements for each plan year. These elements are referred to as normal cost and supplemental cost.

The plan’s normal cost for a plan year generally represents the cost of future benefits allocated to the year by the funding method used by the plan for current employees and, under some funding methods, for separated employees. Specifically, it is the amount actuarially determined that would be required as a contribution by the employer for the plan year in order to maintain the plan if the plan had been in effect from the beginning of service of the included employees and if the costs for prior years had been paid, and all assumptions as to interest, mortality, time of payment, etc., had been fulfilled. The normal cost will be funded by future contributions to the plan: (1) in level dollar amounts; (2) as a uniform percentage of payroll; (3) as a uniform amount per unit of service (e.g., \$1 per hour); or (4) on the basis of the actuarial present values of benefits considered accruing in particular plan years.

The supplemental cost for a plan year is the cost of future benefits that would not be met by future normal costs, future employee contributions, or plan assets. The most common supplemental cost is that attributable to past service liability, which represents the cost of future benefits under the plan: (1) on the date the plan is first effective; or (2) on the date a plan amendment increasing plan benefits is first effective. Other supplemental costs may be attributable to net experience losses, changes in actuarial assumptions, and amounts necessary to make up funding deficiencies for which a waiver was obtained. Supplemental costs must be amortized (i.e., recognized for funding purposes) over a specified number of years, depending on the source. For example, the cost attributable to a past service liability is generally amortized over 30 years.

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

Normal costs and supplemental costs under a plan are computed on the basis of an actuarial valuation of the assets and liabilities of a plan. An actuarial valuation is generally required annually and is made as of a date within the plan year or within one month before the beginning of the plan year. However, a valuation date within the preceding plan year may be used if, as of that date, the value of the plan's assets is at least 100 percent of the plan's current liability (i.e., the present value of benefits under the plan, as described below).

For funding purposes, the actuarial value of plan assets may be used, rather than fair market value. The actuarial value of plan assets is the value determined on the basis of a reasonable actuarial valuation method that takes into account fair market value and is permitted under Treasury regulations. Any actuarial valuation method used must result in a value of plan assets that is not less than 80 percent of the fair market value of the assets and not more than 120 percent of the fair market value. In addition, if the valuation method uses average value of the plan assets, values may be used for a stated period not to exceed the five most recent plan years, including the current year.

In applying the funding rules, all costs, liabilities, interest rates, and other factors are required to be determined on the basis of actuarial assumptions and methods, each of which is reasonable (taking into account the experience of the plan and reasonable expectations), or which, in the aggregate, result in a total plan contribution equivalent to a contribution that would be determined if each assumption and method were reasonable. In addition, the assumptions are required to offer the actuary's best estimate of anticipated experience under the plan.<sup>764</sup>

#### Additional Contributions for Underfunded Plans with Delayed PPA Effective Dates

##### *In general*

Under special funding rules (referred to as the "deficit reduction contribution" rules),<sup>765</sup> an additional charge to a plan's funding standard account is generally required for a plan year if the plan's funded current liability percentage for the plan year is less than 90 percent.<sup>766</sup> A plan's "funded current liability percentage" is generally the actuarial value of plan assets as a percentage of the plan's current liability.<sup>767</sup> In general, a plan's current liability means all

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<sup>764</sup> Under present law, certain changes in actuarial assumptions that decrease the liabilities of an underfunded single-employer plan must be approved by the Secretary of the Treasury.

<sup>765</sup> The deficit reduction contribution rules apply to single-employer plans, other than single-employer plans with no more than 100 participants on any day in the preceding plan year. Single-employer plans with more than 100 but not more than 150 participants are generally subject to lower contribution requirements under these rules.

<sup>766</sup> Under an alternative test, a plan is not subject to the deficit reduction contribution rules for a plan year if: (1) the plan's funded current liability percentage for the plan year is at least 80 percent; and (2) the plan's funded current liability percentage was at least 90 percent for each of the two immediately preceding plan years or each of the second and third immediately preceding plan years.

<sup>767</sup> In determining a plan's funded current liability percentage for a plan year, the value of the plan's assets is generally reduced by the amount of any credit balance under the plan's funding standard account. However, this

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

liabilities to employees and their beneficiaries under the plan, determined on a present-value basis.

The amount of the additional charge required under the deficit reduction contribution rules is the sum of two amounts: (1) the excess, if any, of (a) the deficit reduction contribution (as described below) over (b) the contribution required under the normal funding rules; and (2) the amount (if any) required with respect to unpredictable contingent event benefits. The amount of the additional charge cannot exceed the amount needed to increase the plan's funded current liability percentage to 100 percent (taking into account the expected increase in current liability due to benefits accruing during the plan year).

The deficit reduction contribution is generally the sum of: (1) the "unfunded old liability amount," (2) the "unfunded new liability amount," and (3) the expected increase in current liability due to benefits accruing during the plan year.<sup>768</sup> The "unfunded old liability amount" is the amount needed to amortize certain unfunded liabilities under 1987 and 1994 transition rules. The "unfunded new liability amount" is the applicable percentage of the plan's unfunded new liability. Unfunded new liability generally means the unfunded current liability of the plan (i.e., the amount by which the plan's current liability exceeds the actuarial value of plan assets), but determined without regard to certain liabilities (such as the plan's unfunded old liability and unpredictable contingent event benefits). The applicable percentage is generally 30 percent, but decreases by .40 of one percentage point for each percentage point by which the plan's funded current liability percentage exceeds 60 percent. For example, if a plan's funded current liability percentage is 85 percent (i.e., it exceeds 60 percent by 25 percentage points), the applicable percentage is 20 percent (30 percent minus 10 percentage points (25 multiplied by .4)).<sup>769</sup>

A plan may provide for unpredictable contingent event benefits, which are benefits that depend on contingencies that are not reliably and reasonably predictable, such as facility shutdowns or reductions in workforce. The value of any unpredictable contingent event benefit is not considered in determining additional contributions until the event has occurred. The event on which an unpredictable contingent event benefit is contingent is generally not considered to have occurred until all events on which the benefit is contingent have occurred.

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reduction does not apply in determining the plan's funded current liability percentage for purposes of whether an additional charge is required under the deficit reduction contribution rules.

<sup>768</sup> The deficit reduction contribution may also include an additional amount as a result of the use of a new mortality table prescribed by the Secretary of the Treasury in determining current liability for plan years beginning after 2006.

<sup>769</sup> In making these computations, the value of the plan's assets is reduced by the amount of any credit balance under the plan's funding standard account.

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

New Federal Law (ERISA and uncodified provisions affecting IRC section 412)

In General

The provision offers two types of funding relief to underfunded plans with delayed PPA effective dates.<sup>770</sup> Under the provision, a plan sponsor may elect either: (1) a two year look-back rule for purposes of calculating the plan's deficit reduction contribution; or (2) a 15-year amortization period for purposes of determining the plan's unfunded new liability.

Plan sponsors of eligible plans may elect relief for not more than two applicable years (one year for plans of certain government contractors). Plan sponsors electing two years of relief must elect the same type of relief for each year. Generally, relief may be elected for any two plan years beginning in 2008, 2009, 2010, or 2011. A plan year beginning in 2008 may be an applicable year, however, only if the due date for payment of the plan's minimum required contribution occurs on or after the provision's date of enactment. A plan sponsor is not required to make an election for more than one applicable plan year or to make such election for consecutive applicable plan years; however, a plan sponsor that does make an election for two plan years is required to elect the same relief provision for each year. For example, a plan sponsor that elects to use the two year look-back rule for the plan year beginning in 2009 can make an election to use that same rule for the plan year beginning in 2010 or 2011; however, the plan sponsor is not permitted to elect to use the 15-year amortization period for purposes of determining the plan's unfunded new liability for either of those subsequent eligible plan years. A "pre-effective-date plan year" is any plan year prior to the first year to which the PPA funding rules apply to the plan.

The provision requires the Secretary of the Treasury to prescribe rules for making, and in appropriate circumstances revoking, elections. An election may be revoked only with the consent of the Secretary.

Look-Back Rule

The provision permits plan sponsors of underfunded plans with delayed PPA effective dates to elect to use a two-year look back for purposes of determining their deficit reduction contribution. That is, an eligible underfunded plan may elect to use a plan's funded current liability percentage from the second plan year preceding the plan's first election year under the provision.

In determining its deficit reduction contribution, a plan that elects to use the two-year look back rule is permitted to use the third segment rate under the PPA funding rules<sup>771</sup> in calculating a

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<sup>770</sup> That is, multiple employer plans of certain cooperatives (as defined in section 104 of the PPA), certain PBGC settlement plans (as defined in section 105 of the PPA), and plans of certain government contractors (as defined in section 106 of the PPA).

<sup>771</sup> PPA sections 104(b), 105(b), and 106(b). The third segment rate is derived from a corporate bond yield curve prescribed by the Secretary of the Treasury which reflects the yields on investment grade corporate bonds with varying maturities.

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

portion of its unfunded new liability amount. Under the pre-PPA rules, the unfunded new liability amount is the applicable percentage of the plan's unfunded new liability. Under the provision, in calculating its unfunded new liability amount, an electing plan may use the PPA third segment rate as the applicable percentage rather than the pre-PPA applicable percentage (i.e., 30 percent decreased by .40 of one percentage point for each percentage point by which the plan's funded current liability exceeds 60 percent), but only with respect to the portion of the plan's unfunded new liability that is its "increased unfunded new liability." The electing plan continues to use the pre-PPA applicable percentage in calculating its unfunded new liability amount with respect to the excess of the unfunded new liability over the increased unfunded new liability. The increased unfunded new liability is the excess (if any) of the plan's unfunded new liability over the amount of unfunded new liability determined as if the value of the plan's assets equaled the product of the current liability of the plan for the year multiplied by the funded current liability percentage of the plan for the second plan year preceding the first election year of such plan.

#### 15-Year Amortization

The provision permits plan sponsors of underfunded plans with delayed PPA effective dates to elect to use a special applicable percentage for purposes of calculating a portion of their unfunded new liability amount for any pre-effective date plan year beginning with or after the first election year. The special applicable percentage is the ratio of: (1) the annual installments payable in each year if the increased unfunded new liability for that plan year was amortized over 15 years, using an interest rate equal to the third segment rate under the PPA funding rules; to (2) the increased unfunded new liability for the plan year. This special applicable percentage applies with respect to the portion of the plan's unfunded new liability that is its increased unfunded new liability. The electing plan continues to use the pre-PPA applicable percentage in calculating its unfunded new liability amount with respect to the excess of the unfunded new liability over the increased unfunded new liability.

#### Eligible Charity Plans

The provision amends section 104 of the PPA by making the section applicable to eligible charity plans. Under the provision, therefore, the delayed PPA-effective-date and special-interest-rates rules that apply to eligible cooperative plans apply to eligible charity plans. This provision was intended to allow plans of large national charities and their separately organized local chapters to have access to the relief whether or not they are treated as a single controlled group. An eligible charity plan that makes the election will not have violated the anti-cutback or other qualification requirements merely as a result of operating in accordance with the benefit-limitation rules of IRC section 436 for periods before June 25, 2010.

A plan is an eligible charity plan for a plan year if it is maintained by more than one employer, 100 percent of whom are tax-exempt organizations under IRC section 501(c)(3).<sup>772</sup> For purposes of the provision, the determination of whether a plan is maintained by more than one employer is determined without regard to the controlled group rules of IRC section 414(c).

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<sup>772</sup> Generally, an organization is exempt under IRC section 501(c)(3) if it is a corporation, community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

Effective Date

In general, the provision is effective as if included in the PPA. The provisions relating to eligible charity plans are effective for plan years beginning after December 31, 2007, except that a plan sponsor may elect to apply the provision to plan years beginning after December 31, 2008, pursuant to elections made at the time and in the manner prescribed by the Secretary. An election may be revoked only with the consent of the Secretary.

California Law (R&TC section 17501)

IRC Automatic Conformity

California automatically conforms to the minimum funding standards to the same extent as applicable for federal income tax purposes.<sup>773</sup>

ERISA Preemption

Additionally, federal ERISA provisions specifically preempt state laws relating to certain employee benefit plans in California.

Impact on California Revenue

Baseline.

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<u>Section</u>	<u>Section Title</u>
203	Lookback for Certain Benefit Restrictions

Background

Benefit Restrictions

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 if a plan's adjusted funding

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educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, and which does not participate in, or intervene in, any political campaign of any candidate for public office.

<sup>773</sup> R&TC section 17501 conforms to Part III of Subchapter D of Chapter 1 of Subtitle A of the IRC, without regard to the "specified date" contained in R&TC 17024.5.

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

target attainment percentage is below a certain level.<sup>774</sup> These limits were added by the PPA and are generally applicable to plan years beginning after December 31, 2007. 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.

### Prohibited Payments

#### *General rule*

A plan must provide that, if the plan’s adjusted funding target attainment percentage for a plan year is less than 60 percent, the plan will not make any “prohibited payments” after the valuation date for the plan year.<sup>775</sup> For purposes of these limitations, a prohibited payment is: (1) any payment in excess of the monthly amount paid under a single life annuity (plus any social security supplement provided under the plan) to a participant or beneficiary whose annuity starting date occurs during the period; (2) any payment for the purchase of an irrevocable commitment from an insurer to pay benefits (e.g., an annuity contract); (3) any transfer of assets and liabilities to another plan maintained by the same employer (or by any member of the employer’s controlled group) that is made in order to avoid or terminate the application of the PPA benefit limitations; or (4) any other payment specified by the Secretary by regulations.

A plan must also provide that, if the plan’s adjusted funding target attainment percentage for a plan year is 60 percent or greater, but less than 80 percent, the plan may not pay any prohibited payments exceeding the lesser of: (1) 50 percent of the amount otherwise payable under the plan; and (2) the present value of the maximum PBGC guarantee with respect to the participant (determined under guidance prescribed by the PBGC, using the interest rates and mortality table applicable in determining minimum lump-sum benefits). The plan must provide that only one payment under this exception may be made with respect to any participant<sup>776</sup> during any period of consecutive plan years to which the limitation applies.

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<sup>774</sup> IRC sections 401(a)(29) and 436. Parallel rules apply under ERISA.

<sup>775</sup> IRC section 436(d).

<sup>776</sup> For purposes of the prohibited-payment rules, the benefits provided with respect to a participant and any beneficiary of the participant (including an alternate payee) are aggregated. If the participant’s accrued benefit is allocated to an alternate payee and one or more other persons, the amount that may be distributed is allocated in the same manner unless the applicable qualified domestic relations order provides otherwise.

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

In addition, a plan must provide that, during any period in which the plan sponsor is in bankruptcy proceedings, the plan may not make any prohibited payment. This limitation does not apply on or after the date the plan's enrolled actuary certifies that the adjusted funding target attainment percentage of the plan is not less than 100 percent.

With respect to the prohibited-payment rule, certain frozen plans, meaning plans that do not provide for any future benefit accruals, are grandfathered. The prohibited-payment limitation does not apply to a plan for any plan year if the terms of the plan (as in effect for the period beginning on September 1, 2005, and ending with the plan year) provide for no benefit accruals with respect to any participant during the period. In addition, in the case of a terminated plan, while any benefit restriction in effect immediately before the termination of the plan continues to apply, the limitation on prohibited payments does not apply to payments made to carry out the termination of the plan in accordance with applicable law.<sup>777</sup>

*Definition of social security supplement*

A social security supplement is an ancillary benefit that is permitted to be offered under a defined benefit plan. An ancillary benefit is benefit provided under the plan that is not a retirement-type subsidy or an optional form of payment of a participant's accrued benefit. It is benefit that is paid in addition to a participant's accrued benefit or any benefit treated as an accrued benefit. Specifically, a social security supplement is a benefit for plan participants that commences before the age and terminates before the age when participants are entitled to old-age insurance benefits, unreduced on account of age, under title II of the Social Security Act, as amended (see section 202(a) and (g) of such Act), and does not exceed such old-age insurance benefit.<sup>778</sup>

*Treatment of payments under social security leveling feature*

A social security leveling feature is a feature with respect to an optional form of payment of a participant's accrued benefit commencing prior to a participant's expected commencement of social security benefits that provides for a temporary period of higher payments which is designed to result in an approximately level amount of income when the participant's estimated old age benefits from Social Security are taken into account.<sup>779</sup> Even though an optional form of benefit with this feature may provide the same stream of payments as a single life annuity plus a social security supplement, the amount in excess of a single life annuity paid before social security retirement age is a prohibited payment.

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<sup>777</sup> Treas. Reg. section 1.436-1(a)(3)(ii).

<sup>778</sup> Treas. Reg. section 1.411(a)-7(c)(4).

<sup>779</sup> Treas. Reg. section 1.411(d)-3(g)(16).

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

#### Limitation on Future Benefit Accruals

Among the benefit limitations is a 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 a future benefit accrual limitation or any other IRC section 436 limitation applies to a plan.

A 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 future benefit accrual limitation 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 that would have been paid or accrued but for the limitation.

#### Temporary Modification of Application of Limitation on Benefit Accruals under WRERA

Under section 203 of WRERA, in the case of the first plan year beginning during the period of October 1, 2008, through September 30, 2009 ("WRERA relief plan year"), the future benefit accrual limitation rules under IRC section 436 are applied by substituting the plan's adjusted funding target attainment percentage for the preceding plan year for the adjusted funding target attainment percentage for the WRERA relief plan year. 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. This substitution of the plan's adjusted funding target attainment percentage 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 WRERA relief. Thus, the substitution does not apply if the adjusted funding target attainment percentage for the WRERA relief plan year is greater than the preceding year.

#### New Federal Law (IRC section 436)

#### Limitation on Future Benefit Accruals

The provision extends the temporary modification of the limitation on benefit accruals under section 203 of WRERA to the plan year beginning during the period of October 1, 2009, through September 30, 2010, and provides a special rule for any plan for which the valuation date is not the first day of the plan year. Under the provision, in the case of any plan year beginning during the period of October 1, 2008, through September 30, 2010, the future benefit accrual limitation rules under IRC section 436 are applied by substituting the plan's adjusted funding target

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

attainment percentage for any such plan year with the plan's adjusted funding target attainment percentage for the plan year beginning after October 1, 2007, and before October 1, 2008, as determined under rules prescribed by the Secretary. In the case of a plan for which the valuation date is not the first day of the plan year, for any plan years beginning after December 31, 2007, and before January 1, 2010, the future benefit accrual limitation rules under IRC section 436 are applied by substituting the plan's adjusted funding target attainment percentage for any such plan year with the plan's adjusted funding target attainment percentage for the last plan year beginning before November 1, 2007, as determined under rules prescribed by the Secretary.

This substitution only applies if it results in a greater adjusted funding target attainment percentage for a plan for the relevant plan year. Thus, the future benefit accrual limitation of IRC section 436 is avoided if the plan's adjusted funding target attainment percentage for the plan year beginning after October 1, 2007, and before October 1, 2008, is 60 percent or greater (or, in the case of a plan for which the valuation date is not the first day of the plan year, if the adjusted funding target attainment percentage for the plan year beginning before November 1, 2007 is 60 percent or greater). Because the provision applies to the same period as section 203 of WREERA, it explicitly provides that section 203 of WREERA applies to a plan for any plan year in lieu of the provision only to the extent that such section produces a higher adjusted funding target attainment percentage for such plan for such year.

#### Prohibited Payments

Under the provision, in the case of any plan year beginning during the period of October 1, 2008, through September 30, 2010 (or, in the case of plan where the plan's valuation date is not the first day of the plan year, for any plan years beginning after December 31, 2007, and before January 1, 2010), the same substitution of the plan's adjusted funding target attainment percentage as applies for purposes of the limitation on benefit accruals also applies for purposes of determining whether a plan can pay a prohibited payment in the form of a social security leveling option. For this purpose, a social security leveling option is a payment option that accelerates payments under the plan before, and reduces payments after, a participant starts receiving social security payments in order to provide substantially similar payments before and after such benefits are received.

#### Effective Date

The provision generally is effective for plan years beginning on or after October 1, 2008. In the case of a plan for which the valuation date is not the first day of the plan year, the provision applies to plan years beginning after December 31, 2007.

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

California Law (R&TC section 17501)

IRC Automatic Conformity

California automatically conforms to the federal lookback-for-certain-benefit-restriction rules to the same extent as applicable for federal income tax purposes.<sup>780</sup>

ERISA Preemption

Additionally, federal ERISA provisions specifically preempt state laws relating to certain employee benefit plans in California.

Impact on California Revenue

Baseline.

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<u>Section</u>	<u>Section Title</u>
204	Lookback for Credit Balance Rule for Plans Maintained by Charities

Background

In General

Under the PPA funding rules, credit balances that accumulated under pre-PPA law (“funding standard carryover balances”) are preserved and, for plan years beginning after 2007, new credit balances (referred to as “prefunding balances”) result if a plan sponsor makes contributions greater than those required under the PPA funding rules. In general, plan sponsors may choose whether to count funding standard carryover balances and prefunding balances in determining the value of plan assets or to use the balances to reduce required contributions, but not both.

Funding Standard Carryover Balance

The funding standard carryover balance consists of a beginning balance in the amount of the positive balance in the funding standard account as of the end of the 2007 plan year, decreased (as described below) and adjusted to reflect the rate of net gain or loss on plan assets.

For each plan year beginning after 2008, the funding standard carryover balance is decreased (but not below zero) by the sum of any amount credited to reduce the minimum required

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<sup>780</sup> R&TC section 17501 conforms to Part III of Subchapter D of Chapter 1 of Subtitle A of the IRC, without regard to the “specified date” contained in R&TC 17024.5.

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

contribution for the preceding plan year, plus any amount elected by the plan sponsor as a reduction in the funding standard carryover balance (thus reducing the amount by which the value of plan assets must be reduced in determining minimum required contributions).

#### Prefunding Balance

The prefunding balance consists of a beginning balance of zero for the 2008 plan year, increased and decreased (as described below) and adjusted to reflect the rate of net gain or loss on plan assets.

For subsequent years, i.e., as of the first day of plan year beginning after 2008 (the “current” plan year), the plan sponsor may increase the prefunding balance by an amount, not to exceed the excess (if any) of the aggregate total employer contributions for the preceding plan year over the minimum required contribution for the preceding plan year. For this purpose, any excess contribution for the preceding plan year is adjusted for interest accruing for the periods between the first day of the current plan year and the dates on which the excess contributions were made, determined using the effective interest rate of the plan for the preceding plan year and treating contributions as being first used to satisfy the minimum required contribution.

In determining the amount of the increase in a plan’s prefunding balance, the amount by which the aggregate total employer contributions for the preceding plan year exceeds the minimum required contribution for the preceding plan year is reduced (but not below zero) by the amount of contributions an employer would need to make to avoid a benefit limitation that would otherwise be imposed for the preceding plan year under the rules relating to benefit limitations for single-employer plans (as discussed below).<sup>781</sup>

For each plan year beginning after 2008, the prefunding balance of a plan is decreased (but not below zero) by the sum of: (1) any amount credited to reduce the minimum required contribution for the preceding plan year, plus (2) any amount elected by the plan sponsor as a reduction in the prefunding balance (thus reducing the amount by which the value of plan assets must be reduced in determining minimum required contributions).

#### Application of Balances to the Value of Plan Assets or to Reduce Minimum Required Contributions

If a plan sponsor elects to maintain a funding standard carryover balance or prefunding balance, the amount of those balances is generally subtracted from the value of plan assets for purposes of determining a plan’s minimum required contributions, including a plan’s funding shortfall, and a plan’s funding target attainment percentage (defined as the ratio, expressed as a percentage, that the value of the plan’s assets bears to the plan’s funding target for the year). The value of a plan’s assets is not reduced by these balances if a binding written agreement with the PBGC providing that all or a portion of the plan’s funding standard carryover balance or prefunding balance is not available to offset the minimum required contribution for a plan year is in effect.

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<sup>781</sup> Any contribution that may be taken into account in satisfying the requirement to make additional contributions with respect to more than one type of benefit limitation is taken into account only once for purposes of this reduction.

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

In addition, for purposes of determining whether a plan is required to establish a shortfall amortization base for a plan year, the funding standard carryover balance is not subtracted from the value of plan assets and the prefunding balance is required to be subtracted from the value of plan assets only if an election has been made to use the balance to offset the plan's minimum required contribution for the plan year. However, the plan sponsor may elect to permanently reduce a funding standard carryover balance or prefunding balance, so that the value of plan assets is not required to be reduced by that amount in determining the minimum required contribution for the plan year.

If the value of the plan's assets (reduced by any prefunding balance but not by any funding standard carryover balance) is at least 80 percent of the plan's funding target for the preceding plan year, a plan sponsor is generally permitted to credit all or a portion of the funding standard carryover balance or prefunding balance against the minimum required contribution for the current plan year, thus reducing the amount that must be contributed for the current plan year.<sup>782</sup> If a plan sponsor has elected to permanently reduce a funding standard carryover balance or prefunding balance, any reduction of such balances applies before determining the amount that is available for crediting against minimum required contributions for the plan year.

#### Other Rules

In determining the prefunding balance or funding standard carryover balance as of the first day of a plan year, the plan sponsor must adjust the balance in accordance with regulations prescribed by the Secretary to reflect the rate of return on plan assets for the preceding year.<sup>783</sup> The rate of return is determined on the basis of the fair market value of the plan assets and must properly take into account, in accordance with regulations, all contributions, distributions, and other plan payments made during the period.

To the extent that a plan has a funding standard carryover balance of more than zero for a plan year, none of the plan's prefunding balance may be credited to reduce a minimum required contribution, nor may an election be made to reduce the prefunding balance for purposes of determining the value of plan assets. Thus, the funding standard carryover balance must be used for these purposes before the prefunding balance may be used.

Any election relating to the prefunding balance and funding standard carryover balance is to be made in such form and manner as the Secretary prescribes.<sup>784</sup>

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<sup>782</sup> In the case of plan years beginning in 2008, the percentage for the preceding plan year may be determined using such methods of estimation as the Secretary of Treasury may provide.

<sup>783</sup> Treas. Reg. section 1.430(f)-1(b)(3).

<sup>784</sup> See Treas. Reg. section 1.430(f)-1(f) for the rules governing elections relating to prefunding balances and funding standard carryover balances.

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

New Federal Law (IRC section 430)

Under the provision, for any plan year beginning on or after August 31, 2009, and before September 1, 2011, for purposes of determining whether the plan is sufficiently funded so as to be permitted to credit all or a portion of its funding standard carryover balance or prefunding balance against the minimum required contribution for the plan year, the plan may use the greater of: (1) its funding target attainment percentage (determined without regard to the provision) for the prior plan year; or (2) the funding target attainment percentage for the plan year beginning after August 31, 2007, and before September 1, 2008, as determined under rules prescribed by the Secretary. Thus, the provision temporarily permits plans whose funded status for the look-back year was at least equal to 80 percent to offset their minimum required contributions by a credit balance, even if the plan would not otherwise be permitted to do so.

For plans with valuation dates other than the first day of the plan year, the provision applies for any plan year beginning after December 31, 2007, and before January 1, 2010, and the plan may use the funding target attainment percentage for the last plan year beginning before September 1, 2007, as determined under rules prescribed by the Secretary.

The provision applies only to plans maintained exclusively by one or more charitable organizations exempt from tax under IRC section 501(c)(3).

Effective Date

The provision is generally effective for plan years beginning after August 31, 2009. For plans with valuation dates other than the first day of the plan year, the provision is effective for plan years beginning after December 31, 2008.

California Law (R&TC section 17501)

IRC Automatic Conformity

California automatically conforms to the lookback for credit balance rule for plans maintained by charities to the same extent as applicable for federal income tax purposes.<sup>785</sup>

ERISA Preemption

Additionally, federal ERISA provisions specifically preempt state laws relating to certain employee benefit plans in California.

Impact on California Revenue

Baseline.

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<sup>785</sup> R&TC section 17501 conforms to Part III of Subchapter D of Chapter 1 of Subtitle A of the IRC, without regard to the "specified date" contained in R&TC 17024.5.

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

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<u>Section</u>	<u>Section Title</u>
211	Adjustments to Funding Standard Account Rules

Background

Defined benefit pension plans generally are subject to minimum funding rules under the IRC that require the sponsoring employer to periodically make contributions to fund plan benefits. Similar rules apply to defined benefit pension plans under the Labor Code provisions of ERISA.

The minimum funding rules for single-employer and multiemployer plans are different.<sup>786</sup> A single-employer plan is a plan that is not a multiemployer plan. A multiemployer plan is generally a plan to which more than one employer is required to contribute and which is maintained pursuant to a collective bargaining agreement.<sup>787</sup>

Funding Standard Account

A multiemployer defined benefit pension plan is required to maintain a special account called a “funding standard account” to which charges and credits (such as credits for plan contributions) are made for each plan year. If, as of the close of the plan year, charges to the funding standard account exceed credits to the account, the plan has an “accumulated funding deficiency” equal to the amount of such excess charges. For example, if the balance of charges to the funding standard account of a plan for a year would be \$200,000 without any contributions, then a minimum contribution equal to that amount is required to meet the minimum funding standard for the year to prevent an accumulated funding deficiency. If credits to the funding standard account exceed charges, then the result is a credit balance. The amount of the credit balance, increased with interest, can be used to reduce future required contributions.

Amortization Periods

A plan is required to use an acceptable actuarial cost method to determine the elements included in its funding standard account for a year. Generally, an acceptable actuarial cost method breaks up the cost of benefits under the plan into annual charges consisting of two elements for each plan year. These elements are referred to as the: (1) normal cost; and (2) amortization of supplemental cost. The normal cost for a plan for a plan year generally represents the cost of future benefits allocated to the plan year under the funding method used by the plan for current

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<sup>786</sup> The PPA modified the minimum funding rules for multiemployer defined benefit pension plans. These modifications are generally effective for plan years beginning after 2007.

<sup>787</sup> IRC section 414(f).

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

employees. The supplemental cost for a plan year is the cost of future benefits that would not be met by future normal costs, future employee contributions, or plan assets, such as a net experience loss. Supplemental costs are amortized (i.e., recognized for funding purposes) over a specified number of years, depending on the source. The amortization period applicable to a multiemployer plan for most credits and charges is 15 years.<sup>788</sup> Past service liability under the plan is amortized over 15 years;<sup>789</sup> past service liability due to plan amendments is amortized over 15 years; and experience gains and losses resulting from a change in actuarial assumptions are amortized over 15 years. Experience gains and losses and waived funding deficiencies are also amortized over 15 years.

The Secretary, upon receipt of an application, is required to grant an extension of the amortization period for up to five years with respect to any unfunded past service liability, investment loss, or experience loss.<sup>790</sup> There must be included with the application a certification by the plan's actuary that: (1) absent the extension, the plan would have an accumulated funding deficiency in the current plan year and any of the nine succeeding plan years; (2) the plan sponsor has adopted a plan to improve the plan's funding status; (3) taking into account the extension, the plan is projected to have sufficient assets to timely pay its expected benefit liabilities and other anticipated expenditures; and (4) required notice has been provided. The automatic extension provision does not apply with respect to any application submitted after December 31, 2014. The Secretary may also grant an additional extension of such amortization periods for an additional five years, using the same standards for determining whether such an extension may be granted as under the pre-PPA minimum funding rules.<sup>791</sup>

#### Actuarial Assumptions

In applying the funding rules, all costs, liabilities, interest rates, and other factors are required to be determined on the basis of actuarial assumptions and methods, each of which must be reasonable (taking into account the experience of the plan and reasonable expectations), or that, in the aggregate, result in a total plan contribution equivalent to a contribution that would be obtained if each assumption and method were reasonable. In addition, the assumptions are required to offer the actuary's best estimate of anticipated experience under the plan.

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<sup>788</sup> IRC section 431(b)(2). Prior to the effective date of the PPA, the amortization period was 30 years for past service liability, past service liability due to plan amendments, and losses and gains resulting from a change in actuarial assumptions.

<sup>789</sup> In the case of a plan in existence on January 1, 1974, past service liability under the plan on the first day on which the plan was first subject to ERISA was amortized over 40 years. In the case of a plan which was not in existence on January 1, 1974, past service liability under the plan on the first day on which the plan was first subject to ERISA was amortized over 30 years. Past service liability due to plan amendments was amortized over 30 years.

<sup>790</sup> IRC section 431(d)(1).

<sup>791</sup> IRC section 431(d)(2).

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

### Valuation of Plan Assets

In determining the charges and credits to be made to the plan's funding standard account for a multiemployer plan, the value of plan assets may be determined on the basis of any reasonable actuarial method of valuation which takes into account fair market value and which is permitted under regulations prescribed by the Secretary.<sup>792</sup> Thus, the actuarial value of a plan's assets under a reasonable actuarial valuation method can be used instead of fair market value. A reasonable actuarial valuation method generally can include a smoothing methodology that takes into account reasonable expected investment returns and average values of the plan assets, so long as the smoothing or averaging period does not exceed the five most recent plan years, including the current plan year. In addition, in order to be reasonable, any actuarial valuation method used by the plan is required to result in a value of plan assets that is not less than 80 percent of the current fair market value of the assets and not more than 120 percent of the current fair market value.<sup>793</sup> In determining plan funding under an acceptable actuarial cost method, a plan's actuary generally makes certain assumptions regarding the future experience of a plan.

The actuarial valuation method is considered to be part of the plans funding method. The same method must be used each plan year. If the valuation method is changed, the change is only permitted to take effect if approved by the Secretary of Treasury.<sup>794</sup>

### Additional Funding Rules for Plans in Endangered or Critical Status

Under IRC section 432,<sup>795</sup> 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

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<sup>792</sup> IRC section 431(c)(2).

<sup>793</sup> Treas. Reg. section 1.412(c)(2)-1(b). Rev. Proc. 2000-40, 2000-2 CB 357, generally indicates that only an averaging period that does not exceed five years will be approved by the IRS. The revenue procedure also indicates that for a funding valuation method to be approved, the asset value determined under the method must be adjusted to be no greater than 120 percent and no less than 80 percent of the fair market value.

<sup>794</sup> IRC section 412(d)(1).

<sup>795</sup> Parallel rules apply under ERISA.

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

December 31, 2014, except that a plan operating under a funding improvement or rehabilitation plan for its last year beginning before January 1, 2015, must continue to operate under such plan until the funding improvement or rehabilitation period (as explained below) expires or the plan emerges from endangered or critical status.

#### Failure to Comply with Minimum Funding Rules

In the event of a failure to comply with the minimum funding rules, the IRC imposes a two-level excise tax on the plan sponsor.<sup>796</sup> The initial tax is five percent of the plan's accumulated funding deficiency for multiemployer plans. An additional tax is imposed if the failure is not corrected before the date that a notice of deficiency with respect to the initial tax is mailed to the employer by the IRS or the date of assessment of the initial tax. The additional tax is equal to 100 percent of the unpaid contribution or the accumulated funding deficiency, whichever is applicable. Before issuing a notice of deficiency with respect to the excise tax, the Secretary must notify the Secretary of Labor and provide the Secretary of Labor with a reasonable opportunity to require the employer responsible for contributing to, or under, the plan to correct the deficiency or comment on the imposition of the tax.

#### New Federal Law (IRC section 431)

#### Special Funding Relief Rules

A plan sponsor of a multiemployer plan that meets a solvency test is permitted to use either one or both of two special funding relief rules for either or both of two plan years.

#### *Amortization of net investment losses*

The first special funding relief rule allows the plan sponsor to treat the portion of its experience loss attributable to the net investment losses (if any) incurred in either or both of the first two plan years ending after August 31, 2008, as an item separate from other experience losses, to be amortized in equal annual installments (until fully amortized) over the period beginning with the plan year in which such portion is first recognized in the actuarial value of assets and ending in the 30-plan-year period beginning with the plan year in which the net investment loss was incurred. If this treatment is used for a plan year, the plan sponsor will not be eligible for an extension of this amortization period for this separate item, and if an extension was granted before electing this treatment of net investment losses, such extension must not result in such amortization period exceeding 30 years.

A plan sponsor is required to determine its net investment losses in the manner described by the Secretary, on the basis of the difference between actual and expected returns (including any difference attributable to any criminally fraudulent investment). The determination as to whether an arrangement is a criminally fraudulent investment arrangement shall be made under rules substantially similar to the rules prescribed by the Secretary for purposes of IRC section 165.

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<sup>796</sup> IRC section 4971. Special rules apply under IRC section 4971 for multiemployer plans in endangered or critical status.

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

*Expanded smoothing period and asset valuation corridor*

Under the other special funding relief rule, a multiemployer plan may change its asset valuation method in a manner which spreads the difference between the expected returns and actual returns for either or both of the first two plan years ending before August 31, 2008, over a period of not more than 10 years. However, as under present law, spreading the difference between expected and actual returns under a plan's asset valuation method is only permitted if it does not result in a value of plan assets, when compared to the current fair market value of the plan assets, to be at any time outside an asset valuation corridor.

Under this special funding relief rule, the asset valuation corridor is expanded so that, for either or both of the first two plan years ending before August 31, 2008, the plan's asset value must be adjusted under the valuation method being used so the value of plan assets is not less than 80 percent of the current fair market value of the assets and not more than 130 percent of the current fair market value (rather than 120 percent). This expanded valuation corridor is available whether or not the plan sponsor increases the period for spreading the difference between expected and actual returns under its asset valuation method. If a plan sponsor uses either or both of the options (extending the spreading period and the expanded asset valuation corridor) under this special relief rule for one or both of these plan years, the Secretary will not treat the asset valuation method of the plan as unreasonable because of such change and the change will be deemed to be approved by the Secretary.

*Amortization of Reduction in Unfunded Accrued Liability*

To the extent a plan sponsor uses both of the two special funding relief rules for any plan year, the plan is required to treat any resulting reduction in the plan's unfunded accrued liability as a separate experience amortization base. This separate experience amortization base is amortized in annual installments (until fully amortized) over a period of 30 plan years (rather than the otherwise applicable amortization period).

*Solvency Test*

The solvency test is satisfied only if the plan actuary certifies that the plan is projected to have sufficient assets to timely pay expected benefits and anticipated expenditures over the amortization period taking into account the changes in the funding standard account under the special funding relief rule elected.

*Benefit Restriction*

If a plan sponsor of a multiemployer plan uses one, or both, of the special funding relief rules under this provision, then, in addition to any other applicable restrictions on benefit increases, the following limit also applies. A plan amendment increasing benefits may not go into effect during either of the two plan years immediately following any plan year to which such election first applies unless one of the following conditions is satisfied: either the plan actuary certifies that such increase is paid for out of additional contributions not allocated to the plan at the time the

PRESERVATION OF ACCESS TO CARE FOR MEDICARE BENEFICIARIES AND  
PENSION RELIEF ACT OF 2010  
Public Law 111-192, June 25, 2010

election was made, and the plan's funded percentage and projected credit balances for such two plan years are reasonably expected to be generally at the same levels as such percentage and balances would have been if the benefit increase had not been adopted, or the amendment is required to maintain the plan's status as a qualified retirement plan under the applicable provisions of the IRC or to comply with other applicable law.

#### Reporting

A plan sponsor of a multiemployer plan that uses one or both of these special funding relief rules must give notice to participants and beneficiary of its use of the relief and must inform the PBGC of its use of the relief in such form and manner, as the Director of the PBGC may prescribe.

#### Effective Date

The provision takes effect as of the first day of the first plan year ending after August 31, 2008. However, if a plan sponsor uses either (or both) of the special funding relief provisions and such use affects on the plan's funding standard account for the first plan year ending before August 31, 2008, the use of the rule is disregarded for purposes of applying the provisions for additional funding for multiemployer plans in endangered or critical status under IRC section 432 to such plan year. The restriction on plan amendments increasing benefits is effective on June 25, 2010.

#### California Law (R&TC section 17501)

##### IRC Automatic Conformity

California automatically conforms to the funding standard account rules to the same extent as applicable for federal income tax purposes.<sup>797</sup>

##### ERISA Preemption

Additionally, federal ERISA provisions specifically preempt state laws relating to certain employee benefit plans in California.

#### Impact on California Revenue

Baseline.

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<sup>797</sup> R&TC section 17501 conforms to Part III of Subchapter D of Chapter 1 of Subtitle A of the IRC, without regard to the "specified date" contained in R&TC 17024.5.

DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT  
Public Law 111-203, July 21, 2010

<u>Sections</u>	<u>Act Title</u>
501 - 542	Nonadmitted and Reinsurance Reform Act of 2010

The Nonadmitted and Reinsurance Reform Act of 2010 (NRRRA) reforms and modernizes two important sectors of the commercial insurance marketplace, nonadmitted insurance (also known as surplus-lines insurance) and reinsurance. The NRRRA creates a uniform system for nonadmitted insurance premium tax payments based upon the home state of the policyholder, encourages the states to develop a compact or other procedural mechanism for uniform tax allocation, and establishes regulatory deference for the home state of the insured.<sup>798</sup> The NRRRA adopts uniform eligibility requirements for nonadmitted insurers as developed and promulgated by the National Association of Insurance Commissioners (NAIC) in the Nonadmitted Insurance Model Act. The NRRRA also allows direct access to the nonadmitted insurance markets for certain sophisticated commercial purchasers. The NRRRA could be viewed as preempting state law that is incompatible with it.

A simplified example of a surplus-lines-multistate transaction is a business entity headquartered in one state with offices in other states seeking insurance coverage for all offices. Under the NRRRA, the state in which the business is headquartered would be the home state and placement of the insurance business is subject only to the statutory and regulatory requirements of this state, as is the collection of the premium taxes. A state in which the business has another office must have the statutory authority to participate in a tax-sharing agreement or compact in order for it to receive its apportioned amount of the tax. Absent this authority, the tax monies go only to the home state of the insured.

Most provisions of the NRRRA go into effect on July 21, 2011. However, provisions of a compact or agreement adopted on or before June 16, 2011, apply with respect to premiums for multistate transactions paid on or after July 21, 2010. A compact or agreement adopted after that date would apply with respect to premiums for multistate transactions paid on or after January 1, 2012.

California Law (R&TC sections 13201–13222)

A surplus-lines insurer, also referred to as a nonadmitted insurer, is not licensed in California, but is licensed in another state or country. Under current state law, California licensed surplus-lines brokers may place coverage with a nonadmitted insurer if insurance for the risk is not available from a California licensed insurer and other specified criteria are satisfied. Surplus-lines premium tax imposed on the insured is collected by the Department of Insurance (CDI) from the broker

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<sup>798</sup> More specifically, the NRRRA makes various changes to the business of surplus-lines insurance, including: (1) exclusive home-state-of-the-insured regulation of surplus-lines insurance placements; (2) exclusive home-state-of-the-insured surplus-lines broker license requirements; (3) exclusive home-state-of-the-insured premium tax collection unless a state compacts with other states on a method of allocation of taxes on multistate policy risks; and (4) preemption of many state-specific eligibility requirements for surplus-lines insurers.

DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT  
Public Law 111-203, July 21, 2010

placing the coverage, and the revenue is transferred to the Board of Equalization (BOE) for deposit into the state's General Fund.

In addition, policyholders who directly purchase or renew an insurance contract during the calendar quarter from an insurance company that is not authorized to transact business in California must pay a nonadmitted insurance tax (NIT). The NIT is 3 percent on all premiums paid or to be paid to nonadmitted insurers on contracts covering risks located in California, and is imposed on any corporation, partnership, limited liability company, individual society, association, organization, governmental or quasi-governmental entity, joint-stock company, estate or trust, receiver, trustee, assignee, referee, or any other person acting in a fiduciary capacity.

Policyholders subject to the NIT must file Form 570, Nonadmitted Insurance Tax Return, with the FTB on or before the first day of the third month following the close of any calendar quarter during which a nonadmitted insurance contract took effect or was renewed.

Not all contracts with nonadmitted companies are subject to the NIT. Nonadmitted insurance that is obtained through a California insurance broker is not taxable to the purchaser. Other exceptions to the NIT are: (1) reinsurance of the liability of an admitted insurer; (2) insurance of ship-owner interests; (3) aircraft insurance; (4) insurance on interstate motor transit operations; and (5) life insurance.

Section 3.5 of Article III of the California Constitution prohibits an administrative agency, such as the CDI, BOE, or FTB, from declaring a statute invalid or unenforceable in the absence of an appellate court determination that the statute is unenforceable or unconstitutional. Therefore, unless the statute is amended, these departments will be required to continue to enforce current law unless an appellate court rules otherwise.

Impact on California Revenue

Baseline.



<u>Section</u>	<u>Section Title</u>
1601	Certain Swaps, etc., Not Treated as Section 1256 Contracts

Background

Generally, gain or loss from the sale of property, including stock, is recognized at the time of sale or other disposition of the property, unless there is a specific statutory provision of nonrecognition.<sup>799</sup>

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<sup>799</sup> IRC section 1001.

DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT  
Public Law 111-203, July 21, 2010

Gains and losses from the sale or exchange of capital assets are subject to special rules. In the case of individuals, net capital gain is generally subject to reduced federal tax rates. Net capital gain is the excess of net long-term capital gains over net short-term capital losses. Also, capital losses are allowed only to the extent of capital gains plus, in the case of individuals, \$3,000.<sup>800</sup> Capital losses of individuals may be carried forward indefinitely and capital losses of corporations may generally be carried back three years and forward five years.<sup>801</sup>

Generally, in order for gains or losses on a sale or exchange of a capital asset to be long-term capital gains or losses, the asset must be held for more than one year.<sup>802</sup> A capital asset generally includes all property held by the taxpayer, except certain enumerated types of property such as inventory.<sup>803</sup>

#### IRC section 1256 contracts

Special rules apply to IRC section 1256 contracts, which include regulated futures contracts, certain foreign currency contracts, non-equity options, and dealer equity options. Each IRC section 1256 contract is treated as if it were sold (and repurchased) for its fair market value on the last business day of the year (i.e., “marked to market”). Any gain or loss with respect to an IRC section 1256 contract that is subject to the mark-to-market rule is treated as if 40 percent of the gain or loss was short-term capital gain or loss and 60 percent was long-term capital gain or loss. The mark-to-market rule (and the special 60/40 capital gain treatment) is inapplicable to hedging transactions.

A “regulated futures contract” is a contract: (1) which is traded on or subject to the rules of a national securities exchange registered with the Securities Exchange Commission, a domestic board of trade designated a contract market by the Commodities Futures Trading Commission, or similar exchange, board of trade, or market; and (2) with respect to which the amount required to be deposited and which may be withdrawn depends on a system of marking to market.

A “dealer equity option” means, with respect to an options dealer, an equity option purchased in the normal course of the activity of dealing in options and listed on the qualified board or exchange on which the options dealer is registered. An equity option is an option to buy or sell stock or an option the value of which is determined by reference to any stock, group of stocks, or stock index, other than an option on certain broad-based groups of stock or stock index. An options dealer is any person who is registered with an appropriate national securities exchange as a market maker or specialist in listed options, or whom the Secretary of the Treasury determines performs functions similar to market makers and specialists.

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<sup>800</sup> IRC section 1211.

<sup>801</sup> IRC section 1212.

<sup>802</sup> IRC section 1222.

<sup>803</sup> IRC section 1221.

## Securities Futures Contracts

Except in the case of dealer securities futures contracts described below, securities futures contracts are not treated as IRC section 1256 contracts. Thus, holders of these contracts are not subject to the mark-to-market rules of IRC section 1256 and are not eligible for 60-percent long-term capital gain treatment. Instead, gain or loss on these contracts is recognized under the general rules relating to the disposition of property.

A securities futures contract means a contract of sale for future delivery of a single security or a narrow-based security index. A securities futures contract will not be treated as a commodities futures contract for purposes of the IRC.

Any gain or loss from the sale or exchange of a securities futures contract (other than a dealer securities futures contract) is considered as gain or loss from the sale or exchange of property which has the same character as the property to which the contract relates has (or would have) in the hands of the taxpayer. Thus, if the underlying security would be a capital asset in the taxpayer's hands, then gain or loss from the sale or exchange of the securities futures contract would be capital gain or loss. The termination of a securities futures contract that is a capital asset is treated as a sale or exchange of the contract.

Capital gain treatment does not apply to contracts which themselves are not capital assets because of the exceptions to the definition of a capital asset relating to inventory<sup>804</sup> or hedging,<sup>805</sup> or to any income derived in connection with a contract which would otherwise be treated as ordinary income.

## Dealer Securities Futures Contracts

While securities futures contracts and options on such contracts are not IRC section 1256 contracts, "dealer securities futures contracts" are treated as IRC section 1256 contracts.

The term "dealer securities futures contract" means a securities futures contract which is entered into by a dealer in the normal course of his or her trade or business activity of dealing in such contracts, and is traded on a qualified board of trade or exchange. The term also includes any option to enter into securities futures contracts purchased or granted by a dealer in the normal course of his or her trade or business activity of dealing in such options.

As in the case of dealer equity options, gains and losses allocated to any limited partner or limited entrepreneur with respect to a dealer securities futures contract are treated as short-term capital gain or loss.

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<sup>804</sup> IRC section 1221(a)(1).

<sup>805</sup> IRC section 122(a)(7).

DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT  
Public Law 111-203, July 21, 2010

New Federal Law (IRC section 1256)

Under the provision, the following are specifically not treated as IRC section 1256 contracts: any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, or similar agreement.

California Law (R&TC sections 18151 and 24990)

Under both the PITL and the CTL, for taxable years beginning on or after January 1, 2010, California conforms to IRC section 1256, relating to Section 1256 contracts marked to market, as of the “specified date” of January 1, 2009. Because this provision was enacted after the “specified date,” California does not conform to it.

Impact on California Revenue

No impact. The federal revenue associated with this provision is due to certain financial swaps not qualifying for the long-term capital gain tax rate, as provided for under IRC section 1256. Because California's ordinary and capital gain tax rates are the same, conforming to the provision would have no impact on California revenue.

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

<u>Section</u>	<u>Section Title</u>
211	Rules to Prevent Splitting Foreign Tax Credits from the Income to Which they Relate

Background

The United States employs a worldwide tax system under which U.S. resident individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad; the foreign tax credit provides relief from double taxation. Subject to the limitations discussed below, a U.S. taxpayer is allowed to claim a credit against its U.S. income tax liability for the foreign income taxes that it pays or accrues. A domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation is allowed a deemed-paid credit for foreign income taxes paid by the foreign corporation that the domestic corporation is deemed to have paid when the foreign corporation's earnings are distributed or included in the domestic corporation's income under the provisions of subpart F.<sup>806</sup>

A foreign tax credit is available only for foreign income, war profits, and excess profits taxes, and for certain taxes imposed in lieu of such taxes.<sup>807</sup> Other foreign levies generally are treated as deductible expenses. Treasury regulations under IRC section 901 provide detailed rules for determining whether a foreign levy is a creditable income tax.

The foreign tax credit is elective on a year-by-year basis. In lieu of electing the foreign tax credit, U.S. persons generally are permitted to deduct foreign taxes.<sup>808</sup>

Deemed-Paid Foreign Tax Credit

Domestic corporations owning at least 10 percent of the voting stock of a foreign corporation are treated as if they had paid a share of the foreign income taxes paid by the foreign corporation in the year in which that corporation's earnings and profits become subject to U.S. tax as dividend income of the U.S. shareholder.<sup>809</sup> This credit is the deemed-paid or indirect foreign tax credit. A domestic corporation may also be deemed to have paid taxes paid by a second-, third-, fourth-, fifth-, or sixth-tier foreign corporation, if certain requirements are satisfied.<sup>810</sup> Foreign taxes paid

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<sup>806</sup> IRC sections 901, 902, and 960. Similar rules apply under IRC sections 1291(g) and 1293(f) with respect to income that is includible under the passive foreign investment company ("PFIC") rules.

<sup>807</sup> IRC sections 901(b) and 903.

<sup>808</sup> IRC section 164(a)(3).

<sup>809</sup> IRC section 902(a).

<sup>810</sup> IRC section 902(b).

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

below the third tier are eligible for the deemed-paid credit only with respect to taxes paid in taxable years during which the payor is a controlled foreign corporation (“CFC”). Foreign taxes paid below the sixth tier are not eligible for the deemed-paid credit. In addition, a deemed-paid credit generally is available with respect to subpart F inclusions and inclusions under the passive foreign investment corporation (“PFIC”) provisions.<sup>811</sup>

The amount of foreign tax eligible for the indirect credit is added to the actual dividend or inclusion (the dividend or inclusion is said to be “grossed-up”) and is included in the domestic corporate shareholder’s income; accordingly, the shareholder is treated as if it had received its proportionate share of pre-tax profits of the foreign corporation and paid its proportionate share of the foreign tax paid by the foreign corporation.<sup>812</sup>

For purposes of computing the deemed-paid foreign tax credit, dividends (or other inclusions) are considered made first from the post-1986 pool of all the distributing foreign corporation’s accumulated earnings and profits.<sup>813</sup> Accumulated earnings and profits for this purpose include the earnings and profits of the current year undiminished by the current distribution (or other inclusion).<sup>814</sup> Dividends in excess of the pool of post-1986 undistributed earnings and profits are treated as paid out of pre-1987 accumulated profits and are subject to the ordering principles of pre-1986 Act law.<sup>815</sup>

#### Foreign Tax Credit Limitation

The foreign tax credit generally is limited to a taxpayer’s U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles).<sup>816</sup> This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income. The limit is computed by multiplying a taxpayer’s total U.S. tax liability for the year by the ratio of the taxpayer’s foreign-source taxable income for the year to the taxpayer’s total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer’s foreign tax credit limitation for the year, the taxpayer may carry back the excess foreign taxes to the previous taxable year or carry forward the excess taxes to one of the succeeding ten taxable years.<sup>817</sup>

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<sup>811</sup> IRC sections 960(a), 1291(g), and 1293(f).

<sup>812</sup> IRC section 78.

<sup>813</sup> IRC section 902(c)(6)(B). Earnings and profits computations for these purposes are to be made under U.S. concepts. IRC sections 902(c)(1) and 964(a).

<sup>814</sup> IRC section 902(c)(1).

<sup>815</sup> IRC section 902(c)(6).

<sup>816</sup> IRC sections 901 and 904.

<sup>817</sup> IRC section 904(c).

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

The foreign tax credit limitation is generally applied separately for income in two different categories (referred to as “baskets”), passive basket income and general basket income.<sup>818</sup> Passive basket income generally includes investment income such as dividends, interest, rents, and royalties.<sup>819</sup> General basket income is all income that is not in the passive basket. Because the foreign tax credit limitation must be applied separately to income in these two baskets, credits for foreign tax imposed on income in one basket cannot be used to offset U.S. tax on income in the other basket.

Income that would otherwise constitute passive basket income is treated as general basket income if it is earned by a qualifying financial services entity (and certain other requirements are met).<sup>820</sup> Passive income is also treated as general basket income if it is high-taxed income (i.e., if the foreign tax rate is determined to exceed the highest rate of tax specified in IRC section 1 or 11, as applicable).<sup>821</sup> Dividends (and subpart F inclusions), interest, rents, and royalties received from a CFC by a U.S. person that owns at least ten percent of the CFC are assigned to a separate limitation basket by reference to the basket of income out of which the dividend or other payment is made.<sup>822</sup> Dividends received by a ten-percent corporate shareholder from a foreign corporation that is not a CFC are also categorized on a look-through basis.<sup>823</sup>

New Federal Law (IRC section 909)

The provision adopts a matching rule to prevent the separation of creditable foreign taxes from the associated foreign income. In general, the provision states that when there is a foreign tax credit splitting event with respect to a foreign income tax paid or accrued by the taxpayer, the foreign income tax is not taken into account for federal tax purposes before the taxable year in which the related income is taken into account by the taxpayer. In addition, if there is a foreign tax credit splitting event with respect to a foreign income tax paid or accrued by an IRC section 902 corporation, that tax is not taken into account for purposes of IRC section 902 or 960, or for purposes of determining earnings and profits under IRC section 964(a), before the taxable year in which the related income is taken into account for federal income tax purposes by the IRC section 902 corporation, or a domestic corporation that meets the ownership

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<sup>818</sup> IRC section 904(d). Separate foreign tax credit limitations also apply to certain categories of income described in other sections. See, e.g., IRC sections 901(j), 904(h)(10), and 865(h).

<sup>819</sup> IRC section 904(d)(2)(B). Passive income is defined by reference to the definition of foreign personal holding company income in IRC section 954(c), and thus generally includes dividends, interest, rents, royalties, annuities, net gains from certain property or commodities transactions, foreign currency gains, income equivalent to interest, income from notional principal contracts, and income from certain personal service contracts. Exceptions apply for certain rents and royalties derived in an active business and for certain income earned by dealers in securities or other financial instruments. Passive category income also includes amounts that are includible in gross income under IRC section 1293 (relating to PFICs) and dividends received from certain DISCs and FSCs.

<sup>820</sup> IRC section 904(d)(2)(C), (D).

<sup>821</sup> IRC section 904(d)(2)(F).

<sup>822</sup> IRC section 904(d)(3).

<sup>823</sup> IRC section 904(d)(4).

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

requirements of IRC section 902(a) or (b) with respect to the IRC section 902 corporation. Thus, such tax is not added to the IRC section 902 corporation's foreign tax pool, and its earnings and profits are not reduced by such tax.

In the case of a partnership, the provision's matching rule is applied at the partner level, and, except as otherwise provided by the Secretary, a similar rule applies in the case of any S corporation or trust. The Secretary may also issue regulations to establish the applicability of this matching rule to a regulated investment company that elects under IRC section 853 for the foreign income taxes it pays to be treated as creditable to its shareholders under IRC section 901.

For purposes of the provision, there is a "foreign tax credit splitting event" with respect to a foreign income tax if the related income is (or will be) taken into account for federal income tax purposes by a covered person.<sup>824</sup> A "foreign income tax" is any income, war profits, or excess profits tax paid or accrued to any foreign country or to any possession of the United States. This term includes any tax paid in lieu of such a tax within the meaning of IRC section 903. "Related income" means, with respect to any portion of any foreign income tax, the income (or, as appropriate, earnings and profits), calculated under U.S. tax principles, to which such portion of foreign income tax relates. For purposes of determining related income, the Secretary may provide rules on the treatment of losses, deficits in earnings and profits, and certain timing differences between U.S. and foreign tax law. Moreover, it is not intended that differences in the timing of when income is taken into account for U.S. and foreign tax purposes (e.g., as a result of differences in the U.S. and foreign tax accounting rules) should create a foreign tax credit splitting event in cases in which the same person pays the foreign tax and takes into account the related income, but in different taxable periods.

With respect to any person who pays or accrues a foreign income tax (hereafter referred to in this paragraph as the "payor"), a "covered person" is: (1) any entity in which the payor holds, directly or indirectly, at least a ten-percent ownership interest (determined by vote or value); (2) any person that holds, directly or indirectly, at least a ten-percent ownership interest (determined by vote or value) in the payor; (3) any person that bears a relationship to the payor described in IRC section 267(b) or IRC section 707(b) (including by application of the constructive ownership rules of IRC section 267(c)); or (4) any other person specified by the Secretary. Accordingly, the Secretary may issue regulations that treat an unrelated counterparty as a covered person in certain sale-repurchase transactions and certain other transactions deemed abusive.

An "IRC section 902 corporation" is any foreign corporation with respect to which one or more domestic corporations meets the ownership requirements of IRC section 902(a) or (b).

Except as otherwise provided by the Secretary, in the case of any foreign income tax not currently taken into account by reason of the provision's matching rule, that tax is taken into account as a foreign income tax paid or accrued in the taxable year in which, and to the extent that, the taxpayer, the IRC section 902 corporation, or a domestic corporation that meets the ownership

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<sup>824</sup> It is not intended that there be a foreign tax credit splitting event when, for example, a CFC pays or accrues a foreign income tax and takes into account the related income in the same year, even though the earnings and profits to which the foreign income tax relates may be distributed to a covered person as a dividend or included in such covered person's income under subpart F.

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

requirements of IRC section 902(a) or (b) with respect to the IRC section 902 corporation (as the case may be) takes the related income into account under chapter 1 of the IRC. Accordingly, for purposes of determining the carryback and carryover of excess foreign tax credits under IRC section 904(c), the deduction for foreign taxes paid or accrued under IRC section 164(a), and the extended period for claim of a credit or refund under IRC section 6511(d)(3)(A), foreign income taxes to which the provision applies are first taken into account, and treated as paid or accrued, in the year in which the related foreign income is taken into account. Notwithstanding the preceding rule, foreign taxes are translated into U.S. dollars in the year in which the taxes are paid or accrued under the general rules of IRC section 986 rather than the year in which the related income is taken into account. The Secretary may issue regulations or other guidance providing additional exceptions.

The Secretary is also granted authority to issue regulations or other guidance as is necessary or appropriate to carry out the purposes of the provision. Such guidance may include providing successor rules addressing circumstances such as where, with respect to a foreign tax credit splitting event, the person who pays or accrues the foreign income tax or any covered person is liquidated. This grant of authority also allows the Secretary to provide appropriate exceptions from the application of the provision as well as to provide guidance as to how the provision applies in the case of any foreign tax credit splitting event involving a hybrid instrument. It is anticipated that the Secretary may also provide guidance as to the proper application of the provision in cases involving disregarded payments, group relief, or other arrangements having a similar effect.

An example of a foreign tax credit splitting event involving a hybrid instrument subject to the provision is as follows: U.S. Corp., a domestic corporation, wholly owns CFC1, a country-A corporation. CFC1, in turn, wholly owns CFC2, a country-A corporation. CFC2 is engaged in an active business that generates \$100 of income. CFC2 issues a hybrid instrument to CFC1. This instrument is treated as equity for U.S. tax purposes but as debt for foreign tax purposes. Under the terms of the hybrid instrument, CFC2 accrues (but does not pay currently) interest to CFC1 equal to \$100. As a result, CFC2 has no income for country-A tax purposes, while CFC1 has \$100 of income, which is subject to country-A tax at a 30-percent rate. For U.S. tax purposes, CFC2 still has \$100 of earnings and profits (the accrued interest is ignored since the United States views the hybrid instrument as equity), while CFC1 has paid \$30 of foreign taxes. Under the provision, the related income with respect to the \$30 of foreign taxes paid by CFC1 is the \$100 of earnings and profits of CFC2.

#### Effective Date

In general, the provision is effective with respect to foreign income taxes paid or accrued by U.S. taxpayers and IRC section 902 corporations in taxable years beginning after December 31, 2010.

The provision also applies to foreign income taxes paid or accrued by an IRC section 902 corporation in taxable years beginning on or before December 31, 2010 (and not deemed paid under IRC section 902(a) or IRC section 960 on or before such date), but only for purposes of applying IRC sections 902 and 960 with respect to periods after such date (the “deemed-paid transition rule”). Accordingly, the deemed-paid transition rule applies for purposes of applying

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

IRC sections 902 and 960 to dividends paid, and inclusions under IRC section 951(a) that occur, in taxable years beginning after December 31, 2010. However, no adjustment is made to an IRC section 902 corporation's earnings and profits for the amount of any foreign income taxes suspended under the deemed-paid transition rule, either at the time of suspension or when such taxes are subsequently taken into account under the provision.

California Law (None)

California does not allow a foreign tax credit.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
212	Denial of Foreign Tax Credit with Respect to Foreign Income not Subject to United States Taxation by Reason of Covered Asset Acquisitions

Background

Foreign Tax Credit

The United States employs a worldwide tax system under which U.S. resident individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad; the foreign tax credit provides relief from double taxation. Subject to the limitations discussed below, a U.S. taxpayer is allowed to claim a credit against its U.S. income tax liability for the foreign income taxes that it pays. A domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation is allowed a "deemed-paid" credit for foreign income taxes paid by the foreign corporation that the domestic corporation is deemed to have paid when the related income is distributed or is included in the domestic corporation's income under the provisions of subpart F.<sup>825</sup>

The foreign tax credit is elective on a year-by-year basis. In lieu of electing the foreign tax credit, U.S. persons generally are permitted to deduct foreign taxes.<sup>826</sup>

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<sup>825</sup> IRC sections 901, 902, and 960. Similar rules apply under IRC sections 1291(g) and 1293(f) with respect to income that is includible under the passive foreign investment company ("PFIC") rules.

<sup>826</sup> IRC section 164(a)(3).

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

*Deemed-paid foreign tax credit*

U.S. corporations owning at least ten percent of the voting stock of a foreign corporation are treated as if they had paid a share of the foreign income taxes paid by the foreign corporation in the year in which that corporation's earnings and profits ("E&P") become subject to U.S. tax as dividend income of the U.S. shareholder.<sup>827</sup> This credit is the "deemed-paid" or "indirect" foreign tax credit. A U.S. corporation may also be deemed to have paid foreign income taxes paid by a second-, third-, fourth-, fifth-, or sixth-tier foreign corporation, if certain requirements are satisfied.<sup>828</sup> Foreign income taxes paid below the third tier are eligible for the deemed-paid credit only with respect to foreign income taxes paid in taxable years during which the payor is a controlled foreign corporation ("CFC"). Foreign income taxes paid below the sixth tier are not eligible for the deemed-paid credit. In addition, a deemed-paid credit generally is available with respect to subpart F inclusions.<sup>829</sup> Moreover, a deemed-paid credit generally is available with respect to inclusions under the PFIC provisions by U.S. corporations meeting the requisite ownership threshold.<sup>830</sup>

The amount of foreign income tax eligible for the indirect credit is added to the actual dividend or inclusion (the dividend or inclusion is said to be "grossed-up") and is included in the U.S. corporate shareholder's income; accordingly, the shareholder is treated as if it had received its proportionate share of pre-tax profits of the foreign corporation and paid its proportionate share of the foreign income tax paid by the foreign corporation.<sup>831</sup>

For purposes of computing the deemed-paid foreign tax credit, dividends (or other inclusions) are considered made first from the post-1986 pool of all the distributing foreign corporation's accumulated E&P.<sup>832</sup> Accumulated E&P for this purpose include the E&P of the current year undiminished by the current distribution (or other inclusion).<sup>833</sup> Dividends in excess of the accumulated pool of post-1986 undistributed E&P are treated as paid out of pre-1987 accumulated profits and are subject to the ordering principles of pre-1986 Act law.<sup>834</sup>

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<sup>827</sup> IRC section 902(a).

<sup>828</sup> IRC section 902(b).

<sup>829</sup> IRC section 960(a).

<sup>830</sup> IRC sections 1291(g) and 1293(f).

<sup>831</sup> IRC section 78.

<sup>832</sup> IRC section 902(c)(6)(B). Earnings and profits computations for these purposes are to be made under U.S. concepts. IRC sections 902(c)(1) and 964(a).

<sup>833</sup> IRC section 902(c)(1).

<sup>834</sup> IRC section 902(c)(6).

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

*Foreign tax credit limitation*

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles).<sup>835</sup> This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income. The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may carry the excess back to the previous taxable year or forward to one of the succeeding 10 taxable years.<sup>836</sup>

The foreign tax credit limitation is generally applied separately to two different categories of income (referred to as "baskets"), passive basket income and general basket income.<sup>837</sup> Passive basket income generally includes investment income such as dividends, interest, rents, and royalties.<sup>838</sup>

Income that would otherwise constitute passive basket income is treated as general basket income if it is earned by a qualifying financial services entity (and certain other requirements are met). General basket income is all income that is not in the passive category. Because the foreign tax credit limitation must be applied separately to income in these two baskets, foreign tax imposed on income in one basket cannot be claimed as a credit against U.S. tax on income in the other basket.<sup>839</sup> Passive income is also treated as general basket income if it is high-taxed income (i.e., if the foreign tax rate is determined to exceed the highest rate of tax specified in IRC section 1 or 11, as applicable).<sup>840</sup> Dividends (and subpart F inclusions), interest, rents, and royalties received from a CFC by a U.S. person that owns at least ten percent of the CFC are assigned to a separate limitation basket by reference to the basket of income out of which the

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<sup>835</sup> IRC sections 901 and 904.

<sup>836</sup> IRC section 904(c).

<sup>837</sup> IRC section 904(d). Separate foreign tax credit limitations also apply to certain categories of income described in other sections. See, e.g., IRC sections 901(j), 904(h)(10), and 865(h).

<sup>838</sup> IRC section 904(d)(2)(B). Passive income is defined by reference to the definition of foreign personal holding company income in IRC section 954(c), and thus generally includes dividends, interest, rents, royalties, annuities, net gains from certain property or commodities transactions, foreign currency gains, income equivalent to interest, income from notional principal contracts, and income from certain personal service contracts. Exceptions apply for certain rents and royalties derived in an active business and for certain income earned by dealers in securities or other financial instruments. Passive category income also includes amounts that are includible in gross income under IRC section 1293 (relating to PFICs) and dividends received from certain DISCs and FSCs.

<sup>839</sup> IRC section 904(d)(2)(C), (D).

<sup>840</sup> IRC section 904(d)(2)(F).

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

dividend or other payment is made.<sup>841</sup> Dividends received by a ten-percent corporate shareholder from a foreign corporation that is not a CFC are also categorized on a look-through basis.<sup>842</sup>

#### Items Giving Rise to Permanent Basis Differences

In general, certain elections or transactions can result in the creation of additional asset basis eligible for cost recovery for U.S. tax purposes without a corresponding increase in the basis of such assets for foreign tax purposes. These include: (1) a qualifying stock purchase of a foreign corporation or domestic corporation with foreign assets for which an IRC section 338 election is made; (2) an acquisition of an interest in a partnership holding foreign assets for which an IRC section 754 election is in effect; and (3) certain other transactions involving an entity classification (“check-the-box”) election in which a foreign entity is treated as a corporation for foreign tax purposes and as a partnership or disregarded entity for U.S. tax purposes.<sup>843</sup>

#### *IRC section 338 elections*

In general, the basis of stock acquired by a U.S. taxpayer or a foreign subsidiary of a U.S. taxpayer is its cost,<sup>844</sup> and there is no adjustment to the basis of the assets held by the acquired corporation.<sup>845</sup> In certain circumstances, however, taxpayers may elect to treat a qualifying purchase of 80 percent of the stock of a target corporation (a “qualified stock purchase”) as a purchase of the underlying assets of the target corporation.<sup>846</sup> For this purpose, a “qualified stock purchase” is any transaction or series of transactions in which stock (meeting the requirements of IRC section 1504(a)(2)) of one corporation is acquired by another corporation by purchase during the 12-month acquisition period.<sup>847</sup>

Two alternatives exist for making an IRC section 338 election when there is a qualifying stock purchase—one bilateral and one unilateral. A bilateral election, which is made pursuant to

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<sup>841</sup> IRC section 904(d)(3).

<sup>842</sup> IRC section 904(d)(4).

<sup>843</sup> Treas. Reg. section 301.7701-1, *et seq.*

<sup>844</sup> IRC sections 1011 and 1012.

<sup>845</sup> See IRC section 1016.

<sup>846</sup> IRC section 338(a).

<sup>847</sup> IRC section 338(d)(3). Under IRC section 1504(a)(2), the ownership of stock of any corporation meets the requirements of an affiliated group if it (A) possesses at least 80 percent of the total voting power of the stock of such corporation, and (B) has a value equal to at least 80 percent of the total value of the stock of such corporation. Further, IRC section 1504(a)(4) states that for purposes of meeting the 80-percent requirement, the term stock does not include any stock which (A) is not entitled to vote, (B) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (C) has redemption and liquidation rights which do not exceed the issue price of such stock, and (D) is not convertible into another class of stock.

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

IRC section 338(h)(10), requires a corporation to make a qualifying purchase of 80 percent of the stock of a domestic target corporation<sup>848</sup> that is a member of a selling consolidated group (or affiliated group if no election to file a consolidated return has been made), or a qualifying purchase of 80 percent of the stock of an S corporation by a corporation from S corporation shareholders. The election is made jointly by the buyer and seller of the stock and must be made by the 15th day of the ninth month beginning after the month in which the acquisition date occurs. Pursuant to this election, the assets (rather than the stock) of the target corporation are deemed to have been sold in a single transaction at the close of the acquisition date, and the target corporation is deemed to have liquidated. The asset sale is taken into account by the target prior to its acquisition by the purchasing corporation.<sup>849</sup>

With a unilateral election, which is made pursuant to IRC section 338(g), the purchasing corporation treats a qualified stock purchase of a corporation (including a foreign corporation) as a deemed asset acquisition, whether or not the seller of the stock is a corporation. Pursuant to this election, the seller or sellers recognize gain or loss on the stock sale, and the target corporation also recognizes gain or loss on the deemed asset sale. The deemed asset acquisition also eliminates the historic E&P of the target corporation. In general, in cases in which the target corporation is foreign and the seller is a U.S. person or a CFC, the deemed asset sale has U.S. tax consequences.<sup>850</sup> However, when the seller is neither a U.S. person nor a CFC, generally no U.S. tax consequences result from the deemed asset sale.<sup>851</sup> The election is made by the purchasing corporation and must be made by the 15th day of the ninth month beginning after the month in which the acquisition date occurs.

Pursuant to an IRC section 338 election, the target corporation is treated as having sold all of its assets at the close of the acquisition date at fair market value in a single transaction, and a new corporation that purchased all of the assets as of the beginning of the day after the acquisition date.<sup>852</sup> Accordingly, the aggregate basis of the assets of the target equals the sum of: (1) the grossed-up basis of the purchasing corporation's recently-purchased stock; and (2) the basis of

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<sup>848</sup> A foreign corporation cannot be the target corporation in the case of an IRC section 338(h)(10) election. See Treas. Reg. section 1.338(h)(10)-1(b)(1), (2), (3).

<sup>849</sup> Sec. IRC section 338(h)(10) and Treas. Reg. section 1.338(h)(10)-1(d)(3).

<sup>850</sup> IRC section 338(h)(16) addresses the impact of the deemed asset sale on the E&P of the foreign target corporation for purposes of determining the source and character of any amount includible in gross income as a dividend under IRC section 1248 to the seller.

<sup>851</sup> When a domestic corporation or a CFC is the purchaser with respect to which an IRC section 338(g) election is made for a foreign target corporation, the deemed asset sale may have U.S. tax consequences. For example, if the foreign target becomes a CFC for an uninterrupted period of 30 days or more during a taxable year pursuant to IRC section 951(a) prior to the purchasing corporation completing the qualified stock purchase, the deemed asset sale may generate subpart F income for any U.S. shareholder of the foreign target corporation. Treas. Reg. section. 1.338-9(b).

<sup>852</sup> IRC section 338(a).

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

the purchasing corporation's non-recently-purchased stock, with appropriate adjustments for liabilities and other relevant items under the regulations.<sup>853</sup>

Since an IRC section 338 election is relevant solely for U.S. tax purposes, the adjustment to the basis of the assets of a foreign target corporation (or a foreign branch of a domestic corporation) that increases the amount of depreciation, amortization, depletion, or gain for purposes of calculating U.S. taxable income or E&P results in no corresponding adjustment for foreign income tax purposes. As a result, cost recovery deductions attributable to such additional basis generally result in a permanent difference between: (1) the foreign taxable income upon which foreign income tax is levied; and (2) the U.S. taxable income (or E&P) upon which U.S. tax is levied (whether currently or upon repatriation) and with respect to which a foreign tax credit may be allowed for any foreign income taxes paid.

*IRC section 754 election*

A partnership does not generally adjust the basis of partnership property following the transfer of a partnership interest unless the partnership has made a one-time election under IRC section 754 for such purposes.<sup>854</sup> If an election is in effect, adjustments to the basis of partnership property are made with respect to the transferee partner to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest.<sup>855</sup> These adjustments are intended to adjust the basis of partnership property to approximate the result of a direct purchase of the property by the transferee partner. Because an IRC section 754 election has relevance only for U.S. tax purposes, to the extent that the underlying assets of the partnership include assets generating income subject to foreign tax, the basis adjustments made to these assets may also result in permanent differences between: (1) the foreign taxable income upon which foreign income tax is levied; and (2) the U.S. taxable income (or E&P) upon which U.S. tax is levied (whether currently or upon repatriation) and with respect to which a foreign tax credit may be allowed for any foreign income taxes paid.

*Check-the-box election*

Comparable permanent differences between foreign taxable income and U.S. taxable income (or E&P) may also be achieved as a result of making a check-the-box election. Since a check-the-box election generally has no effect for foreign tax purposes, a sale of a wholly-owned foreign corporation for which an election to be disregarded is in effect will be respected as the sale of the corporation for foreign tax purposes but treated as the sale of branch assets for U.S. tax purposes. If the purchaser is a U.S. taxpayer or a foreign entity owned by a U.S. taxpayer, the U.S. taxpayer may have additional asset basis eligible for cost recovery for U.S. tax purposes without a

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<sup>853</sup> IRC section 338(b).

<sup>854</sup> IRC section 743(a). But see IRC section 743(d) requiring a reduction to the basis of partnership property in certain cases where there is a substantial built-in loss.

<sup>855</sup> IRC section 743(b).

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

corresponding increase in the tax basis of such assets for foreign tax purposes. In this case, there would be a permanent difference between the foreign taxable income upon which foreign income tax is levied, and the U.S. taxable income (or E&P) upon which U.S. tax is levied (whether currently or upon repatriation) and with respect to which a foreign tax credit may be allowed. Similar results may be achieved through other transactions in which a check-the-box election has been made.

New Federal Law (IRC section 901)

The provision denies a foreign tax credit for the disqualified portion of any foreign income tax paid or accrued in connection with a covered asset acquisition.

A “covered asset acquisition” means: (1) a qualified stock purchase (as defined in IRC section 338(d)(3)) to which IRC section 338(a) applies;<sup>856</sup> (2) any transaction that is treated as the acquisition of assets for U.S. tax purposes and as the acquisition of stock (or is disregarded)<sup>857</sup> for purposes of the foreign income taxes of the relevant jurisdiction;<sup>858</sup> (3) any acquisition of an interest in a partnership that has an election in effect under IRC section 754; and (4) to the extent provided by the Secretary, any other similar transaction. It is anticipated that the Secretary will issue regulations identifying other similar transactions that result in an increase to the basis of assets for U.S. tax purposes without a corresponding increase for foreign tax purposes.

The disqualified portion of any foreign income taxes paid or accrued with respect to any covered asset acquisition, for any taxable year, is the ratio (expressed as a percentage) of the aggregate basis differences allocable to such taxable year with respect to all relevant foreign assets divided by the income on which the foreign income tax is determined. For this purpose, the income on which the foreign income tax is determined is the income as determined under the law of the relevant jurisdiction. If the taxpayer fails to substantiate such income to the satisfaction of the Secretary, then such income is determined by dividing the amount of such foreign income tax by the highest marginal tax rate applicable to such income in the relevant jurisdiction.

For purposes of determining the aggregate basis difference allocable to a taxable year, the term “basis difference” means, with respect to any relevant foreign asset, the excess of the adjusted basis of such asset immediately after the covered asset acquisition over the adjusted basis of such asset immediately before the covered asset acquisition. Thus, it is the tax basis for U.S. tax

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<sup>856</sup> This includes transaction under IRC section 338(g) and IRC section 338(h)(10).

<sup>857</sup> For example, the deemed liquidation of a CFC as the result of the making of an entity classification election pursuant to Treas. Reg. section 301.7701-3 may result in an IRC section 331 liquidation for U.S. tax purposes that is disregarded for foreign income tax purposes.

<sup>858</sup> IRC section 336(e) provides that, to the extent provided by the Secretary, in cases in which: (1) a corporation owns at least 80 percent of the vote and value of stock of another corporation (as defined in IRC section 1504(a)(2)); and (2) such corporation sells, exchanges, or distributes all of stock of such corporation, an election may be made to treat this sale, exchange, or distribution as a disposition of all of the assets of the other corporation, and no gain or loss is recognized on the sale, exchange, or distribution of the stock. To date, the Secretary has not promulgated regulations under IRC section 336(e) so no election may be made. Nonetheless, to the extent regulations are promulgated under IRC section 336(e) in the future permitting such an election to be made, a transaction to which the IRC section 336(e) election relates would be a covered asset acquisition.

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

purposes that is relevant, and not the basis as determined under the law of the relevant foreign jurisdiction. Because CFCs are generally limited to straight-line cost recovery, it is anticipated that the basis difference applying U.S. tax principles generally is less than if the taxpayer were required to use the basis as determined under foreign law immediately before the covered asset acquisition. However, it is anticipated that the Secretary will issue regulations identifying those circumstances in which, for purposes of determining the adjusted basis of such assets immediately before the covered asset acquisition, it may be acceptable to utilize the basis of such asset under the law of the relevant jurisdiction or another reasonable method.

A built-in loss in a relevant foreign asset (i.e., in cases in which the fair market value of the asset is less than its adjusted basis immediately before the asset acquisition) is taken into account in determining the aggregate basis difference; however, a built-in loss cannot reduce the aggregate basis difference allocable to a taxable year below zero.

In the case of a qualified stock purchase to which IRC section 338(a) applies, the covered asset acquisition is treated as occurring at the close of the acquisition date (as defined in IRC section 338(h)(2)).

In general, the amount of the basis difference allocable to a taxable year with respect to any relevant foreign asset is determined using the applicable cost-recovery method under U.S. tax rules. If there is a disposition of any relevant foreign asset before its cost has been entirely recovered or of any relevant foreign asset that is not eligible for cost recovery (e.g., land), the basis difference allocated to the taxable year of the disposition is the excess of the basis difference with respect to such asset over the aggregate basis difference with respect to such asset that has been allocated under this provision to all prior taxable years. Thus, any remaining basis difference is captured in the year of the sale, and there is no remaining basis difference to be allocated to any subsequent tax years. However, it is intended that this provision generally apply in circumstances in which there is a disposition of a relevant foreign asset and the associated income or gain is taken into account for purposes of determining foreign income tax in the relevant jurisdiction.

To illustrate, assume USP, a domestic corporation, acquires 100 percent of the stock of FT, a foreign target organized in Country F with a “u” functional currency, in a qualified stock purchase for which an IRC section 338(g) election is made. The tax rate in Country F is 25 percent. Assume further that the aggregate basis difference in connection with the qualified stock purchase is 200u, including: (1) 150u that is attributable to Asset A, with a 15-year recovery period for U.S. tax purposes (10u of annual amortization); and (2) 50u that is attributable to Asset B, with a 5-year recovery period (10u of annual depreciation). In each of years 1 and 2, FT’s taxable income is 100u for foreign tax purposes and FT pays foreign income tax of 25u (equal to \$25 when translated at the average exchange rate for the year). As a result, the disqualified portion of foreign income tax in each of years 1 and 2 is \$5 ((10u + 10u of allocable basis difference / 100u of foreign taxable income) x \$25 foreign tax paid).

In year 3, FT’s taxable income is 140u, 40u of which is attributable to gain on the sale of Asset B. FT’s Country F tax is 35u (equal to \$35 translated at the average exchange rate for the year). Accordingly, the disqualified portion of its foreign income taxes paid is \$10 ((40u (including 10u of

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

annual amortization on Asset A and 30u attributable to disposition of Asset B) of allocable basis difference / 140u of foreign taxable income) x \$35 foreign tax paid).

An asset is a “relevant foreign asset” with respect to any covered asset acquisition, whether the entity acquired is domestic or foreign, only if any income, deduction, gain, or loss attributable to the asset (including goodwill, going concern value, and any other intangible asset) is taken into account in determining foreign income tax in the relevant jurisdiction. For this purpose, the term “foreign income tax” means any income, war profits, or excess profits tax paid or accrued to any foreign country or to any possession of the United States, including any tax paid in lieu of such a tax within the meaning of IRC section 903. In cases in which there has been a covered asset acquisition that involves either: (1) both U.S. assets and relevant foreign assets; or (2) assets in multiple relevant jurisdictions, it is anticipated that the Secretary may issue regulations clarifying the manner in which any relevant foreign asset (such as intangible assets that may relate to more than one jurisdiction) are to be allocated between those jurisdictions. It is also anticipated that the Secretary may issue regulations to clarify the extent to which income is considered attributable to a relevant foreign asset, as well as the treatment of an asset that ceases to be taken into account in determining the foreign income tax in the relevant jurisdiction by some mechanism other than a disposition.

To the extent that a foreign tax credit is disallowed, the disqualified portion is allowed as a deduction to the extent otherwise deductible.<sup>859</sup>

The Secretary may issue regulations or other guidance as is necessary or appropriate to carry out the purposes of this provision, including: (1) to provide an exemption for certain covered asset acquisitions; and (2) to provide an exemption for relevant foreign assets with respect to which the basis difference is de minimis. For example, it is anticipated that the Secretary will exclude covered asset acquisitions that are not taxable for U.S. purposes, or in which the basis of the relevant foreign assets is also increased for purposes of the tax laws of the relevant jurisdiction.

#### Effective Date

In general, the provision is effective for covered asset acquisitions after December 31, 2010. However, the provision does not apply to any covered asset acquisition with respect to which the transferor and transferee are not related if the acquisition is: (1) made pursuant to a written agreement that was binding on January 1, 2011, and at all times thereafter; (2) described in a ruling request<sup>860</sup> submitted to the IRS on or before July 29, 2010; or (3) described in a public announcement or filing with the SEC on or before January 1, 2011.

For this purpose, a person is treated as related to another person if the relationship between such persons is described in IRC section 267 or IRC section 707(b).

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<sup>859</sup> IRC section 164(a)(3).

<sup>860</sup> A private letter ruling may be relied upon only by the taxpayer requesting the ruling. Transition relief is available only with respect to the transaction for which the ruling is requested.

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

California Law (None)

California does not allow a foreign tax credit.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
213	Separate Application of Foreign Tax Credit Limitation, etc., to Items Resourced Under Treaties

Background

The United States taxes its citizens and residents (including domestic corporations) on 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. Subject to limitations discussed below, a U.S. taxpayer is allowed to claim a credit against its U.S. income tax liability for foreign income taxes paid or accrued.<sup>861</sup> A domestic corporation that owns at least ten percent of the voting stock of a foreign corporation is allowed a “deemed-paid” credit for foreign income taxes paid by the foreign corporation that the domestic corporation is deemed to have paid when the foreign corporation’s earnings are distributed or included in the domestic corporation’s income under the provisions of subpart F.<sup>862</sup>

A foreign tax credit is available only for foreign income, war profits, and excess profits taxes, and for certain taxes imposed in lieu of such taxes.<sup>863</sup> Other foreign levies generally are treated as deductible expenses. The foreign tax credit is elective on a year-by-year basis. In lieu of electing the foreign tax credit, U.S. persons generally are permitted to deduct foreign taxes.<sup>864</sup>

The foreign tax credit generally is limited to a taxpayer’s U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles).<sup>865</sup> This limit is intended to

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<sup>861</sup> IRC section 901.

<sup>862</sup> IRC sections 901, 902, and 960. Similar rules apply under IRC sections 1291(g) and 1293(f) with respect to income that is includible under the passive foreign investment company (“PFIC”) rules.

<sup>863</sup> IRC sections 901(b) and 903.

<sup>864</sup> IRC section 164(a)(3).

<sup>865</sup> IRC sections 901 and 904.

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income. The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may carry back the excess foreign taxes to the previous taxable year or carry forward the excess taxes to one of the succeeding ten taxable years.<sup>866</sup>

The foreign tax credit limitation is generally applied separately for income in two different categories (referred to as "baskets"), passive category income and general category income.<sup>867</sup> Passive category income generally includes investment income such as dividends, interest, rents, and royalties.<sup>868</sup> General category income is all income that is not in the passive category. Because the foreign tax credit limitation must be applied separately to income in these two baskets, credits for foreign tax imposed on income in one basket cannot be used to offset U.S. tax on income in the other basket.

Income that would otherwise constitute passive basket income is treated as general basket income if it is earned by a qualifying financial services entity (and certain other requirements are met).<sup>869</sup> Passive income is also treated as general basket income if it is high-taxed income (i.e., if the foreign tax rate is determined to exceed the highest rate of tax specified in IRC section 1 or 11, as applicable).<sup>870</sup> Dividends (and subpart F inclusions), interest, rents, and royalties received from a CFC by a U.S. person that owns at least ten percent of the CFC are assigned to a separate basket by reference to the basket of income out of which the dividend or other payment is made.<sup>871</sup> Dividends received by a ten-percent corporate shareholder from a foreign corporation that is not a CFC are also categorized on a look-through basis.<sup>872</sup>

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<sup>866</sup> IRC section 904(c).

<sup>867</sup> IRC section 904(d). Separate foreign tax credit limitations also apply to certain categories of income described in other sections. See, e.g., IRC sections 901(j), 904(h)(10), and 865(h).

<sup>868</sup> IRC section 904(d)(2)(B). Passive income is defined by reference to the definition of foreign personal holding company income in IRC section 954(c), and thus generally includes dividends, interest, rents, royalties, annuities, net gains from certain property or commodities transactions, foreign currency gains, income equivalent to interest, income from notional principal contracts, and income from certain personal service contracts. Exceptions apply for certain rents and royalties derived in an active business and for certain income earned by dealers in securities or other financial instruments. Passive category income also includes amounts that are includible in gross income under IRC section 1293 (relating to PFICs) and dividends received from certain DISCs and FSCs.

<sup>869</sup> IRC section 904(d)(2)(C), (D).

<sup>870</sup> IRC section 904(d)(2)(F).

<sup>871</sup> IRC section 904(d)(3).

<sup>872</sup> IRC section 904(d)(4).

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

In general, amounts derived from a foreign corporation (such as interest and dividends) are treated as foreign-source income for U.S. foreign tax credit limitation purposes. A special sourcing rule applies to amounts (such as interest and dividends) derived from a U.S.-owned foreign corporation that are attributable to U.S.-source income of the foreign corporation. This special sourcing rule treats such amounts, which would otherwise be treated as foreign source, as U.S. source.<sup>873</sup> For these purposes, a U.S.-owned foreign corporation is a foreign corporation that is at least 50-percent owned (directly or in certain cases indirectly) by vote or value by U.S. persons. The effect of sourcing what under the general rules would be foreign-source income as U.S.-source income under these special rules is to prevent taxpayers from routing U.S.-source income through a foreign affiliate to increase the taxpayer's foreign-source income and, therefore, the taxpayer's foreign tax credit limitation.

A coordination rule applies in the case of an amount that would be treated as U.S.-source income under the special sourcing rule but which is treated as foreign source under a treaty. If any amount derived from a U.S.-owned foreign corporation would be treated as U.S.-source income under the special sourcing rule described above, a U.S. treaty obligation would treat such income as arising from sources outside the United States, and the taxpayer chooses the benefits of this coordination rule, then the amount will be treated as foreign source. However, for foreign tax credit limitation purposes, a separate limitation applies to such amount and the associated foreign taxes. This coordination rule applies only to amounts derived from a U.S.-owned foreign corporation, and not to amounts derived from a foreign branch or disregarded entity.

For gains from the sale of certain stock or intangibles, a similar special sourcing rule applies to treat any such gain as foreign source, while requiring the taxpayer to assign any such gain and associated taxes to a separate limitation category for purposes of computing the foreign tax credit.<sup>874</sup> This rule applies to the gain from sale of stock in a foreign corporation or an intangible that would be U.S. source but which under a U.S.-treaty obligation is treated as foreign source with respect to which the taxpayer chooses the benefits of this rule. This rule also applies to certain gains derived from a liquidating distribution from certain U.S.-possession corporations.

New Federal Law (IRC section 904)

The provision applies a separate foreign tax credit limitation for each item: (1) that is treated as derived from sources within the United States under U.S. tax law without regard to a treaty obligation; (2) that is treated as arising from sources outside the United States under a treaty obligation of the United States; and (3) for which the taxpayer chooses the benefits of the treaty.

The provision does not apply to items of income to which the coordination rule applicable to U.S.-owned foreign corporations or the rule for gains from the sale of certain stock or intangibles

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<sup>873</sup> IRC section 904(h). The special sourcing rule applies in the case of subpart F and passive foreign investment company inclusions to the extent that such amount is attributable to income of the U.S.-owned foreign corporation from U.S. sources; in the case of dividends, to the portion of the U.S.-owned foreign corporation's earnings and profits for the taxable year that are from U.S. sources; and in the case of interest paid to a U.S. shareholder or related person, to amounts properly allocable to the U.S.-owned foreign corporation's U.S.-source income. De minimis exceptions apply if the U.S.-owned foreign corporation has a small amount of U.S.-source income.

<sup>874</sup> IRC section 865(h).

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

(discussed above) apply. The provision gives the Secretary authority to issue guidance as necessary or appropriate to carry out the purposes of the provision, including guidance providing that related items of income may be aggregated for purposes of the provision or grouping together items of income from the same trade or business.

Effective Date

The provision is effective for taxable years beginning after August 10, 2010.

California Law (None)

California does not allow a foreign tax credit.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
214	Limitation on the Amount of Foreign Taxes Deemed Paid with Respect to Section 956 Inclusions

Background

The United States employs a worldwide tax system under which U.S. resident individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad; the foreign tax credit provides relief from double taxation. Income earned directly or through a pass-through entity (such as a partnership) is taxed on a current basis. By contrast, active foreign business earnings that a U.S. person derives indirectly through a foreign corporation generally are not subject to U.S. tax until such earnings are repatriated to the United States through a distribution of those earnings to the U.S. person. This ability of U.S. persons to defer income is circumscribed by various regimes intended to restrict or eliminate tax deferral with respect to certain categories of passive or highly-mobile income. The main anti-deferral regimes are the controlled foreign corporation (“CFC”) rules of subpart F<sup>875</sup> and the passive foreign investment company rules.<sup>876</sup>

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<sup>875</sup> See IRC sections 951-964.

<sup>876</sup> See IRC sections 1291-1298.

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

### The Subpart F CFC Rules

Under the subpart F CFC rules, a ten-percent-or-greater U.S. shareholder (a “U.S. Shareholder”) of a CFC is subject to U.S. tax currently on its pro-rata share of certain income earned by the CFC,<sup>877</sup> and certain untaxed earnings invested in United States property with respect to such shareholder.<sup>878</sup> In each case, the U.S. Shareholder is subject to tax currently, whether or not such income is distributed. A CFC is defined generally as a foreign corporation with respect to which U.S. Shareholders own more than 50 percent of the combined voting power or total value of the stock of the corporation.<sup>879</sup>

#### *United States property held by CFCs*

A U.S. Shareholder that owns stock in a CFC on the last day of the taxable year must include in its gross income the amount determined under IRC section 956 with respect to such shareholder for such year (but only to the extent not previously taxed<sup>880</sup>) (an “IRC section 956 inclusion”). The IRC section 956 inclusion for any taxable year is generally the lesser of: (1) the excess of such shareholder’s pro-rata share of the average of the amounts of United States property held (directly or indirectly) by the CFC as of the close of each quarter of such taxable year over the amount of previously taxed income from prior IRC section 956 inclusions<sup>881</sup> with respect to such shareholder; or (2) such shareholder’s pro-rata share of the applicable earnings of such CFC.<sup>882</sup>

#### Foreign Tax Credits

Subject to the limitations discussed below, a U.S. person is allowed to claim a credit against its U.S. income tax liability for the foreign income taxes that it pays. As discussed below, a domestic corporation may<sup>883</sup> also be allowed a “deemed-paid” credit for foreign income taxes paid by a foreign corporation that the domestic corporation is deemed to have paid when the related income is distributed or is included in the domestic corporation’s income under the provisions of subpart F, including IRC section 956 inclusions.<sup>884</sup>

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<sup>877</sup> IRC section 951(a)(1)(A).

<sup>878</sup> IRC section 951(a)(1)(B).

<sup>879</sup> IRC section 957(a).

<sup>880</sup> IRC section 959(a)(2).

<sup>881</sup> See IRC section 959(c)(1)(A).

<sup>882</sup> IRC section 956(a).

<sup>883</sup> A U.S. Shareholder includes individuals and entities. IRC section 951(b). In contrast, only those U.S. shareholders that are corporations are entitled to the deemed-paid credit.

<sup>884</sup> IRC sections 901, 902, and 960. Similar rules apply under IRC sections 1291(g) and 1293(f) with respect to income that is includible under the passive foreign investment company (“PFIC”) rules.

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

A foreign tax credit is available only for foreign income, war profits, and excess profits taxes, and for certain taxes imposed in lieu of such taxes. Other foreign levies generally are treated as deductible expenses. The foreign tax credit is elective on a year-by-year basis. In lieu of electing the foreign tax credit, U.S. persons generally are permitted to deduct foreign taxes.<sup>885</sup>

*Deemed-paid foreign tax credit*

Domestic corporations owning at least ten percent of the voting stock of a foreign corporation are treated as if they had paid a share of the foreign income taxes paid by the foreign corporation in the year in which that corporation's earnings and profits ("E&P") become subject to U.S. tax as dividend income of the domestic corporation.<sup>886</sup> This credit is the deemed-paid, or indirect, foreign tax credit. A domestic corporation may also be deemed to have paid taxes paid by a second-, third-, fourth-, fifth-, or sixth-tier foreign corporation, if certain requirements are satisfied.<sup>887</sup> Foreign taxes paid below the third tier are eligible for the deemed-paid credit only with respect to taxes paid in taxable years during which the payor is a CFC and the corporation claiming the credit is a U.S. Shareholder of the CFC.<sup>888</sup> Foreign taxes paid below the sixth tier are not eligible for the deemed-paid credit. In addition, a deemed-paid credit generally is available with respect to any inclusion of subpart F income or investments of earnings in United States property for the taxable year.<sup>889</sup> The amount of the credit is determined by the same formula as under IRC section 902, except that the numerator of the ratio is the amount of the inclusion, rather than the amount of dividends received during the taxable year.<sup>890</sup>

E&P is determined under the same rules for purposes of the deemed-paid credit fraction with respect to subpart F and IRC section 956 inclusions as for dividends.<sup>891</sup> These rules generally<sup>892</sup> provide that the E&P of any foreign corporation is determined according to rules substantially similar to those applicable to domestic corporations, under regulations prescribed by the Secretary. The amount of foreign tax eligible for the indirect credit is added to the actual dividend or inclusion (the dividend or inclusion is said to be "grossed-up") and is included in the domestic corporation's income; accordingly, the domestic corporation is treated as if it had received its

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<sup>885</sup> IRC section 164(a)(3).

<sup>886</sup> IRC section 902(a).

<sup>887</sup> IRC section 902(b).

<sup>888</sup> IRC section 902(b)(2).

<sup>889</sup> IRC section 960(a).

<sup>890</sup> IRC section 960(a)(1); and Treas. Reg. section 1.960-1(i)(1).

<sup>891</sup> See IRC sections 902(c)(1) and 964; and Treas. Reg. section 1.964-1(a)(1).

<sup>892</sup> For an exception, see IRC section 312(k)(4).

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

proportionate share of pre-tax profits of the foreign corporation and paid its proportionate share of the foreign tax paid by the foreign corporation.<sup>893</sup>

For purposes of computing the deemed-paid foreign tax credit, distributions (or other inclusions) are considered made first from the post-1986 pool of all the distributing foreign corporation's accumulated E&P.<sup>894</sup> Accumulated E&P for this purpose includes the E&P of the current year undiminished by the current distribution (or other inclusion).<sup>895</sup> Distributions in excess of the accumulated pool of post-1986 undistributed E&P are treated as paid out of pre-1987 accumulated profits and are subject to the ordering principles of pre-1986 Act law.<sup>896</sup>

*Foreign tax credit limitation*

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles).<sup>897</sup> This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income. The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may carry back the excess foreign taxes to the previous taxable year or carry forward the excess taxes to one of the succeeding ten taxable years.<sup>898</sup>

The foreign tax credit limitation is generally applied separately to two different categories of income, passive category income and general category income.<sup>899</sup> Passive category income generally includes investment income such as dividends, interest, rents, and royalties.<sup>900</sup>

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<sup>893</sup> IRC section 78.

<sup>894</sup> IRC section 902(c)(6)(B). E&P computations for these purposes are to be made under U.S. tax principles. IRC sections 902(c)(1) and 964(a).

<sup>895</sup> IRC section 902(c)(1).

<sup>896</sup> IRC section 902(c)(6).

<sup>897</sup> IRC sections 901 and 904.

<sup>898</sup> IRC section 904(c).

<sup>899</sup> IRC section 904(d). Separate foreign tax credit limitations also apply to certain categories of income described in other sections. See, e.g., IRC sections 901(j), 904(h)(10), and 865(h).

<sup>900</sup> IRC section 904(d)(2)(B). Passive income is defined by reference to the definition of foreign personal holding company income in IRC section 954(c), and thus generally includes dividends, interest, rents, royalties, annuities, net gains from certain property or commodities transactions, foreign currency gains, income equivalent to interest, income from notional principal contracts, and income from certain personal service contracts. Exceptions apply for certain rents and royalties derived in an active business and for certain income earned by dealers in securities or other financial instruments. Passive category income also includes amounts that are includible in gross income under IRC section 1293 (relating to PFICs) and dividends received from certain DISCs and FSCs.

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

General category income is generally all income that is not in the passive category. Because the foreign tax credit limitation must be applied separately to income in these two categories, credits for foreign tax imposed on income in one category cannot be used to offset U.S. tax on income in the other category.

Income that would otherwise constitute passive category income is treated as general category income if it is earned by a qualifying financial services entity (and certain other requirements are met).<sup>901</sup> Passive income is also treated as general category income if it is high-taxed income (i.e., if the foreign tax rate is determined to exceed the highest rate of tax specified in IRC section 1 or 11, as applicable).<sup>902</sup> Dividends (and subpart F inclusions), interest, rents, and royalties received from a CFC by a U.S. person are assigned to a separate limitation category by reference to the category of income out of which the dividend or other payment is made.<sup>903</sup> Dividends received by a U.S. person from a foreign corporation that is not a CFC are also categorized on a look-through basis.<sup>904</sup> For purposes of determining the foreign tax credit limitation, IRC section 956 inclusions are treated as dividends.<sup>905</sup>

Under the foreign tax credit limitation rules, the total amount of the credit taken into account cannot exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States (but not in excess of the taxpayer's taxable income) bears to his entire taxable income for the same taxable year.

New Federal Law (IRC section 960)

The provision imposes a limit on the amount of foreign taxes that a U.S. Shareholder is deemed to pay with respect to any IRC section 956 inclusion.

For IRC section 956 inclusions attributable to United States property acquired by a CFC after August 10, 2010, the amount of foreign taxes deemed paid in each separate category is determined by comparing the foreign taxes deemed paid with respect to the U.S. Shareholder's IRC section 956 inclusion (determined without regard to the provision) (the "tentative credit") to its hypothetical amount of foreign taxes deemed paid as computed under the provision (the "hypothetical credit"). The U.S. Shareholder's hypothetical credit is the amount of foreign taxes it would have been deemed to have paid if cash in an amount equal to the IRC section 956 inclusion had been distributed through the chain of ownership that begins with the foreign corporation that holds the investment in United States property and ends with the U.S. Shareholder. If the hypothetical credit is less than the tentative credit, then the amount of foreign

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<sup>901</sup> IRC section 904(d)(2)(C), (D).

<sup>902</sup> IRC section 904(d)(2)(F).

<sup>903</sup> IRC section 904(d)(3).

<sup>904</sup> IRC section 904(d)(4).

<sup>905</sup> IRC section 904(d)(3)(G).

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

taxes deemed paid with respect to the IRC section 956 inclusion is limited to the hypothetical credit. However, the amount of the tentative credit is not increased if the hypothetical credit would have been greater than the tentative credit. This limitation applies whether the U.S. shareholder chooses to claim a credit<sup>906</sup> for foreign taxes paid or accrued, or to deduct such taxes.<sup>907</sup>

In general, present-law foreign tax credit rules apply in determining the hypothetical credit. The only exception is that, to the extent an actual distribution would be subject to any income or withholding tax, such taxes are not taken into account in determining the hypothetical credit.<sup>908</sup> Thus, the generally applicable rules and definitions<sup>909</sup> apply to each hypothetical distribution.

For example, assume that, for the relevant tax year, and before taking into account the hypothetical distribution under the provision, a U.S. parent (“USP”) owns all of the vote and value of CFC1, a CFC organized in Country A with post-1986 undistributed earnings of 200u, and post-1986 foreign income taxes of \$10.<sup>910</sup> CFC1 owns all of the vote and value of CFC2, a CFC organized in Country B with post-1986 undistributed earnings of 100u, and post-1986 foreign income taxes of \$50. If CFC2 makes a loan to USP that results in an IRC section 956 inclusion of 100u, the tentative credit is \$50 (equal to 100u/100u x \$50).

The hypothetical distribution of 100u from CFC2 to CFC1 would increase CFC1’s current E&P by 100u, from 200u to 300u, and increase CFC1’s foreign income taxes from \$10 to \$60. The 100u hypothetical distribution results in a dividend of 100u that is non-subpart F income of CFC1 under the subpart F look-through rules.<sup>911</sup> Although Country B would impose a ten-percent withholding tax on an actual distribution of 100u to CFC1, for a total withholding tax of 10u, this amount is not taken into account in determining the hypothetical credit. Next, the 100u hypothetical distribution from CFC1 to USP would result in a dividend of 100u, on which USP would be deemed to have

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<sup>906</sup> IRC section 901.

<sup>907</sup> IRC section 164(a)(3).

<sup>908</sup> Similarly, if this hypothetical distribution would be subject to a withholding tax upon distribution to USP, if it had been actually made, any such tax would not be taken into account in determining the hypothetical credit. However, this conclusion results because such taxes are described in IRC section 901(b), thus they are outside the scope of the provision.

<sup>909</sup> See, e.g., IRC sections 902(b), (c), and 904(d)(3)(B), (D).

<sup>910</sup> For purposes of this example, assume that each CFC has: (1) a “u” functional currency; (2) E&P comprising solely post-1986 undistributed earnings or deficits in post-1986 undistributed earnings, such that there are no pre-1987 accumulated profits; (3) only post-1986 foreign income taxes; (4) no previously-taxed income; (5) only E&P and foreign income taxes in the IRC section 904(d) general category; and (6) no other attributes than those listed. Except as provided in the example, there are no other distributions or inclusions during the taxable year. In addition, Country B imposes a 10-percent withholding tax on dividend payments to foreign shareholders.

<sup>911</sup> IRC section 954(c)(6). This assumes that the subpart F look-through rules of IRC section 954(c)(6) are extended, and are therefore applicable to the hypothetical distribution. In the event the look-through rule of IRC section 954(c)(6) expires, the 100u hypothetical distribution would result in a dividend of 100u that would be currently included in USP’s income as a subpart F item at the level of CFC1.

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

paid \$20 in taxes.<sup>912</sup> Because the hypothetical credit of \$20 is less than the tentative credit of \$50, USP's foreign taxes deemed paid with respect to its IRC section 956 inclusion are limited to \$20. USP's IRC section 78 gross-up with respect to the IRC section 956 inclusion is also \$20.<sup>913</sup>

The provision is applied with regard to earnings and taxes in each separate category. In addition, treatment of any foreign taxes over the limit imposed under the provision (the "excess taxes") is the same as the treatment of any other foreign taxes paid or accrued, but not yet deemed paid for purposes of the foreign tax credit rules. Thus, if a foreign corporation's excess taxes are in its general category post-1986 foreign income taxes pool, the foreign corporation's excess taxes are still considered general category post-1986 foreign income taxes.<sup>914</sup>

Accordingly, such taxes are included in the computation of foreign taxes deemed paid with respect to a subsequent distribution from, or income inclusion with respect to, that foreign corporation, subject to applicable limitations including the limitation of the provision. In the example above, excess taxes that remain at CFC2 equal \$30.<sup>915</sup>

The provision applies to United States property acquired by a CFC after December 31, 2010. Thus, for example, any IRC section 956 inclusions from a CFC loan that was made to its U.S. parent on or before December 31, 2010 would not be subject to the limitation imposed by the provision. However, the limitation imposed by the provision would apply if, after December 31, 2010, there is a significant modification of the debt instrument such that the original debt instrument is considered as exchanged for a modified instrument that differs materially from the original.<sup>916</sup>

The provision requires the Secretary to issue regulations or guidance to carry out the purposes of the provision, including regulations that prevent the inappropriate use of the foreign corporation's foreign income taxes not deemed paid by reason of the provision. It is anticipated that guidance

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<sup>912</sup> The hypothetical amount of foreign taxes deemed paid equals  $(100u/300u) \times \$60$ . The post-1986 undistributed earnings that is the denominator of the IRC section 902(a) fraction for purposes of the provision equals CFC1's post-1986 undistributed earnings of 200u (determined without regard to the provision) plus the amount of the hypothetical dividend from CFC2, 100u.

<sup>913</sup> If, in the same taxable year, CFC1 were also to make an actual distribution of all its accumulated E&P of 200u, the 100u hypothetical distribution from CFC1 to USP would have no impact on the calculation of USP's actual deemed paid credit from CFC1's actual dividend. The deemed-paid credit on the 200u dividend would be \$10, which equals  $(200u/200u \times \$10)$ . In addition, the calculation of the hypothetical credit with respect to the hypothetical distribution of 100u from CF2 would be the same  $(100u/300u \times \$60 = \$20)$  whether or not CFC1 paid an actual dividend.

<sup>914</sup> IRC section 902(c)(2).

<sup>915</sup> The excess taxes equal the deemed paid foreign tax credit (determined without regard to the provision) of \$50 minus the hypothetical credit of \$20. Alternatively, if CFC2's E&P also included 125u in previously taxed income, then the excess taxes remaining at CFC2 would be \$50, because the applicable ordering rules would prioritize the hypothetical distribution as coming first from the 125u in previously taxed income over the 100u in untaxed earnings. See IRC section 959(c).

<sup>916</sup> See Treas. Reg. section 1.1001-3.

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

will prohibit the inappropriate use of excess taxes, and will address attempted avoidance of the provision through a series of transactions.

Effective Date

The provision is effective for acquisitions of United States property after December 31, 2010.

California Law (None)

California does not allow a foreign tax credit.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
215	Special Rule with Respect to Certain Redemptions by Foreign Subsidiaries

Background

Under IRC section 304, if one corporation (the “acquiring corporation”) purchases stock of a related corporation (the “target corporation”) in exchange for property, the transaction generally is re-characterized as a redemption. To the extent an IRC section 304(a)(1) transaction is treated as a distribution under IRC section 301, the transferor and the acquiring corporation are treated as if the transferor had transferred the stock of the target corporation to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which IRC section 351(a) applies and the acquiring corporation had then transferred the property to the transferor in redemption of the stock it is deemed as having issued.<sup>917</sup> In the case of an IRC section 304 transaction, the amount and the source of a dividend are determined as if the property were distributed by the acquiring corporation to the extent of its earnings and profits (“E&P”), and then by the target corporation to the extent of its E&P.<sup>918</sup> To the extent the dividend is sourced from the E&P of the acquiring corporation, the transferor is considered to receive the dividend directly from the acquiring corporation;<sup>919</sup> this is commonly referred to as “hop scotching” because the dividend bypasses any intermediary shareholders.

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<sup>917</sup> IRC section 304(a)(1).

<sup>918</sup> IRC section 304(b)(2).

<sup>919</sup> See H.R. Rep. No. 98-861 (1984) (Conf. Rep.), 1222-1224; Rev. Rul. 80-189, 1980-2 C.B. 106.

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

Special rules apply if the acquiring corporation is foreign.<sup>920</sup> For purposes of determining the amount of the dividend to the transferor, the foreign acquiring corporation's E&P that is taken into account is limited to the portion of such E&P that is attributable to stock of the foreign acquiring corporation held by a corporation or individual who is the transferor (or a person related thereto) of the target corporation and who is a U.S. shareholder<sup>921</sup> of the foreign acquiring corporation and that was accumulated while such stock was owned by the transferor (or a person related thereto) and while the foreign acquiring corporation was a controlled foreign corporation ("CFC").<sup>922</sup>

IRC section 1442 generally requires a 30-percent gross basis tax to be withheld on dividend payments to foreign persons unless reduced or eliminated pursuant to an applicable income tax treaty.

New Federal Law (IRC section 304)

The provision generally imposes an additional limitation on the E&P of a foreign acquiring corporation that is taken into account in determining the amount (and source) of the distribution that is treated as a dividend.

Under the provision, if more than 50 percent of the dividends arising from acquisition would (without taking into account the provision) not be subject to U.S. tax in the year in which the dividend arises or includible in the E&P of a CFC,<sup>923</sup> then the E&P of the foreign acquiring corporation is not taken into account for this purpose.<sup>924</sup>

If it is determined that the special rule applies, none of the foreign acquiring corporation's E&P is taken into account. In such case, the only E&P that is taken into account to determine the amount constituting a dividend is the target corporation's E&P. The provision prevents the foreign acquiring corporation's E&P from permanently escaping U.S. taxation by being deemed to be distributed directly to a foreign person (i.e., the transferor) without an intermediate distribution to a domestic corporation in the chain of ownership between the acquiring corporation and the transferor corporation. Generally, if the transferor is a foreign corporation (and not a CFC) and the acquiring corporation is a CFC, it is not relevant whether the target corporation is a domestic or a foreign corporation. However, if the target is a U.S. corporation, the 30-percent gross basis withholding tax applies to the amount constituting a dividend from the target, unless reduced or eliminated by treaty.<sup>925</sup>

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<sup>920</sup> IRC section 304(b)(5).

<sup>921</sup> As that term is defined by IRC section 951(b).

<sup>922</sup> See IRC section 304(b)(5).

<sup>923</sup> For purposes of this rule, "CFC" is defined by reference to IRC section 957, but without regard to IRC section 953(c).

<sup>924</sup> It is not intended that the provision apply if an amount is not subject to tax under this chapter for the taxable year in which the dividend arises solely as a result of the application of IRC section 959.

<sup>925</sup> IRC section 1442; Rev. Rul. 92-85; 1992-2 C.B. 69.

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

It is anticipated that regulations will provide rules to prevent the avoidance of the provision, including through the use of partnerships, options, or other arrangements to cause a foreign corporation to be treated as a CFC.

Effective Date

The provision is effective for acquisitions after August 10, 2010.

California Law (R&TC sections 24451, 25110, and 25116)

Water's Edge

Certain controlled foreign corporations (CFCs) affiliated with corporations doing business in California that have a water's-edge election in force are required to use federal rules to determine United States source income, including rules for CFCs. The income and apportionment factors of a CFC included within a water's-edge combined report are the CFC's net income and apportionment factors determined under California law multiplied by the ratio of federal Subpart F income<sup>926</sup> over federal earnings and profits.<sup>927</sup>

Worldwide Combined Reporting

With respect to corporations other than water's-edge corporations, California uses the worldwide combined reporting method of determining the income subject to California tax. Under this filing method, California law generally conforms to IRC section 304 as of the "specified date" of January 1, 2009. Thus, under this filing method, California does not conform to this provision.

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<sup>926</sup> As defined in IRC section 952.

<sup>927</sup> As defined in IRC section 964.

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

Impact on California Revenue

Water's Edge

Baseline—baseline revenue gains are estimated to be \$600,000 in 2011-12, \$400,000 in 2012-13, and \$300,000 in 2013-14.

Worldwide Combined Reporting

Estimated Revenue Impact of Special Rule with Respect to Certain Redemptions by Foreign Subsidiaries For Taxable Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
\$600,000	\$400,000	\$400,000

Estimates are based on a proration of federal estimates developed by the Joint Committee on Taxation.

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<u>Section</u>	<u>Section Title</u>
216	Modification of Affiliation Rules for Purposes of Rules Allocating Interest Expense

Background

The United States employs a worldwide tax system under which U.S. resident individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad; the foreign tax credit provides relief from double taxation. The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source income, in order 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.<sup>928</sup>

To compute the foreign tax credit limitation, a taxpayer must determine the amount of its taxable income from foreign sources by allocating and apportioning deductions between items of U.S.-source gross income, on the one hand, and items of foreign-source gross income, on the other. There are no specific rules for most types of deductions.<sup>929</sup> Specific provisions govern the allocation and apportionment of interest.<sup>930</sup>

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<sup>928</sup> IRC sections 901 and 904.

<sup>929</sup> See, e.g., IRC sections 861(b), 862(b), and 863(a), that require that a taxpayer properly allocate and apportion expenses, losses, or other deductions, without containing any specific rules for allocating and apportioning particular types of deductions.

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

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.<sup>931</sup>

#### Foreign Corporations Owned by an Affiliated Group of Corporations

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.<sup>932</sup> These rules exclude all foreign corporations from an affiliated group.<sup>933</sup> 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.

Under Treasury regulations, however, certain foreign corporations are treated as affiliated corporations, in certain respects, if at least 80 percent of either the vote or value of the corporation’s outstanding stock is owned directly or indirectly by members of an affiliated group, and more than 50 percent of the corporation’s gross income for the taxable year is effectively connected with the conduct of a U.S. trade or business (also known as effectively-connected income).<sup>934</sup>

In the case of a foreign corporation that is treated as an affiliated corporation for interest allocation and apportionment purposes, the percentage of its assets and income that is taken into

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<sup>930</sup> IRC section 864(e). In the case of interest expense, the rules generally are based on the premise 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. Temp. Reg. section 1.861-9T(a).

<sup>931</sup> IRC sections 864(e)(1) and 864(e)(2).

<sup>932</sup> IRC sections 864(e)(5)(A) and 1504. The affiliated group for interest-allocation purposes generally excludes certain corporations that are financial institutions. These corporate financial institutions are not treated as members of the regular affiliated group for purposes of applying the one-taxpayer rule to other non-financial members of that group. Instead, all such corporate financial institutions that would be so affiliated are treated as a separate single corporation for interest allocation purposes. IRC section 864(e)(5)(B).

<sup>933</sup> IRC section 1504(b)(3).

<sup>934</sup> Temp. Reg. section 1.861-11T(d)(6)(ii). The question as to whether a foreign person is engaged in a U.S. trade or business has generated a significant body of case law. Basic issues involved in the determination include whether the activity constitutes business rather than investing, whether sufficient activities in connection with the business are conducted in the United States, and whether the relationship between the foreign person and persons performing functions in the United States with respect to the business is sufficient to attribute those functions to the foreign person. Generally, only U.S.-source income is treated as effectively connected with the conduct of a U.S. trade or business. However, certain limited categories of foreign-source income are treated as effectively connected if the income is attributable to an office or other fixed place of business maintained by the foreign person in the United States. IRC section 864(c).

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

account varies depending on the percentage of the corporation's gross income that is effectively-connected income. If 80 percent or more of the foreign corporation's gross income is effectively-connected income, then all the corporation's assets and interest expense are taken into account. If, instead, between 50 percent and 80 percent of the foreign corporation's gross income is effectively-connected income, then only the corporation's assets that generate effectively-connected income and a percentage of its interest expense equal to the percentage of its assets that generate effectively-connected income are taken into account.<sup>935</sup>

New Federal Law (IRC section 864)

The provision treats a foreign corporation as a member of an affiliated group, for interest allocation and apportionment purposes, if more than 50 percent of the gross income of such foreign corporation for the taxable year is effectively-connected income, and at least 80 percent of either the vote or value of all outstanding stock of such foreign corporation is owned directly or indirectly by members of the affiliated group (determined with regard to this sentence). Thus, under the provision, if more than 50 percent of a foreign corporation's gross income is effectively-connected income and at least 80 percent of either the vote or value of all outstanding stock of such foreign corporation is owned directly or indirectly by members of the affiliated group, then all of the foreign corporation's assets and interest expense are taken into account for the purposes of allocating and apportioning the interest expense of the affiliated group.

Effective Date

The provision applies to taxable years beginning after August 10, 2010.

California Law (R&TC sections 24344, 24425, 25101.15 and 25510)

Water's Edge

Certain controlled foreign corporations (CFCs) affiliated with corporations doing business in California that have a water's-edge election in force are required to use federal rules to determine United States source income, including rules for CFCs. The income and apportionment factors of a CFC included within a water's-edge combined report are the CFC's net income and apportionment factors determined under California law multiplied by the ratio of federal Subpart F income<sup>936</sup> over federal earnings and profits.<sup>937</sup>

Worldwide Combined Reporting

With respect to corporations other than water's-edge corporations, California uses the worldwide combined reporting method of determining the income subject to California tax. Under this filing

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<sup>935</sup> Temp. Reg. section 1.861-11T(d)(6)(ii).

<sup>936</sup> As defined in IRC section 952.

<sup>937</sup> As defined in IRC section 964.

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

method, California does not conform to IRC section 864(e), and instead its own corporate interest-expense rules.

Impact on California Revenue

Water's Edge

Baseline—baseline revenue gains are estimated to be \$4,500,000 in 2011-12, \$1,500,000 in 2012-13, and \$200,000 in 2012-13.

Worldwide Combined Reporting

Not applicable.

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<u>Section</u>	<u>Section Title</u>
217	Termination of Special Rules for Interest and Dividends Received from Persons Meeting the 80-Percent Foreign Business Requirements

Background

The source of interest and dividend income generally is determined by reference to the country of residence of the payor.<sup>938</sup> Thus, an interest or dividend payment from a U.S. payor to a foreign person generally is treated as U.S.-source income and is subject to the 30-percent gross-basis U.S. withholding tax.<sup>939</sup> However, if a resident alien individual or domestic corporation satisfies an 80-percent active foreign business income requirement (the “80/20 test”), all or a portion of any interest paid by the resident alien individual or the domestic corporation (a so-called “80/20 company”) is exempt from U.S. withholding tax. Interest paid by a resident alien individual that satisfies the 80/20 test or by an 80/20 company is treated as foreign-source income and is therefore exempt from the 30-percent withholding tax if it is paid to unrelated parties.<sup>940</sup> When a resident alien individual or 80/20 company pays interest to a related party, the resourcing rule applies only to the percentage of the interest that is equal to the percentage of the resident alien individual’s or 80/20 company’s foreign-source income (described below) as a portion of the resident alien individual’s or 80/20 company’s total gross income during the three-year testing period (a so-called “look-through” approach).<sup>941</sup>

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<sup>938</sup> IRC sections 861(a)(1), (2) and 862(a)(1), (2).

<sup>939</sup> IRC sections 871(a)(1)(A), 881(a)(1), 1441(b), and 1442(a).

<sup>940</sup> IRC section 861(a)(1)(A).

<sup>941</sup> IRC section 861(c)(2).

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

In addition to interest, all or part of a dividend paid by an 80/20 company may also be exempt from U.S. withholding tax. The percentage of the dividend paid by an 80/20 company that equals the percentage of the 80/20 company's total gross income during the testing period that is foreign source is exempt from U.S. withholding tax.<sup>942</sup> Unlike interest, a dividend paid by an 80/20 company remains U.S. source (for example, for foreign tax credit limitation purposes).

In general, a resident alien individual or domestic corporation meets the 80/20 test if at least 80 percent of the gross income of the resident alien individual or corporation during the testing period is derived from foreign sources and is attributable to the active conduct of a trade or business in a foreign country (or a U.S. possession) by the resident alien individual or corporation or, in the case of a corporation, a 50-percent owned subsidiary of that corporation. The testing period generally is the three-year period preceding the year in which the interest or dividend is paid.<sup>943</sup>

New Federal Law (IRC sections 861, 871, 904, and 2104)

The provision repeals the present-law rule that treats as foreign-source all or a portion of any interest paid by a resident alien individual or domestic corporation that meets the 80/20 test. The provision also repeals the present-law rule that exempts from U.S. withholding tax all or a portion of any dividends paid by a domestic corporation that meets the 80/20 test.

The provision provides a grandfather rule for any domestic corporation that: (1) meets the 80/20 test (as in effect before August 10, 2010) (hereinafter "the present law 80/20 test") for its last taxable year beginning before January 1, 2011 ("an existing 80/20 company"); (2) meets a new 80/20 test with respect to each taxable year beginning after December 31, 2010; and (3) has not added a substantial line of business with respect to such corporation after August 10, 2010. Any payment of dividend or interest after December 31, 2010 by an existing 80/20 company that meets the grandfather rule is exempt from withholding tax to the extent of the existing 80/20 company's active foreign business percentage. Nonetheless, any payment of interest will be treated as U.S.-source income.

As with the present law 80/20 test, a corporation meets the 80-percent foreign business requirements of the 80/20 test under the grandfather rule if it is shown to the satisfaction of the Secretary that at least 80-percent of the gross income from all sources of such corporation for the testing period is active foreign business income. This percentage—active foreign business income of the company for the testing period as a percentage of total gross income of the company for the testing period—is also the company's active foreign business percentage for purposes of determining the portion of any dividend or interest paid by an existing 80/20 company that is exempt from withholding tax. However, except as modified by the transition rule below, the existing 80/20 company and all of its subsidiaries are aggregated and treated as one corporation.

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<sup>942</sup> IRC section 871(i).

<sup>943</sup> IRC section 861(c)(1). The income of a subsidiary is attributed to the tested company only to the extent that the tested company actually receives income from the subsidiary in the form of dividends. *Conference Report to the 1986 Tax Reform Act*, Public Law 99-514, Vol. II, 602; see also Rev. Rul. 73-63, 1973-1 C.B. 336; P.L.R. 6905161160A (May 16, 1969).

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

For this purpose, a subsidiary means any corporation in which the existing 80/20 company owns (directly or indirectly) stock meeting the requirements of IRC section 1504(a)(2), determined by substituting 50 percent for 80 percent and without regard to IRC section 1504(b)(3). As a result, an existing 80/20 company must take into account the gross income of any domestic or foreign subsidiary. The Secretary may issue guidance as is necessary or appropriate to carry out the purpose of this provision, including guidance providing for the proper application of the aggregation rules.

Under the 80/20 test provided by the grandfather rule, the testing period is the three-year period ending with the close of the taxable year of the corporation preceding the payment (or such part of such period as may be applicable). If the corporation has no gross income for such three-year period (or part thereof), the testing period is the taxable year in which the payment is made.

The grandfather rule includes a transition rule that applies in the case of any taxable year for which the testing period includes one or more taxable years beginning before January 1, 2011. Under this transition rule, a corporation meets the 80-percent foreign business requirements if, and only if, the weighted average of: (1) the percentage of the corporation's gross income from all sources that is active foreign business income (as defined in subparagraph (B) of IRC section 861(c)(1) (as in effect before August 10, 2010)) for the portion of the testing period that includes taxable years beginning before January 1, 2011;<sup>944</sup> and (2) the percentage of the corporation's gross income from all sources that is active foreign business income for the portion of the testing period, if any, that includes taxable years beginning on or after January 1, 2011, is at least 80 percent. Accordingly, this transition rule applies instead of the new 80/20 test for the relevant tax years. This weighted average percentage is also treated as the active foreign business percentage for purposes of determining the amount of withholding for such taxable years

The following example illustrates the operation of this transition rule. Assume a domestic corporation has \$100 of active foreign business income and no other income on a separate company basis (i.e., without regard to the income of any affiliate) for each of the 2008, 2009, and 2010 tax years. For the 2011, 2012, and 2013 tax years, the domestic company has \$700 of active foreign business income and \$300 of other income on an aggregate basis (including the income of its 50-percent owned domestic and foreign subsidiaries). Under the provision, the domestic company's weighted average percentage for the 2011 tax year is 100 percent, determined by considering the 2008, 2009, and 2010 tax years on a separate-company basis  $((\$100 + \$100 + \$100)/(\$100 + \$100 + \$100))$ . Therefore, for the 2011 tax year, the domestic company meets the 80-percent active foreign business requirements, and its active foreign business percentage is 100 percent for the 2011 tax year.

For the 2012 tax year, the weighted average percentage is 90 percent, determined by considering the 2009 and 2010 tax years on a separate company basis  $(((\$100 + \$100)/(\$100 + \$100) \times 2/3))$  or 66.7 percent) and the 2011 tax year on an aggregate basis  $(((\$700/\$1,000) \times 1/3))$  or 23.3 percent). As a result, the domestic company meets the 80-percent active foreign business requirements, and its active foreign business percentage is 90 percent for the 2012 tax year.

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<sup>944</sup> Hence, this percentage is determined without application of the new aggregation rule.

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

For the 2013 tax year, the weighted average percentage is 80 percent, determined by considering the 2010 tax year on a separate company basis ( $((\$100/\$100) \times 1/3)$  or 33.3 percent) and the 2011 and 2012 tax years on an aggregate basis ( $((\$700 + \$700)/(\$1,000 + \$1,000) \times 2/3)$  or 46.7 percent). Therefore, for the 2013 tax year, the domestic company meets the 80-percent active foreign business requirements, and its active foreign business percentage is 80 percent.

For the 2014 tax year, the transition rule does not apply since none of the years within the three-year testing period begin before January 1, 2011. As a result, the domestic company does not meet the 80-percent foreign business requirements for the 2014 tax year since only 70 percent ( $(\$700 + \$700 + \$700)/(\$1,000 + \$1,000 + \$1,000)$ ) of its gross income from all sources for the testing period is active foreign business income.

An existing 80/20 company does not meet the grandfather rule if there has been an addition of a substantial line of business with respect to such corporation after the date of enactment of this provision. For purposes of determining whether a substantial line of business has been added, rules similar to those of IRC section 7704(g) and the Treasury regulations thereunder (relating to certain publicly-traded partnerships treated as corporations) apply. It is anticipated that the Secretary will issue guidance providing that the acquisition of foreign operating assets or stock of a foreign corporation by the existing 80/20 company for the purpose of increasing its active foreign business percentage will be treated as the addition of a substantial line of business.

#### Effective Date

The provision is effective for taxable years beginning after December 31, 2010. The repeal of the 80/20 company provisions relating to the payment of interest does not apply to payments of interest to persons not related to the 80/20 company (applying rules similar to those of IRC section 954(d)(3)) on obligations issued before the date of enactment.<sup>945</sup> For this purpose, a significant modification of the terms of any obligation (including any extension of the term of such obligation) is treated as the issuance of a new obligation.

#### California Law (R&TC sections 25101.15 and 25510)

#### Water's Edge

Certain controlled foreign corporations (CFCs) affiliated with corporations doing business in California that have a water's-edge election in force are required to use federal rules to determine United States source income, including rules for CFCs. The income and apportionment factors of

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<sup>945</sup> A person will be treated as a related person with respect to a controlled foreign corporation if (A) such person is an individual, corporation, partnership, trust or estate which controls, or is controlled by, the controlled foreign corporation, or (B) such person is a corporation, partnership, trust or estate which is controlled by the same person or persons which control the resident controlled foreign corporation. For purposes of the preceding sentence, control means, with respect to a corporation, the ownership, directly or indirectly, of stock possessing more than 50 percent of the total voting power of all classes of stock entitled to vote or of the total value of stock of such corporation. In the case of a partnership, trust, or estate, control means the ownership, directly or indirectly, of more than 50 percent (by value) of the beneficial interests in such partnership, trust, or estate. For purposes of this paragraph, rules similar to the rules of IRC section 958 shall apply. IRC section 954(d)(3).

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

a CFC included within a water's-edge combined report are the CFC's net income and apportionment factors determined under California law multiplied by the ratio of federal Subpart F income<sup>946</sup> over federal earnings and profits.<sup>947</sup> California does not conform to the federal withholding rules.

#### Worldwide Combined Reporting

With respect to corporations other than water's-edge corporations, California uses the worldwide combined reporting method of determining the income subject to California tax. Under this filing method, California does not conform to federal sourcing or withholding rules.

#### Impact on California Revenue

##### Water's Edge

Baseline.

##### Worldwide Combined Reporting

Not applicable.

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<u>Section</u>	<u>Section Title</u>
218	Limitation on Extension of Statute of Limitations for Failure to Notify Secretary of Certain Foreign Transfers

#### Background

Taxes are generally required to be assessed within three years after a taxpayer's return is filed, whether or not it was timely filed.<sup>948</sup> In the case of a false or fraudulent return filed with the intent to evade tax, or if the taxpayer fails to file a required return, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time.<sup>949</sup> The limitation period also may be extended by taxpayer consent.<sup>950</sup> If a taxpayer engages in a

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<sup>946</sup> As defined in IRC section 952.

<sup>947</sup> As defined in IRC section 964.

<sup>948</sup> IRC section 6501(a). Returns that are filed before the date they are due are deemed filed on the due date. See IRC section 6501(b)(1) and (2).

<sup>949</sup> IRC section 6501(c).

<sup>950</sup> IRC section 6501(c)(4).

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

listed transaction but fails to include any of the information required under IRC section 6011 on any return or statement for a taxable year, the limitation period with respect to such transaction will not expire before the date which is one year after the earlier of: (1) the date on which the Secretary is provided the information so required; or (2) the date that a “material advisor” (as defined in IRC section 6111) makes its IRC section 6112(a) list available for inspection pursuant to a request by the Secretary under IRC section 6112(b)(1)(A).<sup>951</sup> In addition to the exceptions described above, there are also circumstances under which the three-year limitation period is suspended.<sup>952</sup>

IRC section 6501(c)(8) provides an exception to the three-year period of limitations due to failures to provide information about cross-border transactions or foreign assets. Under this exception, as amended by the Hiring Incentives to Restore Employment Act,<sup>953</sup> the limitation period for assessment of tax does not expire any earlier than three years after the required information about certain cross-border transactions or foreign assets is actually provided to the Secretary by the person required to file the return.<sup>954</sup>

In general, such information reporting is due with the taxpayer’s return; thus, the three-year limitation period commences when a timely and complete return (including all information reporting) is filed. Without the inclusion of the information reporting with the return, the limitation period does not commence until such time as the information reports are subsequently provided to the Secretary, even though the return has been filed. The taxes that may be assessed during this suspended or extended period are not limited to those attributable to adjustments to items related to the information required to be reported by one of the enumerated sections.

New Federal Law (IRC section 6501)

The provision modifies the scope of the exception to the limitations period if a failure to provide information on cross-border transactions or foreign assets is shown to be due to reasonable cause and not willful neglect. In the absence of reasonable cause or the presence of willful neglect, the suspension of the limitations period and the subsequent three-year period that begins after information is ultimately supplied apply to all issues with respect to the income tax return. In cases in which a taxpayer establishes reasonable cause, the limitations period is suspended only for the item or items related to the failure to disclose. To prove reasonable cause, it is anticipated

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<sup>951</sup> IRC section 6501(c)(10).

<sup>952</sup> For example, service of an administrative summons triggers the suspension either (1) beginning six months after service (in the case of John Doe summonses) or (2) when a proceeding to quash a summons is initiated by a taxpayer named in a summons to a third-party record-keeper. Judicial proceedings initiated by the government to enforce a summons generally do not suspend the limitation period.

<sup>953</sup> Section 513, Public Law 111-147.

<sup>954</sup> Required information reporting subject to this three-year rule is reporting under IRC sections 6038 (certain foreign corporations and partnerships), 6038A (certain foreign-owned corporations), 6038B (certain transfers to foreign persons), 6038D (individuals with foreign financial assets), 6046 (organizations, reorganizations, and acquisitions of stock of foreign corporations), 6046A (interests in foreign partnerships), and 6048 (certain foreign trusts), as well as information required with respect to elections under IRC section 1295(b) passive foreign investment corporations.

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

that a taxpayer must establish that the failure was objectively reasonable (i.e., the existence of adequate measures to ensure compliance with rules and regulations), and in good faith.

For example, the limitations period for assessing taxes with respect to a tax return filed on March 31, 2011, ordinarily expires on March 31, 2014. In order to assess tax with respect to any issue on the return after March 31, 2014, the IRS must be able to establish that one of the exceptions applies. If the taxpayer fails to attach to that return one of multiple information returns required, the limitations period does not begin to run unless and until that missing information return is supplied. Assuming that the missing report is supplied to the IRS on January 1, 2013, the limitations period for the entire return begins, and elapses no earlier than three years later, on January 1, 2016. All items are subject to adjustment during that time, unless the taxpayer can prove that reasonable cause for the failure to file existed. If the taxpayer establishes reasonable cause, the only adjustments to tax permitted after March 31, 2014, are those related to the failure to file the information return. For this purpose, related items include: (1) adjustments made to the tax consequences claimed on the return with respect to the transaction that was the subject of the information return; (2) adjustments to any item to the extent the item is affected by the transaction even if it is otherwise unrelated to the transaction; and (3) interest and penalties that are related to the transaction or the adjustments made to the tax consequences.

#### Effective Date

The provision is effective as if included in section 513 of the Hiring Incentives to Restore Employment Act.<sup>955</sup> Thus, the provision applies for returns filed after March 18, 2010, the date of enactment of that Act, as well as for any other return for which the assessment period specified in IRC section 6501 had not yet expired as of that date.

#### California Law (R&TC sections 19057, 19058, 19061, 19063, 19065, 19066, 19066.5, and 19067)

California does not conform to IRC section 6501, but instead has its own statute-of-limitation rules for tax assessments.

#### Impact on California Revenue

Baseline.

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<sup>955</sup> Public Law 111-147.

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

<u>Section</u>	<u>Section Title</u>
219	Elimination of Advance Refundability of Earned Income Credit

Background

Low- and moderate-income workers may be eligible for the refundable earned income tax credit (“EITC”). Eligibility for the EITC is based on earned income, adjusted gross income, investment income, filing status, number of qualifying children and immigration, and work status in the United States. The amount of the EITC 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.

The EITC generally equals a specified percentage of earned income<sup>956</sup> up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phase-out range. For taxpayers with earned income (or AGI, if greater) in excess of the beginning of the phase-out range, the maximum EITC amount is reduced by the phase-out rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phase-out range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phase-out range, no credit is allowed.

The EITC is a refundable credit, meaning that if the amount of the credit exceeds the taxpayer’s federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment. Under an advance payment system, eligible taxpayers may elect to receive the credit in their paychecks, rather than waiting to claim a refund on their tax returns filed by April 15 of the following year.

Advance Payment System

Under the advance payment system, available since 1979, eligible taxpayers may elect to receive the credit in their paychecks, rather than waiting to claim a refund on their tax return filed by April 15 of the following year. This means that the taxpayer’s paycheck is adjusted to include not only the nonrefundable portion of the EITC (i.e., by reducing otherwise applicable tax liability) but also a portion of the refundable EITC (i.e., an outlay rather than a reduction in otherwise applicable tax liability). The portion of the EITC eligible for advance payment is limited to 60 percent of the maximum EITC for one qualifying child. A taxpayer electing the advance payment option is required to file a tax return for the taxable year (regardless of the otherwise applicable filing thresholds) in order to reconcile any advance payment with the actual allowable EITC.

Beginning in 1993, Congress required the IRS to notify eligible taxpayers of the advance payment option, but participation in the advance payment option has remained limited to a small percentage of eligible taxpayers.

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<sup>956</sup> 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.

STATE FISCAL RELIEF AND OTHER PROVISIONS; REVENUE OFFSETS  
Title II of Public Law 111-226, August 10, 2010

New Federal Law (IRC sections 32, 3501, 6012, 6051, and 6302)

The provision repeals the advance payment option for the EITC. The taxpayer may still receive the nonrefundable portion of the EITC through the taxpayer's paycheck, by adjusting withholding, to the extent the taxpayer otherwise has positive tax liability.

Effective Date

The provision is effective for taxable years beginning after December 31, 2010.

California Law (None)

California does not conform to the federal EITC.

Impact on California Revenue

Not applicable.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

<u>Section</u>	<u>Section Title</u>
2011	Temporary Exclusion of 100 Percent of Gain on Certain Small Business Stock

Background

In General

Individuals generally may exclude 50 percent (60 percent for certain empowerment zone businesses) of the gain from the sale of certain small business stock acquired at original issue and held for at least five years.<sup>957</sup> The amount of gain eligible for the exclusion by an individual with respect to any corporation is the greater of ten times the taxpayer's basis in the stock or \$10 million. To qualify as a small business, when the stock is issued, the gross assets of the corporation may not exceed \$50 million. The corporation also must meet certain active trade or business requirements.

The portion of the gain includible in taxable income is taxed at a maximum rate of 28 percent under the regular tax.<sup>958</sup> A percentage of the excluded gain is an alternative minimum tax preference;<sup>959</sup> the portion of the gain includible in alternative minimum taxable income is taxed at a maximum rate of 28 percent under the alternative minimum tax.

Gain from the sale of qualified small business stock generally is taxed at effective rates of: (a) 14 percent under the regular tax<sup>960</sup> and 14.98 percent under the alternative minimum tax for dispositions before January 1, 2011; (b) 19.88 percent under the alternative minimum tax for dispositions after December 31, 2010, in the case of stock acquired before January 1, 2001; and (c) 17.92 percent under the alternative minimum tax for dispositions after December 31, 2010, in the case of stock acquired after December 31, 2000.<sup>961</sup>

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<sup>957</sup> IRC section 1202.

<sup>958</sup> IRC section 1(h).

<sup>959</sup> IRC section 57(a)(7). In the case of qualified small business stock, the percentage of gain excluded from gross income that is an alternative minimum tax preference is (i) seven percent in the case of stock disposed of in a taxable year beginning before 2011; (ii) 42 percent in the case of stock acquired before January 1, 2001, and disposed of in a taxable year beginning after 2010; and (iii) 28 percent in the case of stock acquired after December 31, 2000, and disposed of in a taxable year beginning after 2010.

<sup>960</sup> The 50 percent of gain included in taxable income is taxed at a maximum rate of 28 percent.

<sup>961</sup> The amount of gain included in alternative minimum tax is taxed at a maximum rate of 28 percent. The amount so included is the sum of: (1) 50 percent (the percentage included in taxable income) of the total gain; and (2) the applicable preference percentage of the one-half gain that is excluded from taxable income.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

### Temporary Increase in Exclusion

The percentage exclusion for qualified small business stock acquired after February 17, 2009, and before January 1, 2011, is increased to 75 percent. As a result of the increased exclusion, gain from the sale of this qualified small business stock held at least five years is taxed at effective rates of seven percent under the regular tax<sup>962</sup> and 12.88 percent under the alternative minimum tax.<sup>963</sup>

### New Federal Law (IRC section 1202)

Under the provision, the percentage exclusion for qualified small business stock acquired during 2010 is increased to 100 percent and the minimum tax preference does not apply. Thus, no regular tax or alternative minimum tax is imposed on the sale of this stock held at least five years.

### Effective Date

The provision is effective for stock issued after September 27, 2010, and before January 1, 2011.

### California Law (R&TC sections 17062, 18152, and 18152.5)

California specifically does not conform to the federal exclusion for gain on qualified small business stock,<sup>964</sup> and instead provides its own exclusion.<sup>965</sup> Under California law, noncorporate taxpayers may exclude from gross income 50 percent of gain from the sale or exchange of California qualified small business stock acquired at original issue and held for more than five years. The amount of gain eligible for the exclusion with respect to any corporation is the greater of ten times the taxpayer's basis in the stock or \$10 million.

California qualified small business stock generally means stock in a C corporation<sup>966</sup> that: (1) has gross assets that do not exceed \$50 million; (2) has at least 80 percent of its payroll attributable to employment located in California; and (3) uses at least 80 percent of the value of its assets in the active conduct of one or more qualified trades or businesses in California.

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<sup>962</sup> The 25 percent of gain included in taxable income is taxed at a maximum rate of 28 percent.

<sup>963</sup> The 46 percent of gain included in alternative minimum tax is taxed at a maximum rate of 28 percent. Forty-six percent is the sum of 25 percent (the percentage of total gain included in taxable income) plus 21 percent (the percentage of total gain which is an alternative minimum tax preference).

<sup>964</sup> R&TC section 18152.

<sup>965</sup> R&TC section 18152.5. The California exclusion generally parallels the federal exclusion under IRC section 1202, with modifications.

<sup>966</sup> The stock must be that of a domestic C corporation that is not a DISC or former DISC, a regulated investment company, a real estate investment trust, a real estate mortgage investment conduit, or a cooperative.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

Unlike federal law, California does not apply a different tax rate to gains on qualified small business stock. However, similar to federal law, the exclusion is a California AMT preference item—50 percent of the excluded gain is a California AMT preference;<sup>967</sup> and, the portion of the gain includible in alternative minimum taxable income is taxed at a maximum rate of seven percent under the California AMT.

Additionally, although California has its own stand-alone exclusion, any regulation issued by the Secretary of Treasury relating federal qualified small business stock applies for California purposes to the extent that California incorporates the federal qualified-small-business-stock rules.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
2012	General Business Credits of Eligible Small Businesses for 2010 Carried Back 5 Years

Background

The general business credit generally may not exceed the excess of the taxpayer's net income tax over the greater of the taxpayer's tentative minimum tax or 25 percent of so much of the taxpayer's net regular tax liability as exceeds \$25,000.<sup>968</sup> General business credits in excess of this limitation may be carried back one year and forward up to 20 years.<sup>969</sup>

New Federal Law (IRC section 39)

The provision extends the carryback period for eligible small business credits from one to five years. Under the provision, eligible small business credits are defined as the sum of the general business credits determined for the taxable year with respect to an eligible small business. An eligible small business is, with respect to any taxable year, a corporation, the stock of which is not publicly traded, or a partnership which meets the gross-receipts test of IRC section 448(c), substituting \$50 million for \$5 million each place it appears.<sup>970</sup> In the case of a sole

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<sup>967</sup> R&TC section 17062(e).

<sup>968</sup> IRC section 38(c). The general business credit is the sum of the credits allowed under IRC section 38(b).

<sup>969</sup> IRC section 39.

<sup>970</sup> For example, a calendar year corporation meets the \$50 million gross receipts test for the 2010 taxable year, if as of January 1, 2010, its average annual gross receipts for the 3-taxable-year period ending December 31, 2009,

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

proprietorship, the gross receipts test is applied as if it were a corporation. Credits determined with respect to a partnership or S corporation are not treated as eligible small business credits by a partner or shareholder unless the partner or shareholder meets the gross receipts test for the taxable year in which the credits are treated as current year business credits.

Effective Date

The provision is effective for credits determined in the taxpayer's first taxable year beginning after December 31, 2009.

California Law (None)

California does not conform to the general business credit limitations under IRC section 38.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
2013	General Business Credits of Eligible Small Businesses in 2010 Not Subject to Alternative Minimum Tax

Background

For any taxable year, the general business credit, which is the sum of the various business credits, generally may not exceed the excess of the taxpayer's net income tax over the greater of the taxpayer's tentative minimum tax or 25 percent of so much of the taxpayer's net regular tax liability as exceeds \$25,000. Any general business credit in excess of this limitation may be carried back one year and forward up to 20 years. The tentative minimum tax is an amount equal to specified rates of tax imposed on the excess of the alternative minimum taxable income over an exemption amount. However, in applying the tax liability limitation to certain specified credits that are part of the general business credit, the tentative minimum tax is treated as being zero.<sup>971</sup> Thus, the specified credits may offset both regular and alternative minimum tax liability.

New Federal Law (IRC sections 38 and 55)

The provision provides that the tentative minimum tax is treated as being zero for eligible small business credits. Thus, an eligible small business credit may offset both regular and alternative minimum tax liability. Under the provision, eligible small business credits are defined as the sum

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does not exceed \$50 million. The aggregation and special rules under IRC sections 448(c)(2) and (3) apply in applying the test.

<sup>971</sup> See IRC section 38(c)(4)(B) for a list of the specified credits.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

of the general business credits determined for the taxable year with respect to an eligible small business. An eligible small business is, with respect to any taxable year, a corporation, the stock of which is not publicly traded, or a partnership, which meets the gross receipts test of IRC section 448(c), substituting \$50 million for \$5 million each place it appears.<sup>972</sup> In the case of a sole proprietorship, the gross receipts test is applied as if it were a corporation. Credits determined with respect to a partnership or S corporation are not treated as eligible small business credits by a partner or shareholder unless the partner or shareholder meets the gross receipts test for the taxable year in which the credits are treated as current year business credits.

Effective Date

The proposal is effective for credits determined in a taxpayer's first taxable year beginning after December 31, 2009.

California Law (None)

California does not conform to the general business credit limitations under IRC section 38.

Impact on California Revenue

Not applicable.

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Section

Section Title

2014

Temporary Reduction in Recognition Period for Built-in Gains Tax

Background

A "small business corporation" (as defined in IRC section 1361(b)) may elect to be treated as an S corporation. Unlike C corporations, S corporations generally pay no corporate-level tax. Instead, items of income and loss of an S corporation pass through to its shareholders. Each shareholder takes into account separately its share of these items on its individual income tax return.<sup>973</sup>

A corporate level tax, at the highest marginal rate applicable to corporations (currently 35 percent) is imposed on an S corporation's gain that arose prior to the conversion of the C corporation to an S corporation and is recognized by the S corporation during the recognition period, i.e., the ten-

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<sup>972</sup> For example, a calendar year corporation meets the \$50 million gross receipts test for the 2010 taxable year, if as of January 1, 2010, if its average annual gross receipts for the three-taxable-year period ending December 31, 2009, does not exceed \$50 million. The aggregation and special rules under IRC sections 448(c)(2) and (3) apply for purposes of the test.

<sup>973</sup> IRC section 1366.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

year period beginning with the first day of the first taxable year for which the S election is in effect.<sup>974</sup> For any taxable year beginning in 2009 and 2010, no tax is imposed on an S corporation under IRC section 1374 if the seventh taxable year in the corporation's recognition period preceded such taxable year.<sup>975</sup> Thus, with respect to gain that arose prior to the conversion of a C corporation to an S corporation, for taxable years beginning in 2009 and 2010, no tax is imposed under IRC section 1374 after the seventh taxable year the S corporation election is in effect.

The built-in gains tax also applies to gains with respect to net recognized built-in gain attributable to property received by an S corporation from a C corporation in a carryover basis transaction.<sup>976</sup> In the case of built-in gain attributable to an asset received by an S corporation from a C corporation in a carryover basis transaction, the recognition period rules are applied by substituting the date such asset was acquired by the S corporation in lieu of the beginning of the first taxable year for which the corporation was an S corporation.<sup>977</sup>

Gains recognized in the recognition period are not built-in gains to the extent they are shown to have arisen while the S election was in effect or are offset by recognized built-in losses. The amount of the built-in gains tax is treated as a loss taken into account by the shareholders in computing their individual income tax.<sup>978</sup>

New Federal Law (IRC section 1374)

For taxable years beginning in 2011, the provision provides that for purposes of computing the built-in gains tax, the "recognition period" is the five-year period<sup>979</sup> beginning with the first day of the first taxable year for which the corporation was an S corporation.

Effective Date

The provision is effective for taxable years beginning after December 31, 2010.

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<sup>974</sup> IRC section 1374(d)(7)(A). The ten-year period refers to ten calendar years from the first day of the first taxable year for which the corporation was an S corporation.

<sup>975</sup> IRC section 1374(d)(7)(B).

<sup>976</sup> IRC section 1374(d)(8). With respect to such assets, the recognition period runs from the day on which such assets were acquired (in lieu of the beginning of the first taxable year for which the corporation was an S corporation). IRC section 1374(d)(8)(B).

<sup>977</sup> Shareholders continue to take into account all items of gain and loss under IRC section 1366.

<sup>978</sup> IRC section 1366(f)(2).

<sup>979</sup> The five-year period refers to five calendar years from the first day of the first taxable year for which the corporation was an S corporation.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

California Law (R&TC sections 17087.5, 23800, and 23809)

California conforms by reference to IRC section 1374, relating to tax imposed on certain built-in gains, as of the "specified date" of January 1, 2009. Because this provision (to temporarily reduce the recognition period for the built-in gains tax) was enacted after the "specified date," California does not conform to it.

Impact on California Revenue

Estimated Revenue Impact of Temporary Reduction in Recognition Period for Built-in Gains Tax For Taxable Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
-\$850,000	-\$300,000	\$0

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<u>Section</u>	<u>Section Title</u>
2021	Increased Expensing Limitations for 2010 and 2011; Certain Real Property Treated as Section 179 Property

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.<sup>980</sup> For taxable years beginning in 2010, the maximum amount that a taxpayer may expense is \$250,000 of the cost of qualifying property placed in service for the taxable year. The \$250,000 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 \$800,000.<sup>981</sup> 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.

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<sup>980</sup> Additional IRC section 179 incentives are provided with respect to qualified property meeting applicable requirements that is used by a business in an enterprise zone (IRC section 1397A), a renewal community (IRC section 1400J), or the Gulf Opportunity Zone (IRC section 1400N(e)).

<sup>981</sup> The temporary \$250,000 and \$800,000 amounts were enacted in the Economic Stimulus Act of 2008, Public Law 110-185, extended for taxable years beginning in 2009 by the American Recovery and Reinvestment Act of 2009, Public Law 111-5, and extended for taxable years beginning in 2010 by the Hiring Incentives to Restore Employment Act of 2010, Public Law 111-147.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

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).

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.<sup>982</sup>

New Federal Law (IRC section 179)

The provision increases the maximum amount a taxpayer may expense under IRC section 179 to \$500,000 and increases the phase-out threshold amount to \$2 million for taxable years beginning in 2010 and 2011. Thus, the provision provides that the maximum amount a taxpayer may expense, for taxable years beginning after 2009 and before 2012, is \$500,000 of the cost of qualifying property placed in service for the taxable year. The \$500,000 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 \$2 million.

The provision also temporarily expands the definition of property qualifying for IRC section 179 to include certain real property—specifically, qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property.<sup>983</sup> The maximum amount with respect to real property that may be expensed under the proposal is \$250,000.<sup>984</sup> In addition, IRC section 179 deductions attributable to qualified real property that are disallowed under the trade or business income limitation may only be carried over to taxable years in which the definition of eligible IRC section 179 property includes qualified real property. Thus under the

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<sup>982</sup> IRC section 179(c)(1).

<sup>983</sup> For purposes of the provision, qualified leasehold improvement property has the meaning given such term under IRC section 168(e)(6), qualified restaurant property has the meaning given such term under IRC section 168(e)(7) (and includes a building described in IRC section 168(e)(7)(A)(i) that is placed in service after December 31, 2009 and before January 1, 2012), and qualified retail improvement property has the meaning given such term under IRC section 168(e)(8) (without regard to IRC section 168(e)(8)(E)).

<sup>984</sup> For example, assume that during 2010, a company's only asset purchases are IRC section 179-eligible equipment costing \$100,000 and qualifying leasehold improvements costing \$350,000. Assuming the company has no other asset purchases during 2010, and is not subject to the taxable-income limitation, the maximum IRC section 179 deduction the company can claim for 2010 is \$350,000 (\$100,000 with respect to the equipment and \$250,000 with respect to the qualifying leasehold improvements).

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

provision, if a taxpayer's IRC section 179 deduction for 2010 with respect to qualified real property is limited by the taxpayer's active trade or business income, such disallowed amount may be carried over to 2011 in the manner under present law. Any such amounts that are not used in 2011, plus any 2011 disallowed IRC section 179 deductions attributable to qualified real property, are treated as property placed in service in 2011 for purposes of computing depreciation. The carryover amount from 2010 is considered placed in service on the first day of the 2011 taxable year.<sup>985</sup>

The provision also permits a taxpayer to elect to exclude real property from the definition of IRC section 179 property.

Effective Date

The provision is effective for taxable years beginning after December 31, 2009.

California Law (R&TC sections 17255 and 24356)

California conforms to the expensing election under IRC section 179 (commonly referred to as "small business expensing") as of the "specified date" of January 1, 2009, with significant exceptions.

California specifically does not conform to the small-business-expensing election that was first enacted in the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003, and extended and modified in various subsequent federal acts. Thus under California law, both corporate and non-corporate taxpayers with a sufficiently small amount of annual investment in qualified depreciable property 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).

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<sup>985</sup> For example, assume that during 2010, a company's only asset purchases are IRC section 179-eligible equipment costing \$100,000 and qualifying leasehold improvements costing \$200,000. Assume the company has no other asset purchases during 2010, and has a taxable income limitation of \$150,000. The maximum IRC section 179 deduction the company can claim for 2010 is \$150,000, which is allocated pro rata between the properties, such that the carryover to 2011 is allocated \$100,000 to the qualified leasehold improvements and \$50,000 to the equipment.

Assume further that in 2011, the company had no asset purchases and had taxable income of \$-0-. The \$100,000 carryover from 2010 attributable to qualified leasehold improvements is treated as placed in service as of the first day of the company's 2011 taxable year. The \$50,000 carryover allocated to equipment is carried over to 2012 under IRC section 179(b)(3)(B).

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
2022	Additional First-Year Depreciation for 50 Percent of the Basis of Certain Qualified Property

Background

In General

An additional first-year depreciation deduction is allowed equal to 50 percent of the adjusted basis of qualified property placed in service during 2008 and 2009 (2009 and 2010 for certain longer-lived and transportation property).<sup>986</sup> The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes, but is not allowed for purposes of computing earnings and profits. 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 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 2009, a taxpayer purchased new depreciable property and places it in service.<sup>987</sup> 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 is \$500. The remaining \$500 of the cost of the property is depreciable under the rules applicable to five-year property. Thus, 20 percent, or \$100, is also allowed as a depreciation deduction in 2009. The total depreciation deduction with respect to the property for 2009 is \$600. The remaining \$400 adjusted basis of the property generally is recovered through otherwise applicable depreciation rules.

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<sup>986</sup> IRC section 168(k). The additional first-year depreciation deduction is subject to the general rules regarding whether an item must be capitalized under IRC section 263 or IRC section 263A.

<sup>987</sup> Assume that the cost of the property is not eligible for expensing under IRC section 179.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

Property qualifying for the additional first-year depreciation deduction 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)).<sup>988</sup> Second, the original use<sup>989</sup> of the property must commence with the taxpayer after December 31, 2007.<sup>990</sup> 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, 2010. An extension of the placed in service date of one year (i.e., to January 1, 2011) is provided for certain property with a recovery period of ten years or longer and certain transportation property.<sup>991</sup> Transportation property is defined as tangible personal property used in the trade or business of transporting persons or property.

The applicable time period for acquired property is: (1) after December 31, 2007, and before January 1, 2010, 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, 2010.<sup>992</sup> 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, 2010. 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,

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<sup>988</sup> The additional first-year depreciation deduction is not available for any property that is required to be depreciated under the alternative depreciation system of MACRS. The additional first-year depreciation deduction is also not available for qualified New York Liberty Zone leasehold improvement property as defined in IRC section 1400L(c)(2).

<sup>989</sup> 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.

If in the normal course of its business a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first user of each fractional interest (i.e., each fractional owner is considered the original user of its proportionate share of the property).

<sup>990</sup> 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.

If property is originally placed in service by a lessor (including by operation of IRC section 168(k)(2)(D)(i)), such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of such sale.

<sup>991</sup> Property qualifying for the extended placed in service date must have an estimated production period exceeding one year and a cost exceeding \$1 million.

<sup>992</sup> 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.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

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, 2010 ("progress expenditures") is eligible for the additional first-year depreciation.<sup>993</sup>

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 under IRC section 280F on the amount of depreciation deductions allowed with respect to certain passenger automobiles is increased in the first year by \$8,000 for automobiles that qualify (and for which the taxpayer does not elect out of the additional first-year deduction). The \$8,000 increase is not indexed for inflation.

New Federal Law (IRC sections 168, 1400L, and 1400N)

The provision extends the additional first-year depreciation deduction for one year to apply to qualified property acquired and placed in service during 2010 (or placed in service during 2011 for certain long-lived property and transportation property).

Effective Date

The provision applies to property placed in service in taxable years ending after December 31, 2009.

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

Personal Income Tax Law (PITL)

The PITL conforms to the federal MACRS rules as of the "specified date" of January 1, 2009, with modifications. The PITL specifically does not conform to IRC section 168(k), that allows 50-percent bonus depreciation for certain property; thus, this provision is not applicable under the PITL.

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<sup>993</sup> 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 apply.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

Corporate Tax Law (CTL)

This provision is not applicable under the CTL because the CTL does not adopt MACRS.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
2023	Special Rule for Long-Term Contract Accounting

Background

Percentage-of-Completion Method

In general, in the case of a long-term contract, the taxable income from the contract is determined under the percentage-of-completion method.<sup>994</sup> Under such method, the percentage completion is determined by comparing costs allocated to the contract and incurred before the end of the taxable year with the estimated total contract costs. Costs allocated to the contract typically include all costs (including depreciation) that directly benefit or are incurred by reason of the taxpayer's long-term contract activities. The allocation of the costs to a contract is made in accordance with regulations.<sup>995</sup>

Additional First-Year Depreciation Deduction ("Bonus Depreciation")

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 generally is determined under 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 (tangible property other than residential rental property and nonresidential real property) range from three 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.<sup>996</sup> In general, the recovery periods for real property are 39 years

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<sup>994</sup> IRC section 460(a).

<sup>995</sup> Treas. Reg. section 1.460-5.

<sup>996</sup> For certain property, including tangible property used predominantly outside of the United States, tax-exempt use property, tax-exempt bond-financed property, and certain other property, the MACRS "alternative depreciation system" of IRC section 168(g) applies, generally increasing recovery periods and requiring straight-line depreciation.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

for non-residential real property and 27.5 years for residential rental property. The depreciation method for real property is the straight-line method.

An additional first-year depreciation deduction is allowed equal to 50 percent of the adjusted basis of qualified property placed in service during 2008 and 2009 (2009 and 2010 for certain longer-lived and transportation property),<sup>997</sup> and for property placed in service in 2010 (2011 for certain longer-lived and transportation property) under section 2022 of this act. The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes, but is not allowed for purposes of computing earnings and profits. 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 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.

Property qualifying for the additional first-year depreciation deduction 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)).<sup>998</sup> Second, the original use<sup>999</sup> of the property must commence with the taxpayer after December 31, 2007.<sup>1000</sup> 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

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<sup>997</sup> IRC section 168(k). The additional first-year depreciation deduction is subject to the general rules regarding whether an item must be capitalized under IRC section 263 or IRC section 263A.

<sup>998</sup> The additional first-year depreciation deduction is not available for any property that is required to be depreciated under the alternative depreciation system of MACRS. The additional first-year depreciation deduction is also not available for qualified New York Liberty Zone leasehold improvement property as defined in IRC section 1400L(c)(2).

<sup>999</sup> 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.

If in the normal course of its business a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first user of each fractional interest (i.e., each fractional owner is considered the original user of its proportionate share of the property).

<sup>1000</sup> 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.

If property is originally placed in service by a lessor (including by operation of IRC section 168(k)(2)(D)(i)), such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of such sale.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

January 1, 2011. An extension of the placed in service date of one year (i.e., to January 1, 2012) is provided for certain property with a recovery period of ten years or longer, and certain transportation property.<sup>1001</sup> Transportation property is defined as tangible personal property used in the trade or business of transporting persons or property.

The applicable time period for acquired property is after December 31, 2008, and before January 1, 2011, but only if no binding written contract for the acquisition is in effect before January 1, 2010, or pursuant to a binding written contract which was entered into after December 31, 2008, and before January 1, 2011.<sup>1002</sup> 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, 2008, and before January 1, 2010. 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, 2011 ("progress expenditures") is eligible for the additional first-year depreciation.<sup>1003</sup>

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. In addition, the limitation under IRC section 280F on the amount of depreciation deductions allowed with respect to certain passenger automobiles is increased in the first year by \$8,000 for automobiles that qualify (and for which the taxpayer does not elect out of the additional first-year deduction). The \$8,000 increase is not indexed for inflation.

New Federal Law (IRC section 460)

The provision provides that solely for purposes of determining the percentage of completion under IRC section 460(b)(1)(A), the cost of qualified property is taken into account as a cost allocated to the contract as if bonus depreciation had not been enacted.<sup>1004</sup> Qualified property is property

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<sup>1001</sup> Property qualifying for the extended placed in service date must have an estimated production period exceeding one year and a cost exceeding \$1 million.

<sup>1002</sup> 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.

<sup>1003</sup> 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 apply.

<sup>1004</sup> For example, assume a calendar year taxpayer is required to use the percentage-of-completion method to account for a long-term contract during 2010. Assume further that during 2010 the taxpayer purchases and places into service equipment with a cost basis of \$500,000 and MACRS recovery period of 5-years. The taxpayer uses the equipment exclusively in performing its obligation under the contract. In computing the percentage of completion under IRC section 460(b)(1)(A), the depreciation on the equipment (assuming a half-year convention) taken into

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

otherwise eligible for bonus depreciation that has a MACRS recovery period of 7 years or less and that is placed in service after December 31, 2009, and before January 1, 2011 (January 1, 2012, in the case of property described in IRC section 168(k)(2)(B)<sup>1005</sup>).

Effective Date

The provision is effective for property placed in service after December 31, 2009.

California Law (R&TC sections 17201, 17250, 17551, 17564, 24673, and 24673.2))

California conforms to the federal rules for long-term contracts under IRC section 460, as of the "specified date" of January 1, 2009, with modifications; however, California does not conform to bonus depreciation under IRC section 168(k). Thus, this provision is not applicable under California law.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
2031	Increase Amount Allowed as Deduction for Start-Up Expenditures in 2010

Background

Start-Up Expenditures

A taxpayer can elect to deduct up to \$5,000 of start-up expenditures in the taxable year in which the active trade or business begins.<sup>1006</sup> However, the \$5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up expenditures exceeds \$50,000.<sup>1007</sup> Start-up expenditures that are not deductible in the year in which the active trade or business begins are, at the taxpayer's election, amortized over a 15-year period beginning with the month the active trade or business begins.<sup>1008</sup> Start-up expenditures are amounts that would have been

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account as a cost allocated to the contract for 2010 is \$100,000 [ $\$500,000/5*200%*.5$ ]. The amount of the depreciation deduction that may be claimed by the taxpayer in 2010 with respect to the equipment is \$300,000 [ $(\$500,000*50%) + ((\$500,000-(500,000*50%))/5*200%*.5)$ ].

<sup>1005</sup> IRC section 168(k)(2)(B) generally applies to property having longer production periods.

<sup>1006</sup> IRC section 195(b)(1)(A).

<sup>1007</sup> IRC section 195(b)(1)(A).

<sup>1008</sup> IRC section 195(b)(1)(B).

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

deductible as trade or business expenses, had they not been paid or incurred before business began, including amounts paid or incurred in connection with: (1) investigating the creation or acquisition of an active trade or business; (2) creating an active trade or business; or (3) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business.<sup>1009</sup>

Treasury regulations<sup>1010</sup> provide that a taxpayer is deemed to have made an election under IRC section 195(b) to amortize its start-up expenditures for the taxable year in which the active trade or business to which the expenditures relate begins. A taxpayer that chooses to forgo the deemed election must clearly elect to capitalize its start-up expenditures on its timely filed federal income tax return for the taxable year the active trade or business commences. The election either to amortize or capitalize start-up expenditures is irrevocable and applies to all start-up expenditures related to the active trade or business.

New Federal Law (IRC section 195)

For taxable years beginning in 2010, the provision increases the amount of start-up expenditures a taxpayer can elect to deduct from \$5,000 to \$10,000, and increases the deduction phase-out threshold such that the \$10,000 is reduced (but not below zero) by the amount by which the cumulative cost of start-up expenditures exceeds \$60,000.

Effective Date

The provision is effective for taxable years beginning after December 31, 2009.

California Law (R&TC sections 17201 and 24414)

California conforms to the federal rules for start-up expenditures as of the “specified date” of January 1, 2009 under both the PITL and the CTL; thus, California does not conform to this provision (that temporarily increases deductible start-up expenses).

Impact on California Revenue

Not applicable.

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<sup>1009</sup> IRC section 195(c).

<sup>1010</sup> Temp. Treas. Reg. section 1.195-1T(b).

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

<u>Section</u>	<u>Section Title</u>
2041	Limitation on Penalty for Failure to Disclose Reportable Transactions Based on Resulting Tax Benefits

Background

The reporting requirements of IRC sections 6011 through 6112 create interlocking disclosure obligations for both taxpayers and advisors. Each of these disclosure statutes has a parallel penalty provision that enforces it. Prior to enactment of the American Jobs Creation Act of 2004 ("AJCA"),<sup>1011</sup> no penalty was imposed on taxpayers who failed to disclose participation in transactions subject to IRC section 6011. For disclosures that were due after enactment of that legislation, a strict-liability penalty under IRC section 6707A applies to any failure to disclose a reportable transaction.

Regulations under IRC section 6011 require a taxpayer to disclose with its tax return certain information with respect to each "reportable transaction" in which the taxpayer participates.<sup>1012</sup> A reportable transaction is defined as one that the Secretary of the Treasury determines is required to be disclosed because it is determined to have a potential for tax avoidance or evasion.<sup>1013</sup> There are five categories of reportable transactions: listed transactions, confidential transactions, transactions with contractual protection, certain loss transactions and transactions of interest.<sup>1014</sup>

Transactions falling under the first and last categories of reportable transactions are transactions that are described in publications issued by the Treasury Department and identified as one of these types of transaction. A listed transaction is defined as a reportable transaction which is the same as, or substantially similar<sup>1015</sup> to, a transaction specifically identified by the Secretary of the Treasury as a tax-avoidance transaction for purposes of the reporting disclosure requirements.<sup>1016</sup> A "transaction of interest" is one that is the same or substantially similar to a transaction identified

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<sup>1011</sup> Public Law 108-357.

<sup>1012</sup> Treas. Reg. section 1.6011-4.

<sup>1013</sup> IRC section 6707A(c)(1).

<sup>1014</sup> Treas. Reg. section 1.6011-4(b)(2)-(6).

<sup>1015</sup> The regulations clarify that the term "substantially similar" includes any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy. Further, the term must be broadly construed in favor of disclosure. Treas. Reg. section 1.6011-4(c)(4).

<sup>1016</sup> IRC section 6707A(c)(2).

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

by the Secretary as one about which the Secretary is concerned but does not yet have sufficient knowledge to determine that the transaction is abusive.<sup>1017</sup>

The other categories of reportable transactions are not specifically identified in published guidance, but are defined as classes of transactions sharing certain characteristics. In general, a transaction is considered to be offered to a taxpayer under conditions of confidentiality if an advisor who is paid a minimum fee places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that advisor's tax strategies (irrespective if such terms are legally binding).<sup>1018</sup> A transaction involves contractual protection if: (1) the taxpayer has the right to a full or partial refund of fees if the intended tax consequences from the transaction are not sustained; or (2) fees are contingent on the intended tax consequences from the transaction being sustained.<sup>1019</sup> A reportable loss transaction generally includes any transaction that results in a taxpayer claiming a loss (under IRC section 165) of at least: (1) \$10 million in any single year or \$20 million in any combination of years by a corporate taxpayer or a partnership with only corporate partners; (2) \$2 million in any single year or \$4 million in any combination of years by all other partnerships, S corporations, trusts, and individuals; or (3) \$50,000 in any single year for individuals or trusts if the loss arises with respect to foreign currency translation losses.<sup>1020</sup> Treasury has announced its intention to add a sixth category of reportable transactions, patented transactions, but has not yet done so.<sup>1021</sup>

IRC section 6707A imposes a penalty for failure to comply with the reporting requirements of IRC section 6011. A single reportable transaction may have to be reported by multiple taxpayers in connection with multiple tax returns. For example, a reportable transaction entered into by a partnership may have to be reported under IRC section 6011 by both the partnership and its partners.<sup>1022</sup> The amount of the penalty due for each taxpayer's failure to comply varies depending upon whether or not the transaction is a listed transaction and whether the relevant taxpayer is an individual. For listed transactions, the maximum penalty is \$100,000 for natural persons and \$200,000 for all other persons. For reportable transactions other than listed transactions, the maximum penalty is \$10,000 for natural persons and \$50,000 for all other persons.

A public entity that is required to pay a penalty for an undisclosed listed or reportable transaction must disclose the imposition of the penalty in reports to the Securities and Exchange Commission ("SEC") for such periods specified by the Secretary. Disclosure to the SEC applies without regard

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<sup>1017</sup> Treas. Reg. section 1.6011-4(b)(6).

<sup>1018</sup> Treas. Reg. section 1.6011-4(b)(3).

<sup>1019</sup> Treas. Reg. section 1.6011-4(b)(4).

<sup>1020</sup> Treas. Reg. section 1.6011-4(b)(5).

<sup>1021</sup> Proposed Treas. Reg. section 1.6011-4(b)(7), published September 26, 2007 (REG-129916-07).

<sup>1022</sup> See, e.g., Treas. Reg. section 1.6011-4(c)(3)(ii), Example 2.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).<sup>1023</sup> However, the taxpayer is only required to report the penalty one time. A public entity that is subject to a gross valuation misstatement penalty under IRC section 6662(h) attributable to a non-disclosed listed transaction or non-disclosed reportable avoidance transaction may also be required to make disclosures in its SEC filings.<sup>1024</sup>

For reportable transactions other than listed transactions, the Commissioner of the Internal Revenue ("Commissioner") or his delegate can rescind (or abate) the penalty only if rescinding the penalty would promote compliance with the tax laws and effective tax administration.<sup>1025</sup> The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. Determinations by the Commissioner regarding rescission are not subject to judicial review.<sup>1026</sup> The Internal Revenue Service ("IRS") also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this provision and the reasons for the rescission. The IRC section 6707A penalty cannot be waived with respect to a listed transaction.

The IRC section 6707A penalty is assessed in addition to any accuracy-related penalties. If the taxpayer does not adequately disclose a reportable transaction, the strengthened reasonable-cause exception to the accuracy-related penalty is not available, and the taxpayer is subject to an increased penalty equal to 30 percent of the understatement.<sup>1027</sup> However, a taxpayer will be treated as having adequately disclosed a transaction for this purpose if the Commissioner has separately rescinded the separate penalty under IRC section 6707A for failure to disclose a reportable transaction.<sup>1028</sup> The Commissioner is authorized to do this only if the failure does not relate to a listed transaction and only if rescinding the penalty would promote compliance and effective tax administration.<sup>1029</sup>

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<sup>1023</sup> IRC section 6707A(e).

<sup>1024</sup> IRC section 6707A(e)(2)(C); Rev. Proc. 2005-51, 2005-2 CB 296.

<sup>1025</sup> In determining whether to rescind (or abate) the penalty for failing to disclose a reportable transaction on the grounds that doing so would promote compliance with the tax laws and effective tax administration, it is intended that the Commissioner take into account whether: (1) the person on whom the penalty is imposed has a history of complying with the tax laws; (2) the violation is due to an unintentional mistake of fact; and (3) imposing the penalty would be against equity and good conscience.

<sup>1026</sup> This does not limit the ability of a taxpayer to challenge whether a penalty is appropriate (e.g., a taxpayer may litigate the issue of whether a transaction is a reportable transaction (and thus subject to the penalty if not disclosed) or not a reportable transaction (and thus not subject to the penalty)).

<sup>1027</sup> IRC section 6662A(c).

<sup>1028</sup> IRC section 6664(d).

<sup>1029</sup> IRC section 6707A(d).

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

New Federal Law (IRC section 6707A)

The provision changes the general rule for determining the amount of the applicable penalty to achieve proportionality between the penalty and the tax savings that were the object of the transaction, retains the current penalty amounts as the maximum penalty that may be imposed, and establishes a minimum penalty.

First, it provides a general rule that a participant in a reportable transaction who fails to disclose the reportable transaction as required under IRC section 6011 is subject to a penalty equal to 75 percent of the reduction in tax reported on the participant's income tax return as a result of participation in the transaction, or that would result if the transaction were respected for federal tax purposes. Regardless of the amount determined under the general rule, the penalty for each such failure may not exceed certain maximum amounts. The maximum annual penalty that a taxpayer may incur for failing to disclose a particular reportable transaction other than a listed transaction is \$10,000 in the case of a natural person and \$50,000 for all other persons. The maximum annual penalty that a taxpayer may incur for failing to disclose a listed transaction is \$100,000 in the case of a natural person and \$200,000, for all other persons.

The provision also establishes a minimum penalty with respect to failure to disclose a reportable or listed transaction. That minimum penalty is \$5,000 for natural persons and \$10,000 for all other persons.

The following examples illustrate the operation of the maximum and minimum penalties with respect to a partnership or a corporation. First, assume that two individuals participate in a listed transaction through a partnership formed for that purpose. Both partners, as well as the partnership, are required to disclose the transaction. All fail to do so. The failure by the partnership to disclose its participation in a listed or otherwise reportable transaction is subject to the minimum penalty of \$10,000, because income tax liability is not incurred at the partnership level nor reported on a partnership return. The partners in such partnership who also failed to comply with the reporting requirements of IRC section 6011 are each subject to a penalty based on the reduction in tax reported on their respective returns.

In the second example, assume that a corporation participates in a single listed transaction over the course of three taxable years. The decrease in tax shown on the corporate returns is \$1 million in the first year, \$100,000 in the second year, and \$10,000 in the third year. If the corporation fails to disclose the listed transaction in all three years, the corporation is subject to three separate penalties—a penalty of \$200,000 in the first year (as a result of the cap on penalties), a \$75,000 penalty in the second year (computed under the general rule), and a \$10,000 penalty in the third year (as a result of the minimum penalty), for total penalties of \$285,000.

Effective Date

The provision applies to all penalties assessed under section 6707A after December 31, 2006.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

California Law (R&TC section 19772)

California generally conforms to the federal penalty for failure to disclose reportable transactions as of the “specified date” of January 1, 2009, with the following modifications: (1) the penalty only applies to taxpayers with taxable income of more than \$200,000; (2) the penalty for any taxpayer that fails to disclose a reportable transaction (other than a listed transaction) is \$15,000 per transaction; (3) the penalty for any taxpayer that fails to disclose a listed transaction is \$30,000 per transaction; and (4) only the Chief Counsel of the Franchise Tax Board may rescind all or part of the penalty.

Because the provision was enacted after the “specified date,” California does not conform to it.

Impact on California Revenue

Estimated Revenue Impact of Limitation on Penalty for Failure to Disclose Reportable Transactions Based on Resulting Tax Benefits For Taxable Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
-\$400,000	-\$400,000	-\$400,000

Estimates are based on a proration of federal estimates developed by the Joint Committee on Taxation.

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<u>Section</u>	<u>Section Title</u>
2042	Deduction for Health Insurance Costs in Computing Self-Employment Taxes in 2010

Background

Deduction for Health Insurance Premiums of Self-Employed Individuals

In calculating adjusted gross income for income tax purposes, self-employed individuals may deduct the cost of health insurance for themselves and their spouses, dependents, and any children who have not attained age 27 as of the end of the taxable year.<sup>1030</sup> The deduction is not available for any month in which the self-employed individual is eligible to participate in an

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<sup>1030</sup> IRC section 162(l)(1). See Notice 2010-38 for a discussion of the deduction for children who have not attained age 27 as of the end of the taxable year.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

employer-subsidized health plan (maintained by the employer of the taxpayer or the taxpayer's spouse). Moreover, the deduction may not exceed the earned income (within the meaning of IRC section 401(c)(2)) derived by the self-employed individual from the trade or business with respect to which the plan providing the health insurance coverage is established.<sup>1031</sup> The deduction applies only to the cost of insurance (i.e., it does not apply to out-of-pocket expenses that are not reimbursed by insurance).

#### Self-Employment Contributions Act Tax

The Self-Employment Contributions Act ("SECA") imposes taxes on the net earnings from self employment of self-employed individuals ("self-employment income"). The tax is composed of two parts: (1) the old age, survivors, and disability insurance ("OASDI") tax; and (2) the hospital insurance ("HI") tax. The rate of the OASDI portion of SECA taxes is equal to 12.4 percent of self-employment income and generally applies to self-employment income up to the Federal Insurance Contributions Act ("FICA") taxable wage base (\$106,800 in 2010). The rate of the HI portion is equal to 2.9 percent<sup>1032</sup> of self-employment income and there is no cap on the amount of self-employment income to which the rate applies.<sup>1033</sup> The deduction allowable for the cost of health insurance for the self-employed individual and the individual's spouse, dependents, and children who have not attained age 27 as of the end of the taxable year for income taxes is not taken in account in determining an individual's net earnings from self employment for purposes of SECA taxes.<sup>1034</sup>

#### New Federal Law (IRC section 162)

Under the provision, the deduction for income tax purposes allowed to self-employed individuals for the cost of health insurance for themselves, their spouses, dependents, and children who have not attained age 27 as of the end of the taxable year is taken into account, and thus also allowed, in calculating net earnings from self-employment for purposes of SECA taxes.

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<sup>1031</sup> IRC section 162(l)(2).

<sup>1032</sup> IRC section 1401. However, under section 9015 of the Patient Protection and Affordable Care Act (Public Law 111-148), for remuneration and self-employment income received for taxable years beginning after December 31, 2012, the HI tax under SECA is increased by an additional tax of 0.9 percent on self-employment income received in excess of a threshold amount. However, unlike the general 1.45 percent HI tax on self-employment income, this additional tax is on the combined wages and self-employment income of the self-employed individual and spouse, in the case of a joint return. The threshold amount is \$250,000 in the case of a joint return or surviving spouse, \$125,000 in the case of a married individual filing a separate return, and \$200,000 in any other case.

<sup>1033</sup> For purposes of computing net earnings from self-employment, taxpayers are permitted a deduction equal to the product of the taxpayer's earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent); i.e., 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas the self-employed individual's net earnings are economically equivalent to an employee's wages plus the employer share of FICA taxes.

<sup>1034</sup> IRC section 162(l)(4).

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

It is intended that earned income within the meaning of IRC section 401(c)(2) be computed without regard to this deduction for the cost of health insurance.<sup>1035</sup> Thus, earned income for purposes of the limitation applicable to the health insurance deduction is computed without regard to this deduction. The provision only applies for the taxpayer's first taxable year beginning after December 31, 2009.

Effective Date

The provision is effective taxable years beginning after December 31, 2009.

California Law (R&TC sections 17201 and 24343)

California conforms to IRC section 162 as of the "specified date" of January 1, 2009 under both the PITL and the CTL. However, this provision only impacts the measure of employment taxes; that is, it allows a temporary deduction of health insurance taxes from self-employment income for purposes of the self-employment tax, but does not change the amount deductible under IRC section 162. Defer to the Employment Development Department (EDD).

Impact on California Revenue

Defer to the EDD.

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<u>Section</u>	<u>Section Title</u>
2043	Removal of Cellular Telephones and Similar Telecommunications Equipment from Listed Property

Background

Employer Deduction

Property, including cellular telephones and similar telecommunications equipment (hereinafter collectively "cell phones"), used in carrying on a trade or business is subject to the general rules for deducting ordinary and necessary expenses under IRC section 162. Under these rules, a taxpayer may properly claim depreciation deductions under the applicable cost-recovery rules for only the portion of the cost of the property that is attributable to use in a trade or business.<sup>1036</sup> Similarly, the business portion of monthly telecommunication service is generally deductible,

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<sup>1035</sup> A technical correction may be needed to achieve this result.

<sup>1036</sup> IRC section 212 allows deductions for ordinary and necessary expenses paid or incurred for the production or collection of income.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

subject to capitalization rules, as an ordinary and necessary expense of carrying on a trade or business.

In the case of certain listed property, special rules apply. Listed property generally is defined as: (1) any passenger automobile; (2) any other property used as a means of transportation; (3) any property of a type generally used for purposes of entertainment, recreation, or amusement; (4) any computer or peripheral equipment; (5) any cellular telephone (or other similar telecommunications equipment);<sup>1037</sup> and (6) any other property of a type specified in Treasury regulations.<sup>1038</sup>

For listed property, no deduction is allowed unless the taxpayer adequately substantiates the expense and business usage of the property.<sup>1039</sup> A taxpayer must substantiate the elements of each expenditure or use of listed property, including: (1) the amount (e.g., cost) of each separate expenditure and the amount of business or investment use, based on the appropriate measure (e.g., mileage for automobiles), and the total use of the property for the taxable period; (2) the date of the expenditure or use; and (3) the business purposes for the expenditure or use.<sup>1040</sup> The level of substantiation for business or investment use of listed property varies depending on the facts and circumstances. In general, the substantiation must contain sufficient information as to each element of every business or investment use.<sup>1041</sup>

With respect to the business use of listed property made available by an employer for use by an employee, the employer must substantiate that all or a portion of the use of the listed property is by employees in the employer's trade or business.<sup>1042</sup> If any employee used the listed property for personal use, the employer must substantiate that it included an appropriate amount in the employee's income.<sup>1043</sup> An employer generally may rely on adequate records maintained and retained by the employee or on the employee's own statement if it is corroborated by other sufficient evidence, unless the employer knows or has reason to know that the statement, records, or other evidence are not accurate.<sup>1044</sup>

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<sup>1037</sup> Cellular telephones (or other similar telecommunications equipment) were added as listed property as part of the Omnibus Budget Reconciliation Act of 1989, Public Law 101-239, section 7643 (1989).

<sup>1038</sup> IRC section 280F(d)(4)(A).

<sup>1039</sup> IRC section 274(d)(4).

<sup>1040</sup> Temp. Reg. section 1.274-5T(b)(6).

<sup>1041</sup> Temp. Reg. section 1.274-5T(c)(2)(ii)(C).

<sup>1042</sup> Temp. Reg. section 1.274-5T(e)(2)(i)(A).

<sup>1043</sup> Temp. Reg. section 1.274-5T(e)(2)(i)(A).

<sup>1044</sup> Temp. Reg. section 1.274-5T(e)(2)(ii). In Notice 2009-46, 2009-23 I.R.B. 1068, the IRS requested comments regarding several proposals to simplify the procedures for employers to substantiate an employee's business use of certain employer-provide telecommunications equipment (including cellular telephones).

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

## Cost Recovery

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 three 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.

In the case of certain listed property, special depreciation rules apply. First, if for the taxable year that the property is placed in service the use of the property for trade or business purposes does not exceed 50 percent of the total use of the property, then the depreciation deduction with respect to such property is determined under the alternative depreciation system.<sup>1045</sup> The alternative depreciation system generally requires the use of the straight-line method and a recovery period equal to the class life of the property.<sup>1046</sup> Second, if an individual owns or leases listed property that is used by the individual in connection with the performance of services as an employee, no depreciation deduction, expensing allowance, or deduction for lease payments is available with respect to such use unless the use of the property is for the convenience of the employer and required as a condition of employment.<sup>1047</sup>

### New Federal Law (IRC section 280F)

The provision removes cell phones from the definition of listed property. Thus, under the provision, the heightened substantiation requirements and special depreciation rules that apply to listed property do not apply to cell phones.<sup>1048</sup>

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<sup>1045</sup> IRC section 280F(b)(1). If for any taxable year after the year in which the property is placed in service the use of the property for trade or business purposes decreases to 50 percent or less of the total use of the property, then the amount of depreciation allowed in prior years in excess of the amount of depreciation that would have been allowed for such prior years under the alternative depreciation system is recaptured (i.e., included in gross income) for such taxable year.

<sup>1046</sup> IRC section 168(g).

<sup>1047</sup> IRC section 280F(d)(3).

<sup>1048</sup> The provision does not affect Treasury's authority to determine the appropriate characterization of cell phones as a working condition fringe benefit under IRC section 132(d) or that the personal use of such devices that are provided primarily for business purposes may constitute a de minimis fringe benefit, the value of which is so small as to make accounting for it administratively impracticable, under IRC section 132(e).

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

Effective Date

The provision is effective for taxable years ending after December 31, 2009.

California Law (R&TC sections 17201 and 24349.1)

Under the PITL and the CTL, California conforms to the federal rules for listed property under IRC section 280F as of the "specified date" of January 1, 2009, with modifications under the CTL; thus, California does not conform to this provision.

Impact on California Revenue

Estimated Revenue Impact of Removal of Cellular Telephones and Similar Telecommunications Equipment from Listed Property For Taxable Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
-\$1,200,000	-\$1,000,000	-\$1,000,000

Estimates are based on a proration of federal estimates developed by the Joint Committee on Taxation.

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Section

Section Title

2101 Information Reporting for Rental Property Expense Payments

Background

A variety of information reporting requirements apply under present law.<sup>1049</sup> The primary provision governing information reporting by payors requires an information return by every person engaged in a trade or business who makes payments to any one payee aggregating \$600 or more in any taxable year in the course of that payor's trade or business.<sup>1050</sup> Reportable payments include compensation for both goods and services, and may include gross proceeds.

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<sup>1049</sup> IRC sections 6031 through 6060.

<sup>1050</sup> IRC section 6041(a). The information return is generally submitted electronically as a Form 1096 and Form 1099, although certain payments to beneficiaries or employees may require use of Forms W-3 and W-2, respectively. Treas. Reg. section 1.6041-1(a)(2).

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

Certain enumerated types of payments that are subject to other specific reporting requirements are carved out of reporting under this general rule.<sup>1051</sup>

One such regulatory exception carved out payments to corporations,<sup>1052</sup> but was expressly overridden by the addition of new IRC section 6041(h) by section 9006 of the Patient Protection and Affordable Health Care Act ("PPACA").<sup>1053</sup> New IRC section 6041(h) expanded information reporting requirements to include gross proceeds paid in consideration for property and to subject payments to corporations to all of the reporting requirements under IRC section 6041. The payor is required to provide the recipient of the payment with an annual statement showing the aggregate payments made and contact information for the payor.<sup>1054</sup> The regulations generally except from reporting payments to exempt organizations, governmental entities, international organizations, or retirement plans.<sup>1055</sup> Additionally, the requirement that businesses report certain payments is not applicable to persons engaged in a passive investment activity. Thus, a taxpayer whose rental real estate activity is a trade or business is subject to this reporting requirement, but a taxpayer whose rental real estate activity is not considered a trade or business is not subject to such requirement.

In addition, financial institutions are required to report to both taxpayers and the IRS the amount of interest taxpayers paid during the year on mortgages they held on their rental properties.<sup>1056</sup>

A person that fails to comply with the information reporting requirements is subject to penalties, which may include a penalty for failure to file the information return,<sup>1057</sup> for failure to furnish payee statements,<sup>1058</sup> or for failure to comply with other various reporting requirements.<sup>1059</sup>

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<sup>1051</sup> IRC section 6041(a) requires reporting "other than payments to which IRC section 6042(a)(1), 6044(a)(1), 6047(c), 6049(a) or 6050N(a) applies and other than payments with respect to which a statement is required under authority of IRC section 6042(a), 6044(a)(2) or 6045[.]" The payments thus excepted include most interest, royalties, and dividends.

<sup>1052</sup> Treas. Reg. section 1.6041-3(p).

<sup>1053</sup> Public Law 111-148, section 9006 (effective for payments made after December 31, 2011).

<sup>1054</sup> IRC section 6041(d). Specifically, the recipient of the payment is required to provide a Form W-9 to the payor, which enables the payee to provide the recipient of the payment with an annual statement showing the aggregate payments made and contact information for the payor. If a Form W-9 is not provided, the payor is required to "backup withhold" tax at a rate of 28 percent of the gross amount of the payment unless the payee has otherwise established that the income is exempt from backup withholding. The backup withholding tax may be credited by the payee against regular income tax liability, i.e., it is effectively an advance payment of tax, similar to the withholding of tax from wages. This combination of reporting and backup withholding is designed to ensure that U.S. persons pay an appropriate amount of tax with respect to investment income, either by providing the IRS with the information that it needs to audit payment of the tax or, in the absence of such information, requiring collection of the tax on payment.

<sup>1055</sup> Treas. Reg. section 1.6041-3(p).

<sup>1056</sup> IRC section 6050H. This information is provided on federal Form 1098.

<sup>1057</sup> IRC section 6721. The penalty for the failure to file an information return generally is \$50 for each return for which such failure occurs. The total penalty imposed on a person for all failures during a calendar year cannot exceed

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

New Federal Law (IRC section 6041)

Under the provision, recipients of rental income from real estate generally are subject to the same information reporting requirements as taxpayers engaged in a trade or business. In particular, rental income recipients making payments of \$600 or more to a service provider (such as a plumber, painter, or accountant) in the course of earning rental income are required to provide an information return (typically Form 1099-MISC) to the IRS and to the service provider. Exceptions to this reporting requirement are made for: (1) members of the military or employees of the intelligence community (as defined in IRC section 121(d)(9)) who rent their principal residence on a temporary basis; (2) individuals who receive only minimal amounts of rental income, as determined by the Secretary in accordance with regulations; and (3) individuals for whom the requirements would cause hardship, as determined by the Secretary in accordance with regulations.

Effective Date

The provision applies to payments made after December 31, 2010.

California Law (R&TC section 18631)

The FTB may require a copy of any federal information return that is required to be filed with the Secretary of the Treasury under IRC section 6041.<sup>1060</sup>

Impact on California Revenue

Baseline—based on a proration of federal estimates developed by the Joint Committee on Taxation, baseline revenue gains are estimated to be \$13,000,000 in 2011-12, \$8,000,000 in 2012-13, and \$7,500,000 in 2013-14.

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\$250,000. Additionally, special rules apply to reduce the per-failure and maximum penalty where the failure is corrected within a specified period.

<sup>1058</sup> IRC section 6722. The penalty for failure to provide a correct payee statement is \$50 for each statement with respect to which such failure occurs, with the total penalty for a calendar year not to exceed \$100,000. Special rules apply that increase the per-statement and total penalties where there is intentional disregard of the requirement to furnish a payee statement.

<sup>1059</sup> IRC section 6723. The penalty for failure to timely comply with a specified information reporting requirement is \$50 per failure, not to exceed \$100,000 for a calendar year.

<sup>1060</sup> R&TC section 18631(b)(4).

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

<u>Section</u>	<u>Section Title</u>
2102	Increase in Information Return Penalties

Background

Present law imposes information reporting requirements on participants in certain transactions. Under IRC section 6721, any person who is 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. If a person files a correct information return after the prescribed filing date but on or before the date that is 30 days after the prescribed filing date, the amount of the penalty is \$15 per return (the "first-tier penalty"), with a maximum penalty of \$75,000 per calendar year. If a person files a correct information return after the date that is 30 days after the prescribed filing date but on or before August 1, the amount of the penalty is \$30 per return (the "second-tier penalty"), with a maximum penalty of \$150,000 per calendar year. If a correct information return is not filed on or before August 1 of any year, the amount of the penalty is \$50 per return (the "third-tier penalty") with a maximum penalty of \$250,000 per calendar year. If a failure is due to intentional disregard of a filing requirement, the minimum penalty for each failure is \$100, with no calendar-year limit.

Special lower maximum levels for this penalty apply to small businesses. Small businesses are defined as firms having average annual gross receipts for the most recent three taxable years that do not exceed \$5 million. The maximum penalties for small businesses are: \$25,000 (instead of \$75,000) if the failures are corrected on or before 30 days after the prescribed filing date; \$50,000 (instead of \$150,000) if the failures are corrected on or before August 1; and \$100,000 (instead of \$250,000) if the failures are not corrected on or before August 1.

IRC section 6722 imposes penalties for failing to furnish correct payee statements to taxpayers. The penalty amount is \$50 for each failure to furnish a payee statement, up to a maximum of \$100,000. If the failure is due to intentional disregard, the amount of the penalty per failure is increased<sup>1061</sup> and the cap on the penalty is not applicable. In addition, IRC section 6723 imposes a penalty of \$50 for failing to comply with other information reporting requirements, up to a maximum of \$100,000.

New Federal Law (IRC sections 6721 and 6722)

The provision amends IRC section 6721 to increase the first-tier penalty from \$15 to \$30, and increase the calendar-year maximum from \$75,000 to \$250,000. The second-tier penalty is increased from \$30 to \$60, and the calendar-year maximum is increased from \$150,000 to \$500,000. The third-tier penalty is increased from \$50 to \$100, and the calendar-year maximum is increased from \$250,000 to \$1,500,000. For small business filers, the calendar year

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<sup>1061</sup> IRC section 6722(c)(1) provides that the penalty per failure is the greater of \$100 or a fixed percentage of the aggregate items to be shown on the payee statements. The fixed amount is 10 percent for statements other than those required under IRC sections 6045(b), 6041A(e), 6050H(d), 6050J(e), 6050K(b), or 6050L(c). The penalty is the greater of \$100 or five percent of the amount required to be shown on statements required under IRC sections 6045(b), 6050K(b) or 6050L(c).

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

maximum is increased from \$25,000 to \$75,000 for the first-tier penalty, from \$50,000 to \$200,000 for the second-tier penalty, and from \$100,000 to \$500,000 for the third-tier penalty. The minimum penalty for each failure due to intentional disregard is increased from \$100 to \$250.

The penalty for failure to furnish a payee statement is revised to provide tiers and caps similar to those applicable to the penalty for failure to file the information return. A first-tier penalty is \$30, subject to a maximum of \$250,000; a second-tier penalty is \$60 per statement, up to \$500,000, and the third-tier penalty is \$100, up to a maximum of \$1,500,000. The penalty is also amended to provide limitations on penalties for small businesses and increased penalties for intentional disregard that parallel the penalty for failure to furnish information returns.

Both the failure-to-file and failure-to-furnish penalties will be adjusted to account for inflation every five years with the first adjustment to take place after 2012, effective for each year thereafter.

Effective Date

The provision applies with respect to information returns required to be filed on or after January 1, 2011.

California Law (R&TC section 19183)

California conforms to the federal penalty amounts for the failure to file information returns<sup>1062</sup> and for the failure to furnish payee statements<sup>1063</sup> as of the “specified date” of January 1, 2009, and as a result does not conform to this provision’s penalty increases.

Impact on California Revenue

Estimated Revenue Impact of Increase in Information Return Penalties For Taxable Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
\$10,000	\$10,000	\$10,000

Estimates are based on a proration of federal estimates developed by the Joint Committee on Taxation.

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<sup>1062</sup> R&TC section 19183(a).

<sup>1063</sup> R&TC section 19183(b).

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

<u>Section</u>	<u>Section Title</u>
2103	Report on Tax Shelter Penalties and Certain Other Enforcement Actions

Background

Transactions that have the potential for tax avoidance are required to be disclosed by both the taxpayers who engage in the transaction and the various professionals who provide advice with respect to such transactions. Failure to comply with the reporting and disclosure requirements may result in assessment of penalties against both the taxpayer and material advisor and the use of special enforcement measures.

Reporting Obligations

These disclosure requirements<sup>1064</sup> create interlocking disclosure obligations for both taxpayers and advisors. A taxpayer is required to disclose with its tax return certain information with respect to each "reportable transaction," as defined in regulations.<sup>1065</sup> Each advisor who provides material advice with respect to any reportable transaction (including any listed transaction) is required to file an information return with the Secretary (in such form and manner as the Secretary may prescribe).<sup>1066</sup> Finally, the advisor is required to maintain a list of those persons he has advised with respect to a reportable transaction and to provide the list to the IRS upon request.<sup>1067</sup>

A reportable transaction is defined as one that the Secretary requires to be disclosed based on its potential for tax avoidance or evasion.<sup>1068</sup> There are five categories of reportable transactions: listed transactions, confidential transactions, transactions with contractual protection, certain loss transactions and transactions of interest.<sup>1069</sup>

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<sup>1064</sup> IRC sections 6011, 6111 and 6112.

<sup>1065</sup> Treas. Reg. section 1.6011-4.

<sup>1066</sup> IRC section 6111.

<sup>1067</sup> IRC section 6112.

<sup>1068</sup> IRC section 6707A(c)(1) states that the term means "any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under IRC section 6011, such transaction is of a type which the Secretary determines as having a potential for tax avoidance or evasion." IRC sections 6111(b)(2) and 6112 both define "reportable transaction" by reference to the definition in IRC section 6707A(c). The definition of "listed transaction" similarly depends upon identification of transactions by the Secretary as tax avoidance transactions for purposes of IRC section 6011.

<sup>1069</sup> Treas. Reg. section 1.6011-4(b)(2)-(6).

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

Penalties and Other Enforcement Tools Related to Reportable Transactions

Each of the disclosure statutes has a parallel penalty provision to aid enforcement. The taxpayer who participates in a reportable transaction and fails to disclose it is subject to a strict-liability penalty.<sup>1070</sup> The penalty is assessed in addition to any accuracy-related penalties. It may be rescinded with respect to reportable transactions other than listed transactions. Rescission is discretionary and conditioned upon a determination by the Commissioner that rescinding the penalty would promote compliance and effective tax administration.<sup>1071</sup> The IRC also imposes a penalty on any material advisor who fails to file an information return, or who files a false or incomplete information return, with respect to a reportable transaction (including a listed transaction). It may be rescinded, subject to limitations similar to those applicable to rescission of the penalty imposed on investors.<sup>1072</sup> The IRS may also submit a written request that a material advisor make available the list required to be maintained under IRC section 6612(a). A failure to make the list available upon written request is subject to a penalty of \$10,000 per day for as long as the failure continues, unless the advisor can establish reasonable cause for the failure.<sup>1073</sup>

In addition to the penalties that specifically address the failure to comply with the disclosure and reporting obligations, other special enforcement provisions are applicable to reportable transactions. An understatement arising from any listed transactions or from a reportable transaction for which a significant purpose is avoidance or evasion of federal income tax will be subject to an accuracy-related penalty,<sup>1074</sup> unless the taxpayer can establish that the failure was

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<sup>1070</sup> IRC section 6707A imposes a penalty for failure to comply with the reporting requirements of IRC section 6011. A single reportable transaction may have to be reported by multiple taxpayers in connection with multiple tax returns. For example, a reportable transaction entered into by a partnership may have to be reported under IRC section 6011 by both the partnership and its partners. The amount of the penalty due for each taxpayer's failure to comply varies depending upon whether or not the transaction is a listed transaction and whether the relevant taxpayer is an individual. For listed transactions, the maximum penalty is \$100,000 for natural persons and \$200,000 for all other persons. For reportable transactions other than listed transactions, the maximum penalty is \$10,000 for natural persons and \$50,000 for all other persons. A public entity that is required to pay a penalty for an undisclosed listed or reportable transaction must disclose the imposition of the penalty in reports to the SEC for such periods specified by the Secretary. Failure to comply with this reporting requirement may result in assessment of a second tier penalty.

<sup>1071</sup> IRC section 6707A(d). In determining whether to rescind (or abate) the penalty for failing to disclose a reportable transaction on the grounds that doing so would promote compliance with the tax laws and effective tax administration, it is intended that the Commissioner take into account whether: (1) the person on whom the penalty is imposed has a history of complying with the tax laws; (2) the violation is due to an unintentional mistake of fact; and (3) imposing the penalty would be against equity and good conscience.

<sup>1072</sup> IRC section 6707 provides a penalty in the amount of \$50,000. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of: (1) \$200,000; or (2) 50 percent of the gross income of such person with respect to aid, assistance, or advice which is provided with respect to the transaction before the date the information return that includes the transaction is filed. Intentional disregard by a material advisor of the requirement to disclose a listed transaction increases the penalty to 75 percent of the gross income.

<sup>1073</sup> IRC section 6708.

<sup>1074</sup> IRC section 6662A.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

due to reasonable cause as determined under a standard that is more stringent than that applicable to other accuracy-related penalties.<sup>1075</sup>

If the taxpayer does not adequately disclose a reportable transaction, the strengthened reasonable-cause exception is not available and the taxpayer is subject to an increased penalty equal to 30 percent of the understatement.<sup>1076</sup> However, a taxpayer will be treated as having adequately disclosed a transaction for this purpose if the Commissioner has separately rescinded the separate penalty under IRC section 6707A for failure to disclose a reportable transaction.<sup>1077</sup> Finally, a new exception to the statute of limitations provides that the period is suspended if a listed transaction is not properly disclosed.<sup>1078</sup> If the transaction is disclosed either because the taxpayer files the proper disclosure form or a material advisor identifies the transaction to the IRS in a list maintained under IRC section 6112, the period will remain open for at least one year from the earlier of date of the disclosure by the investor or the disclosure by the material advisor with respect to that transaction.

The IRC authorizes civil actions to enjoin any person from specified conduct relating to tax shelters or reportable transactions.<sup>1079</sup> The specified conduct includes failure to comply with respect to the requirements relating to the reporting of reportable transactions<sup>1080</sup> and the keeping of lists of investors by material advisors.<sup>1081</sup> Thus, an injunction may be sought against a material advisor to enjoin the advisor from failing to file an information return with respect to a reportable transaction, or failing to maintain, or to timely furnish upon written request by the Secretary, a list of investors with respect to each reportable transaction. In addition, injunctions, monetary penalties and suspension or disbarment are authorized with respect to violations of any of the rules under Circular 230, which regulates the practice of representatives of persons before the Department of the Treasury.

#### Reports to Congress by the Secretary

The Secretary is required to maintain records and report on the administration of the penalties for failure to disclose a reportable transaction in two ways. First, each decision to rescind a penalty imposed under IRC section 6707 or IRC section 6707A must be memorialized in a record

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<sup>1075</sup> IRC section 6664(d).

<sup>1076</sup> IRC section 6662A(c).

<sup>1077</sup> IRC section 6664(d).

<sup>1078</sup> IRC section 6501(c)(10).

<sup>1079</sup> IRC section 7408.

<sup>1080</sup> IRC section 6707.

<sup>1081</sup> IRC section 6708.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

maintained in the Office of the Commissioner.<sup>1082</sup> That record must include a description of the facts and circumstances of the violation, the reasons for the decision to rescind, and the amount rescinded. Second, the IRS is required to submit an annual report to Congress on the administration of the rescission authority under both IRC sections 6707 and 6707A. The information with respect to the latter is to be in summary form, while the information on rescission of penalties imposed against material advisors is to be more detailed.<sup>1083</sup> The report is not required to address administration of the other enforcement tools described above.

New Federal Law (Uncodified Act section 2103 affecting IRC sections 6662A, 6700, 6707, 6707A, and 6708)

The provision requires that the IRS, in consultation with the Secretary, submit an annual report on administration of certain penalty provisions of the IRC to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate. A summary of penalties assessed the preceding year is required. In addition, the Secretary must report actions taken against practitioners appearing before the Treasury or IRS with respect to a reportable transaction<sup>1084</sup> and instances in which the IRS attempted to rely on the exception to the limitations period for assessment based on failure to disclose a listed transaction.<sup>1085</sup> The penalties that are subject to this reporting requirement are those assessed in the preceding year with respect to: (1) a participant's failure to disclose a reportable transaction;<sup>1086</sup> (2) reportable transaction understatements;<sup>1087</sup> (3) promotion of abusive shelters;<sup>1088</sup> (4) failure of a material advisor to furnish information on a reportable transaction;<sup>1089</sup> and (5) material advisors' failure to maintain or produce a list of reportable transactions.<sup>1090</sup>

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<sup>1082</sup> IRC section 6707(c) incorporates by reference the provisions of IRC section 6707A(d), which details the extent of the Commissioner's authority to rescind the penalty.

<sup>1083</sup> AJCA provides:

"The Commissioner of Internal Revenue shall annually report to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate--

"(1) a summary of the total number and aggregate amount of penalties imposed, and rescinded, under IRC section 6707A, and

"(2) a description of each penalty rescinded under IRC section 6707(c) and the reasons therefor."

Public Law 108-357, Title VIII, Subtitle B, Part I, § 811(d), 118 Stat. 1577, Oct. 22, 2004.

<sup>1084</sup> 31 U.S.C. sec. 330(b) authorizes the Secretary to impose sanctions on those who appear before the Department, including monetary penalties and suspension or disbarment from practice before the Department.

<sup>1085</sup> IRC section 6501(c)(10) provides that the limitations period with respect to tax attributable to a listed transaction shall not expire less than one year after the required disclosure of that transaction is furnished by the taxpayer or by the material advisor, whichever is earlier.

<sup>1086</sup> IRC section 6707A.

<sup>1087</sup> IRC section 6662A.

<sup>1088</sup> IRC section 6700.

<sup>1089</sup> IRC section 6707.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

Effective Date

The first annual report is required to be submitted not later than December 31, 2010.

California Law (None)

This uncodified IRS reporting requirement does not apply under California law.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
2104	Application of Continuous Levy to Tax Liabilities of Certain Federal Contractors

Background

In General

Levy is the IRS's administrative authority to seize a taxpayer's property or rights to property to pay the taxpayer's tax liability.<sup>1091</sup> Generally, the IRS is entitled to seize a taxpayer's property by levy if a federal tax lien has attached to such property,<sup>1092</sup> and the IRS has provided both notice of intention to levy<sup>1093</sup> and notice of the right to an administrative hearing (referred to as a collections due process notice or "CDP" notice)<sup>1094</sup> at least thirty days before the levy is made. A federal tax lien arises automatically when a tax assessment has been made, the taxpayer has been given notice of the assessment stating the amount and demanding payment, and the taxpayer has failed to pay the amount assessed within 10 days after the notice and demand.<sup>1095</sup>

The 30-day pre-levy notice requirements, the taxpayer's rights before, during, and following the CDP hearing, and the Federal payment levy program are discussed below.

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<sup>1090</sup> IRC section 6708.

<sup>1091</sup> IRC section 6331(a). Levy specifically refers to the legal process by which the IRS orders a third party to turn over property in its possession that belongs to the delinquent taxpayer named in a notice of levy.

<sup>1092</sup> IRC section 6331(a).

<sup>1093</sup> IRC section 6331(d).

<sup>1094</sup> IRC section 6330. The administrative hearing is referred to as the CDP hearing.

<sup>1095</sup> IRC sections 6321 and 6331(a).

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

### Pre-Levy Notice Requirements

The notice of intent to levy and the CDP notice must include a brief statement describing the following: (1) the statutory provisions and procedures for levy; (2) the administrative appeals available to the taxpayer; (3) the alternatives available to avoid levy; and (4) the provisions and procedures regarding redemption of levied property.<sup>1096</sup> In addition, the collection due process notice must include the following: (1) the amount of the unpaid tax; and (2) the right to request a hearing during the 30-day period before the IRS serves the levy.

Upon receipt of this information, the taxpayer may stay the levy action by requesting in writing a hearing before the IRS Appeals Office.<sup>1097</sup> Otherwise, the IRS will levy to collect the amount owed after expiration of 30 days from the notice.

The notice of intent to levy is not required if the Secretary finds that collection would be jeopardized by delay. The standard for determining whether jeopardy exists is similar to the standard applicable in permitting the IRS to assess a tax without following the normal deficiency procedures.<sup>1098</sup>

The CDP notice (and pre-levy CDP hearing) is not required if the Secretary finds that collection would be jeopardized by delay or the Secretary has served a levy on a state to collect a federal tax liability from a state tax refund. In addition, a levy issued to collect federal employment taxes is excepted from the CDP notice and the pre-levy CDP hearing requirement if the taxpayer subject to the levy requested a CDP hearing with respect to unpaid employment taxes arising in the two-year period before the beginning of the taxable period with respect to which the employment tax levy is served. The taxpayer, however, in each of these three cases, is provided an opportunity for a hearing within a reasonable period of time after the levy.<sup>1099</sup>

### CDP Hearing

At the CDP hearing, the taxpayer may present defenses to collection as well as arguments disputing the merits of the underlying tax debt if the taxpayer had no prior opportunity to present such arguments.<sup>1100</sup> In addition, the taxpayer is required to be provided the opportunity to negotiate an alternative form of payment, such as an offer in compromise, under which the IRS would accept less than the full amount, or an installment agreement under which payments in

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<sup>1096</sup> IRC sections 6330(a)(3) and 6331(d)(4). In practice, the notice of intent to levy and the collections due process notice is provided together in one document, Letter 1058, *Final Notice, Notice of Intent to Levy and Notice of Your Right to a Hearing*. Chief Counsel Advice Memorandum 2009-041 (November 28, 2008).

<sup>1097</sup> IRC section 6330(b).

<sup>1098</sup> IRC sections 6331(d)(3) and 6861.

<sup>1099</sup> IRC section 6330(f).

<sup>1100</sup> IRC section 6330(c).

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

satisfaction of the debt may be made over time rather than in one lump sum, or some combination of such measures.<sup>1101</sup> If a taxpayer exercises any of these rights in response to the notice of intent to levy, the IRS may not proceed with its levy.

After the CDP hearing, a taxpayer also has a right to seek, within 30 days, judicial review in the U.S. Tax Court of the determination of the CDP hearing to ascertain whether the IRS abused its discretion in reaching its determination.<sup>1102</sup> During this time period, the IRS may not proceed with its levy.

#### Federal Payment Levy Program

To help the IRS collect taxes more effectively, the Taxpayer Relief Act of 1997<sup>1103</sup> authorized the establishment of the Federal Payment Levy Program ("FPLP"), which allows the IRS to continuously levy up to 15 percent of certain "specified payments," such as government payments to federal contractors that are delinquent on their tax obligations. The levy generally continues in effect until the liability is paid or the IRS releases the levy.<sup>1104</sup>

Under FPLP, the IRS matches its accounts receivable records with federal payment records maintained by the Department of the Treasury's Financial Management Service ("FMS"), such as certain Social Security benefit and federal wage records. When the records match, the delinquent taxpayer is provided both notice of intention to levy and notice of the right to the CDP hearing 30 days before the levy is made. If the taxpayer does not respond after 30 days, the IRS can instruct FMS to levy its federal payments. Subsequent payments are continuously levied until the tax debt is paid or IRS releases the levy.

Upon receipt of this information, however, the taxpayer may stay the levy action by requesting in writing a hearing before the IRS Appeals Office. Following the CDP hearing, a taxpayer has a right to seek, within 30 days, judicial review in the U.S. Tax Court of the determination of the CDP hearing to ascertain whether the IRS abused its discretion in reaching its determination. During this time period, the IRS may not proceed with its levy.

#### New Federal Law (IRC section 6330)

The provision allows the IRS to issue levies prior to a CDP hearing with respect to federal tax liabilities of federal contractors identified under the Federal Payment Levy Program. When a levy is issued prior to a CDP hearing under this proposal, the taxpayer has an opportunity for a CDP hearing within a reasonable time after the levy.

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<sup>1101</sup> IRC section 6330(c)(2).

<sup>1102</sup> IRC section 6330(d).

<sup>1103</sup> Public Law 105-34.

<sup>1104</sup> IRC section 6331(h). With respect to federal payments to vendors of goods or services (not defined), the continuous levy may be up to 100 percent of each payment. IRC section 6331(h)(3).

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

Effective Date

The provision applies to levies issued after September 27, 2010.

California Law (None)

California does not conform to IRC section 6330, relating to notice and opportunity for hearing before levy.

Impact on California Revenue

Not applicable.

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Section

Section Title

2111

Participants in Government Section 457 Plans Allowed to Treat Elective Deferrals as Roth Contributions

Background

IRC section 401(k) plans and IRC section 403(b) plans are permitted to have qualified Roth contribution programs under which participants may elect to make non-excludable contributions to "designated Roth accounts" and, if certain conditions are met, to exclude from gross income distributions from these accounts.

A qualified Roth contribution program is a program under which a participant may elect to make designated Roth contributions in lieu of all or a portion of the elective deferrals that he or she otherwise would be eligible to make under the applicable retirement plan. To qualify as a qualified Roth contribution program, a plan must: (1) establish a separate designated Roth account for the designated Roth contributions of each participant (and for the earnings allocable to these contributions); (2) maintain separate records for each account; and (3) refrain from allocating to the designated Roth account amounts from non-designated Roth accounts.

Generally, if an "applicable retirement plan" includes a qualified Roth contribution program then any contribution that a participant makes under the program is treated as an "elective deferral," but is not excludable from gross income.<sup>1105</sup> For purposes of the qualified Roth contribution program rules, the term "applicable retirement plan" means: (1) an employee trust described in IRC section 401(a) that is tax exempt under IRC section 501(a);<sup>1106</sup> and (2) a plan under which amounts are contributed by an individual's employer for an IRC section 403(b) annuity

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<sup>1105</sup> IRC section 402A(a)(1).

<sup>1106</sup> That is, a trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of its employees or their beneficiaries.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

contract.<sup>1107</sup> An "elective deferral" is any deferral described in: (1) IRC section 402(g)(3)(A) (employer contributions to IRC section 401(k) plans not includible in employee's gross income); or (2) IRC section 402(g)(3)(C) (employer contributions to purchase an annuity contract under an IRC section 403(b) salary-reduction agreement).

New Federal Law (IRC section 402A)

The provision amends the definition of "applicable retirement plan" to include eligible deferred compensation plans (as defined under IRC section 457(b)) maintained by a state, a political subdivision of a state, an agency or instrumentality of a state, or an agency or instrumentality of a political subdivision of a state (collectively, "governmental 457(b) plans"). The provision also amends the definition of "elective deferral" in IRC section 402A to include amounts deferred under a governmental 457(b) plan.

Effective Date

The provision is effective for taxable years beginning after December 31, 2010.

California Law (R&TC section 17501)

California automatically conforms to this provision (that adds "governmental 457 plans" to the definition of "applicable retirement plans" that can offer a qualified Roth contribution program).<sup>1108</sup>

Impact on California Revenue

Baseline—based on a proration of federal revenue estimates developed by the Joint Committee on Taxation, baseline revenue gains are estimated to be \$1,000,000 in 2011-12, \$800,000 in 2012-13, and \$1,200,000 in 2013-14.

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<sup>1107</sup> That is, an annuity purchased by an IRC section 501(c)(3) organization or a public school.

<sup>1108</sup> R&TC section 17501(b).

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

<u>Section</u>	<u>Section Title</u>
2112	Rollovers from Elective Deferral Plans to Designated Roth Accounts

Background

Individual Retirement Arrangements

*General rules*

There are two basic types of individual retirement arrangements ("IRAs") under present law: traditional IRAs,<sup>1109</sup> to which both deductible and nondeductible contributions may be made,<sup>1110</sup> and Roth IRAs, to which only nondeductible contributions may be made.<sup>1111</sup> The principal difference between these two types of IRAs is the timing of income tax inclusion. For a traditional IRA, an eligible contributor may deduct the contributions made for the year, but distributions are includible in gross income. For a Roth IRA, all contributions are after-tax (no deduction is allowed) but, if certain requirements are satisfied, distributions are not includable in gross income.

An annual limit applies to contributions to IRAs. The contribution limit is coordinated so that the aggregate maximum amount that can be contributed to all of an individual's IRAs (both traditional and Roth IRAs) for a taxable year is the lesser of a certain dollar amount (\$5,000 for 2010)<sup>1112</sup> or the individual's compensation. 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 is at least equal to the contributed amount.

An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to an IRA. For this purpose, the aggregate dollar limit is increased by \$1,000. Thus for example, if an individual over age 50 contributes \$6,000 to a Roth IRA for 2010 (\$5,000 plus \$1,000 catch-up), the individual will not be permitted to make any contributions to a traditional IRA for the year. In addition, deductible contributions to traditional IRAs and after tax contributions to Roth IRAs generally are subject to AGI limits. IRA contributions generally must be made in cash.

*Roth IRAs*

Individuals with adjusted gross income below certain levels may make nondeductible contributions to a Roth IRA. 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 2010 are: (1) for single taxpayers,

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<sup>1109</sup> IRC section 408.

<sup>1110</sup> IRC section 219.

<sup>1111</sup> IRC section 408A.

<sup>1112</sup> The dollar limit is indexed for inflation.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

\$109,000 to \$124,000; (2) for married taxpayers filing joint returns, \$167,000 to \$177,000; and (3) for married taxpayers filing separate returns, \$0 to \$10,000. Contributions to a Roth IRA may be made even after the account owner has attained age 70 ½.

Taxpayers generally may convert a traditional IRA into a Roth IRA.<sup>1113</sup> A conversion may be accomplished by means of a rollover, trustee-to-trustee transfer, or account re-designation. Regardless of the means used to convert, any amount converted from a traditional IRA to a Roth IRA is treated as distributed from the traditional IRA and rolled over to the Roth IRA. The amount converted is includible in income as if a withdrawal had been made, except that the 10-percent early-withdrawal tax does not apply.

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, or subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that: (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA; and (2) is made after attainment of age 59½, on account of death or disability, or is made for first-time homebuyer expenses of up to \$10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings. Under special ordering rules, after-tax contributions are recovered before income.<sup>1114</sup> The amount includible in income is also subject to the 10-percent early-withdrawal tax unless an exception applies. The same exceptions to the early withdrawal tax that apply to traditional IRAs apply to Roth IRAs.

#### Cash or Deferred Arrangements

##### *IRC section 401(k) plans and IRC section 403(b) plans*

A qualified retirement plan<sup>1115</sup> that is a profit-sharing plan may allow an employee to make an election between cash and an employer contribution to the plan pursuant to a qualified cash or deferred arrangement. A plan with this feature is generally referred to as an IRC section 401(k) plan. An IRC section 403(b) plan may allow a similar salary-reduction agreement under which an employee may make an election between cash and an employer contribution to the plan.<sup>1116</sup>

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<sup>1113</sup> For taxable years beginning before January 1, 2010, such a conversion is not permitted to be made by a taxpayer whose modified adjusted gross income for the year of the distribution exceeds \$100,000 (or who, if married, does not file jointly). For taxable years beginning before January 1, 2010, a rollover from an eligible employer plan not made from a designated Roth account is available only to a taxpayer whose modified adjusted gross income for the year of the distribution does not exceed \$100,000 (and who, if married, files jointly).

<sup>1114</sup> IRC section 408A(d)(4).

<sup>1115</sup> Qualified retirement plans include plans qualified under IRC section 401(a) and IRC section 403(a) annuity plans.

<sup>1116</sup> IRC section 403(b) plans may be maintained only by: (1) tax-exempt charitable organizations; and (2) educational institutions of state or local governments (including public schools). Many of the rules that apply to IRC section 403(b) plans are similar to the rules applicable to qualified retirement plans, including IRC section 401(k) plans.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

Amounts contributed pursuant to these qualified cash or deferred arrangements and salary-reduction agreements generally are referred to as elective contributions and generally are excludable from gross income. There is a dollar limit on the aggregate amount of elective contributions that an employee is permitted to contribute to either of these plans for a taxable year, which is \$16,500 for 2010. There is an additional catch-up amount that employees over age 50 are allowed to contribute, which is \$5,500 for 2010.

Elective contributions under an IRC section 401(k) plan are subject to distribution restrictions under the plan. Such contributions generally may only be distributed after attainment of age 59½, death of the employee, termination of the plan, or severance from employment with the employer maintaining the plan. These contributions are also permitted to be distributed on account of hardship. These limitations also apply to certain other contributions to the plan except that such distributions cannot be distributed on account of hardship. Similar distribution restrictions apply to salary-reduction contributions under IRC section 403(b) plans.

Amounts under a profit sharing plan that are not subject to these specific distribution restrictions are distributable only as permitted under the plan terms. In order to meet the definition of profit-sharing plan, the plan may allow distribution of an amount contributed to a profit sharing plan after a fixed number of years (but not less than two).<sup>1117</sup>

#### *Designated Roth Accounts*

A qualified retirement plan or an IRC section 403(b) plan with a cash or deferred arrangement can include a designated Roth program under which an employee is permitted to designate any elective contribution as a designated Roth contribution in lieu of making a pre-tax elective contribution. Although such a plan is permitted to offer only the opportunity to make pre-tax elective contributions, a plan that allows designated Roth contributions must offer a choice of both pre-tax elective contributions and designated Roth contributions.<sup>1118</sup> The designated contributions are generally treated the same under the plan as pre-tax elective contributions (e.g. the nondiscrimination requirements and contribution limits) except a designated Roth contribution is not excluded from gross income.

All designated Roth contributions made under the plan must be maintained in a separate account (a designated Roth account). Any distribution from a designated Roth account (other than a qualified distribution) is taxable under IRC section 402 by treating the designated Roth account as a separate contract for purpose of IRC section 72. The distribution is included in the distributee's gross income to the extent allocable to income under the contract and excluded from gross income to the extent allocable to investment in the contract (commonly referred to as basis), taking into account only the designated Roth contributions as basis. The special basis-first recovery rule for Roth IRAs does not apply to distributions from designated Roth accounts.

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<sup>1117</sup> Rev. Rul. 71-295, 1971, CB 184 and Treas. Reg. section 1.401(b)(1)(ii).

<sup>1118</sup> Treas. Reg. section 1.401(k)-1(f)(1)(i).

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

A qualified distribution from a designated Roth account is excludable from gross income. A qualified distribution is a distribution that is made after completion of a specified 5-year period and the satisfaction of one of three other requirements. The three other requirements are the same as the other requirements for a qualified distribution from a Roth account except that the first-time home buyer provision does not apply.

Eligible rollover distributions from designated Roth accounts may only be rolled over tax free to another designated Roth account or a Roth IRA.

#### Rollovers from Eligible Retirement Plans

An eligible rollover distribution from an eligible employer plan that is not from a designated Roth account may be rolled over to an eligible retirement plan that is not a Roth IRA or a designated Roth account. An eligible employer plan is a qualified retirement plan, an IRC section 403(b) plan; and a "governmental section 457(b) plan."<sup>1119</sup> In such a case, the distribution generally is not currently includable in the distributee's gross income. An eligible retirement plan means an individual retirement plan or an eligible employer plan. An eligible rollover distribution is any distribution from an eligible employer plan with certain exceptions. Distributions that are not eligible rollover distributions generally are certain periodic payments, any distribution to the extent the distribution is a minimum required distribution, and any distribution made on account of hardship of the employee.<sup>1120</sup> Only an employee or a surviving spouse of an employee is allowed to rollover an eligible rollover distribution from an eligible employer plan to another eligible employer plan.<sup>1121</sup>

Distributions from an eligible employer plan are also permitted to be rolled over into a Roth IRA, subject to the present-law rules that apply to conversions from a traditional IRA into a Roth IRA.<sup>1122</sup> Thus, a rollover from an eligible employer plan into a Roth IRA is includable in gross income (except to the extent it represents a return of after-tax contributions), and the 10-percent early-distribution tax does not apply.<sup>1123</sup> In the case of a distribution and rollover of property, the amount of the distribution for purposes of determining the amount includable in gross income is

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<sup>1119</sup> A "governmental section 457(b) plan" is an eligible IRC section 457(b) plan maintained by a governmental employer described in IRC section 457(e)(1)(A).

<sup>1120</sup> IRC section 402(c)(4).

<sup>1121</sup> IRC Section 402(c)(10) allows non-spouse beneficiaries to make a direct rollover to an IRA but not another eligible employer plan.

<sup>1122</sup> For taxable years beginning before January 1, 2010, a rollover from an eligible employer plan not made from a designated Roth account is available only to a taxpayer whose modified adjusted gross income for the year of the distribution does not exceed \$100,000 (and who, if married, files jointly).

<sup>1123</sup> Prior to enactment of section 824 of the Pension Protection Act of 2006, Public Law 109-280, an eligible rollover distribution from an eligible employer plan not made from a designated Roth account could be rolled over to a non-Roth IRA and then converted to a Roth IRA, but could not be rolled over to a Roth IRA without an intervening rollover to a non-Roth IRA followed by a conversion to a Roth IRA. See Notice 2008-30, 2008-12 I.R.B. 638.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

generally the fair market value of the property on the date of the distribution.<sup>1124</sup> The special rules relating to net unrealized appreciation and certain optional methods for calculating tax available to participants born on or before January 1, 1936, are not applicable.<sup>1125</sup> A special recapture rule relating to the 10-percent additional tax on early distributions applies for distributions made from a Roth IRA within a specified five-year period after a rollover.<sup>1126</sup>

#### Special Rule for 2010 Conversions or Rollovers

In the case of a rollover from a tax-qualified retirement plan (other than a designated Roth account) into a Roth IRA, unless the taxpayer elects to include the distribution in income in 2010, any amount otherwise required to be included in gross income for the 2010 taxable year is not included in that taxable year but is instead included in gross income in equal amounts for the 2011 and 2012 taxable years. The same rule applies to a conversion of a traditional IRA into a Roth IRA in 2010. However, in both cases, the special recapture rule relating to the 10-percent additional tax on early distributions applies for distributions made from a Roth IRA within a specified five-year period after a rollover.

#### New Federal Law (IRC section 402A)

Under the provision, if an IRC section 401(k) plan, IRC section 403(b) plan, or governmental section 457(b) plan<sup>1127</sup> has a qualified designated Roth contribution program, a distribution to an employee (or a surviving spouse) from an account under the plan that is not a designated Roth account is permitted to be rolled over into a designated Roth account under the plan for the individual. However, a plan that does not otherwise have a designated Roth program is not permitted to establish designated Roth accounts solely to accept these rollover contributions. Thus, for example, a qualified employer plan that does not include a qualified cash or deferred arrangement with a designated Roth program cannot allow rollover contributions from accounts that are not designated Roth accounts to designated Roth accounts established solely for purposes of accepting these rollover contributions. Further, the distribution to be rolled over must be otherwise allowed under the plan. For example, an amount under an IRC section 401(k) plan subject to distribution restrictions cannot be rolled over to a designated Roth account under this provision. However, if an employer decides to expand its distribution options beyond those currently allowed under its plan, such as by adding in-service distributions or distributions prior to normal retirement age, in order to allow employees to make the rollover contributions permitted under this provision, the plan may condition eligibility for such a new distribution option on an employee's election to have the distribution directly rolled over to the designated Roth program within that plan.

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<sup>1124</sup> Treas. Reg. section 1.402(a)-1(a)(iii).

<sup>1125</sup> Notice 2009-75, 2009-39 IRB 436.

<sup>1126</sup> IRC section 408A(d)(3)(F), Treas. Reg. section 1.408A-6 A-5, and Notice 2008-30, Q&A-3.

<sup>1127</sup> The act includes a provision that adds governmental IRC section 457(b) plans to the plans that are permitted to include a designated Roth program. See explanation of section 2111 of the Act.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

In the case of a permitted rollover contribution to a designated Roth account under this provision, the individual must include the distribution in gross income (subject to basis recovery) in the same manner as if the distribution were rolled over into a Roth IRA. Thus, the special rule for distributions from eligible retirement plans (other than from designated Roth accounts) that are contributed to a Roth IRA in 2010 applies for these rollover contributions to a designated Roth account. Under this special rule, the taxpayer is allowed to include the amount in income in equal parts in 2011 and 2012. The special recapture rule for the 10-percent early distribution tax also applies if distributions are made from the designated Roth account in the relevant five-year period.

This rollover contribution may be accomplished at the election of the employee (or surviving spouse) through a direct rollover (operationally through a transfer of assets from the account that is not a designated Roth account to the designated Roth account). However, such a direct rollover is only permitted if the employee (or surviving spouse) is eligible for a distribution in that amount and in that form (if property is transferred) and the distribution is an eligible rollover distribution. If the direct rollover is accomplished by a transfer of property to the designated Roth account (rather than cash), the amount of the distribution is the fair market value of the property on the date of the transfer.

A plan that includes a designated Roth program is permitted but not required to allow employees (and surviving spouses) to make the rollover contribution described in this provision to a designated Roth account. If a plan allows these rollover contributions to a designated Roth account, the plan must be amended to reflect this plan feature. It is intended that the IRS will provide employers with a remedial amendment period that allows the employers to offer this option to employees (and surviving spouses) for distributions during 2010 and then have sufficient time to amend the plan to reflect this feature.<sup>1128</sup>

#### Effective Date

The provision is effective for distributions made after September 27, 2010.

#### California Law (R&TC section 17501)

California automatically conforms to this provision (that permits 2010 rollover distributions from IRC section 401(k) plans, IRC section 403(b) plans, or governmental section 457(b) plans to designated Roth accounts).

#### Impact on California Revenue

Baseline—based on a proration of federal revenue estimates developed by the Joint Committee on Taxation, baseline revenue gains are estimated to be \$23,000,000 in 2011-12, \$16,000,000 in 2012-13, and \$15,000,000 in 2013-14.

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<sup>1128</sup> See IRC section 401(b), Treas. Reg. section 1.401(b)-1, and Rev. Proc. 2007-44, 2007-2 CB 54, regarding remedial amendment periods for plan amendments.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

<u>Section</u>	<u>Section Title</u>
2113	Special Rules for Annuities Received from Only a Portion of a Contract

Background

Treatment of Annuity Contracts

In general, earnings and gains on a deferred annuity contract are not subject to tax during the deferral period in the hands of the holder of the contract.<sup>1129</sup> When payout commences under a deferred annuity contract, the tax treatment of amounts distributed depends on whether the amount is received as an annuity (generally, as periodic payments under contract terms) or not.<sup>1130</sup>

For amounts received as an annuity by an individual, an exclusion ratio is provided for determining the taxable portion of each payment.<sup>1131</sup> The portion of each payment that is attributable to recovery of the taxpayer's investment in the contract is not taxed. The taxable portion of each payment is ordinary income. The exclusion ratio is the ratio of the taxpayer's investment in the contract to the expected return under the contract, that is, the total of the payments expected to be received under the contract. The ratio is determined as of the taxpayer's annuity starting date. Once the taxpayer has recovered his or her investment in the contract, all further payments are included in income. If the taxpayer dies before the full investment in the contract is recovered, a deduction is allowed on the final return for the remaining investment in the contract. IRC section 72 uses the term "investment in the contract" in lieu of the more generally applicable term "basis."

Amounts not received as an annuity generally are included as ordinary income if received on or after the annuity starting date, and are included in income to the extent allocable to income on the contract if received before the annuity starting date (i.e., as income first).<sup>1132</sup>

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<sup>1129</sup> If an annuity contract is held by a corporation or by any other person that is not a natural person, the income on the contract is treated as ordinary income accrued by the contract owner and is subject to current taxation. The contract is not treated as an annuity contract (IRC section 72(u)).

<sup>1130</sup> IRC section 72.

<sup>1131</sup> IRC section 72(b).

<sup>1132</sup> IRC section 72(e). By contrast to distributions under an annuity contract, distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income (IRC section 72(e)). In the case of a modified endowment contract, however, distributions are generally treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10-percent tax is imposed on the income portion of distributions made before age 59-1/2 and in certain other circumstances (IRC sections 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test; i.e., generally is funded more rapidly than seven annual level premiums (IRC section 7702A).

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

Specific rules for recovering the investment in the contract for amounts received as an annuity are provided for plans qualified under IRC section 401(a), plans described in IRC section 403(a), and IRC section 403(b) tax-deferred annuities.<sup>1133</sup> In addition, specific rules apply to amounts not received as an annuity under these plans and individual retirement plans.<sup>1134</sup>

#### Tax-Free Exchanges of Annuity Contracts

Present law provides for the exchange of certain insurance contracts without recognition of gain or loss.<sup>1135</sup> No gain or loss is recognized on the exchange of: (1) a life insurance contract for another life insurance contract or for an endowment or annuity contract or for a qualified long-term care insurance contract; (2) an endowment contract for another endowment contract (that provides for regular payments beginning no later than under the exchanged contract) or for an annuity contract or for a qualified long-term care insurance contract; (3) an annuity contract for an annuity contract or for a qualified long-term care insurance contract; or (4) a qualified long-term care insurance contract for a qualified long-term care insurance contract. The basis of the contract received in the exchange generally is the same as the basis of the contract exchanged.<sup>1136</sup>

In interpreting IRC section 1035, case law holds that an exchange of a portion of an annuity contract for another annuity contract qualifies as a tax-free exchange.<sup>1137</sup> Treasury guidance provides rules for determining whether a direct transfer of a portion of the cash surrender value of an annuity contract for a second annuity contract qualifies as an IRC section 1035 tax-free exchange. Under the Treasury guidance, either the annuity contract received, or the contract partially exchanged, in the tax-free exchange may be annuitized without jeopardizing the tax-free exchange (or amounts withdrawn from it or received in surrender of it) after the period ending 12 months from the receipt of the premium in the exchange.<sup>1138</sup>

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<sup>1133</sup> IRC section 72(d).

<sup>1134</sup> IRC section 72(e)(8).

<sup>1135</sup> IRC section 1035.

<sup>1136</sup> IRC section 1031(d).

<sup>1137</sup> *Conway v. Comm'r*, 111 T.C. 350 (1998), *acq.*, 1999-2 C.B. xvi.

<sup>1138</sup> Rev. Proc. 2008-24, 2008-13 I.R.B. 684. The Rev. Proc. further provides that a transfer does not, however, qualify as a tax-free exchange if the payment is a distribution that is part of a series of substantially equal periodic payments, or if the payment is a distribution under an immediate annuity. The Treasury guidance further provides that if a direct transfer of a portion of an annuity contract for a second annuity contract does not qualify as a tax-free exchange under IRC section 1035, it is treated as a taxable distribution followed by a payment for the second contract.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

New Federal Law (IRC section 72)

The provision permits a portion of an annuity, endowment, or life insurance contract to be annuitized while the balance is not annuitized, provided that the annuitization period is for 10 years or more, or is for the lives of one or more individuals.

The provision provides that if any amount is received as an annuity for a period of 10 years or more, or for the lives of one or more individuals, under any portion of an annuity, endowment, or life insurance contract, then that portion of the contract is treated as a separate contract for purposes of IRC section 72.

The investment in the contract is allocated on a pro-rata basis between each portion of the contract from which amounts are received as an annuity and the portion of the contract from which amounts are not received as an annuity. This allocation is made for purposes of applying the rules relating to the exclusion ratio, the determination of the investment in the contract, the expected return, the annuity starting date, and amounts not received as an annuity.<sup>1139</sup> A separate annuity starting date is determined with respect to each portion of the contract from which amounts are received as an annuity.

The provision is not intended to change the present-law rules with respect either to amounts received as an annuity, or to amounts not received as an annuity, in the case of plans qualified under IRC section 401(a), plans described in IRC section 403(a), IRC section 403(b) tax-deferred annuities, or individual retirement plans.

Effective Date

The provision is effective for amounts received in taxable years beginning after December 31, 2010.

California Law (R&TC sections 17081, 17085, 17085.7, and 17087)

California conforms to IRC section 72 as of the “specified date” of January 1, 2009, with modifications, and as a result does not conform to this provision (that permits a portion of an annuity, endowment, or life insurance contract to be annuitized while the balance is not annuitized).

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<sup>1139</sup> IRC sections 72(b), (c), and (e).

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

Impact on California Revenue

Estimated Revenue Impact of Special Rules for Annuities Received from Only a Portion of a Contract For Taxable Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
\$900,000	\$1,200,000	\$1,800,000

Estimates are based on a proration of federal estimates developed by the Joint Committee on Taxation.

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<u>Section</u>	<u>Section Title</u>
2121	Crude Tall Oil Ineligible for Cellulosic Biofuel Producer Credit

Background

The "cellulosic biofuel producer credit" is a nonrefundable income tax credit for each gallon of qualified cellulosic biofuel production of the producer for the taxable year. The amount of the credit is generally \$1.01 per gallon.<sup>1140</sup>

"Qualified cellulosic biofuel production" is any cellulosic biofuel that is produced by the taxpayer and that is: (1) sold by the taxpayer to another person (a) for use by such other person in the production of a qualified cellulosic biofuel 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 cellulosic biofuel at retail to another person and places such cellulosic biofuel in the fuel tank of such other person; or (2) used by the producer for any purpose described in (1)(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; (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 ("EPA") under section 211 of the Clean Air Act. The cellulosic biofuel producer credit cannot be claimed unless the taxpayer is registered by the IRS as a producer of cellulosic biofuel.

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<sup>1140</sup> In the case of cellulosic biofuel that is alcohol, the \$1.01 credit amount is reduced by the credit amount of the alcohol mixture credit, and for ethanol, the credit amount for small ethanol producers, as in effect at the time the cellulosic biofuel fuel is produced.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

Cellulosic biofuel does not include certain unprocessed fuel. Unprocessed fuels are fuels that: (1) are more than four percent (determined by weight) water and sediment in any combination; or (2) have an ash content of more than one percent (determined by weight).<sup>1141</sup> Cellulosic biofuel eligible for the IRC section 40 credit is precluded from qualifying as biodiesel, renewable diesel, or alternative fuel for purposes of the applicable income tax credit, excise tax credit, or payment provisions relating to those fuels.<sup>1142</sup>

Because it is a credit under IRC section 40(a), the cellulosic biofuel producer credit is part of the general business credits in IRC section 38. However, unlike other general business credits, the cellulosic biofuel producer credit can only be carried forward three taxable years after the termination of the credit. The credit is also allowable against the alternative minimum tax. Under IRC section 87, the credit is included in gross income. The cellulosic biofuel producer credit terminates on December 31, 2012.

The kraft process for making paper produces a byproduct called black liquor, which has been used for decades by paper manufacturers as a fuel in the papermaking process. Black liquor is composed of water, lignin and the spent chemicals used to break down the wood. The amount of the biomass in black liquor varies. The portion of the black liquor that is not consumed as a fuel source for the paper mills is recycled back into the papermaking process. Black liquor has ash content (mineral and other inorganic matter) significantly above that of other fuels.

Crude tall oil is generated by reacting acid with black liquor soap. Crude tall oil is used in various applications, such as adhesives, resins and inks. It also can be burned and used as a fuel.

#### New Federal Law (IRC section 40)

The provision modifies the cellulosic biofuel producer credit to exclude from the definition of cellulosic biofuel fuels with an acid number of greater than 25. The acid number is the amount of base required to neutralize the acid in the sample. The acid number is reported as weight of the base (typically potassium hydroxide) per weight of sample, or milligram ("mg") potassium hydroxide per gram. The normal acid number for crude tall oil is between 100 and 175. As a comparison, ASTM D6751 for biodiesel specifies that the acid number be less than 0.5mg potassium hydroxide. ASTM D4806 for ethanol does not have acid value but instead limits "acidity" to 0.007 mg of acetic acid per liter, which is significantly below an acid number of 25.

#### Effective Date

The provision is effective for fuels sold or used on or after January 1, 2010.

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<sup>1141</sup> Water content (including both free water and water in solution with dissolved solids) is determined by distillation, using for example ASTM method D95 or a similar method suitable to the specific fuel being tested. Sediment consists of solid particles that are dispersed in the liquid fuel and is determined by centrifuge or extraction using, for example, ASTM method D1796 or D473 or similar method that reports sediment content in weight percent. Ash is the residue remaining after combustion of the sample using a specified method, such as ASTM D3174 or a similar method suitable for the fuel being tested.

<sup>1142</sup> See IRC sections 40A(d)(1), 40A(f)(3), and 6426(h).

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

California Law (None)

California does not conform to the cellulosic biofuel producer credit.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
2122	Source Rules for Income on Guarantees

Background

The United States taxes U.S. citizens and residents (including domestic corporations) on their worldwide income, whether derived in the United States or abroad. The United States generally taxes nonresident alien individuals and foreign corporations engaged in a trade or business in the United States on income that is effectively connected with the conduct of such trade or business (sometimes referred to as "effectively connected income"). The United States also taxes nonresident alien individuals and foreign corporations on certain U.S.-source income that is not effectively connected with the conduct of a U.S. trade or business.

Income of a nonresident alien individual or foreign corporation that is effectively connected with the conduct of a trade or business in the United States generally is subject to U.S. tax in the same manner and at the same rates as income of a U.S. person. Deductions are allowed to the extent that they are connected with effectively connected income.<sup>1143</sup> A foreign corporation also is subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the effectively connected earnings and profits of the corporation that are removed in any year from the conduct of its U.S. trade or business.<sup>1144</sup> In addition, a foreign corporation is subject to a flat 30-percent branch-level excess interest tax on the excess of the amount of interest that is deducted by the foreign corporation in computing its effectively connected income over the amount of interest that is paid by its U.S. trade or business.<sup>1145</sup>

Subject to a number of exceptions, U.S.-source fixed or determinable, annual or periodical income ("FDAP") of a nonresident alien individual or foreign corporation that is not effectively connected with the conduct of a U.S. trade or business is subject to U.S. tax at a rate of 30 percent of the gross amount paid.<sup>1146</sup> Items of income within the scope of FDAP include, for example, interest,

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<sup>1143</sup> IRC sections 864(c), 871(b), 873, 882(a) and 882(c).

<sup>1144</sup> IRC section 884.

<sup>1145</sup> IRC section 884(f).

<sup>1146</sup> IRC sections 871(a) and 881(a).

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

dividends, rents, royalties, salaries, and annuities. The tax generally is collected by means of withholding.<sup>1147</sup>

Present law provides detailed rules for the determination of whether income is from U.S. sources or foreign sources. For example, the source of compensation for services is generally determined by the location in which the services were performed, regardless of the country of residence of the payor.<sup>1148</sup> In contrast, the source of interest income is generally determined by reference to the country of residence of the obligor.<sup>1149</sup> As a result, interest paid by a U.S. obligor typically is considered U.S.-source income, while interest paid by a foreign obligor is treated as foreign-source income. Rents and royalties paid for the use of property located in the United States are considered to be U.S.-source income.<sup>1150</sup>

To the extent that the source of income is not specified in the statute, the Secretary may promulgate regulations that explain the appropriate treatment. Many items of income are not explicitly addressed by either the statute or the regulations. On several occasions, courts have determined the source of such items by applying the rule for the type of income to which the disputed income is most closely analogous, based on all facts and circumstances.<sup>1151</sup> As a result, items as dissimilar as alimony and letters of credit commissions were sourced by analogy to interest.<sup>1152</sup> The U.S. Tax Court, in *Container Corp. v. Commissioner*, recently rejected IRS arguments that fees paid by a domestic corporation to its foreign parent with respect to guarantees issued by the parent for the debts of the domestic corporation were analogous to interest. The Tax Court held that the payments were more closely analogous to compensation for services, and determined that the source of the fees should be determined by reference to the residence of the foreign parent-guarantor. As a result, the income was treated as income from foreign sources.<sup>1153</sup>

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<sup>1147</sup> IRC sections 1441 and 1442 provide for collection from nonresident aliens and foreign corporations, respectively.

<sup>1148</sup> Under IRC section 861(a)(3), compensation for personal services performed in the United States is U.S. source, unless the individual performing the services is a nonresident alien who is temporarily present in the United States, receives no more than \$3,000 of compensation and is performing the services for a foreign person not engaged in a U.S. trade or business. Conversely, IRC section 862(a)(3) provides that compensation for labor or services performed outside the United States is foreign source.

<sup>1149</sup> IRC sections 861(a)(1) and 862(a)(1).

<sup>1150</sup> IRC section 861(a)(4).

<sup>1151</sup> *Hunt v. Commissioner*, 90 T.C. 1289 (1988).

<sup>1152</sup> *Manning v. Commissioner*, 614 F.2d 815 (1st Cir. 1980); *Bank of America v. United States*, 230 Ct. Cl. 679, 680 F.2d 142 (1982), *aff'g in part, rev'g in part*, 47 AFTR 2d 81-652 (Ct. Cl. 1981).

<sup>1153</sup> *Container Corp. v. Commissioner*, 134 T.C. No. 5 (February 17, 2010), *gov't notice of appeal filed* (5th Cir. June 1, 2010).

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

New Federal Law (IRC sections 861, 862, and 864)

This provision effects a legislative override of the opinion in *Container Corp. v. Commissioner, supra*, by amending the source rules of IRC section 861 and 862 to address income from guarantees issued after September 27, 2010. Under new IRC section 861(a)(9), income from sources within the United States includes amounts received, whether directly or indirectly, from a noncorporate resident or a domestic corporation for the provision of a guarantee of indebtedness of such person. The scope of the provision includes payments that are made indirectly for the provision of a guarantee. For example, the provision would treat as income from U.S. sources a guarantee fee paid by a foreign bank to a foreign corporation for the foreign corporation's guarantee of indebtedness owed to the bank by the foreign corporation's domestic subsidiary, where the cost of the guarantee fee is passed on to the domestic subsidiary through, for example, additional interest charged on the indebtedness.

Such U.S.-source income also includes amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of indebtedness of that foreign person if the payments received are connected with income of such person which is effectively connected with conduct of a U.S. trade or business. A conforming amendment to IRC section 862 provides that amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of that person's debt, are treated as foreign source income if they are not from sources within the United States as determined under new IRC section 861(a)(9).

For purposes of this provision, the phrase "noncorporate residents" has the same meaning as for purposes of IRC section 861(a)(1), except that foreign partnerships are not included. Payments received from a foreign partnership for the provision of a guarantee of indebtedness of that foreign partnership are U.S. source if the amounts received are connected with income which is effectively connected with the conduct of a U.S. trade or business. A conforming amendment to IRC section 864 provides that amounts received, whether directly or indirectly, for the provision of a guarantee are deemed to be effectively connected with the conduct of a U.S. trade or business if derived in the active conduct of a banking, financing, or similar business.

Although this provision overturns the opinion in *Container Corp. v. Commissioner, supra*, no inference is intended with respect to the source of income received for the provision of a guarantee issued before September 27, 2010. The Secretary may provide rules for determining the source of other types of payments that are not within the scope of this provision.

Effective Date

The provision applies to guarantees issued after September 27, 2010. No inference is intended with respect to the source of income received with respect to guarantees issued before September 27, 2010.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

California Law (R&TC sections 25101.15 and 25510)

Water's Edge

Certain controlled foreign corporations (CFCs) affiliated with corporations doing business in California that have a water's-edge election in force are required to use federal rules to determine United States source income, including rules for CFCs. The income and apportionment factors of a CFC included within a water's-edge combined report are the CFC's net income and apportionment factors determined under California law multiplied by the ratio of federal Subpart F income<sup>1154</sup> over federal earnings and profits.<sup>1155</sup>

Worldwide Combined Reporting

With respect to corporations other than water's-edge corporations, California uses the worldwide combined reporting method of determining the income subject to California tax. Under this filing method, California law does not conform to federal sourcing rules.

Impact on California Revenue

Water's Edge

Baseline—based on a proration of federal revenue estimates developed by the Joint Committee on Taxation, baseline revenue gains are estimated to be \$3,900,000 in 2011-12, \$3,400,000 in 2012-13, and \$2,900,000 in 2013-14.

Worldwide Combined Reporting

Not applicable.

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<u>Section</u>	<u>Section Title</u>
2131	Time for Payment of Corporate Estimated Taxes

Background

In general, corporations are required to make quarterly estimated tax payments of their income tax liability.<sup>1156</sup> 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. In the case of a

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<sup>1154</sup> As defined in IRC section 952.

<sup>1155</sup> As defined in IRC section 964.

<sup>1156</sup> IRC section 6655.

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

corporation with assets of at least \$1 billion (determined as of the end of the preceding taxable year):

- (i) Payments due in July, August, or September, 2014, are increased to 174.25 percent of the payment otherwise due;<sup>1157</sup>
- (ii) Payments due in July, August, or September, 2014, are increased to 174.25 percent of the payment otherwise due;<sup>1158</sup> and
- (iii) Payments due in July, August or September, 2019, are increased to 106.5 percent of the payment otherwise due.<sup>1159</sup>

For each of the periods impacted, the next required payment is reduced accordingly.

New Federal Law (IRC section 6655)

The provision increases the required payment of estimated tax otherwise due in July, August, or September, 2015, by 36 percentage points.

Effective Date

The provision is effective on September 27, 2010.

California Law (R&TC section 19025)

California does not conform to IRC section 6655, but instead has its own rules for corporate estimated tax payments.

For taxable years beginning on or after January 1, 2010, required estimated payments are as follows:

Quarter Installment	Percent of Estimated Tax
1 <sup>st</sup>	30
2 <sup>nd</sup>	40
3 <sup>rd</sup>	0
4 <sup>th</sup>	30

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<sup>1157</sup> Public Law 111-171; Public Law 111-152; Public Law 111-147, Section 561, paragraph (1); Public Law 111-124, Section 4; Public Law 111-92, Section 18; Public Law 111-42, Section 202(b)(1).

<sup>1158</sup> Public Law 111-171; Public Law 111-147, Section 561, par. (2).

<sup>1159</sup> Public Law 111-147, Section 561, paragraph (3).

SMALL BUSINESS JOBS ACT OF 2010  
Public Law 111-240, September 27, 2010

Corporate taxpayers who are not required to make an estimate payment installment in the first quarter are required to make the following installment payments in subsequent quarters:

Quarter Installment	Percent of Estimated Tax
2 <sup>nd</sup>	60
3 <sup>rd</sup>	0
4 <sup>th</sup>	40

Corporate taxpayers who are not required to make an estimate payment installment in the first two quarters are required to make the following installment payments in subsequent quarters:

Quarter Installment	Percent of Estimated Tax
3 <sup>rd</sup>	70
4 <sup>th</sup>	30

Corporate taxpayers who are not required to make an estimate payment installment in the first three quarters are required to pay 100 percent in the fourth quarter.

Impact on California Revenue

Not applicable.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

<u>Section</u>	<u>Section Title</u>
101	Temporary Extension of 2001 Tax Relief
102	Temporary Extension of 2003 Tax Relief
103	Temporary Extension of 2009 Tax Relief

## **A. Marginal Individual Income Tax Rate Reduction**

### Background

#### In General

The Economic Growth and Tax Relief Reconciliation Act of 2001<sup>1160</sup> (“EGTRRA”) created a new 10-percent regular income tax bracket for a portion of taxable income that was previously taxed at 15 percent. EGTRRA also reduced the other regular income tax rates. The otherwise applicable regular income tax rates of 28 percent, 31 percent, 36 percent and 39.6 percent were reduced to 25 percent, 28 percent, 33 percent, and 35 percent, respectively. These provisions of EGTRRA shall cease to apply for taxable years beginning after December 31, 2010.

#### Tax Rate Schedules

To determine regular tax liability, a taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer’s income increases. Separate rate schedules apply based on an individual’s filing status. For 2010, the regular individual income tax rate schedules are as follows:

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<sup>1160</sup> Public Law 107-16.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Table 1 – Federal Individual Income Tax Rates for 2010

If taxable income is:	Then income tax equals:
Single Individuals	
Not over \$8,375	10% of the taxable income
Over \$8,375 but not over \$34,000	\$837.50 plus 15% of the excess over \$8,375
Over \$34,000 but not over \$82,400	\$4,681.25 plus 25% of the excess over \$34,000
Over \$82,400 but not over \$171,850	\$16,781.25 plus 28% of the excess over \$82,400
Over \$171,850 but not over \$373,650	\$41,827.25 plus 33% of the excess over \$171,850
Over \$373,650	\$108,421.25 plus 35% of the excess over \$373,650
Heads of Households	
Not over \$11,950	10% of the taxable income
Over \$11,950 but not over \$45,550	\$1,195 plus 15% of the excess over \$11,950
Over \$45,550 but not over \$117,650	\$6,235 plus 25% of the excess over \$45,550
Over \$117,650 but not over \$190,550	\$24,260 plus 28% of the excess over \$117,650
Over \$190,550 but not over \$373,650	\$44,672 plus 33% of the excess over \$190,550
Over \$373,650	\$105,095 plus 35% of the excess over \$373,650
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over \$16,750	10% of the taxable income
Over \$16,750 but not over \$68,000	\$1,675 plus 15% of the excess over \$16,750
Over \$68,000 but not over \$137,300	\$9,362.50 plus 25% of the excess over \$68,000
Over \$137,300 but not over \$209,250	\$26,687.50 plus 28% of the excess over \$137,300
Over \$209,250 but not over \$373,650	\$46,833.50 plus 33% of the excess over \$209,250
Over \$373,650	\$101,085.50 plus 35% of the excess over \$373,650
Married Individuals Filing Separate Returns	
Not over \$8,375	10% of the taxable income
Over \$8,375 but not over \$34,000	\$837.50 plus 15% of the excess over \$8,375
Over \$34,000 but not over \$68,650	\$4,681.25 plus 25% of the excess over \$34,000
Over \$68,650 but not over \$104,625	\$13,343.75 plus 28% of the excess over \$68,650
Over \$104,625 but not over \$186,825	\$23,416.75 plus 33% of the excess over \$104,625
Over \$186,825	\$50,542.75 plus 35% of the excess over \$186,825

New Federal Law (IRC section 1)

The provision extends the 10-percent, 15-percent, 25-percent, 28-percent, 33-percent, and 35-percent individual income tax rates for two years (through 2012).

The rate structure is indexed for inflation.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

A comparison of Table 2, below, with Table 1, above, illustrates the tax rate changes. Note that Table 2 also incorporates the provision to retain the marriage penalty relief with respect to the size of the 15 percent rate bracket, as discussed below.

Table 2 – Federal Individual Income Tax Rates for 2011

If taxable income is:	Then income tax equals:
<b>Single Individuals</b>	
Not over \$8,500	10% of the taxable income
Over \$8,500 but not over \$34,500	\$850 plus 15% of the excess over \$8,500
Over \$34,500 but not over \$83,600	\$4,750 plus 25% of the excess over \$34,500
Over \$83,600 but not over \$174,400	\$17,025 plus 28% of the excess over \$83,600
Over \$174,400 but not over \$379,150	\$42,449 plus 33% of the excess over \$174,400
Over \$379,150	\$110,116 plus 35% of the excess over \$379,150
<b>Heads of Households</b>	
Not over \$12,150	10% of the taxable income
Over \$12,150 but not over \$46,250	\$1,2,15 plus 15% of the excess over \$12,150
Over \$46,250 but not over \$119,400	\$6,330 plus 25% of the excess over \$46,250
Over \$119,400 but not over \$193,350	\$24,617.50 plus 28% of the excess over \$119,400
Over \$193,350 but not over \$379,150	\$45,323.50 plus 33% of the excess over \$193,350
Over \$379,150	\$106,637.50 plus 35% of the excess over \$379,150
<b>Married Individuals Filing Joint Returns and Surviving Spouses</b>	
Not over \$17,000	10% of the taxable income
Over \$17,000 but not over \$69,000	\$1,700 plus 15% of the excess over \$17,000
Over \$69,000 but not over \$139,350	\$9,500 plus 25% of the excess over \$69,000
Over \$139,350 but not over \$212,300	\$27,087.50 plus 28% of the excess over \$139,350
Over \$212,300 but not over \$379,150	\$47,513.50 plus 33% of the excess over \$212,300
Over \$379,150	\$102,574 plus 35% of the excess over \$379,150
<b>Married Individuals Filing Separate Returns</b>	
Not over \$8,500	10% of the taxable income
Over \$8,500 but not over \$34,500	\$850 plus 15% of the excess over \$8,500
Over \$34,500 but not over \$69,675	\$4,750 plus 25% of the excess over \$34,500
Over \$69,675 but not over \$106,150	\$13,543.75 plus 28% of the excess over \$69,675
Over \$106,150 but not over \$189,575	\$23,756.75 plus 33% of the excess over \$106,150
Over \$189,575	\$51,287 plus 35% of the excess over \$189,575

Effective Date

The provision applies to taxable years beginning after December 31, 2010.

California Law (R&TC section 17041)

California does not conform to federal individual income tax rates, and instead has its own individual income tax rates under the PITL that range from 1 percent to 9.3 percent.<sup>1161</sup>

Impact on California Revenue

Not applicable.

**B. The Overall Limitation on Itemized Deductions and the Personal Exemption Phase-Out**

Background

Overall Limitation on Itemized Deductions (“Pease” Limitation)

Unless an individual elects to claim the standard deduction for a taxable year, the taxpayer is allowed to deduct his or her itemized deductions. Itemized deductions generally are those deductions that are not allowed in computing adjusted gross income (AGI). Itemized deductions include unreimbursed medical expenses, investment interest, casualty and theft losses, wagering losses, charitable contributions, qualified residence interest, state and local income and property taxes, unreimbursed employee business expenses, and certain other miscellaneous expenses.

Prior to 2010, the total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) was limited for upper-income taxpayers. In computing this reduction of total itemized deductions, all limitations applicable to such deductions (such as the separate floors) were first applied and, then, the otherwise allowable total amount of itemized deductions was reduced by three percent of the amount by which the taxpayer’s AGI exceeded a threshold amount that was indexed annually for inflation. The otherwise allowable itemized deductions could not be reduced by more than 80 percent.

EGTRRA repealed this overall limitation on itemized deductions with the repeal phased in over five years. EGTRRA provided: (1) a one-third reduction of the otherwise applicable limitation in 2006 and 2007; (2) a two-thirds reduction in 2008, and 2009; and (3) no overall limitation on itemized deductions in 2010. Thus in 2009, for example, the total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) was reduced by three percent of the amount of the taxpayer’s AGI in excess of \$166,800 (\$83,400 for married couples filing separate returns). Then the overall reduction in itemized deductions was phased-down to 1/3 of the full reduction amount (that is, the limitation was reduced by two-thirds).

Pursuant to the general EGTRRA sunset, the phased-in repeal of the Pease limitation sunsets and the limitation becomes fully effective again in 2011. Adjusting for inflation, the AGI threshold is \$169,550 for 2011.

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<sup>1161</sup> This range of individual income tax rates under R&TC section 17041(a) applies to taxable years beginning on or after January 1, 2011.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Personal Exemption Phase-Out for Certain Taxpayers (“PEP”)

Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2010, the amount deductible for each personal exemption is \$3,650. This amount is indexed annually for inflation.

Prior to 2010, the deduction for personal exemptions was reduced or eliminated for taxpayers with incomes over certain thresholds, which were indexed annually for inflation. Specifically, the total amount of exemptions that could be claimed by a taxpayer was reduced by two percent for each \$2,500 (or portion thereof) by which the taxpayer’s AGI exceeded the applicable threshold. (The phase-out rate was two percent for each \$1,250 for married taxpayers filing separate returns.) Thus, the deduction for personal exemptions was phased out over a \$122,500 range (which was not indexed for inflation), beginning at the applicable threshold.

In 2009, for example, the applicable thresholds were \$166,800 for single individuals, \$250,200 for married individuals filing a joint return and surviving spouses, \$208,500 for heads of households, and \$125,100 for married individuals filing separate returns.

EGTRRA repealed PEP with the repeal phased-in over five years. EGTRRA provided: (1) a one-third reduction of the otherwise applicable limitation in 2006 and 2007; (2) a two-thirds reduction in 2008, and 2009; and (3) no PEP in 2010. However, under the EGTRRA sunset, the PEP becomes fully effective again in 2011. Adjusted for inflation, the PEP thresholds for 2011 are: (1) \$169,550 for unmarried individuals; (2) \$254,350 for married couples filing joint returns; and (3) \$211,950 for heads of households.

New Federal Law (IRC sections 68 and 151)

Overall Limitation on Itemized Deductions (“Pease” Limitation)

Under the provision, the overall limitation on itemized deductions does not apply for two additional years (through 2012).

Personal Exemption Phase-Out for Certain Taxpayers (“PEP”)

Under the provision, the personal exemption phase-out does not apply for two additional years (through 2012).

Effective Date

The provision applies to taxable years beginning after December 31, 2010.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

California Law (R&TC sections 17054, 17054.1, and 17077)

Overall Limitation on Itemized Deductions (“Pease” Limitation)

The PITL conforms to the overall limitation on itemized deductions as of the “specified date” of January 1, 2009, with modifications.<sup>1162</sup> The PITL provides its own indexed-for-inflation limitation amounts, and specifically does not conform to the phase out and temporary repeal of the overall limitation on itemized deductions.<sup>1163</sup> Under the PITL, the 2010 amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) is reduced by six percent of the amount of the taxpayer’s AGI in excess of \$162,186 for single or married-filing-separate taxpayers, \$324,376 for married taxpayers filing a joint return, and \$243,283 for taxpayers who file under the head-of-household status.

Personal Exemption Phase-Out for Certain Taxpayers (“PEP”)

California does not conform to federal personal-exemption deductions. Instead of personal-exemption deductions, the PITL provides personal-exemption tax credits.<sup>1164</sup> For taxable year 2010, individual taxpayers are allowed personal-exemption tax credits in the amounts shown below:

Exemption Type	Number of Exemptions	Exemption Amount
Personal Exemption	One exemption for themselves, and one for a spouse, if married filing joint (MFJ).	\$99
Senior	One additional exemption if 65 or older, and one for a spouse 65 or older, if MFJ.	\$99
Blind	One additional exemption if visually impaired and one for a visually impaired spouse.	\$99
Dependent	One exemption for each qualifying dependent.	\$99

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<sup>1162</sup> For taxable years beginning on or after January 1, 2010, R&TC section 17077 conforms to IRC 68, relating to the overall limitation on itemized deductions, with modifications, as of the specified date of January 1, 2009, with modifications.

<sup>1163</sup> R&TC section 17077(d) and (e).

<sup>1164</sup> R&TC section 17054. The exemption credits are adjusted annually based on the California Consumer Price Index.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

The personal-exemption tax credits are reduced when a taxpayer's federal AGI exceeds a threshold amount.<sup>1165</sup> For taxable year 2010, the exemption credits are reduced by \$6 (\$12 if married filing joint) for each \$2,500 (\$1,250 if married filing separately) of AGI or fraction thereof, that exceeds the following threshold amounts:

- Single or Married/Registered Domestic Partner (RDP) filing separate \$162,186
- Married/RDP filing joint \$243,283
- Head of Household \$324,376

Impact on California Revenue

Not applicable.

**C. Child Tax Credit**

Background

An individual may claim a tax credit for each qualifying child under the age of 17. The maximum 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 aggregate amount of child credits that may be claimed is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable aggregate child tax credit amount is reduced by \$50 for each \$1,000 (or fraction thereof) of modified adjusted gross income ("modified AGI") 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 AGI 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, for taxable years beginning before January 1, 2011, is allowed against the alternative minimum tax ("AMT"). To the extent the child tax 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). EGTRRA provided, in general, that this threshold dollar amount is \$10,000 indexed for inflation from 2001. The American Recovery and Reinvestment Act of 2009 ("ARRA")<sup>1166</sup> set the threshold at \$3,000 for both 2009 and 2010. After 2010, the ability to determine the refundable child credit based on earned income in excess of the threshold dollar amount expires.

Families with three or more qualifying children may determine the additional child tax credit using the "alternative formula" if this results in a larger credit than determined under the earned

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<sup>1165</sup> R&TC section 17054.1. The phase-out thresholds are adjusted annually based on the California Consumer Price Index.

<sup>1166</sup> Public Law 111-5.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

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 tax credit ("EITC"). After 2010, due to the expiration of the earned income formula, this is the only manner of obtaining a refundable child credit.

Earned income is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings. Unlike the EITC, 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 EITC, but are excluded from gross income for individual income tax purposes. Therefore, these allowances are not considered earned income for purposes of the additional child tax credit.

New Federal Law (IRC section 24)

The provision extends the \$1,000 child tax credit and allows the child tax credit against the individual's regular income tax and AMT for two years (through 2012). The provision also extends the EGTRRA repeal of a prior-law provision that reduced the refundable child credit by the amount of the AMT for two years (through 2012). The provision extends the earned income formula for determining the refundable child credit, with the earned income threshold of \$3,000 (also, the provision stops indexation for inflation of the \$3,000 earnings threshold) for two years (through 2012).<sup>1167</sup> Finally, the provision extends the rule that the refundable portion of the child tax credit does not constitute income and shall not be treated as resources for purposes of determining eligibility or the amount or nature of benefits or assistance under any federal program or any state or local program financed with federal funds for two years (through 2012).

Effective Date

The provision applies to taxable years beginning after December 31, 2010.

California Law (None)

California does not conform to the federal child tax credit.

Impact on California Revenue

Not applicable.

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<sup>1167</sup> Section 101 of the Act extends the EGTRRA modifications to the provision. Section 103 of the Act extends certain modifications to the provision (including reduction in the earnings threshold for the refundable portion of the child tax credit to \$3,000). See Section J, below, for an additional discussion of the child tax credit.

## **D. Marriage Penalty Relief and Earned Income Tax Credit Simplification**

### Background

#### Marriage Penalty

A married couple generally is treated as one tax unit that must pay tax on the couple's total taxable income. Although married couples may elect to file separate returns, the rate schedules and other provisions are structured so that filing separate returns usually results in a higher tax than filing a joint return. Other rate schedules apply to single persons and to single heads of households.

A "marriage penalty" exists when the combined tax liability of a married couple filing a joint return is greater than the sum of the tax liabilities of each individual computed as if they were not married. A "marriage bonus" exists when the combined tax liability of a married couple filing a joint return is less than the sum of the tax liabilities of each individual computed as if they were not married.

#### Basic Standard Deduction

EGTRRA increased the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return. The basic standard deduction for a married taxpayer filing separately continued to equal one-half of the basic standard deduction for a married couple filing jointly; thus, the basic standard deduction for unmarried individuals filing a single return and for married couples filing separately are the same.

#### Fifteen Percent Rate Bracket

EGTRRA increased the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return to twice the size of the corresponding rate bracket for an unmarried individual filing a single return.

#### Earned Income Tax Credit

The earned income tax credit ("EITC") is a refundable credit available to certain low income taxpayers. Generally, the amount of an individual's allowable earned income credit is dependent on the individual's earned income, adjusted gross income, the number of qualifying children and (through 2010) filing status.

### New Federal Law (IRC sections 1, 32 and 63)

#### Basic Standard Deduction

The provision increases the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return for two years (through 2012).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Fifteen Percent Rate Bracket

The provision increases the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return to twice the 15-percent regular income tax rate bracket for an unmarried individual filing a single return for two years (through 2012).

Earned Income Tax Credit

The provision extends certain EITC provisions adopted by EGTRRA for two years (through 2012). These include: (1) a simplified definition of earned income; (2) a simplified relationship test; (3) use of AGI instead of modified AGI; (4) a simplified tie-breaking rule; (5) additional math error authority for the IRS; (6) a repeal of the prior-law provision that reduced an individual's EITC by the amount of his alternative minimum tax liability; and (7) increases in the beginning and ending points of the credit phase-out for married taxpayers by \$5,000.<sup>1168</sup>

Effective Date

The provision applies to taxable years beginning after December 31, 2010.

California Law (R&TC sections 17073.5 and 17041)

Basic Standard Deduction

California does not conform to the federal standard deduction, and instead provides its own standard deduction.<sup>1169</sup>

Fifteen Percent Rate Bracket

California does not conform to federal income tax rate brackets, and instead provides its own income tax rate brackets.<sup>1170</sup>

Earned Income Tax Credit

California does not conform to the federal earned income tax credit.

Impact on California Revenue

Not applicable.

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<sup>1168</sup> The amount is indexed for inflation annually. See section K, below, for a more complete description of the EITC.

<sup>1169</sup> R&TC section 17073.5.

<sup>1170</sup> R&TC section 17041.

## E. Education Incentives

### Background

Income and wage exclusion for awards under the National Health Service Corps Scholarship Program and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program

IRC section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by IRC section 117 does not extend to scholarship amounts covering regular living expenses, such as room and board. In addition to the exclusion for qualified scholarships, IRC section 117 provides an exclusion from gross income for qualified tuition reductions for certain education provided to employees (and their spouses and dependents) of certain educational organizations. Amounts excludable from gross income under IRC section 117 are also excludable from wages for payroll tax purposes.<sup>1171</sup>

The exclusion for qualified scholarships and qualified tuition reductions does not apply to any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship or tuition reduction. An exception to this rule applies in the case of the National Health Service Corps Scholarship Program (the “NHSC Scholarship Program”) and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program (the “Armed Forces Scholarship Program”).

The NHSC Scholarship Program and the Armed Forces Scholarship Program provide education awards to participants on the condition that the participants provide certain services. In the case of the NHSC Scholarship Program, the recipient of the scholarship is obligated to provide medical services in a geographic area (or to an underserved population group or designated facility) identified by the Public Health Service as having a shortage of health care professionals. In the case of the Armed Forces Scholarship Program, the recipient of the scholarship is obligated to serve a certain number of years in the military at an armed forces medical facility.

Under the sunset provisions of EGTRRA, the exclusion from gross income and wages for the NHSC Scholarship Program and the Armed Forces Scholarship Program will no longer apply for taxable years beginning after December 31, 2010.

### Income and Wage Exclusion for Employer-Provided Educational Assistance

If certain requirements are satisfied, up to \$5,250 annually of educational assistance, provided by an employer to an employee, is excludable from gross income for income tax purposes and from wages for employment tax purposes.<sup>1172</sup> This exclusion applies to both graduate and

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<sup>1171</sup> IRC section 3121(a)(20).

<sup>1172</sup> IRC sections 127, 3121(a)(18).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

undergraduate courses.<sup>1173</sup> For the exclusion to apply, certain requirements must be satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer. The employer's educational assistance program must not discriminate in favor of highly-compensated employees. In addition, no more than five percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance program can be provided for the class of individuals consisting of more than five percent owners of the employer and the spouses or dependents of such more than five-percent owners.

For purposes of the exclusion, educational assistance means the payment by an employer of expenses incurred by or on behalf of the employee for education of the employee including, but not limited to, tuition, fees, and similar payments, books, supplies, and equipment. Educational assistance also includes the provision by the employer of courses of instruction for the employee (including books, supplies, and equipment). Educational assistance does not include: (1) tools or supplies that may be retained by the employee after completion of a course; (2) meals, lodging, or transportation; or (3) any education involving sports, games, or hobbies. The exclusion for employer-provided educational assistance applies only with respect to education provided to the employee (e.g., it does not apply to education provided to the spouse or a child of the employee).

In the absence of the specific exclusion for employer-provided educational assistance under IRC section 127, employer-provided educational assistance is excludable from gross income and wages only if the education expenses qualify as a working condition fringe benefit.<sup>1174</sup> In general, education qualifies as a working condition fringe benefit if the employee could have deducted the education expenses under IRC section 162 if the employee paid for the education. In general, education expenses are deductible by an individual under IRC section 162 if the education: (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer; or (2) meets the express requirements of the taxpayer's employer, applicable law, or regulations imposed as a condition of continued employment. However, education expenses are generally not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In determining the amount deductible for this purpose, the two-percent floor on miscellaneous itemized deductions is disregarded.

The specific exclusion for employer-provided educational assistance was originally enacted on a temporary basis and was subsequently extended 10 times.<sup>1175</sup> EGTRRA deleted the exclusion's

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<sup>1173</sup> The exclusion has not always applied to graduate courses. The exclusion was first made inapplicable to graduate-level courses by the Technical and Miscellaneous Revenue Act of 1988. The exclusion was reinstated with respect to graduate-level courses by the Omnibus Budget Reconciliation Act of 1990, effective for taxable years beginning after December 31, 1990. The exclusion was again made inapplicable to graduate-level courses by the Small Business Job Protection Act of 1996, effective for courses beginning after June 30, 1996. The exclusion for graduate-level courses was reinstated by EGTRRA, although that change does not apply to taxable years beginning after December 31, 2010 (under EGTRRA's sunset provision).

<sup>1174</sup> IRC section 132(d).

<sup>1175</sup> The exclusion was first enacted as part of the Revenue Act of 1978 (with a 1983 expiration date).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

explicit expiration date and extended the exclusion to graduate courses. However, those changes are subject to EGTRRA's sunset provision so that the exclusion will not be available for taxable years beginning after December 31, 2010. Thus, at that time, educational assistance will be excludable from gross income only if it qualifies as a working condition fringe benefit (i.e., the expenses would have been deductible as business expenses if paid by the employee). As previously discussed, to meet such requirement, the expenses must be related to the employee's current job.<sup>1176</sup>

#### Deduction for Student Loan Interest

Certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, subject to a maximum annual deduction limit.<sup>1177</sup> Required payments of interest generally do not include voluntary payments, such as interest payments made during a period of loan forbearance. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.

A qualified education loan generally is defined as any indebtedness incurred solely to pay for the costs of attendance (including room and board) of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending an eligible educational institution on at least a half-time basis. Eligible educational institutions are: (1) post-secondary educational institutions and certain vocational schools defined by reference to IRC section 481 of the Higher Education Act of 1965; or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training. Additionally, to qualify as an eligible educational institution, an institution must be eligible to participate in Department of Education student aid programs.

The maximum allowable deduction per year is \$2,500. For 2010, the deduction is phased out ratably for single taxpayers with AGI between \$60,000 and \$75,000 and between \$120,000 and \$150,000 for married taxpayers filing a joint return. The income phase-out ranges are indexed for inflation and rounded to the next lowest multiple of \$5,000.

Effective for taxable years beginning after December 31, 2010, the changes made by EGTRRA to the student loan provisions no longer apply. The EGTRRA changes scheduled to expire are: (1) increases that were made in the AGI phase-out ranges for the deduction; and (2) rules that extended deductibility of interest beyond the first 60 months that interest payments are required. With the expiration of EGTRRA, the phase-out ranges will revert to a base level of \$40,000 to \$55,000 (\$60,000 to \$75,000 in the case of a married couple filing jointly), but with an adjustment for inflation occurring since 2002.

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<sup>1176</sup> Treas. Reg. section 1.162-5.

<sup>1177</sup> IRC section 221.

## Coverdell Education Savings Accounts

A Coverdell education savings account is a trust or custodial account created exclusively for the purpose of paying qualified education expenses of a named beneficiary.<sup>1178</sup> Annual contributions to Coverdell education savings accounts may not exceed \$2,000 per designated beneficiary and may not be made after the designated beneficiary reaches age 18 (except in the case of a special needs beneficiary). The contribution limit is phased out for taxpayers with modified AGI between \$95,000 and \$110,000 (\$190,000 and \$220,000 for married taxpayers filing a joint return); the AGI of the contributor, and not that of the beneficiary, controls whether a contribution is permitted by the taxpayer.

Earnings on contributions to a Coverdell education savings account generally are subject to tax when withdrawn.<sup>1179</sup> However, distributions from a Coverdell education savings account are excludable from the gross income of the distributee (i.e., the student) to the extent that the distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. The earnings portion of a Coverdell education savings account distribution not used to pay qualified education expenses is includible in the gross income of the distributee and generally is subject to an additional 10-percent tax.<sup>1180</sup>

Tax-free (including free of additional 10-percent tax) transfers or rollovers of account balances from one Coverdell education savings account benefiting one beneficiary to another Coverdell education savings account benefiting another beneficiary (as well as re-designations of the named beneficiary) are permitted, provided that the new beneficiary is a member of the family of the prior beneficiary and is under age 30 (except in the case of a special needs beneficiary). In general, any balance remaining in a Coverdell education savings account is deemed to be distributed within 30 days after the date that the beneficiary reaches age 30 (or, if the beneficiary dies before attaining age 30, within 30 days of the date that the beneficiary dies).

Qualified education expenses include “qualified higher education expenses” and “qualified elementary and secondary education expenses.”

The term “qualified higher education expenses” includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible education institution, regardless of whether the beneficiary is enrolled at an eligible educational institution on a full-time, half-time, or less than half-time basis.<sup>1181</sup> Moreover, qualified higher education expenses include certain room and board expenses for any period during which the

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<sup>1178</sup> IRC section 530.

<sup>1179</sup> In addition, Coverdell education savings accounts are subject to the unrelated business income tax imposed by IRC section 511.

<sup>1180</sup> This 10-percent additional tax does not apply if a distribution from an education savings account is made on account of the death or disability of the designated beneficiary, or if made on account of a scholarship received by the designated beneficiary.

<sup>1181</sup> Qualified higher education expenses are defined in the same manner as for qualified tuition programs.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

beneficiary is at least a half-time student. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses. In addition, qualified higher education expenses include amounts paid or incurred to purchase tuition credits (or to make contributions to an account) under a qualified tuition program for the benefit of the beneficiary of the Coverdell education savings account.<sup>1182</sup>

The term “qualified elementary and secondary education expenses,” means expenses for: (1) tuition, fees, academic tutoring, special needs services, books, supplies, and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under state law; (2) room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the beneficiary; and (3) the purchase of any computer technology or equipment (as defined in IRC section 170(e)(6)(F)(i)) or Internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary’s family during any of the years the beneficiary is in elementary or secondary school. Computer software primarily involving sports, games, or hobbies is not considered a qualified elementary and secondary education expense unless the software is predominantly educational in nature.

Qualified education expenses generally include only out-of-pocket expenses. Such qualified education expenses do not include expenses covered by employer-provided educational assistance or scholarships for the benefit of the beneficiary that are excludable from gross income. Thus, total qualified education expenses are reduced by scholarship or fellowship grants excludable from gross income under IRC section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance, that are excludable from the employee’s gross income under IRC section 127.

Effective for taxable years beginning after December 31, 2010, the changes made by EGTRRA to Coverdell education savings accounts no longer apply. The EGTRRA changes scheduled to expire are: (1) the increase in the contribution limit to \$2,000 from \$500; (2) the increase in the phase-out range for married taxpayers filing jointly to \$190,000 - \$220,000 from \$150,000 - \$160,000; (3) the expansion of qualified expenses to include elementary and secondary education expenses; (4) special age rules for special needs beneficiaries; (5) clarification that corporations and other entities are permitted to make contributions, regardless of the income of the corporation or entity during the year of the contribution; (6) certain rules regarding when contributions are deemed made and extending the time during which excess contributions may be returned without additional tax; (7) certain rules regarding coordination with the Hope and Lifetime Learning credits; and (8) certain rules regarding coordination with qualified tuition programs.

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<sup>1182</sup> IRC section 530(b)(2)(B).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Amount of Governmental Bonds that May be Issued by Governments Qualifying for the “Small Governmental Unit” Arbitrage Rebate Exception

To prevent state and local governments from issuing more federally subsidized tax-exempt bonds than is necessary for the activity being financed or from issuing such bonds earlier than needed for the purpose of the borrowing, the IRC includes arbitrage restrictions limiting the ability to profit from investment of tax-exempt bond proceeds.<sup>1183</sup> The IRC also provides certain exceptions to the arbitrage restrictions. Under one such exception, small issuers of governmental bonds issued for local governmental activities are not subject to the rebate requirement.<sup>1184</sup> To qualify for this exception the governmental bonds must be issued by a governmental unit with general taxing powers that reasonably expects to issue no more than \$5 million of tax-exempt governmental bonds in a calendar year.<sup>1185</sup> Prior to EGTRRA, the \$5 million limit was increased to \$10 million if at least \$5 million of the bonds are used to finance public schools. EGTRRA provided the additional amount of governmental bonds for public schools that small governmental units may issue without being subject to the arbitrage rebate requirements is increased from \$5 million to \$10 million.<sup>1186</sup> Thus, these governmental units may issue up to \$15 million of governmental bonds in a calendar year provided that at least \$10 million of the bonds are used to finance public school construction expenditures. This increase is subject to the EGTRRA sunset.

Issuance of Tax-Exempt Private Activity Bonds for Public School Facilities

Interest on 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 a private person is taxable unless the purpose of the borrowing is approved specifically in the IRC or in a non-IRC provision of a revenue act. These bonds are called “private activity bonds.”<sup>1187</sup> The term “private person” includes the federal government and all other individuals and entities other than state or local governments.

Only specified private activity bonds are tax-exempt. EGTRRA added a new type of private activity bond that is subject to the EGTRRA sunset. This category is bonds for elementary and secondary public school facilities that are owned by private, for-profit corporations pursuant to public-private

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<sup>1183</sup> The exclusion from gross income for interest on state and local bonds does not apply to any arbitrage bond (IRC section 103(a), (b)(2)). A bond is an arbitrage bond if it is part of an issue that violates the restrictions against investing in higher-yielding investments under IRC section 148(a) or that fails to satisfy the requirement to rebate arbitrage earnings under IRC section 148(f).

<sup>1184</sup> Ninety-five percent or more of the net proceeds of governmental bond issue are to be used for local governmental activities of the issuer. IRC section 148(f)(4)(D).

<sup>1185</sup> Under the Treasury regulations, an issuer may apply a fact-based rather than an expectations-based test. Treas. Reg. section 1.148-8(c)(1).

<sup>1186</sup> IRC section 148(f)(4)(D)(vii).

<sup>1187</sup> The IRC provides that the exclusion from gross income does not apply to interest on private activity bonds that are not qualified bonds within the meaning of IRC section 141. See IRC sections 103(b)(1) and 141.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

partnership agreements with a state or local educational agency.<sup>1188</sup> The term school facility includes school buildings and functionally related and subordinate land (including stadiums or other athletic facilities primarily used for school events) and depreciable personal property used in the school facility. The school facilities for which these bonds are issued must be operated by a public educational agency as part of a system of public schools.

A public-private partnership agreement is defined as an arrangement pursuant to which the for-profit corporate party constructs, rehabilitates, refurbishes, or equips a school facility for a public school agency (typically pursuant to a lease arrangement). The agreement must provide that, at the end of the contract term, ownership of the bond-financed property is transferred to the public school agency party to the agreement for no additional consideration.

Issuance of these bonds is subject to a separate annual per-state private activity bond volume limit equal to \$10 per resident (\$5 million, if greater) in lieu of the present-law state private activity bond volume limits. As with the present-law state private activity bond volume limits, states can decide how to allocate the bond authority to state and local government agencies. Bond authority that is unused in the year in which it arises may be carried forward for up to three years for public school projects under rules similar to the carryforward rules of the present-law private activity bond volume limits.

New Federal Law (IRC sections 117, 127, 142, 146-148, 221, and 530)

The provision delays the EGTRRA sunset as it applies to the NHSC Scholarship Program and the Armed Forces Scholarship Program, the IRC section 127 exclusion from income and wages for employer-provided educational assistance, the student loan interest deduction, and Coverdell education savings accounts for two years. The provision also delays the EGTRRA sunset as it applies to the expansion of the small government unit exception to arbitrage rebate and allowing issuance of tax-exempt private activity bonds for public school facilities. Thus, all of these tax benefits for education continue to be available through 2012.

Effective Date

The provision is effective on December 17, 2010.

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<sup>1188</sup> IRC section 142(a)(13), (k).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

California Law (R&TC sections 17072, 17131, 17143, 17151, 17201, 23712, and 24272)

Income and Wage Exclusion for awards under the NHSC Scholarship Program and the Armed Forces Health Professions Scholarship Program

*Income exclusion*

The PITL conforms to the federal income exclusion for qualified scholarships, including the EGTRRA income exclusion for awards under the NHSC and Armed-Forces-Health-Professions Scholarship Programs, as of the “specified date” of January 1, 2009.<sup>1189</sup> Additionally, the PITL automatically conforms to the two-year extension of the EGTRRA sunset date.<sup>1190</sup> Thus, the gross income exclusion for awards under the NHSC and Armed Forces Health Professions Scholarship Programs is extended two years under the PITL, and will no longer apply for taxable years beginning after December 31, 2012.

*Wage exclusion*

The FTB does not administer payroll taxes. Defer to the Employment Development Department (EDD).

Income and Wage Exclusion for Employer-Provided Educational Assistance

*Income exclusion*

The PITL specifically does not conform to the federal income exclusion for educational assistance programs, and instead provides its own educational assistance exclusion that allows a maximum exclusion of \$5,250, may be claimed by both undergraduate and graduate students, and is permanent.<sup>1191</sup>

*Wage exclusion*

The FTB does not administer payroll taxes. Defer to the EDD.

Deduction for Student Loan Interest

The PITL conforms to the federal deduction for student loan interest as of the “specified date” of January 1, 2009.<sup>1192</sup> Additionally, the PITL automatically conforms to the two-year extension of

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<sup>1189</sup> For taxable years beginning on or after January 1, 2010, R&TC section 17131 conforms to IRC section 117, relating to qualified scholarships, as of the “specified date” of January 1, 2009.

<sup>1190</sup> R&TC section 17024.5(a)(2)(B).

<sup>1191</sup> R&TC section 17151.

<sup>1192</sup> For taxable years beginning on or after January 1, 2010: (1) R&TC section 17072 conforms to IRC section 62, relating to adjusted gross income, as of the “specified date” of January 1, 2009, with modifications; and, (2) R&TC

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

the EGTRRA sunset date.<sup>1193</sup> Thus, the EGTRRA increases to the AGI phase out and the extended deductibility of interest beyond the first 60 months are extended under the PITL for two years, and will no longer apply for taxable years beginning after December 31, 2012.

#### Coverdell Education Savings Accounts

The CTL conforms to the federal rules for Coverdell education savings accounts as of the “specified date” of January 1, 2009, with modifications.<sup>1194</sup> Additionally, the CTL automatically conforms to the two-year extension of the EGTRRA sunset date.<sup>1195</sup> Thus, the EGTRRA modifications are extended for two years, and will no longer apply for taxable years beginning after December 31, 2012.

#### Amount of Governmental Bonds that May be Issued by Governments Qualifying for the “Small Governmental Unit” Arbitrage Rebate Exception; and, Issuance of Tax-Exempt Private Activity Bonds for Public School Facilities

The PITL specifically does not conform to the federal rules relating to interest on government bonds.<sup>1196</sup> In addition, the federal “private-activity-bond” rules have not been adopted by California. 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) and tax-exempt bonds issued by this state or a local government in this state.

Under the CTL, interest received from federal, state, municipal, or other bonds is includable in the gross income of corporations taxable under the franchise tax.<sup>1197</sup> 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. In other words, bond interest income is not subject to a direct income tax under the CTL, but is included in the measure of a corporation’s income in order to compute its franchise tax.

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section 17201 conforms to IRC section 221, relating to interest on education loans, as of the “specified date” of January 1, 2009.

<sup>1193</sup> R&TC section 17024.5(a)(2)(B).

<sup>1194</sup> For taxable years beginning on or after January 1, 2010, R&TC section 23712 conforms to IRC section 530, relating to Coverdell education savings accounts, as of the “specified date” of January 1, 2009, with modifications.

<sup>1195</sup> R&TC section 23051.5(a)(2)(B).

<sup>1196</sup> R&TC section 17143.

<sup>1197</sup> R&TC section 24272.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Impact on California Revenue

Income and Wage Exclusion for awards under the NHSC Scholarship Program and the Armed Forces Health Professions Scholarship Program

*Income exclusion*

Baseline—based on a proration of federal estimates developed by the Joint Committee on Taxation, baseline revenue losses are estimated to be \$1,500,000 in 2011-12, \$1,000,000 in 2012-13, and \$300,000 in 2013-14.

*Wage exclusion*

Defer to the EDD.

Income and Wage Exclusion for Employer-Provided Educational Assistance

*Income exclusion*

Baseline—although California does not conform to the federal exclusion, the EGTRAA extension will have a baseline revenue impact on the California employer-provided educational assistance exclusion allowed under the PITL.

*Wage exclusion*

Defer to the EDD.

Deduction for Student Loan Interest

Baseline—based on a proration of federal estimates developed by the Joint Committee on Taxation, baseline revenue losses are estimated to be \$24,000,000 in 2011-12, \$16,000,000 in 2012-13, and \$6,400,000 in 2013-14.

Coverdell Education Savings Accounts

Baseline—based on a proration of federal estimates developed by the Joint Committee on Taxation, baseline revenue losses are estimated to be \$1,000,000 in 2011-12, \$300,000 in 2012-13, and \$60,000 in 2013-14.

Amount of Governmental Bonds that May be Issued by Governments Qualifying for the “Small Governmental Unit” Arbitrage Rebate Exception; and, Issuance of Tax-Exempt Private Activity Bonds for Public School Facilities

Not applicable.

## F. Other Incentives for Families and Children

### Background

#### Adoption Credit and Exclusion from Income for Employer-Provided Adoption Assistance

Present law for 2010 provides: (1) a maximum adoption credit of \$13,170 per eligible child (both special needs and non-special needs adoptions); and (2) a maximum exclusion of \$13,170 per eligible child (both special needs and non-special needs adoptions).<sup>1198</sup> These dollar amounts are adjusted annually for inflation. These benefits are phased-out over a \$40,000 range for taxpayers with modified adjusted gross income (“modified AGI”) in excess of certain dollar levels. For 2010, the phase-out range is between \$182,520 and \$222,520. The phase-out threshold is adjusted for inflation annually, but the phase-out range remains a \$40,000 range.

For taxable years beginning after December 31, 2011, the adoption credit and employer-provided adoption assistance exclusion are available only to special needs adoptions and the maximum credit and exclusion are reduced to \$6,000, respectively. The phase-out range is reduced to lower income levels (i.e., between \$75,000 and \$115,000). The maximum credit, exclusion, and phase-out range are not indexed for inflation.

#### Employer-Provided Child Care Tax Credit

Taxpayers receive a tax credit equal to 25 percent of qualified expenses for employee child care and 10 percent of qualified expenses for child care resource and referral services. The maximum total credit that may be claimed by a taxpayer cannot exceed \$150,000 per taxable year.

Qualified child care expenses include costs paid or incurred: (1) to acquire, construct, rehabilitate or expand property that is to be used as part of the taxpayer’s qualified child care facility; (2) for the operation of the taxpayer’s qualified child care facility, including the costs of training and certain compensation for employees of the child care facility, and scholarship programs; or (3) under a contract with a qualified child care facility to provide child care services to employees of the taxpayer. To be a qualified child care facility, the principal use of the facility must be for child care (unless it is the principal residence of the taxpayer), and the facility must meet all applicable state and local laws and regulations, including any licensing laws. A facility is not treated as a qualified child care facility with respect to a taxpayer unless: (1) it has open enrollment to the employees of the taxpayer; (2) use of the facility (or eligibility to use such facility) does not discriminate in favor of highly-compensated employees of the taxpayer (within the meaning of IRC section 414(q)); and (3) at least 30 percent of the children enrolled in the center are dependents of the taxpayer’s employees, if the facility is the principal trade or business of the

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<sup>1198</sup> EGTRRA increased the maximum credit and exclusion to \$10,000 (indexed for inflation after 2002) for both non-special needs and special needs adoptions, increased the phase-out starting point to \$150,000 (indexed for inflation after 2002), and allowed the credit against the AMT. Section 10909 of the Patient Protection and Affordable Care Act (Public Law 111-148): (1) extended the EGTRRA expansion of the adoption credit and exclusion from income for employer-provided adoption assistance for one year (for 2011); (2) increased by \$1,000 (to \$13,170, indexed for inflation) the maximum adoption credit and exclusion from income for employer-provided adoption assistance for two years (2010 and 2011); and (3) made the credit refundable for two years (2010 and 2011).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

taxpayer. Qualified child care resource and referral expenses are amounts paid or incurred under a contract to provide child care resource and referral services to the employees of the taxpayer. Qualified child care services and qualified child care resource and referral expenditures must be provided (or be eligible for use) in a way that does not discriminate in favor of highly-compensated employees of the taxpayer (within the meaning of IRC section 414(q)).

Any amounts for which the taxpayer may otherwise claim a tax deduction are reduced by the amount of these credits. Similarly, if the credits are taken for expenses of acquiring, constructing, rehabilitating, or expanding a facility, the taxpayer's basis in the facility is reduced by the amount of the credits.

Credits taken for the expenses of acquiring, constructing, rehabilitating, or expanding a qualified facility are subject to recapture for the first ten years after the qualified child care facility is placed in service. The amount of recapture is reduced as a percentage of the applicable credit over the 10-year recapture period. Recapture takes effect if the taxpayer either ceases operation of the qualified child care facility or transfers its interest in the qualified child care facility without securing an agreement to assume recapture liability for the transferee. The recapture tax is not treated as a tax for purposes of determining the amount of other credits or determining the amount of the alternative minimum tax. Other rules apply.

This tax credit expires for taxable years beginning after December 31, 2010.

#### Dependent Care Tax Credit

The maximum dependent care tax credit is \$1,050 (35 percent of up to \$3,000 of eligible expenses) if there is one qualifying individual, and \$2,100 (35 percent of up to \$6,000 of eligible expenses) if there are two or more qualifying individuals. The 35-percent credit rate is reduced, but not below 20 percent, by one percentage point for each \$2,000 (or fraction thereof) of adjusted gross income ("AGI") above \$15,000. Therefore, the credit percentage is reduced to 20 percent for taxpayers with AGI over \$43,000.

The level of this credit is reduced for taxable years beginning after December 31, 2010, under the EGTRRA sunset.

#### New Federal Law (IRC sections 21, 23, 36C, 45D, and 137)

#### Adoption Credit and Exclusion from Income for Employer-Provided Adoption Assistance

The provision extends the EGTRRA expansion of these two benefits for one year (2012). Therefore, for 2012, the maximum benefit is \$13,170 (indexed for inflation after 2010). The adoption credit and exclusion are phased out ratably for taxpayers with modified adjusted gross income between \$182,520 and \$222,520 (indexed for inflation after 2010).<sup>1199</sup>

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<sup>1199</sup> The changes to the adoption credit and exclusion from employer-provided adoption assistance for 2010 and 2011 (relating to the \$1,000 increase in the maximum credit and exclusion and the refundability of the credit) enacted as part of the Patient Protection and Affordable Care Act (Pub. L. No. 111-148) are not extended by the provision.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Employer-Provided Child Care Tax Credit

The provision extends this tax benefit for two years (through 2012).

Expansion of Dependent Care Tax Credit

The provision extends the dependent care tax credit EGTRRA expansion for two years (through 2012).

Effective Date

The provisions apply to taxable years beginning after December 31, 2010.

California Law (R&TC sections 17052.6, 17052.17, 17052.18, 17052.25, 17131, 23617, and 23617.5)

Adoption Credit and Exclusion from Income for Employer-Provided Adoption Assistance

*Adoption credit*

California does not conform to the federal adoption credit; instead, the PITL provides a stand-alone state credit for adoption costs.<sup>1200</sup> The state adoption credit is equal to 50 percent of the cost of adopting a minor child who is an American citizen and is in the custody of a California public agency or a political subdivision of California. The credit is claimed in the taxable year in which the decree or order of adoption is entered, although qualifying costs paid or incurred in prior years can qualify for the credit.

Costs eligible for the credit include: (1) fees for required services of either the Department of Social Services or a licensed adoption agency; (2) travel and related expenses for the adoptive family that are directly related to the adoption process; and (3) medical fees and expenses that are not reimbursed by insurance and are directly related to the adoption process.

The maximum allowable credit cannot exceed \$2,500 per minor child. The credit cannot reduce regular tax below tentative minimum tax for alternative minimum tax purposes; however, credit amounts subject to this limitation may be carried over to succeeding taxable years until exhausted.

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<sup>1200</sup> R&TC section 17052.25.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

*Adoption exclusion*

The PITL conforms to the employee gross income exclusion of expenses paid or reimbursed by an employer under an adoption assistance program as of the specified date of January 1, 2009.<sup>1201</sup> Thus, the PITL conforms to the EGTRAA modifications, but does not conform to the to the \$1,000 increase to the maximum gross income exclusion that was enacted in the Patient Protection and Affordable Care Act.<sup>1202</sup> Under the PITL, the maximum exclusion for 2010 is \$12,170 per eligible child. Additionally, the PITL automatically conforms to the one-year delay of the EGTRRA sunset<sup>1203</sup> that extends the exclusion through 2012; therefore, the maximum exclusion for 2011 and 2012 is \$12,170 (indexed for inflation after 2010).

For taxable years beginning after December 31, 2012, the employer-provided adoption assistance exclusion is available only to special needs adoptions and the maximum exclusion is reduced to \$6,000. The phase-out range is reduced to lower income levels (i.e., between \$75,000 and \$115,000). The maximum exclusion and phase-out range are not indexed for inflation.

Employer-Provided Child Care Tax Credit

California does not conform to the federal employer-provided child care credit. Instead, the PITL and the CTL provide a stand-alone state credit for employer-provided child care assistance.<sup>1204</sup>

Expansion of Dependent Care Tax Credit

The PITL allows a refundable dependent care credit that is computed as a percentage of the allowable federal credit.<sup>1205</sup> The credit percentage varies based on the taxpayer's federal adjusted gross income (AGI), as follows:

<b>AGI Amount</b>	<b>Percentage</b>
\$40,000 or less	50 percent
\$40,001 - \$70,000	43 percent
\$70,001 - \$100,000	34 percent
Over \$100,000	0 percent

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<sup>1201</sup> For taxable years beginning on or after January 1, 2010, R&TC section 17131 conforms to IRC section 137, relating to adoption assistance programs, as of the "specified date" of January 1, 2009.

<sup>1202</sup> Section 10909 of the Patient Protection and Affordable Care Act (Public Law 111-148) increased the maximum exclusion by \$1,000, to \$13,170, for taxable years beginning in 2010.

<sup>1203</sup> R&TC section 17024.5(a)(2)(B).

<sup>1204</sup> R&TC sections 17052.17 and 23617.5.

<sup>1205</sup> R&TC section 17052.6.

Impact on California Revenue

Adoption Credit and Exclusion from Income for Employer-Provided Adoption Assistance

*Adoption credit*

Not applicable.

*Adoption exclusion*

Baseline—based on a proration of federal estimates developed by the Joint Committee on Taxation, baseline revenue losses are estimated to be \$700,000 in 2011-12 and \$500,000 in 2012-13.

Employer-Provided Child Care Tax Credit

Not applicable.

Expansion of Dependent Care Tax Credit

Baseline—based on a proration of federal estimates developed by the Joint Committee on Taxation, baseline revenue losses are estimated to be \$25,000,000 in 2011-12 and \$7,200,000 in 2012-13.

**G. Alaska Native Settlement Trusts**

Background

The Alaska Native Claims Settlement Act (“ANCSA”)<sup>1206</sup> established Alaska Native Corporations to hold property for Alaska Natives. Alaska Natives are generally the only permitted common shareholders of those corporations under section 7(h) of ANCSA, unless an Alaska Native Corporation specifically allows other shareholders under specified procedures.

ANCSA permits an Alaska Native Corporation to transfer money or other property to an Alaska Native Settlement Trust (“Settlement Trust”) for the benefit of beneficiaries who constitute all or a class of the shareholders of the Alaska Native Corporation, to promote the health, education and welfare of beneficiaries and to preserve the heritage and culture of Alaska Natives.<sup>1207</sup>

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<sup>1206</sup> 43 U.S.C. 1601 et. seq.

<sup>1207</sup> With certain exceptions, once an Alaska Native Corporation has made a conveyance to a Settlement Trust, the assets conveyed shall not be subject to attachment, distraint, or sale or execution of judgment, except with respect to the lawful debts and obligations of the Settlement Trust.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Alaska Native Corporations and Settlement Trusts, as well as their shareholders and beneficiaries, are generally subject to tax under the same rules and in the same manner as other taxpayers that are corporations, trusts, shareholders, or beneficiaries.

Special tax rules enacted in 2001 allow an election to use a more favorable tax regime for transfers of property by an Alaska Native Corporation to a Settlement Trust and for income taxation of the Settlement Trust. There is also simplified reporting to beneficiaries.

Under the special tax rules, a Settlement Trust may make an irrevocable election to pay tax on taxable income at the lowest rate specified for individuals, (rather than the highest rate that is generally applicable to trusts) and to pay tax on capital gains at a rate consistent with being subject to such lowest rate of tax. As described further below, beneficiaries may generally thereafter exclude from gross income distributions from a trust that has made this election. Also, contributions from an Alaska Native Corporation to an electing Settlement Trust generally will not result in the recognition of gross income by beneficiaries on account of the contribution. An electing Settlement Trust remains subject to generally applicable requirements for classification and taxation as a trust.

A Settlement Trust distribution is excludable from the gross income of beneficiaries to the extent of the taxable income of the Settlement Trust for the taxable year and all prior taxable years for which an election was in effect, decreased by income tax paid by the Trust, plus tax-exempt interest from state and local bonds for the same period. Amounts distributed in excess of the amount excludable is taxed to the beneficiaries as if distributed by the sponsoring Alaska Native Corporation in the year of distribution by the Trust, which means that the beneficiaries must include in gross income as dividends the amount of the distribution, up to the current and accumulated earnings and profits of the Alaska Native Corporation. Amounts distributed in excess of the current and accumulated earnings and profits are not included in gross income by the beneficiaries.

A special loss disallowance rule reduces (but not below zero) any loss that would otherwise be recognized upon disposition of stock of a sponsoring Alaska Native Corporation by a proportion, determined on a per share basis, of all contributions to all electing Settlement Trusts by the sponsoring Alaska Native Corporation. This rule prevents a stockholder from being able to take advantage of a decrease in value of an Alaska Native Corporation that is caused by a transfer of assets from the Alaska Native Corporation to a Settlement Trust.

The fiduciary of an electing Settlement Trust is obligated to provide certain information relating to distributions from the trust in lieu of reporting requirements under IRC section 6034A.

The earnings and profits of an Alaska Native Corporation are not reduced by the amount of its contributions to an electing Trust at the time of the contributions. However, the Alaska Native Corporation earnings and profits are reduced as and when distributions are thereafter made by the electing Trust that are taxed to the beneficiaries as dividends from the Alaska Native Corporation to the beneficiaries.

The election to pay tax at the lowest rate is not available in certain disqualifying cases: (1) where transfer restrictions have been modified either to allow a transfer of a beneficial interest that

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

would not be permitted by section 7(h) of the Alaska Native Claims Settlement Act if the interest were Settlement Common stock; or (2) where transfer restrictions have been modified to allow a transfer of any Stock in an Alaska Native Corporation that would not be permitted by section 7(h) if it were Settlement Common Stock and the Alaska Native Corporation thereafter makes a transfer to the Trust. Where an election is already in effect at the time of such disqualifying situations, the special rules applicable to an electing trust cease to apply and rules generally applicable to trusts apply. In addition, the distributable net income of the trust is increased by undistributed current and accumulated earnings and profits of the trust, limited by the fair market value of trust assets at the date the trust becomes so disposable. The effect is to cause the trust to be taxed at regular trust rates on the amount of recomputed distributable net income not distributed to beneficiaries, and to cause the beneficiaries to be taxed on the amount of any distributions received consistent with the applicable tax rate bracket.<sup>1208</sup>

New Federal Law (IRC section 646)

The provision delays for two years the EGTRRA sunset as it applies to electing Settlement Trusts.

Effective Date

The provision is effective for taxable years of electing Settlement Trusts, their beneficiaries, and sponsoring Alaska Native Corporations beginning after December 31, 2010.

California Law (R&TC section 17734.6)

The PITL specifically does not conform to the federal rules relating to the tax treatment of electing Alaska Native Settlement Trusts.

Impact on California Revenue

Not applicable.

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<sup>1208</sup> These provisions were enacted by EGTRRA, Public Law 107-16, section 671 (June 7, 2001), scheduled to sunset in taxable years beginning after December 31, 2010. See H.R. Rep. No. 107-84 (2001).

## H. Reduced Rate on Dividends and Capital Gains

### Background

#### Dividends

##### *In general*

A dividend is the distribution of property made by a corporation to its shareholders out of its after-tax earnings and profits.

##### *Tax rates before 2011*

An individual's qualified dividend income is taxed at the same rates that apply to net capital gain. This treatment applies for purposes of both the regular tax and the alternative minimum tax. Thus, for taxable years beginning before 2011, an individual's qualified dividend income is taxed at rates of zero and 15 percent. The zero-percent rate applies to qualified dividend income which otherwise would be taxed at a 10- or 15-percent rate if the special rates did not apply.

Qualified dividend income generally includes dividends received from domestic corporations and qualified foreign corporations. The term "qualified foreign corporation" includes a foreign corporation that is eligible for the benefits of a comprehensive income tax treaty with the United States which the Treasury Department determines to be satisfactory and which includes an exchange-of-information program. In addition, a foreign corporation is treated as a qualified foreign corporation for any dividend paid by the corporation with respect to stock that is readily tradable on an established securities market in the United States.

If a shareholder does not hold a share of stock for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date (as measured under IRC section 246(c)), dividends received on the stock are not eligible for the reduced rates. Also, the reduced rates are not available for dividends to the extent that the taxpayer is obligated to make related payments with respect to positions in substantially similar or related property.

Dividends received from a corporation that is a passive foreign investment company (as defined in IRC section 1297) in either the taxable year of the distribution, or the preceding taxable year, are not qualified dividends.

Special rules apply in determining a taxpayer's foreign tax credit limitation under IRC section 904 in the case of qualified dividend income. For these purposes, rules similar to the rules of IRC section 904(b)(2)(B,) concerning adjustments to the foreign tax credit limitation to reflect any capital gain rate differential, will apply to any qualified dividend income.

If a taxpayer receives an extraordinary dividend (within the meaning of IRC section 1059(c)) eligible for the reduced rates with respect to any share of stock, any loss on the sale of the stock is treated as a long-term capital loss to the extent of the dividend.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

A dividend is treated as investment income for purposes of determining the amount of deductible investment interest only if the taxpayer elects to treat the dividend as not eligible for the reduced rates.

The amount of dividends qualifying for reduced rates that may be paid by a regulated investment company ("RIC") for any taxable year in which the qualified dividend income received by the RIC is less than 95 percent of its gross income (as specially computed) may not exceed the sum of: (1) the qualified dividend income of the RIC for the taxable year; and (2) the amount of earnings and profits accumulated in a non-RIC taxable year that were distributed by the RIC during the taxable year.

The amount of dividends qualifying for reduced rates that may be paid by a real estate investment trust ("REIT") for any taxable year may not exceed the sum of: (1) the qualified dividend income of the REIT for the taxable year; (2) an amount equal to the excess of the income subject to the taxes imposed by IRC section 857(b)(1) and the regulations prescribed under IRC section 337(d) for the preceding taxable year over the amount of these taxes for the preceding taxable year; and (3) the amount of earnings and profits accumulated in a non-REIT taxable year that were distributed by the REIT during the taxable year.

The reduced rates do not apply to dividends received from an organization that was exempt from tax under IRC section 501 or was a tax-exempt farmers' cooperative in either the taxable year of the distribution or the preceding taxable year; dividends received from a mutual savings bank that received a deduction under IRC section 591; or deductible dividends paid on employer securities.<sup>1209</sup>

## Tax Rates After 2010

For taxable years beginning after 2010, dividends received by an individual are taxed at ordinary income tax rates.

## Capital Gains

### *In general*

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual generally is taxed at rates lower than rates applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

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<sup>1209</sup> In addition, for taxable years beginning before 2011, amounts treated as ordinary income on the disposition of certain preferred stock (IRC sec. 306) are treated as dividends for purposes of applying the reduced rates; the tax rate for the accumulated earnings tax (IRC sec. 531) and the personal holding company tax (IRC sec. 541) is reduced to 15 percent; and the collapsible corporation rules (IRC sec. 341) are repealed.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to \$3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year. A capital asset generally means any property except: (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business; (2) depreciable or real property used in the taxpayer's trade or business; (3) specified literary or artistic property; (4) business accounts or notes receivable; (5) certain U.S. publications; (6) certain commodity derivative financial instruments; (7) hedging transactions; and (8) business supplies. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances available under the straight-line method of depreciation.

#### Tax Rates Before 2011

Under present law, for taxable years beginning before January 1, 2011, the maximum rate of tax on the adjusted net capital gain of an individual is 15 percent. Any adjusted net capital gain which otherwise would be taxed at a 10- or 15-percent rate is taxed at a zero rate. These rates apply for purposes of both the regular tax and the AMT.

Under present law, the "adjusted net capital gain" of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured IRC section 1250 gain. The net capital gain is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation under IRC section 163(d).

The term "28-percent rate gain" means the excess of the sum of the amount of net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles (as defined in IRC section 408(m) without regard to paragraph (3) thereof) and the amount of gain equal to the additional amount of gain that would be excluded from gross income under IRC section 1202 (relating to certain small business stock) if the percentage limitations of IRC section 1202(a) did not apply, over the sum of the net short-term capital loss for the taxable year and any long-term capital loss carryover to the taxable year.

"Unrecaptured IRC section 1250 gain" means any long-term capital gain from the sale or exchange of IRC section 1250 property (i.e., depreciable real estate) held more than one year to the extent of the gain that would have been treated as ordinary income if IRC section 1250 applied to all depreciation, reduced by the net loss (if any) attributable to the items taken into account in computing 28-percent rate gain. The amount of unrecaptured IRC section 1250 gain (before the reduction for the net loss) attributable to the disposition of property to which IRC section 1231 (relating to certain property used in a trade or business) applies may not exceed the net IRC section 1231 gain for the year.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

An individual's unrecaptured IRC section 1250 gain is taxed at a maximum rate of 25 percent, and the 28-percent rate gain is taxed at a maximum rate of 28 percent. Any amount of unrecaptured IRC section 1250 gain or 28-percent rate gain otherwise taxed at a 10- or 15-percent rate is taxed at the otherwise applicable rate.

#### Tax Rates After 2010

For taxable years beginning after December 31, 2010, the maximum rate of tax on the adjusted net capital gain of an individual is 20 percent. Any adjusted net capital gain which otherwise would be taxed at the 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 capital gain 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, that would otherwise have been taxed at a 20-percent rate is taxed at an 18-percent rate.

The tax rates on 28-percent gain and unrecaptured IRC section 1250 gain are the same as for taxable years beginning before 2011.

#### New Federal Law (IRC section 1)

Under the provision, the regular and minimum tax rates for qualified dividend income and capital gain in effect before 2011 are extended for two additional years (through 2012).

#### Effective Date

The provision applies to taxable years beginning after December 31, 2010.

#### California Law (R&TC sections 17321, 18151, 24451, and 24990)

#### Dividends

The PITL and the CTL generally conform to the federal rules for computing dividends.<sup>1210</sup> However, California does not provide special tax rates for dividends; instead, dividends are taxed at the same rates as ordinary income.

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<sup>1210</sup> For taxable years beginning on or after January 1, 2010, R&TC sections 17321 and 24451 conform to Subchapter C of Chapter 1 of Subtitle A of the IRC, relating to corporate distributions and adjustments, as of the "specified date" of January 1, 2009.

## Capital Gains

The PITL and the CTL generally conform to the federal rules for computing capital gains and losses.<sup>1211</sup> However, California does not provide special tax rates for net capital gain; instead, such gains are taxed at the same rates as ordinary income.

### Impact on California Revenue

Not applicable.

## I. Extend the American Opportunity Tax Credit

### Background

#### Hope Credit

For taxable years beginning before 2009 and after 2010, individual taxpayers are allowed to claim a nonrefundable credit, the Hope credit, against federal income taxes of up to \$1,800 (for 2008) per eligible student per year for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree or certificate program. The Hope credit rate is 100 percent on the first \$1,200 of qualified tuition and related expenses, and 50 percent on the next \$1,200 of qualified tuition and related expenses; these dollar amounts are indexed for inflation, with the amount rounded down to the next lowest multiple of \$100. Thus, for example, a taxpayer who incurs \$1,200 of qualified tuition and related expenses for an eligible student is eligible (subject to the adjusted gross income phase-out described below) for a \$1,200 Hope credit. If a taxpayer incurs \$2,400 of qualified tuition and related expenses for an eligible student, then he or she is eligible for a \$1,800 Hope credit.

The Hope credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between \$48,000 and \$58,000 (\$96,000 and \$116,000 for married taxpayers filing a joint return) for 2008. The beginning points of the AGI phase-out ranges are indexed for inflation, with the amount rounded down to the next lowest multiple of \$1,000. The size of the phase-out ranges are always \$10,000 and \$20,000 respectively.

The qualified tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. The Hope credit is available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education before the beginning of the second taxable year.

The Hope credit is available in the taxable year the expenses are paid, subject to the requirement that the education is furnished to the student during that year or during an academic period beginning during the first three months of the next taxable year. Qualified tuition and related

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<sup>1211</sup> For taxable years beginning on or after January 1, 2010, R&TC sections 18151 and 24990 conform to Subchapter P of Chapter 1 of Subtitle A of the IRC, relating to capital gains and losses, as of the "specified date" of January 1, 2009.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

expenses paid with the proceeds of a loan generally are eligible for the Hope credit. The repayment of a loan itself is not a qualified tuition or related expense.

A taxpayer may claim the Hope credit with respect to an eligible student who is not the taxpayer or the taxpayer's spouse (e.g., in cases in which the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent, the student is not entitled to claim a Hope credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of determining the amount of qualified tuition and related expenses paid by such parent (or other taxpayer) under the provision. In addition, for each taxable year, a taxpayer may elect the Hope credit, the Lifetime Learning credit, or an above-the-line deduction for qualified tuition and related expenses with respect to an eligible student.

The Hope credit is available for "qualified tuition and related expenses," that include tuition and fees (excluding nonacademic fees) required to be paid to an eligible educational institution as a condition of enrollment or attendance of an eligible student at the institution. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living, or family expenses are not eligible for the credit. The expenses of education involving sports, games, or hobbies are not qualified tuition and related expenses unless this education is part of the student's degree program.

Qualified tuition and related expenses generally include only out-of-pocket expenses. Qualified tuition and related expenses do not include expenses covered by employer-provided educational assistance and scholarships that are not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and related expenses are reduced by any scholarship or fellowship grants excludable from gross income under IRC section 117 and any other tax-free educational benefits received by the student (or the taxpayer claiming the credit) during the taxable year. The Hope credit is not allowed with respect to any education expense for which a deduction is claimed under IRC section 162 or any other section of the IRC.

An eligible student for purposes of the Hope credit is an individual who is enrolled in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible educational institution. The student must pursue a course of study on at least a halftime basis. A student is considered to pursue a course of study on at least a half-time basis if the student carries at least one half the normal full-time work load for the course of study the student is pursuing for at least one academic period that begins during the taxable year. To be eligible for the Hope credit, a student must not have been convicted of a federal or state felony consisting of the possession or distribution of a controlled substance.

Eligible educational institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible educational institutions. To qualify as an eligible educational institution, an institution must be eligible to participate in Department of Education student aid programs.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Effective for taxable years beginning after December 31, 2010, the changes to the Hope credit made by EGTRRA no longer apply. The principal EGTRRA change scheduled to expire is the change that permits a taxpayer to claim a Hope credit in the same year that he or she claims an exclusion from a Coverdell education savings account. Thus, after 2010, a taxpayer cannot claim a Hope credit in the same year he or she claims an exclusion from a Coverdell education savings account.

#### American Opportunity Tax Credit

The American Opportunity Tax Credit refers to modifications to the Hope credit that apply for taxable years beginning in 2009 or 2010. The maximum allowable modified credit is \$2,500 per eligible student per year for qualified tuition and related expenses paid for each of the first four years of the student's post-secondary education in a degree or certificate program. The modified credit rate is 100 percent on the first \$2,000 of qualified tuition and related expenses, and 25 percent on the next \$2,000 of qualified tuition and related expenses. For purposes of the modified credit, the definition of qualified tuition and related expenses is expanded to include course materials.

Under the provision, the modified credit is available with respect to an individual student for four years, provided that the student has not completed the first four years of post-secondary education before the beginning of the fourth taxable year. Thus, the modified credit, in addition to other modifications, extends the application of the Hope credit to two more years of postsecondary education.

The modified credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between \$80,000 and \$90,000 (\$160,000 and \$180,000 for married taxpayers filing a joint return). The modified credit may be claimed against a taxpayer's AMT liability.

Forty percent of a taxpayer's otherwise allowable modified credit is refundable. However, no portion of the modified credit is refundable if the taxpayer claiming the credit is a child to whom IRC section 1(g) applies for such taxable year (generally, any child who has at least one living parent, does not file a joint return, and is either under age 18 or under age 24 and a student providing less than one-half of his or her own support).

Bona fide residents of the U.S. possessions are not permitted to claim the refundable portion of the modified credit in the United States. Rather, a bona fide resident of a mirror IRC possession (Commonwealth of the Northern Mariana Islands, Guam, and the Virgin Islands) may claim the refundable portion of the credit in the possession in which the individual is a resident. Similarly, a bona fide resident of a non-mirror IRC possession (Commonwealth of Puerto Rico and American Samoa) may claim the refundable portion of the credit in the possession in which the individual is resident, but only if the possession establishes a plan for permitting the claim under its internal law. The U.S. Treasury will make payments to the possession in respect of credits allowable to their residents under their internal laws.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

New Federal Law (IRC section 25A)

The provision extends for two years (through 2012) the temporary modifications to the Hope credit for taxable years beginning in 2009 and 2010 that are known as the American Opportunity Tax Credit, including the rules governing the treatment of the U.S. possessions.

Effective Date

The provision is effective for taxable years beginning after December 31, 2010.

California Law (None)

California does not conform to the Hope credit (or to the American Opportunity Tax Credit modifications).

Impact on California Revenue

Not applicable.

**J. Child Tax Credit**

Background

An individual may claim a tax credit for each qualifying child under the age of 17. The maximum 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 aggregate amount of child credits that may be claimed is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable aggregate child tax credit amount is reduced by \$50 for each \$1,000 (or fraction thereof) of modified adjusted gross income ("modified AGI") 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 AGI 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, for taxable years beginning before January 1, 2011, is allowed against the alternative minimum tax ("AMT"). To the extent the child tax 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). EGTRRA provided, in general, that this threshold dollar amount is \$10,000 indexed for inflation from 2001. The American Recovery and Reinvestment Act of 2009 set the threshold at \$3,000 for both 2009 and 2010. After 2010, the ability to determine the refundable child credit based on earned income in excess of the threshold dollar amount expires.

Families with three or more qualifying children may determine the additional child tax credit using the "alternative formula" if this results in a larger credit than determined under the earned

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

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 tax credit ("EITC"). After 2010, due to the expiration of the earned income formula, this is the only manner of obtaining a refundable child credit.

Earned income is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings. Unlike the EITC, 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 EITC, 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 extends for two years the earned income threshold of \$3,000. Also, the provision stops indexation for inflation of the \$3,000 earnings threshold for that period.

Effective Date

The provision applies to taxable years beginning after December 31, 2010.

California Law (None)

California does not conform to the child tax credit.

Impact on California Revenue

Not applicable.

**K. Increase in Earned Income Tax Credit**

Overview

Low- and moderate-income workers may be eligible for the refundable earned income tax credit ("EITC"). Eligibility for the EITC is based on earned income, adjusted gross income, investment income, filing status, number of children, and immigration and work status in the United States. The amount of the EITC 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.

The EITC generally equals a specified percentage of earned income up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phase-out range. For taxpayers with earned income (or adjusted gross income ("AGI"), if greater) in excess of the beginning of the phase-out range, the maximum EITC amount is reduced by the phase-out rate multiplied by the amount of earned income (or AGI, if greater) in

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

excess of the beginning of the phase-out range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phase-out range, no credit is allowed.

An individual is not eligible for the EITC if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds \$3,100 (for 2010). This threshold is indexed for inflation. Disqualified income is the sum of: (1) interest (both taxable and tax exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gains net income; and (5) net passive income that is not self-employment income (if greater than zero).

The EITC is a refundable credit, meaning that if the amount of the credit exceeds the taxpayer's federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment.

#### Filing Status

An unmarried individual may claim the EITC if he or she files as a single filer or as a head of household. Married individuals generally may not claim the EITC unless they file jointly. An exception to the joint return filing requirement applies to certain spouses who are separated. Under this exception, a married taxpayer who is separated from his or her spouse for the last six months of the taxable year is not considered to be married (and, accordingly, may file a return as head of household and claim the EITC), provided that the taxpayer maintains a household that constitutes the principal place of abode for a dependent child (including a son, stepson, daughter, stepdaughter, adopted child, or a foster child) for over half the taxable year, and pays over half the cost of maintaining the household in which he or she resides with the child during the year.

#### Presence of Qualifying Children and Amount of the Earned Income Credit

Four separate credit schedules apply: one schedule for taxpayers with no qualifying children, one schedule for taxpayers with one qualifying child, one schedule for taxpayers with two qualifying children, and one schedule for taxpayers with three or more qualifying children.

Taxpayers with no qualifying children may claim a credit if they are over age 24 and below age 65. The credit is 7.65 percent of earnings up to \$5,980, resulting in a maximum credit of \$457 for 2010. The maximum is available for those with incomes between \$5,980 and \$7,480 (\$12,490 if married filing jointly). The credit begins to phase out at a rate of 7.65 percent of earnings above \$7,480 (\$12,480 if married filing jointly) resulting in a \$0 credit at \$13,460 of earnings (\$18,470 if married filing jointly).

Taxpayers with one qualifying child may claim a credit in 2010 of 34 percent of their earnings up to \$8,970, resulting in a maximum credit of \$3,050. The maximum credit is available for those with earnings between \$8,970 and \$16,450 (\$21,460 if married filing jointly). The credit begins to phase out at a rate of 15.98 percent of earnings above \$16,450 (\$21,460 if married filing jointly). The credit is completely phased out at \$35,535 of earnings (\$40,545 if married filing jointly).

Taxpayers with two qualifying children may claim a credit in 2010 of 40 percent of earnings up to \$12,590, resulting in a maximum credit of \$5,036. The maximum credit is available for those with earnings between \$12,590 and \$16,450 (\$21,460 if married filing jointly). The credit begins

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

to phase out at a rate of 21.06 percent of earnings above \$16,450 (\$21,460 if married filing jointly). The credit is completely phased out at \$40,363 of earnings (\$45,373 if married filing jointly).

A temporary provision enacted by the American Recovery and Reinvestment Act of 2009 (ARRA) allows taxpayers with three or more qualifying children to claim a credit of 45 percent for 2009 and 2010. For example, in 2010 taxpayers with three or more qualifying children may claim a credit of 45 percent of earnings up to \$12,590, resulting in a maximum credit of \$5,666. The maximum credit is available for those with earnings between \$12,590 and \$16,450 (\$21,460 if married filing jointly). The credit begins to phase out at a rate of 21.06 percent of earnings above \$16,450 (\$21,460 if married filing jointly). The credit is completely phased out at \$43,352 of earnings (\$48,362 if married filing jointly).

Under another provision of ARRA, the phase-out thresholds for married couples were raised to an amount \$5,000 above that for other filers for 2009 (and indexed for inflation). The increase is \$5,010 for 2010. Formerly, the phase-out thresholds for married couples were \$3,000 (indexed for inflation from 2008) greater than those for other filers as provided for in EGTRRA.

If more than one taxpayer lives with a qualifying child, only one of these taxpayers may claim the child for purposes of the EITC. If multiple eligible taxpayers actually claim the same qualifying child, then a tiebreaker rule determines which taxpayer is entitled to the EITC with respect to the qualifying child. Any eligible taxpayer with at least one qualifying child who does not claim the EITC with respect to qualifying children due to failure to meet certain identification requirements with respect to such children (i.e., providing the name, age and taxpayer identification number of each of such children) may not claim the EITC for taxpayers without qualifying children.

#### New Federal Law (IRC section 32)

The provision extends the EITC at a rate of 45 percent for three or more qualifying children for two years (through 2012).

The provision extends the higher phase-out thresholds for married couples filing joint returns enacted as part of ARRA for two years (through 2012).

#### Effective Date

The provision applies to taxable years beginning after December 31, 2010.

#### California Law (None)

California does not conform to the earned income tax credit.

#### Impact on California Revenue

Not applicable.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

<u>Sections</u>	<u>Section Titles</u>
201-202	Extension of Alternative Minimum Tax Relief for Nonrefundable Personal Credits and Increased Alternative Minimum Tax Exemption Amount

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 exemption amounts are: (1) \$70,950 for taxable years beginning in 2009 and \$45,000 in taxable years beginning after 2009 in the case of married individuals filing a joint return and surviving spouses; (2) \$46,700 for taxable years beginning in 2009 and \$33,750 in taxable years beginning after 2009 in the case of other unmarried individuals; (3) \$35,475 for taxable years beginning in 2009 and \$22,500 in taxable years beginning after 2009 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 child credit, 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, the credit for certain plug-in electric vehicles, the credit for alternative motor vehicles, the credit for new qualified plug-in electric drive motor vehicles, and the D.C. first-time homebuyer credit).

For taxable years beginning before 2010, 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 2009, the nonrefundable personal credits (other than the child credit, the credit for savers, the credit for residential energy efficient property, the credit for certain plug-in electric drive motor vehicles, the credit for alternative motor vehicles, and credit for new qualified plug-in electric drive motor vehicles) 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 remaining nonrefundable

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

personal credits are allowed to the full extent of the individual's regular tax and alternative minimum tax.<sup>1212</sup>

New Federal Law (IRC sections 26 and 55)

The provision allows an individual to offset the entire regular tax liability and alternative minimum tax liability by the nonrefundable personal credits for 2010 and 2011. The provision provides that the individual AMT exemption amount for taxable years beginning in 2010 is: (1) \$72,450, in the case of married individuals filing a joint return and surviving spouses; (2) \$47,450 in the case of other unmarried individuals; and (3) \$36,225 in the case of married individuals filing separate returns.

The provision provides that the individual AMT exemption amount for taxable years beginning in 2011 is: (1) \$74,450, in the case of married individuals filing a joint return and surviving spouses; (2) \$48,450 in the case of other unmarried individuals; and (3) \$37,225 in the case of married individuals filing separate returns.

Effective Date

The provision is effective for taxable years beginning after 2009.

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

California conforms to federal AMT rules as of the "specified date" of January 1, 2009, with modifications.<sup>1213</sup> As a result, the California AMT is similar to federal AMT in many respects, but the modifications relevant to this provision are that: (1) California has its own AMT exemption amounts; and (2) the California AMT exemption amounts are automatically indexed for inflation.<sup>1214</sup> In other words, this provision's extension of indexed AMT exemption amounts, known as the "AMT patch," does not apply to the California AMT.

Impact on California Revenue

Not applicable.

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<sup>1212</sup> The rule applicable to the child credit after 2010 is subject to the EGTRRA sunset. The adoption credit is refundable in 2010 and 2011 and beginning in 2012 is nonrefundable and treated for purposes of the AMT in the same manner as the child credit.

<sup>1213</sup> For taxable years beginning on or after January 1, 2010, R&TC sections 17062 and 23400 conform to Part VI of Subchapter A of Chapter 1 of Subtitle A of the IRC, containing IRC sections 55 to 59, as of the "specified date" of January 1, 2009, with modifications.

<sup>1214</sup> For taxable years beginning after 1997, R&TC section 17062(b)(5) specifically modifies the exemption amounts in IRC section 55(d)(1), and provides California AMT exemption and phase-out amounts that are indexed annually for inflation.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

<u>Sections</u>	<u>Section Title</u>
301 - 304	Modify and Extend the Estate, Gift, and Generation Skipping Transfer Taxes After 2009

In General

In general, a gift tax is imposed on certain lifetime transfers and an estate tax is imposed on certain transfers at death. A generation skipping transfer tax generally is imposed on certain transfers, either directly or in trust or similar arrangement, to a “skip person” (i.e., a beneficiary in a generation more than one generation younger than that of the transferor). Transfers subject to the generation skipping transfer tax include direct skips, taxable terminations, and taxable distributions.

The estate and generation skipping transfers taxes are repealed for decedents dying and gifts made during 2010, but are reinstated for decedents dying and gifts made after 2010.

Exemption Equivalent Amounts and Applicable Tax Rates

*In general*

Under present law in effect through 2009 and after 2010, a unified credit is available with respect to taxable transfers by gift and at death.<sup>1215</sup> The unified credit offsets tax computed at the lowest estate and gift tax rates.

Before 2004, the estate and gift taxes were fully unified, such that a single graduated rate schedule and a single effective exemption amount of the unified credit applied for purposes of determining the tax on cumulative taxable transfers made by a taxpayer during his or her lifetime and at death. For years 2004 through 2009, the gift tax and the estate tax continued to be determined using a single graduated rate schedule, but the effective exemption amount allowed for estate tax purposes was higher than the effective exemption amount allowed for gift tax purposes. In 2009, the highest estate and gift tax rate was 45 percent. The unified credit effective exemption amount was \$3.5 million for estate tax purposes and \$1 million for gift tax purposes.

For 2009 and after 2010, the generation skipping transfer tax is imposed using a flat rate equal to the highest estate tax rate on cumulative generation skipping transfers in excess of the exemption amount in effect at the time of the transfer. The generation skipping transfer tax exemption for a given year (prior to and after repeal, discussed below) is equal to the unified credit effective exemption amount for estate tax purposes.

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<sup>1215</sup> IRC section 2010.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

*Repeal of estate and generation skipping transfer taxes in 2010; modifications to gift tax*

Under the Economic Growth and Tax Relief Act of 2001 (EGTRRA),<sup>1216</sup> the estate and generation skipping transfer taxes are repealed for decedents dying and generation skipping transfers made during 2010. The gift tax remains in effect during 2010, with a \$1 million exemption amount and a gift tax rate of 35 percent. Also, in 2010, except as provided in regulations, certain transfers in trust are treated as transfers of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under the grantor trust provisions of the IRC.

*Reinstatement of the estate and generation skipping transfer taxes for decedents dying and generation skipping transfers made after December 31, 2010*

The estate, gift, and generation skipping transfer tax provisions of EGTRRA sunset at the end of 2010, such that those provisions (including repeal of the estate and generation skipping transfer taxes) do not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, in general, the estate, gift, and generation skipping transfer tax rates and exemption amounts that would have been in effect had EGTRRA not been enacted apply for estates of decedents dying, gifts made, or generation skipping transfers made in 2011 or later years. A single graduated rate schedule with a top rate of 55 percent and a single effective exemption amount of \$1 million applies for purposes of determining the tax on cumulative taxable transfers by lifetime gift or bequest.

Basis in Property Received

*In general*

Gain or loss, if any, on the disposition of property is measured by the taxpayer's amount realized (i.e., gross proceeds received) on the disposition, less the taxpayer's basis in such property.<sup>1217</sup> Basis generally represents a taxpayer's investment in property, with certain adjustments required after acquisition. For example, basis is increased by the cost of capital improvements made to the property and decreased by depreciation deductions taken with respect to the property.

*Basis in property received by lifetime gift*

Property received from a donor of a lifetime gift generally takes a carryover basis.<sup>1218</sup> "Carryover basis" means that the basis in the hands of the donee is the same as it was in the hands of the donor. The basis of property transferred by lifetime gift also is increased, but not above fair market value, by any gift tax paid by the donor. The basis of a lifetime gift, however, generally cannot exceed the property's fair market value on the date of the gift. If the basis of property is

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<sup>1216</sup> Public Law 107-16.

<sup>1217</sup> IRC section 1001.

<sup>1218</sup> IRC section 1015.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

greater than the fair market value of the property on the date of the gift, then, for purposes of determining loss, the basis is the property's fair market value on the date of the gift.

*Basis in property received from a decedent who died in 2009*

Property passing from a decedent who died during 2009 generally takes a "stepped-up" basis.<sup>1219</sup> In other words, the basis of property passing from such a decedent's estate generally is the fair market value on the date of the decedent's death (or, if the alternate valuation date is elected, the earlier of six months after the decedent's death or the date the property is sold or distributed by the estate).<sup>1220</sup> This step up in basis generally eliminates the recognition of income on any appreciation of the property that occurred prior to the decedent's death. If the value of property on the date of the decedent's death was less than its adjusted basis, the property takes a stepped-down basis when it passes from a decedent's estate. This stepped-down basis eliminates the tax benefit from any unrealized loss.

*Basis in property received from a decedent who dies during 2010*

The rules providing for stepped-up basis in property acquired from a decedent are repealed for assets acquired from decedents dying in 2010, and a modified carryover basis regime applies.<sup>1221</sup> Under this regime, recipients of property acquired from a decedent at the decedent's death receive a basis equal to the lesser of the decedent's adjusted basis or the fair market value of the property on the date of the decedent's death. The modified carryover basis rules apply to property acquired by bequest, devise, or inheritance, or property acquired by the decedent's estate from the decedent, property passing from the decedent to the extent such property passed without consideration, and certain other property to which the prior law rules apply, other than property that is income in respect of a decedent. Property acquired from a decedent is treated as if the property had been acquired by gift. Thus, the character of gain on the sale of property received from a decedent's estate is carried over to the heir. For example, real estate that has been depreciated and would be subject to recapture if sold by the decedent will be subject to recapture if sold by the heir.

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<sup>1219</sup> IRC section 1014.

<sup>1220</sup> There is an exception to the rule that assets subject to the federal estate tax receive stepped-up basis in the case of "income in respect of a decedent." IRC section 1014(c). The basis of assets that are "income in respect of a decedent" is a carryover basis (i.e., the basis of such assets to the estate or heir is the same as it was in the hands of the decedent) increased by estate tax paid on that asset. Income in respect of a decedent includes rights to income that has been earned, but not recognized, by the date of death (e.g., wages that were earned, but not paid, before death), individual retirement accounts (IRAs), and assets held in accounts governed by IRC section 401(k).

In community property states, a surviving spouse's one-half share of community property held by the decedent and the surviving spouse generally is treated as having passed from the decedent and, thus, is eligible for stepped-up basis. Under 2009 law, this rule applies if at least one-half of the whole of the community interest is includible in the decedent's gross estate.

<sup>1221</sup> IRC section 1022.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

An executor generally may increase the basis in assets owned by the decedent and acquired by the beneficiaries at death, subject to certain special rules and exceptions. Under these rules, each decedent's estate generally is permitted to increase the basis of assets transferred by up to a total of \$1.3 million. The \$1.3 million is increased by the amount of unused capital losses, net operating losses, and certain "built-in" losses of the decedent. Nonresidents who are not U.S. citizens may be allowed to increase the basis of property by up to \$60,000. In addition, the basis of property transferred to a surviving spouse may be increased by an additional \$3 million. Thus, the basis of property transferred to surviving spouses generally may be increased by up to \$4.3 million.

*Repeal of modified carryover basis regime for determining basis in property received from a decedent who dies after December 31, 2010*

As a result of the EGTRRA sunset at the end of 2010, the modified carryover basis regime in effect for determining basis in property passing from a decedent who dies during 2010 does not apply for purposes of determining basis in property received from a decedent who dies after December 31, 2010. Instead, the law in effect prior to 2010, which generally provides for stepped-up basis in property passing from a decedent, applies.

State Death Tax Credit; Deduction for State Death Taxes Paid

*State death tax credit under prior law*

Before 2005, a credit was allowed against the federal estate tax for any estate, inheritance, legacy, or succession taxes ("death taxes") actually paid to any state or the District of Columbia with respect to any property included in the decedent's gross estate.<sup>1222</sup> The maximum amount of credit allowable for state death taxes was determined under a graduated rate table, the top rate of which was 16 percent, based on the size of the decedent's adjusted taxable estate. Most States imposed a "pick-up" or "soak-up" estate tax, which served to impose a state tax equal to the maximum federal credit allowed.

*Phase-out of state death tax credit; deduction for state death taxes paid*

Under EGTRRA, the amount of allowable state death tax credit was reduced from 2002 through 2004. For decedents dying after 2004, the state death tax credit was repealed and replaced with a deduction for death taxes actually paid to any state or the District of Columbia, in respect of property included in the gross estate of the decedent.<sup>1223</sup> Such state taxes must have been paid and claimed before the later of: (1) four years after the filing of the estate tax return; or (2) (a) 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final, (b) the expiration of the period of extension to pay estate taxes over time under IRC section 6166, or (c) the expiration of the period of limitations in which to file a claim for refund or generally 60 days after a decision of a court in which such refund suit has become final.

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<sup>1222</sup> IRC section 2011.

<sup>1223</sup> IRC section 2058.

## Reinstatement of State Death Tax Credit for Decedents Dying after December 31, 2010

As described above, the estate, gift, and generation skipping transfer tax provisions of EGTRRA sunset at the end of 2010, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, neither the EGTRRA modifications to the state death tax credit nor the replacement of the credit with a deduction applies for decedents dying after December 31, 2010. Instead, the state death tax credit as in effect for decedents who died prior to 2002 applies.

### Exclusions and Deductions

#### *Gift tax annual exclusion*

Donors of lifetime gifts are provided an annual exclusion of \$13,000 (for 2010 and 2011) on transfers of present interests in property to each donee during the taxable year.<sup>1224</sup> If the non-donor spouse consents to split the gift with the donor spouse, then the annual exclusion is \$26,000 for 2010 and 2011. The dollar amounts are indexed for inflation.

#### *Transfers to a surviving spouse*

In general – A 100-percent marital deduction generally is permitted for estate and gift tax purposes for the value of property transferred between spouses.<sup>1225</sup> Transfers of “qualified terminable interest property” are eligible for the marital deduction. “Qualified terminable interest property” is property: (1) that passes from the decedent; (2) in which the surviving spouse has a “qualifying income interest for life”; and (3) to which an election applies. A “qualifying income interest for life” exists if: (1) the surviving spouse is entitled to all the income from the property (payable annually or at more frequent intervals) or has the right to use the property during the spouse’s life; and (2) no person has the power to appoint any part of the property to any person other than the surviving spouse.

Transfers to surviving spouses who are not U.S. citizens – A marital deduction generally is denied for property passing to a surviving spouse who is not a citizen of the United States.<sup>1226</sup> A marital deduction is permitted, however, for property passing to a qualified domestic trust of which the noncitizen surviving spouse is a beneficiary. A qualified domestic trust is a trust that has as its trustee at least one U.S. citizen or U.S. corporation. No corpus may be distributed from a qualified domestic trust unless the U.S. trustee has the right to withhold any estate tax imposed on the distribution.

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<sup>1224</sup> IRC section 2503(b).

<sup>1225</sup> IRC sections 2056 and 2523.

<sup>1226</sup> IRC sections 2056(d)(1) and 2523(i)(1).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

For years when the estate tax is in effect, the estate tax is imposed on: (1) any distribution from a qualified domestic trust before the date of the death of the noncitizen surviving spouse; and (2) the value of the property remaining in a qualified domestic trust on the date of death of the noncitizen surviving spouse. The tax is computed as an additional estate tax on the estate of the first spouse to die.

*Conservation easements*

For years when an estate tax is in effect, an executor generally may elect to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement, up to a maximum exclusion of \$500,000.<sup>1227</sup> The exclusion percentage is reduced by two percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30 percent of the value of the land (determined without regard to the value of such easement and reduced by the value of any retained development right).

Before 2001, a qualified conservation easement generally was one that met the following requirements: (1) the land was located within 25 miles of a metropolitan area (as defined by the Office of Management and Budget) or a national park or wilderness area, or within 10 miles of an Urban National Forest (as designated by the Forest Service of the U.S. Department of Agriculture); (2) the land had been owned by the decedent or a member of the decedent's family at all times during the three-year period ending on the date of the decedent's death; and (3) a qualified conservation contribution (within the meaning of IRC section 170(h)) of a qualified real property interest (as generally defined in IRC section 170(h)(2)(C)) was granted by the decedent or a member of his or her family. Preservation of a historically important land area or a certified historic structure does not qualify as a conservation purpose.

Effective for estates of decedents dying after December 31, 2000, EGTRRA expanded the availability of qualified conservation easements by eliminating the requirement that the land be located within a certain distance of a metropolitan area, national park, wilderness area, or Urban National Forest. A qualified conservation easement may be claimed with respect to any land that is located in the United States or its possessions. EGTRRA also clarifies that the date for determining easement compliance is the date on which the donation is made.

As a result of the EGTRRA sunset at the end of 2010, the EGTRRA modifications to expand the availability of qualified conservation contributions do not apply for decedents dying after December 31, 2010.

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<sup>1227</sup> IRC section 2031(c).

## Provisions Affecting Small and Family-Owned Businesses and Farms

### *Special-use valuation*

For years when an estate tax is in effect, an executor may elect to value for estate tax purposes certain “qualified real property” used in farming or another qualifying closely-held trade or business at its current-use value, rather than its fair market value.<sup>1228</sup> The maximum reduction in value for such real property was \$1 million for 2009. Real property generally can qualify for special-use valuation if at least 50 percent of the adjusted value of the decedent’s gross estate consists of a farm or closely-held business assets in the decedent’s estate (including both real and personal property) and at least 25 percent of the adjusted value of the gross estate consists of farm or closely-held business real property. In addition, the property must be used in a qualified use (e.g., farming) by the decedent or a member of the decedent’s family for five of the eight years immediately preceding the decedent’s death.

If, after a special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years of the decedent’s death, an additional estate tax is imposed in order to recapture the entire estate-tax benefit of the special-use valuation.

### *Family-owned business deduction*

Prior to 2004, an estate was permitted to deduct the adjusted value of a qualified family-owned business interest of the decedent, up to \$675,000.<sup>1229</sup> A qualified family-owned business interest generally is defined as any interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if the decedent’s family owns at least 50 percent of the trade or business, two families own 70 percent, or three families own 90 percent, as long as the decedent’s family owns, in the case of the 70-percent and 90-percent rules, at least 30 percent of the trade or business.

To qualify for the deduction, the decedent (or a member of the decedent’s family) must have owned and materially participated in the trade or business for at least five of the eight years preceding the decedent’s date of death. In addition, at least one qualified heir (or member of the qualified heir’s family) is required to materially participate in the trade or business for at least 10 years following the decedent’s death. The qualified family-owned business rules provide a graduated recapture based on the number of years after the decedent’s death within which a disqualifying event occurred.

In general, there is no requirement that the qualified heir (or members of his or her family) continue to hold or participate in the trade or business more than 10 years after the decedent’s

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<sup>1228</sup> IRC section 2032A.

<sup>1229</sup> IRC section 2057. The qualified family-owned business deduction and the unified credit effective exemption amount are coordinated. If the maximum deduction amount of \$675,000 is elected, then the unified credit effective exemption amount is \$625,000, for a total of \$1.3 million. Because of the coordination between the qualified family-owned business deduction and the unified credit effective exemption amount, the qualified family-owned business deduction would not provide a benefit in any year in which the applicable exclusion amount exceeds \$1.3 million.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

death. However, the 10-year recapture period can be extended for a period of up to two years if the qualified heir does not begin to use the property for a period of up to two years after the decedent's death.

EGTRRA repealed the qualified family-owned business deduction for estates of decedents dying after December 31, 2003. As a result of the EGTRRA sunset at the end of 2010, the qualified family-owned business deduction applies to estates of decedents dying after December 31, 2010.

*Installment payment of estate tax for closely held businesses*

Estate tax generally is due within nine months of a decedent's death. However, an executor generally may elect to pay estate tax attributable to an interest in a closely held business in two or more installments (but no more than 10).<sup>1230</sup> An estate is eligible for payment of estate tax in installments if the value of the decedent's interest in a closely held business exceeds 35 percent of the decedent's adjusted gross estate (i.e., the gross estate less certain deductions). If the election is made, the estate may defer payment of principal and pay only interest for the first five years, followed by up to 10 annual installments of principal and interest. This provision effectively extends the time for paying estate tax by 14 years from the original due date of the estate tax. A special two-percent interest rate applies to the amount of deferred estate tax attributable to the first \$1.34 million<sup>1231</sup> (as adjusted annually for inflation occurring after 1998; the original amount for 1998 was \$1 million) in taxable value of a closely held business. The interest rate applicable to the amount of estate tax attributable to the taxable value of the closely held business in excess of \$1.34 million is equal to 45 percent of the rate applicable to underpayments of tax under IRC section 6621 (i.e., 45 percent of the federal short-term rate plus two percentage points). Interest paid on deferred estate taxes is not deductible for estate or income tax purposes.

Under pre-EGTRRA law, for purposes of these rules an interest in a closely held business was: (1) an interest as a proprietor in a sole proprietorship; (2) an interest as a partner in a partnership carrying on a trade or business if 20 percent or more of the total capital interest of such partnership was included in the decedent's gross estate or the partnership had 15 or fewer partners; and (3) stock in a corporation carrying on a trade or business if 20 percent or more of the value of the voting stock of the corporation was included in the decedent's gross estate or such corporation had 15 or fewer shareholders.

Under present and pre-EGTRRA law, the decedent may own the interest directly or, in certain cases, indirectly through a holding company. If ownership is through a holding company, the stock must be non-readily tradable. If stock in a holding company is treated as business company stock for purposes of the installment payment provisions, the five-year deferral for principal and the two-percent interest rate do not apply. The value of any interest in a closely held business does not include the value of that portion of such interest attributable to passive assets held by such business.

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<sup>1230</sup> IRC section 6166.

<sup>1231</sup> Rev. Proc. 2009-50, I.R.B. 2009-45 (Nov. 9, 2009).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Effective for estates of decedents dying after December 31, 2001, EGTRRA expands the definition of a closely held business for purposes of installment payment of estate tax. EGTRRA increases from 15 to 45 the maximum number of partners in a partnership and shareholders in a corporation that may be treated as a closely held business in which a decedent held an interest, and thus will qualify the estate for installment payment of estate tax.

EGTRRA also expands availability of the installment payment provisions by providing that an estate of a decedent with an interest in a qualifying lending and financing business is eligible for installment payment of the estate tax. EGTRRA provides that an estate with an interest in a qualifying lending and financing business that claims installment payment of estate tax must make installment payments of estate tax (which will include both principal and interest) relating to the interest in a qualifying lending and financing business over five years.

EGTRRA clarifies that the installment payment provisions require that only the stock of holding companies, not the stock of operating subsidiaries, must be non-readily tradable to qualify for installment payment of the estate tax. EGTRRA provides that an estate with a qualifying property interest held through holding companies that claims installment payment of estate tax must make all installment payments of estate tax (which will include both principal and interest) relating to a qualifying property interest held through holding companies over five years.

As a result of the EGTRRA sunset at the end of 2010, the EGTRRA modifications to the estate tax installment payment rules described above do not apply for estates of decedents dying after December 31, 2010.

### Generation-Skipping Transfer Tax Rules

#### *In general*

For years before and after 2010, a generation skipping transfer tax generally is imposed on transfers, either directly or in trust or similar arrangement, to a “skip person” (as defined above).<sup>1232</sup> Transfers subject to the generation skipping transfer tax include direct skips, taxable terminations, and taxable distributions.<sup>1233</sup> An exemption generally equal to the estate tax effective exemption amount is provided for each person making generation skipping transfers. The exemption may be allocated by a transferor (or his or her executor) to transferred property.

A direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person.<sup>1234</sup> Natural persons or certain trusts may be skip persons. All persons assigned to the second or more remote generation below the transferor are skip persons (e.g., grandchildren and great-grandchildren). Trusts are skip persons if all interests in the trust are held by skip persons or no person holds an interest in the trust and at no time after the transfer may a distribution

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<sup>1232</sup> IRC section 2601.

<sup>1233</sup> IRC section 2611.

<sup>1234</sup> IRC section 2612(c).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

(including distributions and terminations) be made to a non-skip person. A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person.<sup>1235</sup> A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip).<sup>1236</sup> If a transferor allocates generation skipping transfer tax exemption to a trust prior to the taxable distribution, generation skipping transfer tax may be avoided.

The tax rate on generation skipping transfers is a flat rate of tax equal to the maximum estate and gift tax rate in effect at the time of the transfer multiplied by the “inclusion ratio.” The inclusion ratio with respect to any property transferred in a generation skipping transfer indicates the amount of “generation skipping transfer tax exemption” allocated to a trust. The allocation of generation skipping transfer tax exemption effectively reduces the tax rate on a generation skipping transfer.

If an individual makes a direct skip during his or her lifetime, any unused generation-skipping transfer tax exemption is automatically allocated to a direct skip to the extent necessary to make the inclusion ratio for such property equal to zero. An individual can elect out of the automatic allocation for lifetime direct skips.

Under pre-EGTRRA law, for lifetime transfers made to a trust that were not direct skips, the transferor had to make an affirmative allocation of generation skipping transfer tax exemption; the allocation was not automatic. If generation skipping transfer tax exemption was allocated on a timely filed gift tax return, then the portion of the trust that was exempt from generation skipping transfer tax was based on the value of the property at the time of the transfer. If, however, the allocation was not made on a timely-filed gift tax return, then the portion of the trust that was exempt from generation skipping transfer tax was based on the value of the property at the time the allocation of generation skipping transfer tax exemption was made.

An election to allocate generation skipping transfer tax to a specific transfer generally may be made at any time up to the time for filing the transferor’s estate tax return.

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<sup>1235</sup> IRC section 2612(a).

<sup>1236</sup> IRC section 2612(b).

*Modifications to the generation skipping transfer tax rules under EGTRRA*

Generally effective after 2000, EGTRRA modifies and adds certain mechanical rules related to the generation skipping transfer tax. First, EGTRRA generally provides that generation skipping transfer tax exemption will be allocated automatically to transfers made during life that are “indirect skips.” An indirect skip is any transfer of property (that is not a direct skip) subject to the gift tax that is made to a generation skipping transfer trust, as defined in the IRC. If any individual makes an indirect skip during the individual’s lifetime, then any unused portion of such individual’s generation skipping transfer tax exemption is allocated to the property transferred to the extent necessary to produce the lowest possible inclusion ratio for such property. An individual can elect out of the automatic allocation or may elect to treat a trust as a generation skipping transfer trust attracting the automatic allocation.

Second, EGTRRA provides that, under certain circumstances, generation skipping transfer tax exemption can be allocated retroactively when there is an unnatural order of death. In general, if a lineal descendant of the transferor predeceases the transferor, then the transferor can allocate any unused generation skipping transfer exemption to any previous transfer or transfers to the trust on a chronological basis.

Third, EGTRRA provides that a trust that is only partially subject to generation skipping transfer tax because its inclusion ratio is less than one can be severed in a “qualified severance.” A qualified severance generally is defined as the division of a single trust and the creation of two or more trusts, one of which would be exempt from generation skipping transfer tax and another of which would be fully subject to generation skipping transfer tax, if the single trust was divided on a fractional basis and the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust.

Fourth, EGTRRA provides that in connection with timely and automatic allocations of generation skipping transfer tax exemption, the value of the property for purposes of determining the inclusion ratio shall be its finally determined gift tax value or estate tax value depending on the circumstances of the transfer. In the case of a generation skipping transfer tax exemption allocation deemed to be made at the conclusion of an estate tax inclusion period, the value for purposes of determining the inclusion ratio shall be its value at that time.

Fifth, under EGTRRA, the Secretary of the Treasury generally is authorized and directed to grant extensions of time to make the election to allocate generation skipping transfer tax exemption and to grant exceptions to the time requirement, without regard to whether any period of limitations has expired. If such relief is granted, then the gift tax or estate tax value of the transfer to trust would be used for determining generation skipping transfer tax exemption allocation.

Sixth, EGTRRA provides that substantial compliance with the statutory and regulatory requirements for allocating generation skipping transfer tax exemption will suffice to establish that generation skipping transfer tax exemption was allocated to a particular transfer or a particular trust. If a taxpayer demonstrates substantial compliance, then so much of the transferor’s unused generation skipping transfer tax exemption will be allocated as produces the lowest possible inclusion ratio.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Sunset of EGTRRA Modifications to the Generation Skipping Transfer Tax Rules

The estate and generation skipping transfer taxes are repealed for decedents dying and gifts made in 2010. As a result of the EGTRRA sunset at the end of 2010, the generation skipping transfer tax again will apply after December 31, 2010. However, the EGTRRA modifications to the generation skipping transfer tax rules described above do not apply to generation skipping transfers made after December 31, 2010. Instead, in general, the rules as in effect prior to 2001, apply.

New Federal Law (IRC sections 2001, 2010, 2502, 2505, 2511, and 6018)

In General

The provision reinstates the estate and generation skipping transfer taxes effective for decedents dying and transfers made after December 31, 2009. The estate tax applicable exclusion amount is \$5 million under the provision and is indexed for inflation for decedents dying in calendar years after 2011, and the maximum estate tax rate is 35 percent. For gifts made in 2010, the applicable exclusion amount for gift tax purposes is \$1 million, and the gift tax rate is 35 percent. For gifts made after December 31, 2010, the gift tax is reunified with the estate tax, with an applicable exclusion amount of \$5 million and a top estate and gift tax rate of 35 percent.<sup>1237</sup>

The generation skipping transfer tax exemption for decedents dying or gifts made after December 31, 2009, is equal to the applicable exclusion amount for estate tax purposes (e.g., \$5 million for 2010).<sup>1238</sup> Therefore, up to \$5 million in generation skipping transfer tax exemption may be allocated to a trust created or funded during 2010, depending upon the amount of such exemption used by the taxpayer before 2010. Although the generation skipping transfer tax is applicable in 2010, the generation skipping transfer tax rate for transfers made during 2010 is zero percent. The generation skipping transfer tax rate for transfers made after 2010 is equal to the highest estate and gift tax rate in effect for such year (35 percent for 2011 and 2012).

The provision allows a deduction for certain death taxes paid to any state or the District of Columbia for decedents dying after December 31, 2009.

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<sup>1237</sup> The provision clarifies current law regarding the computation of estate and gift taxes. Under present law, the gift tax on taxable transfers for a year is determined by computing a tentative tax on the cumulative value of current year transfers and all gifts made by a decedent after December 31, 1976, and subtracting from the tentative tax the amount of gift tax that would have been paid by the decedent on taxable gifts after December 31, 1976, if the tax rate schedule in effect in the current year had been in effect on the date of the prior-year gifts. Under the provision, for purposes of determining the amount of gift tax that would have been paid on one or more prior year gifts, the estate tax rates in effect under IRC section 2001(c) at the time of the decedent's death are used to compute both: (1) the gift tax imposed by Chapter 12 of Subtitle A of the IRC with respect to such gifts; and (2) the unified credit allowed against such gifts under IRC section 2505 (including in computing the applicable credit amount under IRC section 2505(a)(1) and the sum of amounts allowed as a credit for all preceding periods under IRC section 2505(a)(2)).

<sup>1238</sup> The \$5 million generation skipping transfer tax exemption is available in 2010 regardless of whether the executor of an estate of a decedent who dies in 2010 makes the election described below to apply the EGTRRA 2010 estate tax rules and IRC section 1022 basis rules.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

The provision generally repeals the modified carryover basis rules that, under EGTRRA, would apply for purposes of determining basis in property acquired from a decedent who dies in 2010. Under the provision, a recipient of property acquired from a decedent who dies after December 31, 2009, generally will receive fair market value basis (i.e., “stepped up” basis) under the basis rules applicable to assets acquired from decedents who died in 2009.<sup>1239</sup>

The provision extends the EGTRRA modifications to the rules regarding: (1) qualified conservation easements; (2) installment payment of estate taxes; and (3) various technical aspects of the generation skipping transfer tax, described in the background section, above.

#### Election for Decedents Who Die During 2010

In the case of a decedent who dies during 2010, the provision generally allows the executor of such decedent’s estate to elect to apply the IRC as if the new estate tax and basis step-up rules described in the preceding section had not been enacted. In other words, instead of applying the above-described new estate tax and basis step-up rules of the provision, the executor may elect to have present law (as enacted under EGTRRA) apply. In general, if such an election is made, the estate would not be subject to estate tax, and the basis of assets acquired from the decedent would be determined under the modified carryover basis rules of IRC section 1022.<sup>1240</sup> This election will have no effect on the continued applicability of the generation skipping transfer tax. In addition, in applying the definition of transferor in IRC section 2652(a)(1), the determination of whether any property is subject to the tax imposed by Chapter 11 of Subtitle A of the IRC is made without regard to an election made under this provision.

The Secretary of the Treasury or his delegate shall determine the time and manner for making the election. The election, once made, is revocable only with the consent of the Secretary or his delegate.

#### Extension of Certain Filing Deadlines

The provision also provides for the extension of filing deadlines for certain transfer tax returns. Specifically, in the case of a decedent dying after December 31, 2009, and before the date of enactment, the due date shall not be earlier than the date which is nine months after the date of enactment for: (1) filing an estate tax return required under IRC section 6018; (2) making the payment of estate tax under Chapter 11 of Subtitle A of the IRC; and (3) making any disclaimer described in IRC section 2518(b) of an interest in property passing by reason the death of such a decedent. In the case of a generation skipping transfer made after December 31, 2009, and before the date of enactment, the due date for filing any return required under IRC section 2662 (including the making of any election required to be made on the return) shall not be earlier than the date which is nine months after December 17, 2010.

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<sup>1239</sup> See generally IRC section 1014.

<sup>1240</sup> Therefore, an heir who acquires an asset from the estate of a decedent who died in 2010 and whose executor elected application of the 2010 EGTRRA rules has a basis in the asset determined under the modified carryover basis rules of IRC section 1022. Such basis is applicable for the determination of any gain or loss on the sale or disposition of the asset in any future year regardless of the status of the sunset provision described below.

### Portability of Unused Exemption between Spouses

Under the provision, any applicable exclusion amount that remains unused as of the death of a spouse who dies after December 31, 2010 (the "deceased spousal unused exclusion amount"), generally is available for use by the surviving spouse, as an addition to such surviving spouse's applicable exclusion amount.<sup>1241</sup>

If a surviving spouse is predeceased by more than one spouse, the amount of unused exclusion that is available for use by such surviving spouse is limited to the lesser of \$5 million or the unused exclusion of the last such deceased spouse.<sup>1242</sup> A surviving spouse may use the predeceased spousal carryover amount in addition to such surviving spouse's own \$5 million exclusion for taxable transfers made during life or at death.

A deceased spousal unused exclusion amount is available to a surviving spouse only if an election is made on a timely-filed estate tax return (including extensions) of the predeceased spouse on which such amount is computed, regardless of whether the estate of the predeceased spouse otherwise is required to file an estate tax return. In addition, notwithstanding the statute of limitations for assessing estate or gift tax with respect to a predeceased spouse, the Secretary of the Treasury may examine the return of a predeceased spouse for purposes of determining the deceased spousal unused exclusion amount available for use by the surviving spouse. The Secretary of the Treasury shall prescribe regulations as may be appropriate and necessary to carry out the rules described in this paragraph.

Example 1 – Assume that Husband 1 dies in 2011, having made taxable transfers of \$3 million and having no taxable estate. An election is made on Husband 1's estate tax return to permit Wife to use Husband 1's deceased spousal unused exclusion amount. As of Husband 1's death, Wife has made no taxable gifts. Thereafter, Wife's applicable exclusion amount is \$7 million (her \$5 million basic exclusion amount plus \$2 million deceased spousal unused exclusion amount from Husband 1), which she may use for lifetime gifts or for transfers at death.

Example 2 – Assume the same facts as in Example 1, except that Wife subsequently marries Husband 2. Husband 2 also predeceases Wife, having made \$4 million in taxable transfers and having no taxable estate. An election is made on Husband 2's estate tax return to permit Wife to use Husband 2's deceased spousal unused exclusion amount. Although the combined amount of unused exclusion of Husband 1 and Husband 2 is \$3 million (\$2 million for Husband 1 and \$1 million for Husband 2), only Husband 2's \$1 million unused exclusion is available for use by Wife, because the deceased spousal unused exclusion amount is limited to the lesser of the basic exclusion amount (\$5 million) or the unused exclusion of the last deceased spouse of the surviving spouse (here, Husband 2's \$1 million unused exclusion). Thereafter, Wife's applicable

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<sup>1241</sup> The provision does not allow a surviving spouse to use the unused generation skipping transfer tax exemption of a predeceased spouse.

<sup>1242</sup> The last deceased spouse limitation applies whether or not the last deceased spouse has any unused exclusion or the last deceased spouse's estate makes a timely election.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

exclusion amount is \$6 million (her \$5 million basic exclusion amount plus \$1 million deceased spousal unused exclusion amount from Husband 2), which she may use for lifetime gifts or for transfers at death.

Example 3 – Assume the same facts as in Examples 1 and 2, except that Wife predeceases Husband 2. Following Husband 1's death, Wife's applicable exclusion amount is \$7 million (her \$5 million basic exclusion amount plus \$2 million deceased spousal unused exclusion amount from Husband 1). Wife made no taxable transfers and has a taxable estate of \$3 million. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's deceased spousal unused exclusion amount, which is \$4 million (Wife's \$7 million applicable exclusion amount less her \$3 million taxable estate). Under the provision, Husband 2's applicable exclusion amount is increased by \$4 million, i.e., the amount of deceased spousal unused exclusion amount of Wife.

#### Sunset Provision

Under the bill, the sunset of the EGTRRA estate, gift, and generation skipping transfer tax provisions, scheduled to apply to estates of decedents dying, gifts made, or generation skipping transfers after December 31, 2010, is extended to apply to estates of decedents dying, gifts made, or generation skipping transfers after December 31, 2012. The EGTRRA sunset, as extended by the bill, applies to the amendments made by the provision. Therefore, neither the EGTRRA rules nor the new rules of the provision will apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2012.

#### Effective Date

The estate and generation skipping transfer tax provisions generally are effective for decedents dying, gifts made, and generation skipping transfers made after December 31, 2009. The modifications to the gift tax exemption and rate generally are effective for gifts made after December 31, 2010. The new rules providing for portability of unused exemption between spouses generally are effective for decedents dying and gifts made after December 31, 2010.

#### California Law (R&TC section 18035.6)

#### Estate "Pick-Up" Tax

California does not conform to the federal estate and generation skipping transfer taxes, but instead imposes what is referred to as the estate "pick-up" tax. The estate "pick-up" tax is a tax equal to the maximum federal estate tax credit allowed. The federal estate tax credit was reduced from 2002 to 2004, repealed for decedents dying after 2004, and is reinstated for decedents dying after 2012 under the rules that applied to decedents who died before 2002.<sup>1243</sup> The California estate "pick-up" tax is administered by the State Controller's Office.

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<sup>1243</sup> Under EGTRRA, the amount of allowable state death tax credit was reduced from 2002 through 2004, and for decedents dying after 2004, the state death tax credit was repealed and replaced with a deduction; thus, there is no "pick-up" tax for decedents dying after 2004 and before 2013. For decedents dying after 2012, the EGTRRA deduction is repealed, and replaced with the prior state death tax credit, as in effect for decedents dying prior to 2002.

## Basis in Property Received from a Decedent

The PITL conforms to the federal “stepped-up” basis rules,<sup>1244</sup> modified to provide that the rules do not expire for decedents who die after 2009. In other words, the “stepped-up” basis rules are permanent under California law.

## Impact on California Revenue

Defer to the State Controller.

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<u>Section</u>	<u>Section Title</u>
401	Extension of Bonus Depreciation; Temporary 100 Percent Expensing for Certain Business Assets

## Background

### In General

An additional first-year depreciation deduction is allowed equal to 50 percent of the adjusted basis of qualified property placed in service during 2008, 2009, and 2010 (2009, 2010, and 2011 for certain longer-lived and transportation property).<sup>1245</sup> The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes, but is not allowed for purposes of computing earnings and profits. 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 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 2009, a taxpayer purchased new depreciable property and placed it in service.<sup>1246</sup> 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

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<sup>1244</sup> For taxable years beginning on or after January 1, 2010, R&TC section 18035.6 conforms to IRC section 1014 as of the “specified date” of January 1, 2009.

<sup>1245</sup> IRC section 168(k). The additional first-year depreciation deduction is subject to the general rules regarding whether an item must be capitalized under IRC section 263 or IRC section 263A.

<sup>1246</sup> Assume that the cost of the property is not eligible for expensing under IRC section 179.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

allowed is \$500. The remaining \$500 of the cost of the property is depreciable under the rules applicable to five-year property. Thus, 20 percent, or \$100, is also allowed as a depreciation deduction in 2009. The total depreciation deduction with respect to the property for 2009 is \$600. The remaining \$400 adjusted basis of the property generally is recovered through otherwise applicable depreciation rules.

Property qualifying for the additional first-year depreciation deduction 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)).<sup>1247</sup> Second, the original use<sup>1248</sup> of the property must commence with the taxpayer after December 31, 2007.<sup>1249</sup> 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, 2011. An extension of the placed in service date of one year (i.e., to January 1, 2012) is provided for certain property with a recovery period of 10 years or longer and certain transportation property.<sup>1250</sup> Transportation property is defined as tangible personal property used in the trade or business of transporting persons or property.

To qualify, property must be acquired: (1) after December 31, 2007, and before January 1, 2011, but only if no binding written contract for the acquisition is in effect before January 1, 2008; or

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<sup>1247</sup> The additional first-year depreciation deduction is not available for any property that is required to be depreciated under the alternative depreciation system of MACRS. The additional first-year depreciation deduction is also not available for qualified New York Liberty Zone leasehold improvement property as defined in IRC section 1400L(c)(2).

<sup>1248</sup> 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.

If in the normal course of its business a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first user of each fractional interest (i.e., each fractional owner is considered the original user of its proportionate share of the property).

<sup>1249</sup> 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.

If property is originally placed in service by a lessor (including by operation of IRC section 168(k)(2)(E)(i)), such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of such sale.

<sup>1250</sup> Property qualifying for the extended placed in service date must have an estimated production period exceeding one year and a cost exceeding \$1 million.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

(2) pursuant to a binding written contract which was entered into after December 31, 2007, and before January 1, 2011.<sup>1251</sup> 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, 2011.

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, 2011 ("progress expenditures") is eligible for the additional first-year depreciation.<sup>1252</sup>

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 under IRC section 280F on the amount of depreciation deductions allowed with respect to certain passenger automobiles is increased in the first year by \$8,000 for automobiles that qualify (and for which the taxpayer does not elect out of the additional first-year deduction). The \$8,000 increase is not indexed for inflation.

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<sup>1251</sup> 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.

<sup>1252</sup> 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 apply.

### Election to Accelerate Certain Credits in Lieu of Claiming Bonus Depreciation

A corporation 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 and before December 31, 2008.<sup>1253</sup> 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.<sup>1254</sup> The increases in the allowable credits are treated as refundable. 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 the bonus depreciation amount, which is equal to 20 percent of bonus depreciation<sup>1255</sup> for certain eligible qualified property that could 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, 2010, but only if no binding written contract for the acquisition is in effect before April 1, 2008,<sup>1256</sup> or (b) pursuant to a binding written contract which was entered into after March 31, 2008, and before January 1, 2010;<sup>1257</sup> and (3) the property must be placed in service after March 31, 2008, and before January 1, 2010 (January 1, 2011 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) are treated as one taxpayer for purposes of the limitation, as well as for electing the application of this provision.

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<sup>1253</sup> IRC section 168(k)(4). In the case of an 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.

<sup>1254</sup> Special rules apply to an applicable partnership.

<sup>1255</sup> For this purpose, bonus depreciation is the difference between (i) the aggregate amount of depreciation for all eligible qualified property determined if IRC section 168(k)(1) applied using the most accelerated depreciation method (determined without regard to this provision), and shortest life allowable for each property, and (ii) the amount of depreciation that would be determined if IRC section 168(k)(1) did not apply using the same method and life for each property.

<sup>1256</sup> In the case of passenger aircraft, the written binding contract limitation does not apply.

<sup>1257</sup> Special rules apply to property manufactured, constructed, or produced by the taxpayer for use by the taxpayer.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

A corporation may make a separate election to increase the research credit or minimum tax credit limitation by the bonus depreciation amount with respect to certain property placed in service in 2009 (2010 in the case of certain longer-lived and transportation property). The election applies with respect to extension property, which is defined as property that is eligible qualified property solely because it meets the requirements under the extension of the special allowance for certain property acquired during 2009.

A corporation that has made an election to increase the research credit or minimum tax credit limitation for eligible qualified property for its first taxable year ending after March 31, 2008, may choose not to make this election for extension property. Further, a corporation that has not made an election for eligible qualified property for its first taxable year ending after March 31, 2008, is permitted to make the election for extension property for its first taxable year ending after December 31, 2008, and for each subsequent year. In the case of a taxpayer electing to increase the research or minimum tax credit for both eligible qualified property and extension property, a separate bonus depreciation amount, maximum amount, and maximum increase amount is computed and applied to each group of property.<sup>1258</sup>

New Federal Law (IRC sections 68, 1400L, and 1400N)

The provision extends and expands the additional first-year depreciation to equal 100 percent of the cost of qualified property placed in service after September 8, 2010 and before January 1, 2012 (before January 1, 2013 for certain longer-lived and transportation property), and provides for a 50 percent first-year additional depreciation deduction for qualified property placed in service after December 31, 2011 and before January 1, 2013 (after December 31, 2012 and before January 1, 2014 for certain longer-lived and transportation property).

Rules similar to those in IRC section 168(k)(2)(A)(ii) and (iii), which provide that qualified property does not include property acquired pursuant to a written binding contract that was in effect prior to January 1, 2008, apply for purposes of determining whether property is eligible for the temporary 100 percent additional first-year depreciation deduction. Thus under the provision, property acquired pursuant to a written binding contract entered into after December 31, 2007 is qualified property for purposes of the 100 percent additional first-year depreciation deduction assuming all other requirements of IRC section 168(k)(2) are met.

The provision generally permits a corporation to increase the minimum tax credit limitation by the bonus depreciation amount with respect to certain property placed in service after December 31, 2010 and before January 1, 2013 (January 1, 2014 in the case of certain longer-lived and transportation property).<sup>1259</sup> The provision applies with respect to round-2 extension

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<sup>1258</sup> In computing the maximum amount, the maximum increase amount for extension property is reduced by bonus depreciation amounts for preceding taxable years only with respect to extension property.

<sup>1259</sup> A taxpayer does not compute a bonus depreciation amount under IRC section 168(k)(4)(C) for any bonus depreciation allowable with respect to property placed in service during 2010. For example, assume in its taxable year beginning October 1, 2010, and ending September 30, 2011, a corporation places into service qualified property with a total cost of \$1,000,000, of which \$250,000 was placed in service before December 31, 2010. The

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

property, which is defined as property that is eligible qualified property solely because it meets the requirements under the extension of the additional first-year depreciation deduction for certain property placed in service after December 31, 2010.<sup>1260</sup>

Under the provision, a taxpayer that has made an election to increase the research credit or minimum tax credit limitation for eligible qualified property for its first taxable year ending after March 31, 2008 or for extension property may choose not to make this election for round-2 extension property. Further, the provision allows a taxpayer that has not made an election for eligible qualified property for its first taxable year ending after March 31, 2008, or for extension property, to make the election for round-2 extension property for its first taxable year ending after December 31, 2010, and for each subsequent year. In the case of a taxpayer electing to increase the research or minimum tax credit for eligible qualified property and extension property and the minimum tax credit for round-2 extension property a separate bonus depreciation amount, maximum amount, and maximum increase amount is computed and applied to each group of property.<sup>1261</sup>

Effective Date

The provision generally applies to property placed in service by the taxpayer after December 31, 2010, in taxable years ending after such date. The provision expanding the additional first-year depreciation deduction to 100 percent of the basis of qualified property applies to property placed in service by the taxpayer after September 8, 2010, in taxable years ending after such date.

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

This provision is not applicable under California law.

The PITL generally conforms to MACRS as of the “specified date” of January 1, 2009, with modifications.<sup>1262</sup> However, the PITL specifically does not conform to bonus depreciation;<sup>1263</sup> thus, this provision that modifies and extends bonus depreciation is not applicable under the PITL.

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corporation computes its bonus depreciation amount under IRC section 168(k)(4)(C) taking into account only the bonus depreciation computed with respect to the \$750,000 of property placed in service after December 31, 2010.

<sup>1260</sup> An election under new IRC section 168(k)(4)(l) with respect to round 2 extension property is binding for any property that is eligible qualified property solely by reason of the amendments made by section 401(a) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (and the application of such extension to this paragraph pursuant to the amendment made by section 401(c)(1) of such Act), even if such property is placed in service in 2012.

<sup>1261</sup> In computing the maximum amount, the maximum increase amount for extension property or for round-2 extension property is reduced by bonus depreciation amounts for preceding taxable years only with respect to extension property or round-2 extension property, respectively.

<sup>1262</sup> For taxable years beginning on or after January 1, 2010, R&TC section 17201 conforms to MACRS under IRC section 168 as of the “specified date” of January 1, 2009, with modifications.

<sup>1263</sup> R&TC section 17250(a)(2)(C)(4).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

This provision is not applicable under the CTL because the CTL does not adopt MACRS. The CTL is generally in substantial conformity to the pre-1981 federal asset depreciation range (ADR) depreciation rules, which generally allow property to be depreciated based on its "useful life."<sup>1264</sup>

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
402	Temporary Extension of Increased Small Business Expensing

Background

Subject to certain limitations, a taxpayer that invests in certain qualifying property may elect under IRC section 179 to deduct (or "expense") the cost of qualifying property, rather than to recover such costs through depreciation deductions.<sup>1265</sup> For taxable years beginning in 2010 and 2011, the maximum amount that a taxpayer may expense is \$500,000 of the cost of qualifying property placed in service for the taxable year.<sup>1266</sup> The \$500,000 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 \$2,000,000.<sup>1267</sup> Off-the-shelf computer software placed in service in taxable years beginning before 2012 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 generally may be carried forward to succeeding taxable years (subject to similar

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<sup>1264</sup> R&TC section 24349.

<sup>1265</sup> 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)). In addition, IRC section 179(e) provides for an enhanced IRC section 179 deduction for qualified disaster assistance property.

<sup>1266</sup> The definition of qualifying property was temporarily (for 2010 and 2011) expanded to include up to \$250,000 of qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. See IRC section 179(f)(2).

<sup>1267</sup> The temporary \$500,000 and \$2,000,000 amounts were enacted in the Small Business Jobs Act of 2010, Public Law 111-240.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

limitations).<sup>1268</sup> 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.<sup>1269</sup>

For taxable years beginning in 2012 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).

New Federal Law (IRC section 179)

Under the provision, for taxable years beginning in 2012, the maximum amount a taxpayer may expense 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 addition, the provision extends the treatment of off-the-shelf computer software as qualifying property,<sup>1270</sup> as well as the provision permitting a taxpayer to amend or irrevocably revoke an election for a taxable year under IRC section 179 without the consent of the Commissioner for one year (through 2012).

For taxable years beginning in 2013, and thereafter, the maximum amount a taxpayer may expense is \$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.

Effective Date

The provision is effective for taxable years beginning after December 31, 2011.

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<sup>1268</sup> Special rules apply to limit the carryover of unused IRC section 179 deductions attributable to qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. See IRC section 179(f)(4).

<sup>1269</sup> IRC section 179(c)(1). Under Treas. Reg. section 1.179-5, applicable to property placed in service in taxable years beginning after 2002 and before 2008, a taxpayer is permitted to make or revoke an election under IRC section 179 without the consent of the Commissioner on an amended federal tax return for that taxable year. This amended return must be filed within the time prescribed by law for filing an amended return for the taxable year. T.D. 9209, July 12, 2005.

<sup>1270</sup> The temporary extension of the definition of qualifying property to include qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property is not extended.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

California Law (R&TC sections 17201, 17255, and 24356)

California conforms to the election to deduct (or “expense”) the cost of qualifying property under IRC section 179 (commonly referred to as “small business expensing”) as of the “specified date” of January 1, 2009, with significant modifications.

California specifically does not conform to the small-business-expensing election that was first enacted in the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003<sup>1271</sup> and then extended and modified in several federal acts.<sup>1272</sup> Thus, under California law, both corporate and non-corporate taxpayers with a sufficiently small amount of annual investment in qualified depreciable property 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.

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<sup>1271</sup> Public Law 108-27, Section 202.

<sup>1272</sup> Federal acts that extended small business expensing include Public Law 108-357, Section 201; Public Law 109-222, Section 101; Public Law 110-28, Section 8212; Public Law 111-5, Section 1202; and, Public Law 111-147, Section 201.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

<u>Section</u>	<u>Section Title</u>
501	Temporary Extension of Unemployment Insurance Provisions

Background

None.

New Federal Law (IRC section 3304)

This provision extends unemployment compensation for thirteen months, to January, 2012.

California Law

The FTB does not administer unemployment compensation provisions. Defer to the Employment Development Department (EDD).

Impact on California Revenue

Defer to the EDD.

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<u>Section</u>	<u>Section Title</u>
502	Temporary Modification of Indicators under the Extended Benefit Program

Background

None.

New Federal Law (IRC section 3304)

This provision provides temporary modifications to the unemployment compensation rules.

California Law

The FTB does not administer unemployment compensation provisions. Defer to the Employment Development Department (EDD).

Impact on California Revenue

Defer to the EDD.

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TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

<u>Section</u>	<u>Section Title</u>
503	Technical Amendment Relating to Collection of Unemployment Compensation Debts

Background

None.

New Federal Law (IRC section 6402)

This provision makes a technical correction to the federal rules relating to the collection of unemployment compensation debts resulting from fraud.

California Law

The FTB does not administer unemployment compensation provisions. Defer to the Employment Development Department (EDD).

Impact on California Revenue

Defer to the EDD.

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<u>Section</u>	<u>Section Title</u>
601	Temporary Employee Payroll Tax Cut

Background

Federal Insurance Contributions Act ("FICA") Tax

The FICA tax applies to employers based on the amount of covered wages paid to an employee during the year.<sup>1273</sup> Generally, covered wages means all remuneration for employment, including the cash value of all remuneration paid in any medium other than cash.<sup>1274</sup> Certain exceptions from covered wages are also provided. The tax imposed is composed of two parts: (1) the old age, survivors, and disability insurance ("OASDI") tax equal to 6.2 percent of covered wages up to the taxable wage base (\$106,800 in 2010); and (2) the Medicare hospital insurance ("HI") tax amount equal to 1.45 percent of covered wages.

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<sup>1273</sup> IRC section 3111.

<sup>1274</sup> IRC section 3121.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

In addition to the tax on employers, each employee is subject to FICA taxes equal to the amount of tax imposed on the employer (the "employee portion").<sup>1275</sup> The employee portion generally must be withheld and remitted to the federal government by the employer.

#### Self-Employment Contributions Act ("SECA") Tax

As a parallel to FICA taxes, the SECA tax applies to the self-employment income of self-employed individuals.<sup>1276</sup> The rate of the OASDI portion of SECA tax is 12.4 percent, which is equal to the combined employee and employer OASDI FICA tax rates, and applies to self-employment income up to the FICA taxable wage base. Similarly, the rate of the HI portion is 2.9 percent, the same as the combined employer and employee HI rates under the FICA tax, and there is no cap on the amount of self-employment income to which the rate applies.<sup>1277</sup>

An individual may deduct, in determining net earnings from self-employment under the SECA tax, the amount of the net earnings from self-employment (determined without regard to this deduction) for the taxable year multiplied by one half of the combined OASDI and HI rates.<sup>1278</sup>

Additionally, a deduction, for purposes of computing the income tax of an individual, is allowed for one half of the amount of the SECA tax imposed on the individual's self-employment income for the taxable year.<sup>1279</sup>

#### Railroad Retirement Tax

The Railroad Retirement System has two main components. Tier I of the system is financed by taxes on employers and employees equal to the Social Security payroll tax and provides qualified railroad retirees (and their qualified spouses, dependents, widows, or widowers) with benefits that are roughly equal to Social Security. Covered railroad workers and their employers pay the Tier I tax instead of the Social Security payroll tax, and most railroad retirees collect Tier I benefits instead of Social Security. Tier II of the system replicates a private pension plan, with employers and employees contributing a certain percentage of pay toward the system to finance defined benefits to eligible railroad retirees (and qualified spouses, dependents, widows, or widowers) upon retirement; however, the federal government collects the Tier II payroll contribution and pays out the benefits.

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<sup>1275</sup> IRC section 3101. For taxable years beginning after 2012, an additional HI tax applies.

<sup>1276</sup> IRC section 1401.

<sup>1277</sup> For taxable years beginning after 2012, an additional HI tax applies.

<sup>1278</sup> IRC section 1402(a)(12).

<sup>1279</sup> IRC section 164(f).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

New Federal Law (IRC section 1401)

The provision reduces the employee OASDI tax rate under the FICA tax by two percentage points to 4.2 percent for one year (2011). Similarly, the provision reduces the OASDI tax rate under the SECA tax by two percentage points to 10.4 percent for taxable years of individuals that begin in 2011. A similar reduction applies to the railroad retirement tax.

The provision provides rules for coordination with deductions for employment taxes. The rate reduction is not taken into account in determining the SECA tax deduction allowed for determining the amount of the net earnings from self-employment for the taxable year. Thus, the deduction for 2011 remains at 7.65 percent of self-employment income, determined without regard to the deduction.

The income tax deduction allowed under IRC section 164(f) for taxable years beginning in 2011 is computed at the rate of 59.6 percent of the OASDI tax paid, plus one half of the HI tax paid.<sup>1280</sup>

The provision provides that the Treasury Secretary is to notify employers of the payroll tax cut.

The Federal Old-Age and Survivors Trust Fund, the Federal Disability Insurance Trust Fund, and the Social Security Equivalent Benefit Account established under the Railroad Retirement Act of 1974<sup>1281</sup> will receive transfers from the General Fund of the United States Treasury equal to any reduction in payroll taxes attributable to this provision. The amounts will be transferred from the General Fund at such times and in such a manner as to replicate to the extent possible the transfers which would have occurred to the Trust Funds or Benefit Account had the provision not been enacted.

For purposes of applying any provision of federal law other than the provisions of the IRC, the rate of tax in effect under IRC section 3101(a) is determined without regard to the reduction in that rate under this provision.

Effective Date

The provision is effective for remuneration received during 2011 and for self-employment income for taxable years beginning in 2011.

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<sup>1280</sup> This percentage replaces the rate of one half (50 percent) allowed under present law for this portion of the deduction. The new percentage is necessary to continue to allow the self-employed taxpayer to deduct the full amount of the employer portion of SECA taxes. The employer OASDI tax rate remains at 6.2 percent, while the employee portion falls to 4.2 percent. Thus, the employer share of total OASDI taxes is 6.2 divided by 10.4, or 59.6 percent of the OASDI portion of SECA taxes.

<sup>1281</sup> 45 U.S.C. 231n-1(a).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

California Law (R&TC section 17201)

OASDI Tax Cut

The FTB does not administer payroll taxes. Defer to the Employment Development Department (EDD).

Deductible OASDI Portion of SECA Tax

For purposes of computing the deductible OASDI portion of the SECA tax, the PITL conforms to the deduction allowed under federal law as of the “specified date” of January 1, 2009, with modifications;<sup>1282</sup> thus, California does not conform to this provision’s change to the computation of the SECA income tax deduction for 2011 (this provision changes the federal percentage of deductible SECA tax from 50 percent to 59.6 percent of the OASDI tax paid, plus one half of the HI tax paid). Instead, the California deduction for SECA taxes is 50 percent of the reduced OASDI tax paid plus one half of the HI tax paid.

Impact on California Revenue

OASDI Tax Cut

Defer to the EDD.

Deductible OASDI Portion of SECA Tax

Estimated Revenue Impact of Temporary Employee Payroll Tax Cut – Deductible OASDI Portion of SECA Tax For Taxable Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
-\$33,000,000	\$0	\$0

Estimates are based on a proration of federal estimates developed by the Joint Committee on Taxation.

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<sup>1282</sup> For taxable years beginning on or after January 1, 2010, R&TC section 17201 conforms to IRC section 164, relating to taxes, as of the “specified date” of January 1, 2009, with modifications in R&TC sections 17220 and 17222.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

<u>Section</u>	<u>Section Title</u>
701	Incentives for Biodiesel and Renewable Diesel

Background

Biodiesel

The IRC provides an income tax credit for biodiesel fuels (the "biodiesel fuels credit").<sup>1283</sup> 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, 2009.

Biodiesel is monoalkyl esters of long chain fatty acids derived from plant or animal matter that meet the registration requirements established by the EPA under section 211 of the Clean Air Act (42 U.S.C. sec. 7545) and 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, camelina, 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 \$1.00 for each gallon of biodiesel (including agri-biodiesel) used by the taxpayer in the production of a qualified biodiesel mixture. 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.

Per IRS guidance a mixture need only contain 1/10th of one percent of diesel fuel to be a qualified mixture.<sup>1284</sup> Thus, a qualified biodiesel mixture can contain 99.9 percent biodiesel and 0.1 percent diesel fuel.

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<sup>1283</sup> IRC section 40A.

<sup>1284</sup> Notice 2005-62, I.R.B. 2005-35, 443 (2005). "A biodiesel mixture is a mixture of biodiesel and diesel fuel containing at least 0.1 percent (by volume) of diesel fuel. Thus, for example, a mixture of 999 gallons of biodiesel and 1 gallon of diesel fuel is a biodiesel mixture." IRC section 40A.

*Biodiesel credit (B-100)*

The biodiesel credit is \$1.00 for each gallon of biodiesel that is not in a mixture with diesel fuel (100 percent biodiesel or B-100) and that during the taxable year is used by the taxpayer as a fuel in a trade or business or sold by the taxpayer at retail to a person and placed in the fuel tank of such person's vehicle.

*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 10-cents-per-gallon 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 agri-biodiesel must: (1) be 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.<sup>1285</sup> The credit is \$1.00 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. A biodiesel mixture is a mixture of biodiesel and diesel fuel that is sold by the taxpayer producing such mixture to any person for use as a fuel or 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.<sup>1286</sup>

The credit is not available for any sale or use for any period after December 31, 2009. 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.

*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.<sup>1287</sup> The biodiesel fuel mixture credit must first be taken against any tax liability for taxable fuels. To the extent the

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<sup>1285</sup> IRC section 6426(c).

<sup>1286</sup> IRC section 6426(c)(4).

<sup>1287</sup> IRC section 6427(e).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

biodiesel fuel mixture credit exceeds such tax liability, the excess may be received as a payment. 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, 2009.

#### Renewable Diesel

"Renewable diesel" is liquid fuel that: (1) is derived from biomass (as defined in IRC section 45K(c)(3)); (2) meets the registration requirements for fuels and fuel additives established by the EPA under section 211 of the Clean Air Act; and (3) meets the requirements of the ASTM D975 or D396, or equivalent standard established by the Secretary. 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. Renewable diesel also includes fuel derived from biomass that meets the requirements of a Department of Defense specification for military jet fuel or an ASTM for aviation turbine fuel.

For purposes of the IRC, renewable diesel is generally treated the same as biodiesel. In the case of renewable diesel that is aviation fuel, kerosene is treated as though it were diesel fuel for purposes of a qualified renewable diesel mixture. Like biodiesel, the incentive may be taken as an income tax credit, an excise tax credit, or as a payment from the Secretary.<sup>1288</sup> 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, 2009.

#### New Federal Law (IRC sections 40A, 6426, and 6427)

The provision extends the income tax credit, excise tax credit and payment provisions for biodiesel and renewable diesel for two additional years (through December 31, 2011).

In light of the retroactive nature of the provision, the provision creates a special rule to address claims regarding excise credits and claims for payment associated with periods occurring during 2010. In particular the provision directs the Secretary to issue guidance within 30 days of December 17, 2010. Such guidance is to provide for a one-time submission of claims covering periods occurring during 2010. The guidance is to provide for a 180-day period for the submission of such claims (in such manner as prescribed by the Secretary) to begin no later than 30 days after such guidance is issued. Such claims shall be paid by the Secretary of the Treasury not later than 60 days after receipt. If the claim is not paid within 60 days of the date of the filing, the claim shall be paid with interest from such date determined by using the overpayment rate and method under IRC section 6621.

#### Effective Date

The provision is effective for sales and uses after December 31, 2009.

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<sup>1288</sup> IRC sections 40A(f), 6426(c), and 6427(e).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

California Law

Income Tax Credit

California does not conform to the biodiesel fuels credit.

Excise Tax Credits and Payments

The FTB does not administer excise taxes. Defer to the Board of Equalization (BOE).

Impact on California Revenue

Income Tax Credit

Not applicable.

Excise Tax Credits and Payments

Defer to the BOE.

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<u>Section</u>	<u>Section Title</u>
702	Credit for Refined Coal Facilities

Background

In General

A credit is available for refined coal. In general, refined coal is a fuel produced from coal that is (1) used to produce steam or (2) used to produce steel industry fuel.

Refined Coal Used to Produce Steam

An income tax credit is allowed for the production at qualified facilities of certain refined coal sold to an unrelated person for use to produce steam. The amount of the refined coal credit is \$4.375 per ton (adjusted for inflation using 1992 as the base year; \$6.27 for 2010). A taxpayer may generally claim the credit during the 10-year period commencing with the date the qualified facility is placed in service.

A qualifying refined coal facility is a facility producing refined coal that is placed in service after October 22, 2004, and before January 1, 2010. Refined coal is a qualifying liquid, gaseous, or solid synthetic fuel produced from coal (including lignite) or high-carbon fly ash, including such fuel used as a feedstock. A qualifying fuel is a fuel that, when burned, emits 20 percent less nitrogen oxides and either sulfur dioxide or mercury than the burning of feedstock coal or

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

comparable coal predominantly available in the marketplace as of January 1, 2003, but only if the fuel sells at prices at least 50 percent greater than the prices of the feedstock coal or comparable coal. In addition, to be qualified refined coal, the taxpayer must sell the fuel with the reasonable expectation that it will be used for the primary purpose of producing steam.

The refined coal credit is reduced over an \$8.75 phase-out range as the reference price of the fuel used as feedstock for the refined coal exceeds an amount equal to 1.7 times the reference price for such fuel in 2002 (adjusted for inflation). The amount of the 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.

The credit is a component of the general business credit,<sup>1289</sup> allowing excess credits to be carried back one year and forward up to 20 years. The credit is also subject to the alternative minimum tax.

#### Facilities Placed in Service after 2008 that Make Refined Coal Used to Produce Steam

For refined coal facilities placed in service after 2008, the requirement that the qualified refined coal fuel sell at a price at least 50 percent greater than the price of the feedstock coal does not apply. However, to be credit-eligible, refined coal produced by such facilities must reduce by 40 percent (not 20 percent) the amount by which refined coal must reduce, when burned, emissions of either sulfur dioxide or mercury compared to the emissions released by the feedstock coal or comparable coal predominantly available in the marketplace as of January 1, 2003.

#### Refined Coal that is Steel Industry Fuel

Each barrel-of-oil equivalent (defined as 5.8 million British thermal units) of steel industry fuel produced at a qualified facility during the credit period receives a \$2 credit (adjusted for inflation using 1992 as the base year; \$2.87 for 2010). A qualified facility is any facility capable of producing steel industry fuel (or any modification to a facility making it so capable) that is placed in service before January 1, 2010. For facilities capable of producing steel industry fuel on or before October 1, 2008, the credit is available for fuel produced and sold on or after such date and before January 1, 2010. For facilities placed in service or modified to produce steel industry fuel after October 1, 2008, the credit period begins on the placed-in-service or modification date and ends one year after such date or December 31, 2009, whichever is later.

Steel industry fuel is defined as a fuel produced through a process of liquefying coal waste sludge, distributing the liquefied product on coal, and using the resulting mixture as a feedstock for the manufacture of coke. Coal waste sludge includes tar decanter sludge and related byproducts of the coking process.

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<sup>1289</sup> IRC section 38(b)(8).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

New Federal Law (IRC section 45)

The provision extends for two years (through December 31, 2011) the placed-in-service period for new refined coal facilities other than refined coal facilities that produce steel industry fuel.

Effective Date

The modifications to the placed-in-service period are effective on December 17, 2010.

California Law (None)

California does not conform to the refined coal facilities credit.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
703	New Energy Efficient Home Credit

Background

The IRC provides a credit to an eligible contractor for each qualified new energy-efficient home that is constructed by the eligible contractor and acquired by a person from such eligible contractor for use as a residence during the taxable year. To qualify as a new energy-efficient 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.

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. The eligible contractor is the person who constructed the home, or in the case of a manufactured home, the producer of such home.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

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. Only manufactured homes are eligible for the \$1,000 credit.

In lieu of meeting the standards of chapter 4 of the 2003 International Energy Conservation Code, 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 applies to homes that are purchased prior to January 1, 2010. The credit is part of the general business credit.

New Federal Law (IRC section 45L)

The provision extends the credit to homes that are purchased prior to January 1, 2012.

Effective Date

The provision applies to homes acquired after December 31, 2009.

California Law (None)

California does not conform to the new energy efficient home credit.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
704	Excise Tax Credits and Outlay Payments for Alternative Fuel and Alternative Fuel Mixtures

Background

The IRC provides two per-gallon excise tax credits with respect to alternative fuel: the alternative fuel credit, and the alternative fuel mixture credit. For this purpose, the term "alternative fuel" means liquefied petroleum gas, P Series fuels (as defined by the Secretary of Energy under 42 U.S.C. sec. 13211(2)), compressed or liquefied natural gas, liquefied hydrogen, liquid fuel derived from coal through the Fischer-Tropsch process ("coal-to-liquids"), compressed or liquified gas derived from biomass, or liquid fuel derived from biomass. Such term does not include ethanol, methanol, or biodiesel.

For coal-to-liquids produced after September 30, 2009 through December 30, 2009, the fuel must be certified as having been derived from coal produced at a gasification facility that

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

separates and sequesters 50 percent of such facility's total carbon dioxide emissions. The sequestration percentage increases to 75 percent for fuel produced after December 30, 2009.

The alternative fuel credit is allowed against IRC section 4041 liability, and the alternative fuel mixture credit is allowed against IRC section 4081 liability. Neither credit is allowed unless the taxpayer is registered with the Secretary. The alternative fuel credit is 50 cents per gallon of alternative fuel or gasoline gallon equivalents<sup>1290</sup> of nonliquid alternative fuel sold by the taxpayer for use as a motor fuel in a motor vehicle or motorboat, sold for use in aviation or so used by the taxpayer.

The alternative fuel mixture credit is 50 cents per gallon of alternative fuel used in producing an alternative fuel mixture for sale or use in a trade or business of the taxpayer. An "alternative fuel mixture" is a mixture of alternative fuel and taxable fuel that contains at least 1/10 of one percent taxable fuel. The mixture must be sold by the taxpayer producing such mixture to any person for use as a fuel, or used by the taxpayer producing the mixture as a fuel. The credits generally expired after December 31, 2009 (September 30, 2014 for liquefied hydrogen).

A person may file a claim for payment equal to the amount of the alternative fuel credit and alternative fuel mixture credits. These payment provisions generally also expired after December 31, 2009. With respect to liquefied hydrogen, the payment provisions expire after September 30, 2014. The alternative fuel credit and alternative fuel mixture credit must first be applied to excise tax liability for special and alternative fuels, and any excess credit may be taken as a payment.

New Federal Law (IRC sections 6426 and 6427)

The provision extends the alternative fuel credit, alternative fuel mixture credit, and related payment provisions, for two additional years (through December 31, 2011). For purposes of the alternative fuel credit, alternative fuel mixture credit and related payment provisions, the provision excludes fuel (including lignin, wood residues, or spent pulping liquors) derived from the production of paper or pulp.

In light of the retroactive nature of the provision, the provision creates a special rule to address claims regarding excise credits and claims for payment associated with periods occurring during 2010. In particular the provision directs the Secretary to issue guidance within 30 days of December 17, 2010. Such guidance is to provide for a one-time submission of claims covering periods occurring during 2010. The guidance is to provide for a 180-day period for the submission of such claims (in such manner as prescribed by the Secretary) to begin no later than 30 days after such guidance is issued. Such claims shall be paid by the Secretary of the Treasury not later than 60 days after receipt. If the claim is not paid within 60 days of the date of the filing, the claim shall be paid with interest from such date determined by using the overpayment rate and method under IRC section 6621.

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<sup>1290</sup> "Gasoline gallon equivalent" means, with respect to any non-liquid alternative fuel (for example, compressed natural gas), the amount of such fuel having a Btu (British thermal unit) content of 124,800 (higher heating value).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Effective Date

The provision is effective for fuel sold or used after December 31, 2009.

California Law

The FTB does not administer excise taxes. Defer to the Board of Equalization (BOE).

Impact on California Revenue

Defer to the BOE.

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<u>Section</u>	<u>Section Title</u>
705	Special Rule for Sales or Dispositions to Implement FERC or State Electric Restructuring Policy for Qualified Electric Utilities

A taxpayer selling property generally 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<sup>1291</sup> (the "reinvestment property").<sup>1292</sup> 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 a qualified electric utility to an independent transmission company prior to January 1, 2010. A qualified electric utility is defined as an electric utility, that as of the date of the qualifying electric transmission transaction, is vertically integrated in that it is both: (1) a transmitting utility

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<sup>1291</sup> 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.

<sup>1292</sup> IRC section 451(i).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

(as defined in the Federal Power Act)<sup>1293</sup> with respect to the transmission facilities to which the election applies; and (2) an electric utility (as defined in the Federal Power Act).<sup>1294</sup>

In general, an independent transmission company is defined as: (1) an independent transmission provider<sup>1295</sup> approved by the Federal Energy Regulatory Commission ("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 no later than four years after the close of the taxable year in which the transaction occurs; 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 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). Exempt utility property does not include any property that is located outside of the United States.

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 that occur prior to January 1, 2012.

Effective Date

The extension provision applies to dispositions after December 31, 2009.

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<sup>1293</sup> Section 3(23), 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.

<sup>1294</sup> 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.

<sup>1295</sup> Examples include a regional transmission organization, an independent system operator, and an independent transmission company.

California Law (R&TC sections 17551, 24661, and 24661.6)

The PITL and the CTL generally conform to the federal rules relating to the taxable year of inclusion;<sup>1296</sup> however, both the PITL and the CTL specifically do not conform to the special rule for sales or dispositions to implement FERC or state electric restructuring policy.<sup>1297</sup>

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
706	Suspension of Limitation on Percentage Depletion for Oil and Gas from Marginal Wells

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: the cost depletion method, and the percentage depletion method.<sup>1298</sup> Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the depletable property that 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.<sup>1299</sup> Generally, under the percentage depletion method, 15 percent of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year.<sup>1300</sup> The amount deducted generally may not exceed 100 percent of the net income from that property in any year (the "net-income limitation").<sup>1301</sup>

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<sup>1296</sup> For taxable years beginning on or after January 1, 2010: (1) R&TC section 17551 conforms to Subchapter E of Chapter 1 of Subtitle A of the IRC, containing IRC sections 441-483, as of the "specified date" of January 1, 2009, with modifications; and, (2) R&TC section 24661 conforms to IRC section 451, relating to the general rule for taxable year of inclusion, as of the "specified date" of January 1, 2009.

<sup>1297</sup> R&TC sections 17551(f) and 24661.6.

<sup>1298</sup> IRC sections 611-613.

<sup>1299</sup> IRC section 613A.

<sup>1300</sup> IRC section 613A(c).

<sup>1301</sup> IRC section 613(a).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

The 100-percent net-income limitation for marginal production has been suspended for taxable years beginning before January 1, 2010.

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).<sup>1302</sup>

New Federal Law (IRC section 613A)

The provision extends the suspension of the 100-percent net-income limitation for marginal production for two years (to apply to tax years beginning before January 1, 2012).

Effective Date

The provision is effective for taxable years beginning after December 31, 2009.

California Law (R&TC sections 17681, 17681.6, 24831, and 24831.6)

The PITL and the CTL conform to the federal depletion rules as of the “specified date” of January 1, 2009, with modifications.<sup>1303</sup> However, both the PITL and the CTL specifically do not conform to the suspension of the 100-percent net-income limitation for marginal production.<sup>1304</sup>

Impact on California Revenue

Not applicable.

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<sup>1302</sup> The American Petroleum Institute gravity, or API gravity, is a measure of how heavy or light a petroleum liquid is compared to water.

<sup>1303</sup> For taxable years beginning on or after January 1, 2010, R&TC sections 17731 and 24831 conform to Subchapter I of Chapter 1 of Subtitle A of the IRC, containing IRC sections 611-638, as of the “specified date” of January 1, 2009, with modifications.

<sup>1304</sup> R&TC sections 17681.6 and 24831.6.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Section            Section Title  
707                  Extension of Grants for Specified Energy Property in Lieu of Tax Credits

Renewable Electricity Production Credit

An income tax credit is allowed for the production of electricity from qualified energy resources at qualified facilities (the "renewable electricity production credit").<sup>1305</sup> Qualified energy resources comprise wind, closed-loop biomass, open-loop biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, qualified hydropower production, and marine and hydrokinetic renewable energy. 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.

Summary of Credit for Electricity Produced from Certain Renewable Resources		
Eligible Electricity Production Activity (IRC section 45)	Credit Amount for 2010 <sup>1</sup> (cents per kilowatt-hour)	Expiration <sup>2</sup>
Wind	2.2	December 31, 2012
Closed-loop biomass	2.2	December 31, 2013
Open-loop biomass (including agricultural livestock waste nutrient facilities)	1.1	December 31, 2013
Geothermal	2.2	December 31, 2013
Solar (pre-2006 facilities only)	2.2	December 31, 2005
Small irrigation power	1.1	December 31, 2013
Municipal solid waste (including landfill gas facilities and trash combustion facilities)	1.1	December 31, 2013
Qualified hydropower	1.1	December 31, 2013
Marine and hydrokinetic	1.1	December 31, 2013
<sup>1</sup> In general, the credit is available for electricity produced during the first 10 years after a facility has been placed in service. <sup>2</sup> Expires for property placed in service after this date.		

<sup>1305</sup> IRC section 45. In addition to the renewable electricity production credit, IRC section 45 also provides income tax credits for the production of Indian coal and refined coal at qualified facilities.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Energy Credit

An income tax credit is also allowed for certain energy property placed in service. Qualifying property includes certain fuel cell property, solar property, geothermal power production property, small wind energy property, combined heat and power system property, and geothermal heat pump property.<sup>1306</sup>

Summary of Energy Investment Tax Credit			
Energy Credit (IRC section 48)	Credit Rate	Maximum Credit	Expiration
Equipment to produce a geothermal deposit	10%	None	None
Equipment to use ground or ground water for heating or cooling	10%	None	December 31, 2016
Microturbine property (< 2 Mw electrical generation power plants of >26% efficiency)	10%	\$200 per Kw of capacity	December 31, 2016
Combined heat and power property (simultaneous production of electrical/mechanical power and useful heat > 60% efficiency)	10%	None	December 31, 2016
Solar electric or solar hot water property	30% (10% after December 31, 2016)	None	None
Fuel cell property (generates electricity through electrochemical process)	30%	\$1,500 for each 1/2 Kw of capacity	December 31, 2016
Small (<100 Kw capacity) wind electrical generation property	30%	None	December 31, 2016

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<sup>1306</sup> IRC section 48.

### Election to Claim Energy Credit in Lieu of Renewable Electricity Production Credit

A taxpayer may make an irrevocable election to have certain property which is part of a qualified renewable electricity production facility be treated as energy property eligible for a 30 percent investment credit under IRC section 48. For this purpose, qualified facilities are facilities otherwise eligible for the renewable electricity production credit with respect to which no credit under IRC section 45 has been allowed. A taxpayer electing to treat a facility as energy property may not claim the renewable electricity production credit. The eligible basis for the investment credit for taxpayers making this election is the basis of the depreciable (or amortizable) property that would comprise a facility capable of generating electricity eligible for the renewable electricity production credit.

### Grants in Lieu of Credits

The Secretary of the Treasury is authorized to provide a grant to each person who places in service depreciable property that is either part of a qualified renewable electricity production facility, or qualifying property otherwise eligible for the energy credit. In general, the grant amount is 30 percent of the basis of the qualified property. For qualified microturbine, combined heat and power system, and geothermal heat pump property, the amount is 10 percent of the basis of the property. Otherwise eligible property must be placed in service in calendar years 2009 or 2010, or its construction must begin during that period and must be completed prior to 2013 (in the case of wind facility property), 2014 (in the case of other renewable power facility property eligible for credit under IRC section 45), or 2017 (in the case of any specified energy property described in IRC section 48).

The grant provision mimics the operation of the energy credit. For example, the amount of the grant is not includable in gross income. However, the basis of the property is reduced by 50 percent of the amount of the grant. In addition, some or all of each grant is subject to recapture if the grant-eligible property is disposed of by the grant recipient within five years of being placed in service.

Under the provision, if a grant is paid, no renewable electricity credit or energy credit may be claimed with respect to the grant-eligible property. In general, tax-exempt entities are not eligible to receive a grant. No grant may be made unless the application for the grant has been received before October 1, 2011.

### New Federal Law (IRC section 48)

The provision extends the Secretary's authority to provide grants in lieu of credits for one year (through 2011). Otherwise eligible property must thus be placed in service in calendar years 2009, 2010, or 2011, or its construction must begin during that period and must be completed prior to 2013 (in the case of wind facility property), 2014 (in the case of other renewable power facility property eligible for credit under IRC section 45), or 2017 (in the case of any specified energy property described in IRC section 48).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Effective Date

The proposal is effective on December 17, 2010.

California Law (R&TC sections 17131.3 and 24303)

California does not conform to the renewable electricity production credit or the energy credit; however, under both the PITL and the CTL, any grants provided in lieu of such credits, including grants provided during this provision's extension period, are specifically excluded from California gross income.<sup>1307</sup>

Impact on California Revenue

Baseline—based on federal estimates developed by the U.S. Department of Treasury's Office of Tax Analysis, baseline revenue losses are estimated to be \$17,000,000 in 2011-12, \$8,900,000 in 2012-13, and \$4,300,000 in 2013-14.

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<u>Section</u>	<u>Section Title</u>
708	Extension of Provisions Related to Alcohol Used as Fuel

Background

IRC sections 40, 6426 and 6427(e) provide per-gallon tax incentives for the sale, use and production of alcohol fuel and alcohol fuel mixtures. The incentives for alcohol generally do not apply after December 31, 2010. For cellulosic biofuel (discussed infra), the incentive is unavailable after December 31, 2012.

"Alcohol" includes methanol and ethanol, and the alcohol gallon equivalent of ethyl tertiary butyl ether, or other ethers produced from such alcohol. It does not include alcohol produced from petroleum, natural gas, or coal, or any alcohol with a proof of less than 150 (190 proof for purposes of the credit taken under IRC section 6426 or payment under IRC section 6427). Denaturants (additives that make the alcohol unfit for human consumption) are disregarded for purposes of determining proof. However, denaturants are taken into account in determining the volume of alcohol eligible for the per-gallon incentive. In calculating alcohol volume, denaturants cannot exceed two percent of volume.

The IRC section 40 alcohol fuels credit is an income tax credit comprised of four components: (1) the alcohol mixture credit; (2) the alcohol credit; (3) the small ethanol producer credit; and (4) the cellulosic biofuel producer credit. IRC sections 6426 and 6427(e) pertain to alcohol fuel mixtures only.

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<sup>1307</sup> R&TC sections 17131.3 and 24303 specifically exclude such grants from regular and alternative minimum taxable income.

*Alcohol mixture credits and payments*

The alcohol fuel mixture credit may be taken as part of the IRC section 40 income tax credit, the IRC section 6426 excise tax credit, or as a payment under IRC section 6427. For IRC section 40, an alcohol fuel mixture is a mixture of alcohol and gasoline or alcohol and a special fuel. Since the excise tax credit is taken against the liability for taxable fuels (gasoline, kerosene, or diesel), for purposes of the excise tax payments and credits, an alcohol fuel mixture is a mixture of alcohol and a taxable fuel.

The fuel must be either sold for use as a fuel to another person or used as fuel in the mixture producer's trade or business. The addition of denaturants does not constitute production of a mixture. The credit is allowed only for the gallons of alcohol used to produce the mixture. For alcohol that is ethanol, the amount of the incentive is 45 cents per gallon. For other alcohol, the incentive is generally 60 cents per gallon.

The alcohol mixture credit is most often taken as an excise tax credit or payment. Persons who blend alcohol with gasoline, diesel fuel, or kerosene to produce an alcohol fuel mixture must pay tax on the volume of alcohol in the mixture when the mixture is sold or removed. The alcohol fuel mixture credit must first be taken to reduce excise tax liability for gasoline, diesel fuel or kerosene. Any excess credit may be taken as a payment or income tax credit.

*Alcohol credit (straight or "neat" alcohol)*

The second component of the IRC section 40 income tax credit is the alcohol credit. The credit is available for alcohol (not in a mixture) that is either used as a fuel in the taxpayer's trade or business, or sold at retail and placed in the fuel tank of the retail buyer. The credit cannot be claimed for alcohol bought at retail, even if the buyer uses it as a fuel in a trade or business. This credit is not available as an excise tax credit or payment.

*Small ethanol producer credit*

The third component of the IRC section 40 income tax credit is the small ethanol producer credit. It is in addition to the credits described above and is an extra 10 cents per gallon available for up to 15 million gallons of qualified ethanol fuel production for any tax year. The 15 million gallon limitation is waived for ethanol that is cellulosic ethanol. The credit is available to eligible small ethanol producers, defined as producers who have an annual productive capacity of not more than 60 million gallons of any type of alcohol. Qualified ethanol fuel production is ethanol produced and 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. Qualified ethanol fuel production also includes use or sale 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 small ethanol producer credit is not available as an excise tax credit or payment.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

*Cellulosic biofuel producer credit*

The cellulosic biofuel producer 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 also 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 that is alcohol is entitled to the \$1.01 without reduction.

Duties on Ethanol

Heading 9901.00.50 of the Harmonized Tariff Schedule of the United States imposes a cumulative general duty of 14.27 cents per liter (approximately 54 cents per gallon) on imports of ethyl alcohol, and any mixture containing ethyl alcohol, if used as a fuel or in producing a mixture to be used as a fuel, that are entered into the United States prior to January 1, 2011. Heading 9901.00.52 of the Harmonized Tariff Schedule of the United States imposes a general duty of 5.99 cents per liter on imports of ethyl tertiary-butyl ether, and any mixture containing ethyl tertiary-butyl ether, that are entered into the United States prior to January 1, 2011.

New Federal Law (IRC sections 40, 6426, and 6427)

Extension of Income Tax Credit

The provision extends the present-law income tax credit for alcohol fuels (other than the cellulosic biofuel producer credit) an additional year, through December 31, 2011.

Extension of Excise Tax Credit and Outlay Payment Provisions for Alcohol Used as a Fuel

The provision extends the present-law excise tax credit and outlay payments for alcohol fuel mixtures for an additional year, through December 31, 2011.

Extension of Additional Duties on Ethanol

The provision extends the present-law duties on ethanol and ethyl tertiary butyl ether for an additional year, through December 31, 2011.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Effective Date

The extension of the income tax credit is effective for periods after December 31, 2010. The extension of excise tax credit for alcohol fuel mixtures applies to periods after December 31, 2010. The extension of the payment provisions for alcohol fuel mixtures apply to sales and uses after December 31, 2010. The extension of additional duties on ethanol takes effect on January 1, 2011.

California Law

Extension of Income Tax Credit

California does not conform to the alcohol fuels credit.

Extension of Excise Tax Credit and Outlay Payment Provisions for Alcohol Used as a Fuel and  
Extension of Additional Duties on Ethanol

The FTB does not administer excise taxes. Defer to the Board of Equalization (BOE).

Impact on California Revenue

Extension of Income Tax Credit

Not applicable.

Extension of Excise Tax Credit and Outlay Payment Provisions for Alcohol Used as a Fuel and  
Extension of Additional Duties on Ethanol

Defer to the BOE.

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TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

<u>Section</u>	<u>Section Title</u>
709	Energy Efficient Appliance Credit

Background

In General

A credit is allowed for the eligible production of certain energy-efficient dishwashers, clothes washers, and refrigerators. The credit is part of the general business credit.

The credits are as follows:

*Dishwashers*

- \$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
- \$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*

- \$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 an 8.0 water consumption factor;
- \$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;
- \$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,
- \$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*

- \$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;
- \$75 in the case of a refrigerator that is manufactured in calendar year 2008 or 2009 that consumes at least 23 percent but not more than 24.9 percent less kilowatt hours per year than the 2001 energy conservation standards;

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

- \$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
- \$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.

*Definitions*

- Dishwasher. A dishwasher is any 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, which satisfies the relevant efficiency standard.
- Modified Energy Factor. The term "modified energy factor" means the modified energy factor established by the Department of Energy for compliance with the Federal energy conservation standard.
- Gallons per Cycle. 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.
- Water Consumption Factor. 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.

*Other Rules*

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 two prior calendar years for each category of appliance. 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. 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.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

New Federal Law (IRC section 45M)

The provision extends the credit for one year, for appliances manufactured in 2011, and changes the aggregate credit limitation to permit up to \$25 million in credits to be claimed per manufacturer for appliances manufactured in 2011. Additionally, the provision changes the two-percent gross-receipts limitation on the credit to four percent. The credit modifies the standards and credit amounts as follows:

*Dishwashers*

- \$25 in the case of a dishwasher that is manufactured in calendar year 2011 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);
- \$50 in the case of a dishwasher that is manufactured in calendar year 2011 and that uses no more than 295 kilowatt hours per year and 4.25 gallons per cycle (4.75 gallons per cycle for dishwashers designed for greater than 12 place settings); and
- \$75 in the case of a dishwasher that is manufactured in calendar year 2011 and that uses no more than 280 kilowatt hours per year and 4 gallons per cycle (4.5 gallons per cycle for dishwashers designed for greater than 12 place settings).

*Clothes washers*

- \$175 in the case of a top-loading clothes washer manufactured in calendar year 2011 that meets or exceeds a 2.2 modified energy factor and does not exceed a 4.5 water consumption factor; and,
- \$225 in the case of a clothes washer manufactured in calendar year 2011 that: (1) is a top-loading clothes washer and which meets or exceeds a 2.4 modified energy factor and does not exceed a 4.2 water consumption factor; or (2) is a front-loading clothes washer and that meets or exceeds a 2.8 modified energy factor and does not exceed a 3.5 water consumption factor.

*Refrigerators*

- \$150 in the case of a refrigerator manufactured in calendar year 2011 that consumes at least 30 percent less energy than the 2001 energy conservation standards, and
- \$200 in the case of a refrigerator manufactured in calendar year 2011 that consumes at least 35 percent less energy than the 2001 energy conservation standards.

Effective Date

The provision applies to appliances produced after December 31, 2010. The provision related to the gross receipts limitation applies to taxable years beginning after December 31, 2010.

California Law (None)

California does not conform to the energy efficient appliance credit.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
710	Credit for Nonbusiness Energy Property

Background

In General

IRC section 25C provides a 30-percent credit for the purchase of qualified energy efficiency improvements to the envelope of existing homes. Additionally, IRC section 25C provides a 30 percent credit for the purchase of: (1) qualified natural gas, propane, or oil furnace or hot water boilers; (2) qualified energy efficient property; and (3) advanced main air circulating fans.

The credit applies to expenditures made after December 31, 2008, for property placed in service after December 31, 2008, and prior to January 1, 2011.<sup>1308</sup> The aggregate amount of the credit allowed for a taxpayer for taxable years beginning in 2009 and 2010 is \$1,500.

Building Envelope Improvements

A qualified energy efficiency improvement is any energy efficiency building envelope component: (1) that meets or exceeds the prescriptive criteria for such a component established by the 2000 International Energy Conservation Code<sup>1309</sup> 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); (2) that is installed in or on a dwelling located in the United States and owned and used by the taxpayer as the taxpayer's principal residence; (3) the original use of which commences with the taxpayer; and (4) that reasonably can be expected to remain in use for at least five years. The credit is nonrefundable.

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<sup>1308</sup> With the exception of biomass fuel property, property placed in service after December 31, 2008 and prior to February 17, 2009, qualifies for the new 30-percent credit rate (and \$1,500 aggregate cap) if it met the efficiency standards of prior law for property placed in service during 2009. Biomass fuel property placed in service at any point in 2009 is governed by the new efficiency standard.

<sup>1309</sup> This reference to the 2000 International Energy Conservation Code is superseded by the additional requirements described in the paragraph below regarding building envelope components.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Building envelope components are: (1) insulation materials or systems that are specifically and primarily designed to reduce the heat loss or gain for a dwelling and that meet the prescriptive criteria for such material or system established by the 2009 International Energy Conservation Code, as such Code (including supplements) is in effect on the date of the enactment of the American Recovery and Reinvestment Tax Act of 2009 (February 17, 2009); (2) exterior windows (including skylights) and doors provided such component has a U-factor and a seasonal heat gain coefficient ("SHGC") of 0.3 or less; and (3) metal or asphalt roofs with appropriate pigmented coatings or cooling granules that are specifically and primarily designed to reduce the heat gain for a dwelling.

#### Other Eligible Property

##### *Qualified natural gas, propane, or oil furnace or hot water boilers*

A qualified natural gas, propane, or oil hot water boiler is a natural gas, propane, or oil hot water boiler with an annual fuel utilization efficiency rate of at least 90. A qualified natural gas or propane furnace is a natural gas or propane furnace with an annual fuel utilization efficiency rate of at least 95. A qualified oil furnace is an oil furnace with an annual fuel utilization efficiency rate of at least 90.

##### *Qualified energy-efficient property*

Qualified energy-efficient property is: (1) an electric heat pump water heater that yields an energy factor of at least 2.0 in the standard Department of Energy test procedure; (2) an electric heat pump that achieves the highest efficiency tier established by the Consortium for Energy Efficiency, as in effect on January 1, 2009;<sup>1310</sup> (3) a central air conditioner that achieves the highest efficiency tier established by the Consortium for Energy Efficiency as in effect on Jan. 1, 2009;<sup>1311</sup> (4) a natural gas, propane, or oil water heater that has an energy factor of at least 0.82 or thermal efficiency of at least 90 percent; and (5) biomass fuel property.

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 as measured using a lower heating value. 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.

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<sup>1310</sup> These standards are a seasonal energy efficiency ratio ("SEER") greater than or equal to 15, an energy efficiency ratio ("EER") greater than or equal to 12.5, and heating seasonal performance factor ("HSPF") greater than or equal to 8.5 for split heat pumps, and SEER greater than or equal to 14, EER greater than or equal to 12, and HSPF greater than or equal to 8.0 for packaged heat pumps.

<sup>1311</sup> These standards are a SEER greater than or equal to 16 and EER greater than or equal to 13 for split systems, and SEER greater than or equal to 14 and EER greater than or equal to 12 for packaged systems.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

*Advanced main air circulating fan*

An advanced main air circulating fan is a fan used in a natural gas, propane, or oil furnace and that 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).

Additional Rules

The taxpayer's basis in the property is reduced by the amount of 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.

New Federal Law (IRC section 25C)

The provision extends the credits for one year but utilizes the credit structure and credit rates that existed prior to the enactment of the American Recovery and Reinvestment Act of 2009. The provision reinstates the rule that expenditures made from subsidized energy financing are not qualifying expenditures. Additionally, certain efficiency standards that were weakened in the American Recovery and Reinvestment Act are restored to their prior levels. Lastly, the provision provides that windows, skylights and doors that meet the Energy Star standards are qualified improvements.

The following describes the operation of the credit under the provision:

IRC section 25C provides 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: (1) that meets or exceeds the prescriptive criteria for such a component established by the 2009 International Energy Conservation Code as such Code (including supplements) is in effect on the date of the enactment of the American Recovery and Reinvestment Tax Act of 2009 (February 17, 2009) (or, in the case of windows, skylights and doors, and metal roofs with appropriate pigmented coatings or asphalt roofs with appropriate cooling granules, meets the Energy Star program requirements); (2) that is installed in or on a dwelling located in the United States and owned and used by the taxpayer as the taxpayer's principal residence; (3) the original use of which commences with the taxpayer; and (4) that 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 that are specifically and primarily designed to reduce the heat loss or gain for a dwelling and that meet the prescriptive criteria for such material or system established by the 2009 International Energy Conservation Code, as such Code (including supplements) is in effect on the date of the enactment of the American Recovery and Reinvestment Tax Act of 2009 (February 17, 2009); (2) exterior windows (including skylights) and doors; and (3) metal or asphalt roofs with appropriate pigmented coatings or cooling granules that are specifically and primarily designed to reduce the heat gain for a dwelling.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Additionally, IRC section 25C provides specified credits for the purchase of specific energy efficient property originally placed in service by the taxpayer during the taxable year. 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 and that 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 that yields an energy factor of at least 2.0 in the standard Department of Energy test procedure; (2) an electric heat pump that achieves the highest efficiency tier established by the Consortium for Energy Efficiency, as in effect on January 1, 2009;<sup>1312</sup> (3) a central air conditioner that achieves the highest efficiency tier established by the Consortium for Energy Efficiency as in effect on Jan. 1, 2009;<sup>1313</sup> (4) a natural gas, propane, or oil water heater that has an energy factor of at least 0.82 or thermal efficiency of at least 90 percent; and (5) biomass fuel property.

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.

Under IRC section 25C, the maximum credit for a taxpayer for all taxable years is \$500, and no more than \$200 of such credit may be attributable to expenditures on windows.

The taxpayer's basis in the property is reduced by the amount of 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.

For purposes of determining the amount of expenditures made by any individual with respect to any dwelling unit, expenditures which are made from subsidized energy financing are not taken

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<sup>1312</sup> These standards are a seasonal energy efficiency ratio ("SEER") greater than or equal to 15, an energy efficiency ratio ("EER") greater than or equal to 12.5, and heating seasonal performance factor ("HSPF") greater than or equal to 8.5 for split heat pumps, and SEER greater than or equal to 14, EER greater than or equal to 12, and HSPF greater than or equal to 8.0 for packaged heat pumps.

<sup>1313</sup> These standards are a SEER greater than or equal to 16 and EER greater than or equal to 13 for split systems, and SEER greater than or equal to 14 and EER greater than or equal to 12 for packaged systems.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

into account. The term "subsidized energy financing" means financing provided under a federal, state, or local program a principal purpose of which is to provide subsidized financing for projects designed to conserve or produce energy.

Effective Date

The provision applies to property placed in service after December 31, 2010.

California Law (None)

California does not conform to the nonbusiness energy property credit.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
711	Alternative Fuel Vehicle Refueling Property

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.<sup>1314</sup> 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 which is used as a principal residence.

For property placed in service in 2009 or 2010, the maximum credit available for business property is increased to \$200,000 for qualified hydrogen refueling property and to \$50,000 for other qualified refueling property. For nonbusiness property, the maximum credit is increased to \$2,000 for refueling property other than hydrogen refueling property. In addition, during these years, the credit rate is increased from 30 percent to 50 percent for refueling property other than hydrogen refueling property.

Qualified refueling property is property (not including a building or its structural components) for the storage or dispensing of a clean-burning fuel or electricity into the fuel tank or battery of a motor vehicle propelled by such fuel or electricity, but only if the storage or dispensing of the fuel or electricity is at the point of delivery into the fuel tank or battery of the motor vehicle. The original use of such property must begin with the taxpayer.

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<sup>1314</sup> IRC section 30C.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

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.

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, 2011. 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 through 2011 the 30-percent credit for alternative fuel refueling property (other than hydrogen refueling property, the credit for which continues under present law through 2014), subject to the pre-2009 maximum credit amounts.

Effective Date

The provision is effective for property placed in service after December 31, 2010.

California Law (None)

California does not conform to the alternative fuel vehicle refueling property credit.

Impact on California Revenue

Not applicable.

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TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

<u>Section</u>	<u>Section Title</u>
721	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. With the exception of taxable years beginning in 2010, an individual's otherwise allowable itemized deductions may be further limited by the overall limitation on itemized deductions, that reduces itemized deductions for taxpayers with adjusted gross income in excess of a threshold amount. In addition, miscellaneous itemized deductions are not allowable under the alternative minimum tax.

Certain expenses of eligible educators are allowed as an above-the-line deduction. Specifically, for taxable years beginning prior to January 1, 2010, 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 nonathletic 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.<sup>1315</sup> 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 section 135 (relating to education savings bonds), IRC section 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-twelve 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.

The above-the-line deduction for eligible educators is not allowed for taxable years beginning after December 31, 2009.

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, 2012.

Effective Date

The provision is effective for expenses incurred in taxable years beginning after December 31, 2009.

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<sup>1315</sup> IRC section 62(a)(2)(D).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

California Law (R&TC section 17072)

California specifically does not conform to the above-the-line deduction for certain expenses of elementary and secondary school teachers.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
722	Deduction for State and Local Taxes

Background

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 2004-2009, 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 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

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

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 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, 2011).

Effective Date

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

California Law (R&TC section 17220)

California specifically does not conform to the federal deduction allowed for state and local sales taxes.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
723	Contributions of Capital Gain Real Property Made for Conservation Purposes

Background

Charitable Contributions Generally

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.<sup>1316</sup>

In general, in any taxable year, charitable contributions by a corporation are not deductible to the extent the aggregate contributions exceed 10 percent of the corporation's taxable income computed without regard to net operating or capital loss carrybacks. For individuals, the amount

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<sup>1316</sup> IRC sections 170, 2055, and 2522, respectively.

deductible is a percentage of the taxpayer's contribution base (i.e., taxpayer's adjusted gross income computed without regard to any net operating loss carryback). The applicable percentage of the contribution base varies depending on the type of donee organization and property contributed. Cash contributions by an individual taxpayer to public charities, private operating foundations, and certain types of private non-operating foundations may not exceed 50 percent of the taxpayer's contribution base. Cash contributions to private foundations and certain other organizations generally may be deducted up to 30 percent of the taxpayer's contribution base.

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 percent 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-percent 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 percent 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.<sup>1317</sup> 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.

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<sup>1317</sup> IRC sections 170(f)(3)(B)(iii) and 170(h).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

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 as other charitable contributions of capital gain property.

Special Rule Regarding Contributions of Capital Gain Real Property for Conservation Purposes

*In general*

Under a temporary provision that is effective for contributions made in taxable years beginning after December 31, 2005,<sup>1318</sup> the 30-percent contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions (as defined under present law). 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 percent 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-percent 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-percent limitation of \$60. The individual is allowed a deduction of \$50 in the current taxable year for the non-conservation contributions (50 percent 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.

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<sup>1318</sup> IRC section 170(b)(1)(E).

*Farmers and ranchers*

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 percent 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 conservation contribution is allowed and \$30 may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.

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 percent 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-percent limitation.<sup>1319</sup>

As an additional condition of eligibility for the 100 percent 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 on or before August 17, 2006.

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

*Termination*

The special rule regarding contributions of capital gain real property for conservation purposes does not apply to contributions made in taxable years beginning after December 31, 2009.<sup>1320</sup>

New Federal Law (IRC section 170)

The act extends the special rule regarding contributions of capital gain real property for conservation purposes for two years for contributions made in taxable years beginning before January 1, 2012.

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<sup>1319</sup> IRC section 170(b)(2)(B).

<sup>1320</sup> IRC sections 170(b)(1)(E)(vi) and 170(b)(2)(B)(iii).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Effective Date

The provision is effective for contributions made in taxable years beginning after December 31, 2009.

California Law (R&TC sections 17201, 17275.5, and 24357-24357.9)

For taxable years beginning on or after January 1, 2010, the PITL conforms to the federal rules for charitable contributions as of the “specified date” of January 1, 2009, with modifications.<sup>1321</sup> Thus, the PITL generally conforms to the federal rules for general charitable contributions and the rules for contributions of capital gain property; however, the PITL does not conform to federal special rule regarding contributions of capital gain real property for conservation purposes. As a result, qualified conservation contributions of capital gain property under the PITL are subject to the same limitations and carryover rules as other charitable contributions of capital gain property.

Under the CTL, California has stand-alone law for corporate charitable contribution deductions that incorporates some of the federal contribution rules by reference.<sup>1322</sup> In general, in any taxable year, charitable contributions by a corporation are not deductible to the extent the aggregate contributions exceed 10 percent of the corporation's taxable income computed without regard to net operating or capital loss carrybacks, and any excess may be carried forward for up to five years.<sup>1323</sup> The CTL provides its own rules for qualified conservation contributions that generally parallel the federal rules for such contributions;<sup>1324</sup> for example, such contributions are not subject to the “partial interest” rule. However, the CTL does not conform to the federal special rule regarding contributions of capital gain real property (by certain corporate farmers and ranchers) for conservation purposes. Instead, the amount of charitable contribution deduction for contributed property is specifically limited to the adjusted basis of that property.<sup>1325</sup>

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<sup>1321</sup> For taxable years beginning on or after January 1, 2010, R&TC section 17201 conforms IRC section 170, relating to charitable contributions, as of the “specified date” of January 1, 2009, with modifications in R&TC section 17275.5.

<sup>1322</sup> R&TC sections 24357-24357.9.

<sup>1323</sup> R&TC section 24357.

<sup>1324</sup> R&TC sections 24357.2 and 24357.7.

<sup>1325</sup> R&TC section 24357.1.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Impact on California Revenue

Estimated Revenue Impact of Contributions of Capital Gain Real Property Made for Conservation Purposes (under the PITL) For Contributions Made in Taxable Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
-\$1,500,000	No Impact	No Impact

Estimates are based on a proration of federal estimates developed by the Joint Committee on Taxation.

<u>Section</u>	<u>Section Title</u>
724	Above-the-Line Deduction for 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.<sup>1326</sup> The term qualified tuition and related expenses is 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.<sup>1327</sup> 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, 2009.

<sup>1326</sup> IRC section 222.

<sup>1327</sup> 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.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

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,<sup>1328</sup> 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.<sup>1329</sup> 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, 2012.

Effective Date

The provision is effective for taxable years beginning after December 31, 2009.

California Law (R&TC section 17204.7)

California specifically does not conform to the federal qualified tuition deduction.

Impact on California Revenue

Not applicable.

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<sup>1328</sup> IRC sections 222(d)(1) and 25A(g)(2).

<sup>1329</sup> IRC section 222(c). These reductions are the same as those that apply to the Hope and Lifetime Learning credits.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

<u>Section</u>	<u>Section Title</u>
725	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 the following entities: (1) a charity described in IRC section 501(c)(3); (2) certain veterans' organizations, fraternal societies, and cemetery companies;<sup>1330</sup> and (3) a federal, state, or local governmental entity, but only if the contribution is made for exclusively public purposes.<sup>1331</sup> 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.<sup>1332</sup>

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.<sup>1333</sup>

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 provided)

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<sup>1330</sup> IRC sections 170(c)(3)-(5).

<sup>1331</sup> IRC section 170(c)(1).

<sup>1332</sup> IRC sections 170(b) and (e).

<sup>1333</sup> IRC section 170(a).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

to the taxpayer in consideration for the contribution.<sup>1334</sup> 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.<sup>1335</sup>

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private non-operating foundations generally 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 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 generally 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 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 non-charity for less than full and adequate consideration.<sup>1336</sup> 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.<sup>1337</sup> For such interests, a charitable deduction is allowed to the extent of the present value of the interest designated for a charitable organization.

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<sup>1334</sup> IRC section 170(f)(8). For any contribution of cash, check, or other monetary gift, no deduction is allowed unless the donor maintains as a record of such contribution a bank record or written communication from the donee charity showing the name of the donee organization, the date of the contribution, and the amount of the contribution. IRC section 170(f)(17).

<sup>1335</sup> IRC section 6115.

<sup>1336</sup> IRC sections 170(f), 2055(e)(2), and 2522(c)(2).

<sup>1337</sup> IRC section 170(f)(2).

## 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). Certain individuals also may make nondeductible contributions to a Roth IRA (deductible contributions cannot be made to Roth IRAs). Qualified withdrawals from a Roth IRA 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 59-½ 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 April 1 of the calendar year following the year in which the IRA owner attains age 70-½.<sup>1338</sup>

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;<sup>1339</sup> (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.<sup>1340</sup> Elections not to have withholding apply are to be made in the time and manner prescribed by the Secretary.

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<sup>1338</sup> Minimum distribution rules also apply in the case of distributions after the death of a traditional or Roth IRA owner.

<sup>1339</sup> Conversion contributions refer to conversions of amounts in a traditional IRA to a Roth IRA.

<sup>1340</sup> IRC section 3405.

## 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.<sup>1341</sup> 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 distributions. A qualified charitable distribution is 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 as a result of qualified charitable distributions being 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 and only to the extent the distribution would be includible in gross income (without regard to this provision).

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.

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<sup>1341</sup> IRC section 408(d)(8). The exclusion does not apply to distributions from employer-sponsored retirement plans, including SIMPLE IRAs and simplified employee pensions ("SEPs").

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

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, 2009.

New Federal Law (IRC section 408)

The provision extends the exclusion for qualified charitable distributions to distributions made in taxable years beginning after December 31, 2009 and before January 1, 2012. The provision contains a special rule permitting taxpayers to elect (in such form and manner as the Secretary may prescribe) to have qualified charitable distributions made in January 2011 treated as having been made on December 31, 2010 for purposes of IRC sections 408(a)(6), 408(b)(3), and 408(d)(8). Thus, a qualified charitable distribution made in January 2011 is permitted to be: (1) treated as made in the taxpayer's 2010 taxable year and thus permitted to count against the 2010 \$100,000 limitation on the exclusion; and (2) treated as made in the 2010 calendar year and thus permitted to be used to satisfy the taxpayer's minimum distribution requirement for 2010.

Effective Date

The provision is effective for distributions made in taxable years beginning after December 31, 2009.

California Law (R&TC section 17501)

The PITL generally conforms by reference to the federal rules relating to deferred compensation as of the "specified date" of January 1, 2009.<sup>1342</sup> However, except for the allowable amount of elective deferrals, the PITL specifically provides that federal changes to IRC section 408 apply without regard to taxable year to the same extent as applicable for federal income tax purposes.<sup>1343</sup> In other words, except for elective deferrals, the PITL automatically conforms to federal changes made to IRC section 408. As a result, this provision's extension of the exclusion for qualified charitable distributions to distributions made in taxable years beginning after December 31, 2009, and before January 1, 2012, automatically applies under California law.

Impact on California Revenue

Baseline—based on a proration of federal revenue estimates developed by the Joint Committee on Taxation, baseline revenue losses are estimated to be \$20,000,000 in 2011-12, \$3,100,000 in 2012-13, and \$1,200,000 in 2013-14.

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<sup>1342</sup> R&TC section 17501 conforms to Subchapter D of Chapter 1 of Subtitle A of the IRC (consisting of IRC sections 401 to 436), relating to deferred compensation.

<sup>1343</sup> R&TC sections 17501(b). For taxable years beginning on or after January 1, 2010, the maximum amount of elective deferrals under the PITL are the same as the maximum amount allowed for federal purposes as of January 1, 2010.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

<u>Section</u>	<u>Section Title</u>
726	Look-Thru of Certain Regulated Investment Company Stock in Determining Gross Estate of Non-Residents

Background

The gross estate of a decedent who was a U.S. citizen or resident generally includes all property – real, personal, tangible, and intangible—wherever situated.<sup>1344</sup> The gross estate of a nonresident non-citizen decedent, by contrast, generally includes only property that at the time of the decedent's death is situated within the United States.<sup>1345</sup> Property within the United States generally includes debt obligations of U.S. persons, including the federal government and state and local governments, but does not include either bank deposits or portfolio obligations the interest on which would be exempt from U.S. income tax under IRC section 871.<sup>1346</sup> Stock owned and held by a nonresident non-citizen generally is treated as property within the United States if the stock was issued by a domestic corporation.<sup>1347</sup>

Treaties may reduce U.S. taxation of transfers of the estates of nonresident non-citizens. Under recent treaties, for example, U.S. tax generally may be eliminated except insofar as the property transferred includes U.S. real property or business property of a U.S. permanent establishment.

Although stock issued by a domestic corporation generally is treated as property within the United States, stock of a regulated investment company ("RIC") that was owned by a nonresident non-citizen is not deemed property within the United States in the proportion that, at the end of the quarter of the RIC's taxable year immediately before a decedent's date of death, the assets held by the RIC are debt obligations, deposits, or other property that would be treated as situated outside the United States if held directly by the estate (the "estate tax look-through rule for RIC stock").<sup>1348</sup> This estate tax look-through rule for RIC stock does not apply to estates of decedents dying after December 31, 2009.

New Federal Law (IRC section 2105)

The provision permits the estate tax look-through rule for RIC stock to apply to estates of decedents dying before January 1, 2012.

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<sup>1344</sup> IRC section 2031. The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") repealed the estate tax for estates of decedents dying after December 31, 2009. EGTRRA, however, included a termination provision under which EGTRRA's rules, including estate tax repeal, do not apply to estates of decedents dying after December 31, 2010.

<sup>1345</sup> IRC section 2103.

<sup>1346</sup> IRC sections 2104(c), 2105(b).

<sup>1347</sup> IRC section 2104(a); Treas. Reg. section 20.2104-1(a)(5)).

<sup>1348</sup> IRC section 2105(d).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Effective Date

The provision is effective for decedents dying after December 31, 2009.

California Law

California does not conform to the federal estate and generation skipping transfer taxes, but instead imposes what is referred to as the estate "pick-up" tax. The estate "pick-up" tax is a tax equal to the maximum federal estate tax credit allowed. The federal estate tax credit was reduced from 2002 to 2004, repealed for decedents dying after 2004, and is reinstated for decedents dying after 2012 under the rules that applied to decedents who died before 2002.<sup>1349</sup> The California estate "pick-up" tax is administered by the State Controller's Office.

Impact on California Revenue

Defer to the State Controller.

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<u>Section</u>	<u>Section Title</u>
727	Parity for Exclusion from Income for Employer-Provided Mass Transit and Parking Benefits

Background

Qualified transportation fringe benefits provided by an employer are excluded from an employee's gross income for income tax purposes and from an employee's wages for payroll tax purposes.<sup>1350</sup> Qualified transportation fringe benefits include parking, transit passes, vanpool benefits, and qualified bicycle commuting reimbursements. No amount is includible in the income of an employee merely because the employer offers the employee a choice between cash and qualified transportation fringe benefits (other than a qualified bicycle commuting reimbursement). Qualified transportation fringe benefits also include a cash reimbursement by an employer to an employee. In the case of transit passes, however, 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.

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<sup>1349</sup> Under EGTRRA, the amount of allowable state death tax credit was reduced from 2002 through 2004, and for decedents dying after 2004, the state death tax credit was repealed and replaced with a deduction; thus, there is no "pick-up" tax for decedents dying after 2004 and before 2013. For decedents dying after 2012, the EGTRAA deduction is repealed, and replaced with the prior state death tax credit, as in effect for decedents dying prior to 2002.

<sup>1350</sup> IRC sections 132(f), 3121(b)(2), 3306(b)(16), and 3401(a)(19).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Prior to February 17, 2009, the amount that could be excluded as qualified transportation fringe benefits was limited to \$100 per month in combined vanpooling and transit pass benefits and \$175 per month in qualified parking benefits. All limits were adjusted annually for inflation, using 1998 as the base year (in 2009 the limits were \$120 and \$230, respectively). The American Recovery and Reinvestment Act of 2009 (ARRA), however, temporarily increased the monthly exclusion for employer-provided vanpool and transit pass benefits to the same level as the exclusion for employer-provided parking (\$230 for 2010). The American Recovery and Reinvestment Act of 2009 limits expired on December 31, 2010.

New Federal Law (IRC section 132)

The provision extends the parity in qualified transportation fringe benefits for one year (through December 31, 2011).

Effective Date

The provision is effective for months after December, 2010.

California Law (R&TC sections 17131 and 17149)

The PITL generally conforms to the federal rules for items specifically excluded from gross income as of the “specified date” of January 1, 2009,<sup>1351</sup> and as a result conforms to the federal exclusion for qualified transportation fringe benefits under IRC section 132 as of the “specified date.” Additionally, the PITL provides a state-only exclusion for qualified California qualified transportation fringe benefits,<sup>1352</sup> and the state exclusion is not subject to any limitation; thus, while California does not conform to this provision, the enhanced exclusion is allowable under current California law.

Impact on California Revenue

Baseline—although California currently allows an exclusion of income for qualified commuter reimbursements for employees, taxpayers are expected to follow the new federal rules. Based on a proration of federal revenue estimates developed by the Joint Committee on Taxation, the baseline revenue loss is estimated to be \$5,400,000 in 2011-12.

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<sup>1351</sup> For taxable years beginning on or after January 1, 2010, R&TC section 17131 conforms to Part III of Subchapter B of Chapter 1 of Subtitle A of the IRC, containing IRC sections 101 to 138, as of the “specified date” of January 1, 2009, with modifications.

<sup>1352</sup> R&TC section 17149.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

<u>Section</u>	<u>Section Title</u>
728	Refunds Disregarded in the Administration of Federal Programs and Federally Assisted Programs

Background

Qualifying individuals may receive refundable credits under various provisions in the IRC. Some of these credits are not taken into account for purposes of determining eligibility for benefits or assistance under federal programs, but the treatment of such credits is not uniform. For example, for purposes of determining an individual's eligibility under any federal program or federally funded state or local program, the child tax credit<sup>1353</sup> is not considered a resource for the month of receipt and the following month,<sup>1354</sup> but the making work pay credit<sup>1355</sup> is not so considered for the month of receipt and the following two months.<sup>1356</sup> The earned income credit has a similar rule to the child tax credit but only with respect to certain specifically listed benefit programs.<sup>1357</sup>

New Federal Law (IRC section 6409)

Under this provision, any tax refund (or advance payment with respect to a refundable credit) received by an individual after December 31, 2009 begins a period of 12 months during which such refund may not be taken into account as a resource for purposes of determining the eligibility of such individual (or any other individual) for benefits or assistance (or the amount or extent of benefits or assistance) under any federal program or under any state or local program financed in whole or in part with Federal funds. The provision terminates on December 31, 2012.

Effective Date

The provision is effective for amounts received after December 31, 2009 and on or before December 31, 2012.

California Law (None)

California does not conform to the federal eligibility benefit rules under IRC section 6409.

Impact on California Revenue

Not applicable.

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<sup>1353</sup> IRC section 24.

<sup>1354</sup> Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107-16, section 203.

<sup>1355</sup> IRC section 36A.

<sup>1356</sup> American Recovery and Reinvestment Act of 2009, Public Law 111-5, section 1001(c).

<sup>1357</sup> IRC section 32(l).

<u>Section</u>	<u>Section Title</u>
731	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.<sup>1358</sup> Thus, the research credit is generally available with respect to incremental increases in qualified research.

A 20-percent research tax credit is also available with respect to the excess of 100 percent of corporate cash expenses (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over the sum of: (1) the greater of two minimum basic research floors; plus (2) an amount reflecting any decrease in non-research 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.<sup>1359</sup>

Finally, 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.

The research credit, including the university basic research credit and the energy research credit, expires for amounts paid or incurred after December 31, 2009.<sup>1360</sup>

#### 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 least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified

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<sup>1358</sup> IRC section 41.

<sup>1359</sup> IRC section 41(e).

<sup>1360</sup> IRC section 41(h).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

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.<sup>1361</sup>

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.<sup>1362</sup> 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.<sup>1363</sup>

#### Alternative Incremental Research Credit

For taxable years beginning before January 1, 2009, taxpayers were allowed to elect an alternative incremental research credit regime.<sup>1364</sup> A taxpayer electing to be subject to this alternative regime 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

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<sup>1361</sup> 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 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).

<sup>1362</sup> IRC section 41(f)(1).

<sup>1363</sup> IRC section 41(f)(3).

<sup>1364</sup> IRC section 41(c)(4).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

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.<sup>1365</sup>

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

Taxpayers may elect to claim an alternative simplified credit for qualified research expenses. The alternative simplified research credit is equal to 14 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.

#### 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).<sup>1366</sup> 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 not only has to satisfy the requirements of present-law IRC section 174 (described below) 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 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 factors or seasonal design

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<sup>1365</sup> A special transition rule applies for fiscal year 2006-2007 taxpayers.

<sup>1366</sup> 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).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

factors.<sup>1367</sup> 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.<sup>1368</sup> 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.<sup>1369</sup> 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.<sup>1370</sup> Taxpayers may alternatively elect to claim a reduced research tax credit amount under IRC section 41 in lieu of reducing deductions otherwise allowed.<sup>1371</sup>

#### New Federal Law (IRC sections 41 and 45C)

The provision extends the research credit for two years, through December 31, 2011.

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<sup>1367</sup> IRC section 41(d)(3).

<sup>1368</sup> IRC section 41(d)(4).

<sup>1369</sup> 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).

<sup>1370</sup> IRC section 280C(c).

<sup>1371</sup> IRC section 280C(c)(3).

California Law (R&TC sections 17052.12 and 23609)

California Research Credit

Under both the PITL and the CTL, California conforms to the federal research credit as of the “specified date” of January 1, 2009, with modifications.<sup>1372</sup> California specifically does not conform to the federal credit termination date,<sup>1373</sup> which means the research credit is permanent under California law, and this provision’s two-year extension does not apply. Other state modifications are discussed below.

*California research credit percentages*

California modifies (1) the federal 20-percent general credit to be 15 percent of qualified expenses, and (2) the federal 20-percent university “basic research” credit to be 24 percent of qualified expenses.

*California 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 of business, that is delivered or shipped to a purchaser within California, will be included. Qualified research expenses are 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.

*University “basic research” expenses*

Similar to federal law, only corporations qualify for the credit for the university “basic research” credit. However, California modifies “basic research” 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; or,
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.

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<sup>1372</sup> For taxable years beginning on or after January 1, 2010, R&TC sections 17052.12 and 23609 conform to IRC section 41, relating to credit for increasing research activities, as of the “specified date” of January 1, 2009, with modifications.

<sup>1373</sup> R&TC sections 17052.12(h) and 23609(i).

*Alternative incremental research credit*

For taxable years beginning on or after January 1, 2010, California conforms to the alternative incremental credit as of the “specified date” of January 1, 2009, with modifications. For California purposes, the federal credit rates of 3 percent, 4 percent and 5 percent are modified to be 1.49 percent, 1.98 percent, and 2.48 percent, respectively,<sup>1374</sup> and the federal December 31, 2008, election termination date does not apply.<sup>1375</sup>

*Alternative simplified credit*

California specifically does not conform to the alternative simplified credit.

*Eligible expenses*

California generally conforms to the federal rules for eligible expenses, but does not conform to the special rules that allow qualified research expenses to include 100 percent of amounts paid or incurred by the taxpayer to an eligible small business, university, or federal laboratory for qualified energy research.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
732	Indian Employment Tax 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.<sup>1376</sup> 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

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<sup>1374</sup> R&TC sections 17052.12(g) and 23609(h).

<sup>1375</sup> R&TC sections 17052.12(h) and 23609(i).

<sup>1376</sup> IRC section 45A.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

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<sup>1377</sup> or section 4(10) of the Indian Child Welfare Act of 1978.<sup>1378</sup> For purposes of the preceding sentence, section 3(d) is applied by treating "former Indian reservations in Oklahoma" as including only lands that are within the jurisdictional area of an Oklahoma Indian tribe as determined by the Secretary of the Interior, and 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 adjusted for inflation is currently \$45,000 for 2009). 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 five 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 wage credit is available for wages paid or incurred in taxable years that begin before January 1, 2010.

#### 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, 2011).

#### Effective Date

The provision is effective for taxable years beginning after December 31, 2009.

#### California Law (None)

California does not conform to the Indian employment tax credit.

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<sup>1377</sup> Public Law 93-262.

<sup>1378</sup> Public Law 95-608.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
733	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").<sup>1379</sup> 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.<sup>1380</sup> 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 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.<sup>1381</sup> 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: (1) ceases to be a qualified CDE; (2) the proceeds of the investment cease to be used as required; or (3) the equity investment is redeemed.<sup>1382</sup>

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.<sup>1383</sup> 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.<sup>1384</sup> Substantially all of the investment

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<sup>1379</sup> 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).

<sup>1380</sup> IRC section 45D(a)(2).

<sup>1381</sup> IRC section 45D(a)(3).

<sup>1382</sup> IRC section 45D(g).

<sup>1383</sup> IRC section 45D(c).

<sup>1384</sup> IRC section 45D(b).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

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.<sup>1385</sup>

A "low-income community" is a population census tract with either a poverty rate of at least 20 percent or 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 (as opposed to 80 percent) of statewide median family income.<sup>1386</sup> 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 is authorized to designate "targeted populations" as low-income communities for purposes of the new markets tax credit.<sup>1387</sup> 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<sup>1388</sup> (the "Act") to mean individuals, or an identifiable group of individuals, including an Indian tribe, who are low-income persons or otherwise lack adequate access to loans or equity investments. Section 103(17) of the Act provides that "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.<sup>1389</sup> 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 the business is used in

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<sup>1385</sup> IRC section 45D(d).

<sup>1386</sup> IRC section 45D(e).

<sup>1387</sup> IRC section 45D(e)(2).

<sup>1388</sup> Public Law 103-325.

<sup>1389</sup> Public Law 103-325.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

a low-income community; (3) a substantial portion of the services performed for the 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 the business is attributable to certain financial property or to certain collectibles.<sup>1390</sup>

The maximum annual amount of qualified equity investments was \$5.0 billion for calendar years 2008 and 2009. The new markets tax credit expired on December 31, 2009.

New Federal Law (IRC section 45D)

The provision extends the new markets tax credit for two years, through 2011, permitting up to \$3.5 billion in qualified equity investments for each of the 2010 and 2011 calendar years. The provision also extends for two years, through 2016, the carryover period for unused new markets tax credits.

Effective Date

The provision applies to calendar years beginning after December 31, 2009.

California Law (R&TC sections 17053.57 and 23657)

New Markets Tax Credit

California does not conform to the federal new markets tax credit.

California Community Development Financial Institution Credit

The PITL and the CTL provide a state-only credit that is 20 percent of each “qualified investment” in a California community development financial institution (CDFI). The “qualified investment” in the California CDFI must be at least \$50,000, be for a minimum duration of 60 months, and consist of either: (1) a deposit or loan that does not earn interest; or (2) an equity investment.

A California CDFI is defined as a private financial institution located in California that has community development as its primary mission and lends in urban, rural, or reservation-based communities in California. A CDFI includes a community development bank, a community development loan fund, a community development credit union, a micro-enterprise fund, a community development corporation-based lender, or a community development venture fund.

The California CDFI credit will cease to be operative for taxable years beginning on or after January 1, 2012.

Impact on California Revenue

Not applicable.

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<sup>1390</sup> IRC section 45D(d)(2).

<u>Section</u>	<u>Section Title</u>
734	Railroad Track Maintenance Credit

#### Background

Present law provides a 50-percent business tax credit for qualified railroad track maintenance expenditures paid or incurred by an eligible taxpayer during taxable years beginning before January 1, 2010.<sup>1391</sup> The credit is limited to the product of \$3,500 times the number of miles of railroad track owned or leased by an eligible taxpayer as of the close of its taxable year, and 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.<sup>1392</sup> 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. The credit may also reduce a taxpayer's tax liability below its tentative minimum tax.<sup>1393</sup>

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).<sup>1394</sup>

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.<sup>1395</sup>

The terms Class II or Class III railroad have the meanings given by the Surface Transportation Board.<sup>1396</sup>

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<sup>1391</sup> IRC section 45G(a).

<sup>1392</sup> Sec. 45G(b)(1).

<sup>1393</sup> IRC section 38(c)(4).

<sup>1394</sup> IRC section 45G(d).

<sup>1395</sup> IRC section 45G(c).

<sup>1396</sup> IRC section 45G(e)(1).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

New Federal Law (IRC section 45G)

The provision extends the present law credit for two years, for qualified railroad track maintenance expenses paid or incurred during taxable years beginning after December 31, 2009 and before January 1, 2012.

Effective Date

The provision is effective for expenses paid or incurred in taxable years beginning after December 31, 2009.

California Law (None)

California does not conform to the railroad track maintenance credit.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
735	Mine Rescue Team Training Credit

Background

An eligible employer may claim a general business credit against income tax with respect to each qualified mine rescue team employee equal to the lesser of: (1) 20 percent of the amount paid or incurred by the taxpayer during the taxable year with respect to the training program costs of the qualified mine rescue team employee (including the wages of the employee while attending the program); or (2) \$10,000. 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 not allowable for purposes of computing the alternative minimum tax.<sup>1397</sup>

An eligible employer is any taxpayer which employs individuals as miners in underground mines in the United States. The term "wages" has the meaning given to such term by IRC section 3306(b)<sup>1398</sup> (determined without regard to any dollar limitation contained in that section).

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<sup>1397</sup> IRC section 38(c).

<sup>1398</sup> IRC section 3306(b) defines wages for purposes of Federal Unemployment Tax.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

No deduction is allowed for the portion of the expenses otherwise deductible that is equal to the amount of the credit.<sup>1399</sup> The credit does not apply to taxable years beginning after December 31, 2009. Additionally, the credit may not offset the alternative minimum tax.

New Federal Law (IRC section 45N)

The provision extends the credit for two years through taxable years beginning on or before December 31, 2011.

Effective Date

The provision generally is effective for taxable years beginning after December 31, 2009.

California Law (None)

California does not conform to the mine rescue team training credit.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
736	Employer Wage Credit for Employees Who Are Active Duty Members of the Uniformed Services

Background

Differential Pay

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 by the employer is often referred to as "differential pay."

Wage Credit for Differential Pay

If an employer qualifies as an eligible small business employer, the employer is allowed to take a credit against its income tax liability for a taxable year in an amount equal to 20 percent of the

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<sup>1399</sup> IRC section 280C(e).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

sum of the eligible differential wage payments for each of the employer's qualified employees for the taxable year.<sup>1400</sup>

An eligible small business employer means, with respect to a taxable year, any taxpayer that: (1) 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).

Differential wage payment 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. A qualified employee is an individual who has been an employee for the 91-day period immediately preceding the period for which any differential wage payment is made.

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.

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. Any credit that is included in the general business credit, however, cannot be carried back to a tax year before the first tax year for which that credit is allowable under the effective date of that credit. Thus, the differential wage payment credit, if disallowed under IRC section 38(c), cannot be carried back to tax years ending before June 18, 2008. In addition, unlike many of the other credits that are included in the general business credit, the differential wage payment credit is not a "qualified business credit" under IRC section 196(c). Thus, a taxpayer cannot deduct under IRC section 196(c) any differential wage payment credits that remain unused at the end of the 20-year carryforward period.

Rules similar to the rules in IRC section 52(c), which bars the work opportunity tax credit for tax-exempt organizations other than certain farmer's cooperatives, apply to the differential wage payment credit. Additionally, rules similar to the rules in IRC section 52(e), which limits the work

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<sup>1400</sup> IRC section 45P.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

opportunity tax credit allowable to regulated investment companies, real estate investment trusts, and certain cooperatives, apply to the differential wage payment credit.

The credit is not allowable against a taxpayer's alternative minimum tax liability. The amount of credit otherwise allowable under the income tax rules for compensation paid to any employee must be reduced by the differential wage payment credit with respect to that employee.

There are special rules for trusts and estates and their beneficiaries.

The credit is available with respect to amounts paid after June 17, 2008<sup>1401</sup> and before January 1, 2010.

New Federal Law (IRC section 45P)

The provision extends the availability of the credit to amounts paid before January 1, 2012.

Effective Date

The provision applies to payments made after December 31, 2009.

California Law (None)

California does not conform to the employer wage credit for employees who are active duty members of the uniformed services.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
737	15-Year Straight-Line Cost Recovery for Qualified Leasehold Improvements, Qualified Restaurant Building Improvements, and Qualified Retail Improvements

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

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<sup>1401</sup> This date is the date of enactment of the Heroes Earnings Assistance and Relief Tax Act of 2008, Public Law 110-245.

conventions, and depreciation methods to the cost of various types of depreciable property.<sup>1402</sup> 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, qualified restaurant property, and qualified retail improvement 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, 2010. Qualified leasehold improvement property is recovered using the straight-line method and a half-year convention. Leasehold improvements placed in service after December 31, 2009 will be subject to the general rules described above.

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 sub-lessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sub-lessee). 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.

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<sup>1402</sup> IRC section 168.

### 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, 2010. Qualified restaurant property is any IRC section 1250 property that is a building (if the building is placed in service after December 31, 2008, and before January 1, 2010) or an improvement to a building, if 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.<sup>1403</sup> Qualified restaurant property is recovered using the straight-line method and a half-year convention. Additionally, qualified restaurant property is not eligible for bonus depreciation.<sup>1404</sup> Restaurant property placed in service after December 31, 2009 is subject to the general rules described above.

### Qualified Retail Improvement Property

IRC section 168(e)(3)(E)(ix) provides a statutory 15-year recovery period and for qualified retail improvement property placed in service after December 31, 2008, and before January 1, 2010. Qualified retail improvement property is any improvement to an interior portion of a building which is nonresidential real property if such portion is open to the general public<sup>1405</sup> and is used in the retail trade or business of selling tangible personal property to the general public, and such improvement is placed in service more than three years after the date the building was first placed in service. Qualified retail improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building. In the case of an improvement made by the owner of such improvement, the improvement is a qualified retail improvement only so long as the improvement is held by such owner.

Retail establishments that qualify for the 15-year recovery period include those primarily engaged in the sale of goods. Examples of these retail establishments include, but are not limited to, grocery stores, clothing stores, hardware stores and convenience stores. Establishments primarily engaged in providing services, such as professional services, financial services, personal services, health services, and entertainment, do not qualify. It is generally intended that businesses defined as a store retailer under the current North American Industry Classification System (industry sub-sectors 441 through 453) qualify while those in other industry classes do not qualify.

Qualified retail improvement property is recovered using the straight-line method and a half-year convention. Additionally, qualified retail improvement property is not eligible for bonus depreciation.<sup>1406</sup> Qualified retail improvement property placed in service on or after

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<sup>1403</sup> IRC section 168(e)(7)(A).

<sup>1404</sup> Property that satisfies the definition of both qualified leasehold improvement property and qualified restaurant property is eligible for bonus depreciation.

<sup>1405</sup> Improvements to portions of a building not open to the general public (e.g., stock room in back of retail space) do not qualify under the provision.

<sup>1406</sup> Property that satisfies the definition of both qualified leasehold improvement property and qualified retail property is eligible for bonus depreciation.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

January 1, 2010, is subject to the general rules described above.

New Federal Law (IRC sections 179 and 168)

The present law provisions for qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property are extended for two years to apply to property placed in service on or before December 31, 2011.

Effective Date

The provision is effective for property placed in service after December 31, 2009.

California Law (R&TC sections 17201, 17250, and 24349-24355.4)

This provision is not applicable under California law.

The PITL generally conforms to MACRS, with modifications, but specifically does not conform to the MACRS exception that allows 15-year straight-line cost recovery for qualified leasehold improvements, qualified restaurant improvements, and qualified retail improvements.<sup>1407</sup>

The CTL did not adopt pre-1986 accelerated cost recovery system (ACRS) depreciation, and does not adopt MACRS. The CTL is generally in substantial conformity to the pre-1981 federal asset depreciation range (ADR) depreciation rules, which generally allow property to be depreciated based on its "useful life."<sup>1408</sup> Additionally, the CTL allows the use of component depreciation.<sup>1409</sup>

Impact on California Revenue

Not applicable.

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<sup>1407</sup> R&TC section 17250(a)(6).

<sup>1408</sup> R&TC sections 24349-24355.4.

<sup>1409</sup> Prior to the adoption of accelerated cost recovery system (ACRS) by the Economic Recovery Tax Act of 1981, federal law allowed taxpayers to depreciate various components of a building as separate assets with separate useful lives. The CTL has never been amended to repeal the use of component depreciation, as ACRS and MACRS were never adopted in the CTL.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

<u>Section</u>	<u>Section Title</u>
738	7-Year Recovery Period for Motorsports Entertainment Complexes

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.<sup>1410</sup> 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, 2009 is assigned a recovery period of seven years.<sup>1411</sup> For these purposes, a motorsports entertainment complex means a racing track facility that is permanently situated on land and which during the 36-month period following its placed-in-service date hosts a racing event.<sup>1412</sup> 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).

New Federal Law (IRC section 168)

The provision extends the present law seven-year recovery period for motorsports entertainment complexes two years to apply to property placed in service before January 1, 2012.

Effective Date

The provision is effective for property placed in service after December 31, 2009.

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<sup>1410</sup> IRC section 168.

<sup>1411</sup> IRC section 168(e)(3)(C)(ii).

<sup>1412</sup> IRC section 168(i)(15).

California Law (R&TC sections 17250 and 24349)

Under the PITL and the CTL, California conformed to the seven-year recovery period for motorsports entertainment complexes for property placed in service on or before December 31, 2007.<sup>1413</sup> However, under the PITL, California specifically does not conform to the seven-year recovery period for property placed in service on or after January 1, 2008,<sup>1414</sup> and under the CTL, the seven-year recovery period was repealed in 2010.<sup>1415</sup>

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
739	Accelerated Depreciation for Business Property on an Indian Reservation

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

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<sup>1413</sup> For taxable years beginning on or after January 1, 2005, and before January 1, 2010, the PITL conformed to the IRC section 168(i)(15) seven-year recovery period under RT&C section 17250, as of the “specified date” of January 1, 2005; thus, California conformed to the December 31, 2007, termination date contained in IRC section 168(i)(15) that applied as of January 1, 2005. Former R&TC section 24355.3, as added by Chapter 691 of the Statutes of 2005, allowed the seven-year recovery period under the CTL for the same period that was allowed under the PITL.

<sup>1414</sup> R&TC section 17250(a)(11).

<sup>1415</sup> Former R&TC section 24355.3, as added by Chapter 691 of the Statutes of 2005, was repealed by Section 68 of Chapter 14 of the Statutes of 2010, which applied to taxable years beginning on or after January 1, 2010.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

"Qualified Indian reservation property" eligible for accelerated depreciation includes property described in the table above that 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;<sup>1416</sup> and (4) is not property placed in service for purposes of conducting gaming activities.<sup>1417</sup> 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).<sup>1418</sup>

An "Indian reservation" means a reservation as defined in section 3(d) of the Indian Financing Act of 1974<sup>1419</sup> or section 4(10) of the Indian Child Welfare Act of 1978 (25 U.S.C. 1903(10)).<sup>1420</sup> For purposes of the preceding sentence, section 3(d) is applied by treating "former Indian reservations in Oklahoma" as including only lands that are within the jurisdictional area of an Oklahoma Indian tribe as determined by the Secretary of the Interior, and 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 qualified Indian reservation property is available with respect to property placed in service on or after January 1, 1994, and before January 1, 2010.

New Federal Law (IRC section 168)

The provision extends for two years the present-law accelerated MACRS recovery periods for qualified Indian reservation property to apply to property placed in service before January 1, 2012.

Effective Date

The provision is effective for property placed in service after December 31, 2009.

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<sup>1416</sup> For these purposes, related persons is defined in IRC section 465(b)(3)(C).

<sup>1417</sup> IRC section 168(j)(4)(A).

<sup>1418</sup> IRC section 168(j)(4)(C).

<sup>1419</sup> Public Law 93-262.

<sup>1420</sup> Public Law 95-608.

California Law (R&TC sections 17250 and 24349-24355.4)

This provision is not applicable under California law.

The PITL generally conforms to MACRS recovery periods, but specifically does not conform to accelerated depreciation for business property on an Indian Reservation.<sup>1421</sup>

The CTL did not adopt pre-1986 accelerated cost recovery system (ACRS) depreciation, and does not adopt MACRS. The CTL is generally in substantial conformity to the pre-1981 federal asset depreciation range (ADR) depreciation rules, which generally allow property to be depreciated based on its “useful life.”<sup>1422</sup> Additionally, the CTL allows the use of component depreciation.<sup>1423</sup>

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
740	Enhanced Charitable Deduction for Contributions of Food Inventory

Background

Charitable Contributions in General

In general, an income tax deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization.<sup>1424</sup>

Charitable contributions of cash are deductible in the amount contributed. In general, contributions of capital gain property to a qualified charity are deductible at fair market value with

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<sup>1421</sup> R&TC section 17250(a)(3).

<sup>1422</sup> R&TC sections 24349-24355.4.

<sup>1423</sup> Prior to the adoption of accelerated cost recovery system (ACRS) by the Economic Recovery Tax Act of 1981, federal law allowed taxpayers to depreciate various components of a building as separate assets with separate useful lives. The CTL has never been amended to repeal the use of component depreciation, as ACRS and MACRS were never adopted in the CTL.

<sup>1424</sup> IRC section 170.

certain exceptions. 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 other appreciated property generally are deductible at the donor's basis in the property. Contributions of depreciated property generally are deductible at the fair market value of the property.

#### 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.<sup>1425</sup> In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income.<sup>1426</sup> 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 non-operating 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.<sup>1427</sup> In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, as amended, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.<sup>1428</sup>

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.<sup>1429</sup> 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.

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<sup>1425</sup> IRC section 170(e)(3).

<sup>1426</sup> IRC section 170(b)(2).

<sup>1427</sup> IRC section 170(e)(3)(A)(i)-(iii).

<sup>1428</sup> IRC section 170(e)(3)(A)(iv).

<sup>1429</sup> Treas. Reg. section 1.170A-4A(c)(3).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

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.<sup>1430</sup>

Temporary Rule Expanding and Modifying the Enhanced Deduction for Contributions of Food Inventory

Under a special temporary provision, 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.<sup>1431</sup> 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.<sup>1432</sup>

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, 2009.

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, 2012.

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<sup>1430</sup> *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).

<sup>1431</sup> IRC section 170(e)(3)(C).

<sup>1432</sup> 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.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Effective Date

The provision is effective for contributions made after December 31, 2009.

California Law (R&TC sections 17201, 17275.2, 17275.5, and 24357–24359.1)

This provision is not applicable under California law.

The PITL generally conforms to the federal rules relating to charitable contributions as of the “specified date” of January 1, 2009,<sup>1433</sup> but specifically does not conform to the enhanced deduction for a contribution of food inventory.<sup>1434</sup> The deduction under the PITL for charitable contributions of inventory is limited to the taxpayer’s basis in the inventory, generally its cost.

The CTL does not adopt the general federal rules that allow enhanced deductions for C-corporation contributions of inventory, and does not adopt the enhanced deduction for a contribution of food inventory. The deduction under the CTL for contributions of inventory is limited to the taxpayer’s basis in the inventory (generally its cost), and may not exceed ten percent of the corporation’s net income. Any excess may be carried forward for up to five years.<sup>1435</sup>

Impact on California Revenue

Not applicable.

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<sup>1433</sup> For taxable years beginning on or after January 1, 2010, R&TC section 17201 conforms to IRC section 170, relating to charitable contributions and gifts, as of the “specified date” of January 1, 2009, with modifications.

<sup>1434</sup> R&TC section 17275.2.

<sup>1435</sup> R&TC sections 24357–24359.1.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

<u>Section</u>	<u>Section Title</u>
741	Enhanced Charitable Deduction for Contributions of Book Inventory to Public Schools

Background

Charitable Contributions in General

In general, an income tax deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization.<sup>1436</sup>

Charitable contributions of cash are deductible in the amount contributed. In general, contributions of capital gain property to a qualified charity are deductible at fair market value with certain exceptions. 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 other appreciated property generally are deductible at the donor's basis in the property. Contributions of depreciated property generally are deductible at the fair market value of the property.

General Rules Regarding Contributions of Book 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.

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.<sup>1437</sup> In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income.<sup>1438</sup> 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 non-operating 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.<sup>1439</sup> In the case of contributed property subject to the Federal Food, Drug, and

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<sup>1436</sup> IRC section 170.

<sup>1437</sup> IRC section 170(e)(3).

<sup>1438</sup> IRC section 170(b)(2).

<sup>1439</sup> IRC section 170(e)(3)(A)(i)-(iii).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Cosmetic Act, as amended, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.<sup>1440</sup>

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.<sup>1441</sup> 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.

#### Special Rule Expanding and Modifying the Enhanced Deduction for Contributions of Book Inventory

The generally applicable enhanced deduction for C corporations is expanded and modified to include certain qualified book contributions made after August 28, 2005, and before January 1, 2010.<sup>1442</sup> 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.

#### New Federal Law (IRC section 170)

The provision extends the expansion of, and modifications to, the enhanced deduction for contributions of book inventory to contributions made before January 1, 2012.

#### Effective Date

The provision is effective for contributions made after December 31, 2009.

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<sup>1440</sup> IRC section 170(e)(3)(A)(iv).

<sup>1441</sup> Treas. Reg. section 1.170A-4A(c)(3).

<sup>1442</sup> IRC section 170(e)(3)(D).

California Law (R&TC sections 24357-24359.1)

This provision is not applicable under California law.

The CTL does not adopt the general federal rules that allow enhanced deductions for C-corporation contributions of inventory, and does not adopt the enhanced deduction for a contribution of book inventory. The deduction under the CTL for contributions of inventory is limited to the taxpayer's basis in the inventory (generally its cost), and may not exceed ten percent of the corporation's net income. Any excess may be carried forward for up to five years.<sup>1443</sup>

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
742	Enhanced Charitable Deduction for Corporate Contributions of Computer Inventory for Educational Purposes

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.<sup>1444</sup>

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. Under a special, temporary provision, certain corporations may claim a deduction in excess of basis for a "qualified computer contribution."<sup>1445</sup> 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, 2009.<sup>1446</sup>

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<sup>1443</sup> R&TC sections 24357-24359.1.

<sup>1444</sup> IRC section 170(e)(1).

<sup>1445</sup> IRC section 170(e)(6).

<sup>1446</sup> IRC section 170(e)(6)(G).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

A qualified computer contribution means a charitable contribution of any computer technology or equipment, which meets several requirements. The contribution must meet 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, the date construction or assembly of the property is substantially completed).<sup>1447</sup> The original use of the property must be by the donor or the donee,<sup>1448</sup> and substantially all of the donee's use of the property must be within the United States 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.<sup>1449</sup>

New Federal Law (IRC section 170)

The provision extends the enhanced deduction for computer technology and equipment to contributions made before January 1, 2012.

Effective Date

The provision is effective for contributions made in taxable years beginning after December 31, 2009.

California Law (R&TC sections 24357-24359.1)

This provision is not applicable under California law.

The CTL does not adopt the general federal rules that allow enhanced deductions for C-corporation contributions of inventory, and does not adopt the enhanced deduction for corporate contributions of computer inventory for educational purposes for any contribution made in any taxable year beginning after December 31, 2003. The deduction under the CTL for contributions of inventory is limited to the taxpayer's basis in the inventory (generally its cost), and may not exceed ten percent of the corporation's net income. Any excess may be carried forward for up to five years.<sup>1450</sup>

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<sup>1447</sup> 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).

<sup>1448</sup> This requirement does not apply if the property was reacquired by the manufacturer and contributed. IRC section 170(e)(6)(D)(ii).

<sup>1449</sup> IRC section 170(e)(6)(C).

<sup>1450</sup> R&TC sections 24357–24359.1.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
743	Election to Expense Mine Safety Equipment

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").<sup>1451</sup> Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from three to 20 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.

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct (or "expense") such costs under IRC section 179. Present law provides that the maximum amount a taxpayer may expense for taxable years beginning in 2010 is \$500,000 of the cost of the qualifying property 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.<sup>1452</sup> The \$500,000 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 \$2,000,000.

A taxpayer may elect to treat 50 percent of the cost of any qualified advanced mine safety equipment property as an expense in the taxable year in which the equipment is placed in service.<sup>1453</sup> The deduction under IRC section 179E is allowed for both regular and alternative minimum tax purposes, including adjusted current earnings. In computing earnings and profits,

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<sup>1451</sup> IRC section 168.

<sup>1452</sup> The definition of qualifying property was temporarily (for 2010 and 2011) expanded to include up to \$250,000 of qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. See IRC section 179(c).

<sup>1453</sup> IRC section 179E(a).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

the amount deductible under IRC section 179E is allowed as a deduction ratably over five taxable years beginning with the year the amount is deductible under IRC section 179E.<sup>1454</sup>

"Qualified advanced mine safety equipment property" means any advanced mine safety equipment property for use in any underground mine located in the United States the original use of which commences with the taxpayer and which is placed in service before January 1, 2010.<sup>1455</sup>

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.<sup>1456</sup>

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-percent deduction under IRC section 179E.<sup>1457</sup> In addition, a taxpayer making an election under IRC section 179E must file with the Secretary a report containing information with respect to the operation of the mines of the taxpayer as required by the Secretary.<sup>1458</sup>

New Federal Law (IRC section 179E)

The provision extends for two years, to December 31, 2011, the present-law placed in service date relating to expensing of mine safety equipment.

Effective Date

The provision applies to property placed in service after December 31, 2009.

California Law (R&TC sections 17201, 17255, 17257.4, and 24356)

This provision is not applicable under California law.

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<sup>1454</sup> IRC section 312(k)(3). IRC section 56(g)(4)(C)(i) does not apply to a deduction under IRC section 179E (or under IRC sections 179, 179A, 179B, and 179D), as such deduction is permitted for purposes of computing earnings and profits.

<sup>1455</sup> IRC sections 179E(c) and (g).

<sup>1456</sup> IRC section 179E(d).

<sup>1457</sup> IRC section 179E(e).

<sup>1458</sup> IRC section 179E(f).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Under the PITL, California specifically does not conform to the federal election to expense advanced mine safety equipment,<sup>1459</sup> and the election has not been adopted under the CTL. Under both the PITL and the CTL, as it relates to the election to deduct (or “expense”) costs in lieu of depreciation, California conforms to IRC section 179, with significant modifications.<sup>1460</sup> 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. 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.

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<u>Section</u>	<u>Section Title</u>
744	Special Expensing Rules for Certain 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

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<sup>1459</sup> R&TC section 17257.4.

<sup>1460</sup> R&TC sections 17255 and 24356.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

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<sup>1461</sup> to deduct the cost of any qualifying film and television production, commencing prior to January 1, 2010, in the year the expenditure is incurred in lieu of capitalizing the cost and recovering it through depreciation allowances.<sup>1462</sup> Taxpayers may elect to deduct up to \$15 million of the aggregate cost of the film or television production under this section.<sup>1463</sup> 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.<sup>1464</sup>

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.<sup>1465</sup> The term "compensation" does not include participations and residuals (as defined in IRC section 167(g)(7)(B)).<sup>1466</sup> With respect to property that 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.<sup>1467</sup> Qualified property does not include sexually explicit productions as defined by section 2257 of title 18 of the U.S. Code.<sup>1468</sup>

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.<sup>1469</sup>

New Federal Law (IRC section 181)

The provision extends the present law expensing provision for two years, to qualified film and television productions commencing prior to January 1, 2012.

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<sup>1461</sup> See Treas. Reg. section 1.181-2T for rules on making an election under this section.

<sup>1462</sup> For this purpose, a production is treated as commencing on the first date of principal photography.

<sup>1463</sup> IRC section 181(a)(2)(A).

<sup>1464</sup> IRC section 181(a)(2)(B).

<sup>1465</sup> IRC section 181(d)(3)(A).

<sup>1466</sup> IRC section 181(d)(3)(B).

<sup>1467</sup> IRC section 181(d)(2)(B).

<sup>1468</sup> IRC section 181(d)(2)(C).

<sup>1469</sup> IRC section 1245(a)(2)(C).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Effective Date

The provision applies to qualified film and television productions commencing after December 31, 2009.

California Law (R&TC sections 17201.5, 17250.5, and 24349)

This provision is not applicable under California law.

Under the PITL, California specifically does not conform to the federal election to deduct the cost of any qualifying film and television production in the year the expenditure is incurred in lieu of capitalizing the cost and recovering it through depreciation allowances,<sup>1470</sup> and the election has not been adopted under the CTL.

Under both the PITL and the CTL, California generally conforms to the federal income forecast method of depreciation.<sup>1471</sup> This method generally applies to determine depreciation allowances of property such as films, videotapes, television, book rights, patents, master sound recordings, video games, and like items.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
745	Expensing of Environmental Remediation Costs

Present law allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business.<sup>1472</sup> 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.<sup>1473</sup>

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<sup>1470</sup> R&TC section 17201.5.

<sup>1471</sup> For taxable years beginning on or after January 1, 2010, R&TC sections 17250.5 and 24349(f) conform to IRC section 167(g), relating to depreciation under the income forecast method, as of the “specified date” of January 1, 2009, with modifications.

<sup>1472</sup> IRC section 162.

<sup>1473</sup> Treas. Reg. section 1.162-4.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

IRC section 263(a)(1) limits the scope of IRC section 162 by prohibiting a current deduction for certain capital expenditures. Treasury regulations define "capital expenditures" as amounts paid or incurred to materially add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or to adapt property to a new or different use.<sup>1474</sup> Amounts paid for repairs and maintenance do not constitute capital expenditures. The determination of whether an expense is deductible or capitalizable is based on all relevant facts and circumstances.

Taxpayers may elect to treat certain environmental remediation expenditures paid or incurred before January 1, 2010, that would otherwise be chargeable to capital account as deductible in the year paid or incurred.<sup>1475</sup> The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site does not constitute a qualified-environmental-remediation expenditure. However, depreciation deductions allowable for such property that would otherwise be allocated to the site under the principles set forth in *Commissioner v. Idaho Power Co.*<sup>1476</sup> 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")<sup>1477</sup> 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 (demolition of structures) and 468 (special rules for mining and solid waste reclamation and closing costs) do not apply to amounts that are treated as expenses under IRC section 198.

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<sup>1474</sup> Treas. Reg. section 1.263(a)-1(b).

<sup>1475</sup> IRC section 198.

<sup>1476</sup> 418 U.S. 1 (1974).

<sup>1477</sup> Public Law 96-510 (1980).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

New Federal Law (IRC section 198)

The provision extends the present-law expensing for two years to include expenditures paid or incurred before January 1, 2012.

Effective Date

The provision is effective for expenditures paid or incurred after December 31, 2009.

California Law (R&TC sections 17279.4 and 24369.4)

This provision is not applicable under California law.

Under both the PITL and the CTL, for expenditures paid or incurred after December 31, 2003, California specifically does not conform to the federal election to treat certain environmental remediation expenditures that would otherwise be chargeable to a capital account as deductible in the year paid or incurred.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
746	Deduction Allowable with Respect to Income Attributable to Domestic Production Activities in Puerto Rico

In General

Present law provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to nine percent of the lesser of the taxpayer's qualified production activities income or taxable income for the taxable year. 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.

In general, qualified production activities income is equal to domestic production gross receipts reduced by the sum of: (1) the costs of goods sold that are allocable to those receipts; and (2) other expenses, losses, or deductions that are properly allocable to those 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<sup>1478</sup> that was manufactured, produced, grown or extracted by the taxpayer in

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<sup>1478</sup> Qualifying production property generally includes any tangible personal property, computer software, and sound recordings.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

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<sup>1479</sup> 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.

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.<sup>1480</sup> Wages paid to bona fide residents of Puerto Rico generally are not included in the definition of wages for purposes of computing the wage limitation amount.<sup>1481</sup>

#### 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.<sup>1482</sup> 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 Puerto Rico-sourced gross receipts are taxable under the federal income tax for individuals or corporations.<sup>1483</sup> In computing the 50-percent wage limitation, the taxpayer is permitted to take into account wages paid to bona fide residents of Puerto Rico for services performed in Puerto Rico.<sup>1484</sup>

The special rules for Puerto Rico apply only with respect to the first four taxable years of a taxpayer beginning after December 31, 2005 and before January 1, 2010.

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<sup>1479</sup> 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.

<sup>1480</sup> 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.

<sup>1481</sup> IRC section 3401(a)(8)(C) excludes wages paid to United States citizens who are bona fide residents of Puerto Rico from the term wages for purposes of income tax withholding.

<sup>1482</sup> IRC section 7701(a)(9).

<sup>1483</sup> IRC section 199(d)(8)(A).

<sup>1484</sup> IRC section 199(d)(8)(B).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

New Federal Law (IRC section 199)

The provision allows the special domestic production activities rules for Puerto Rico to apply for the first six taxable years of a taxpayer beginning after December 31, 2005 and before January 1, 2012.

Effective Date

The provision is effective for taxable years beginning after December 31, 2009.

California Law (R&TC section 17201.6)

This provision is not applicable under California law.

Under the PITL, California specifically does not conform to the deduction for income attributable to domestic production entities, and the deduction has not been adopted under the CTL.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
747	Modification of Tax Treatment of Certain Payments to Controlling Exempt Organizations

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.<sup>1485</sup> In general, interest, rents, royalties, and annuities are excluded from the unrelated business income of tax-exempt organizations.<sup>1486</sup>

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 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

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<sup>1485</sup> IRC section 511.

<sup>1486</sup> IRC section 512(b).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

IRC section 512(b)(13) applies only to the portion of payments received or accrued 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 (i.e., at arm's length).<sup>1487</sup> 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).

The special rule does not apply to payments received or accrued after December 31, 2009.

New Federal Law (IRC section 512)

The provision extends the special rule to payments received or accrued before January 1, 2012. Accordingly, under the provision, 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 (i.e., at arm's length). 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, 2009.

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,<sup>1488</sup> and generally conforms to the federal rules that apply to unrelated business taxable income as of the "specified date" of January 1, 2009.<sup>1489</sup> However, the federal special rule for certain amounts received or accrued from controlled entities does not apply under California law.

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<sup>1487</sup> IRC section 512(b)(13)(E).

<sup>1488</sup> R&TC sections 17561 and 23732.

<sup>1489</sup> For taxable years beginning on or after January 1, 2010, R&TC section 23732 conforms to IRC section 512, relating to unrelated business taxable income, as of the "specified date" of January 1, 2009, with modifications.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

California never conformed to the special rule for payments received or accrued on or before December 31, 2009, and because this provision (to extend the special rule through 2011) was enacted after the "specified date," California does not conform to it.

Impact on California Revenue

Estimated Revenue Impact of Modification of Tax Treatment of Certain Payments to Controlling Exempt Organizations For Payments Received On or After January 1, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
-\$800,000	-\$100,000	\$10,000

Estimates are based on a proration of federal estimates developed by the Joint Committee on Taxation.

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<u>Section</u>	<u>Section Title</u>
748	Treatment of Certain Dividends of Regulated Investment Companies

In General

A regulated investment company ("RIC") is an entity that meets certain requirements, including a requirement that its income generally be derived from passive investments such as dividends and interest, that it distribute 90 percent of its income, and that elects to be taxed under a special tax regime. Unlike an entity taxed as a corporation, an entity that is taxed as a RIC can deduct amounts paid to its shareholders as dividends. In this manner, tax on RIC income is generally not paid by the RIC but rather by its shareholders. However, income of a RIC is treated as a dividend by those shareholders, unless other special rules apply. Dividends received by foreign persons from a RIC are generally subject to gross-basis tax under IRC sections 871(a) or 881, and the RIC payor of such dividends is obligated to withhold such tax under IRC sections 1441 and 1442.

Under present law, a RIC that earns certain interest income that would not be subject to U.S. tax if earned by a foreign person directly may, to the extent of such net income, designate a dividend it pays as derived from such interest income. A foreign person who is a shareholder in the RIC generally can treat such a dividend as exempt from gross-basis U.S. tax, as if the foreign person had earned the interest directly. Also, subject to certain requirements, the RIC is exempt from withholding the gross basis tax on such dividends. Similar rules apply with respect to the designation of certain short term capital gain dividends. However, these provisions relating to certain dividends with respect to interest income and short term capital gain of the RIC do not apply to dividends with respect to any taxable year of a RIC beginning after December 31, 2009.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

New Federal Law (IRC section 871)

The provision extends the rules exempting from gross basis tax and from withholding tax the interest-related dividends and short term capital gain dividends received from a RIC, to dividends with respect to taxable years of a RIC beginning before January 1, 2012.

Effective Date

The provision applies to dividends paid with respect to any taxable year of the RIC beginning after December 31, 2009.

California Law (None)

California does not conform to the federal gross-basis tax.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
749	RIC Qualified Investment Entity Treated Under FIRPTA

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, although 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 active business requirements are met, a foreign person who sells a U.S. real property interest ("USRPI") is subject to tax at the same rates as a U.S. person, under the Foreign Investment in Real Property Tax Act ("FIRPTA") provisions codified in IRC section 897. Withholding tax is also imposed under IRC section 1445.

A USRPI includes stock or a beneficial interest in any domestic corporation unless such corporation has not been a U.S. real property holding corporation (as defined) during the testing period. A USRPI does not include an interest in a domestically controlled "qualified investment entity." A distribution from a "qualified investment entity" that is attributable to the sale of a USRPI is also 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 States and the recipient foreign corporation or nonresident alien individual did not hold more than five percent of that class of stock or beneficial interest within the one-year period ending on the date of distribution.<sup>1490</sup> Special rules apply to situations involving tiers of qualified investment entities.

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<sup>1490</sup> IRC sections 857(b)(3)(F), 852(b)(3)(E), and 871(k)(2)(E) require dividend treatment, rather than capital gain treatment, for certain distributions to which FIRPTA does not apply by reason of this exception. See also IRC section 881(e)(2).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

The term "qualified investment entity" includes a real estate investment trust ("REIT") and also includes a regulated investment company ("RIC") that meets certain requirements, although the inclusion of a RIC in that definition does not apply for certain purposes after December 31, 2009.<sup>1491</sup>

New Federal Law (IRC section 897)

The provision extends the inclusion of a RIC within the definition of a "qualified investment entity" under IRC section 897 through December 31, 2011, for those situations in which that inclusion would otherwise have expired at the end of 2009.

Effective Date

The provision is generally effective on January 1, 2010.

The provision does not apply with respect to the withholding requirement under IRC section 1445 for any payment made before December 17, 2010, but a RIC that withheld and remitted tax under IRC section 1445 on distributions made after December 31, 2009 and before December 17, 2010, is not liable to the distributee with respect to such withheld and remitted amounts.

California Law (None)

California does not conform to the federal rules for sourcing the income of foreign corporations.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
750	Exceptions for Active Financing Income

Background

Under the subpart F rules,<sup>1492</sup> 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

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<sup>1491</sup> IRC section 897(h).

<sup>1492</sup> IRC sections 951 - 954.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

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 real estate mortgage investment conduits ("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.

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.<sup>1493</sup>

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"). These provisions were enacted in the Taxpayer Relief Act of 1997 as one-year temporary exceptions, and in 1998, 1999, 2002, 2006, and 2008, the provisions were extended, and in some cases, modified.<sup>1494</sup>

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, that 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

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<sup>1493</sup> Prop. Treas. Reg. section 1.953-1(a).

<sup>1494</sup> 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. The Emergency Economic Stabilization Act of 2008 (Public Law 110-343) extended the temporary provisions for one year, for taxable years beginning after 2008 and before 2010.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

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 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 sections 953 and 954)

The provision extends for two years (for taxable years beginning before 2012) 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.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 2009, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

California Law (R&TC sections 25110 and 25116)

The CTL does not conform by reference to subpart F rules under IRC sections 951 through 971. However, relating to the water's-edge election, the CTL 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 federal earnings and profits, as defined by IRC section 964. Subpart F income, as defined in IRC section 952, includes:

- Insurance income;<sup>1495</sup>
- Foreign base company income;<sup>1496</sup>
- International boycott income;<sup>1497</sup>
- Income from illegal bribes and kickbacks;<sup>1498</sup> and,
- Foreign country income ineligible for the foreign tax credit.<sup>1499</sup>

When applying provisions of the IRC in connection with a water's-edge election that are otherwise not applicable, such as subpart F rules, the federal rules—as applicable for federal purposes—apply.<sup>1500</sup> Thus, under California water's-edge rules, the two-year extension of active-financing-income exception automatically applies.

Impact on California Revenue

Baseline—based on a proration of federal revenue estimates developed by the Joint Committee on Taxation, baseline revenue losses are estimated to be \$63,000,000 in 2011-12 and \$9,100,000 in 2012-13.

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<sup>1495</sup> IRC section 953.

<sup>1496</sup> IRC section 954.

<sup>1497</sup> IRC sections 952(a)(3) and 999.

<sup>1498</sup> IRC section 952(a)(4).

<sup>1499</sup> IRC sections 901(j) and 952(a)(5).

<sup>1500</sup> R&TC section 25116.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

<u>Section</u>	<u>Section Title</u>
751	Look-Thru Treatment of Payments Between Related Controlled Foreign Corporations Under Foreign Holding Company Rules

Background

In General

The rules of subpart F<sup>1501</sup> 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.

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 that 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-Thru Rule"

Under the "look-thru rule,"<sup>1502</sup> dividends, interest (including factoring income that 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 income 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-thru rule, including such regulations as are appropriate to prevent the abuse of the purposes of such rule.

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<sup>1501</sup> IRC sections 951 – 964.

<sup>1502</sup> IRC section 954(c)(6).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

The look-thru rule is effective for 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.

New Federal Law (IRC section 954)

The provision extends for two years the application of the look-thru rule, to taxable years of foreign corporations beginning before January 1, 2012, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 2009, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

California Law (R&TC sections 25110 and 25116)

The CTL does not conform by reference to subpart F rules under IRC sections 951 through 971. However, relating to the water's-edge election, the CTL 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 federal earnings and profits, as defined by IRC section 964. Subpart F income, as defined in IRC section 952, includes:

- Insurance income;<sup>1503</sup>
- Foreign base company income;<sup>1504</sup>
- International boycott income;<sup>1505</sup>
- Income from illegal bribes and kickbacks;<sup>1506</sup> and,
- Foreign country income ineligible for the foreign tax credit.<sup>1507</sup>

When applying provisions of the IRC in connection with a water's-edge election that are otherwise not applicable, such as subpart F rules, the federal rules—as applicable for federal purposes—apply.<sup>1508</sup> Thus, under California water's-edge rules, the two-year extension of active-financing-income exception automatically applies.

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<sup>1503</sup> IRC section 953.

<sup>1504</sup> IRC section 954.

<sup>1505</sup> IRC sections 952(a)(3) and 999.

<sup>1506</sup> IRC section 952(a)(4).

<sup>1507</sup> IRC sections 901(j) and 952(a)(5).

<sup>1508</sup> R&TC section 25116.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Impact on California Revenue

Baseline—based on a proration of federal revenue estimates developed by the Joint Committee on Taxation, a baseline revenue loss of \$10,000,000 is estimated for 2011-12, and a baseline revenue gain of \$1,500,000 is estimated for 2012-13.

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<u>Section</u>	<u>Section Title</u>
752	Basis Adjustment to Stock of S Corps Making Charitable Contribution 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.<sup>1509</sup> 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.<sup>1510</sup>

In the case of contributions made in taxable years beginning before January 1, 2010, 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, 2009, 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 provision 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, 2012.

Effective Date

The provision applies to contributions made in taxable years beginning after December 31, 2009.

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<sup>1509</sup> IRC section 1366(a)(1)(A).

<sup>1510</sup> IRC section 1367(a)(2)(B).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

California Law (R&TC sections 17087.5, 23800 and 23804)

The PITL and the CTL generally conform to the federal rules relating to the tax treatment of S corporations and their shareholders as of the "specified date" of January 1, 2009.<sup>1511</sup> As a result, the PITL and the CTL do not conform to the temporary federal pro-rata-share-of-adjusted-basis rule. Under California law, if an S corporation contributes money or other property to a charity, the amount of the shareholder's California basis reduction in the stock of the S corporation is the shareholder's pro-rata share of the fair market value of the contributed property.

Impact on California Revenue

Estimated Revenue Impact of Basis Adjustments to Stock of S Corps Making Charitable Contributions of Property For Contributions Made On or After January 1, 2011 and Before January 1, 2012 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
-\$1,300,000	-\$100,000	-\$70,000

Estimates are based on a proration of federal estimates developed by the Joint Committee on Taxation.

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<u>Section</u>	<u>Section Title</u>
753	Empowerment Zone Tax Incentives

Background

The Omnibus Budget Reconciliation Act of 1993 ("OBRA 93")<sup>1512</sup> authorized the designation of nine empowerment zones ("Round I empowerment zones") to provide tax incentives for businesses to locate within certain targeted areas<sup>1513</sup> designated by the Secretaries of the Department of Housing and Urban Development ("HUD") and the U.S Department of Agriculture

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<sup>1511</sup> For taxable years beginning on or after January 1, 2010, R&TC sections 17087.5 and 23800 conform to IRC section 1367, relating to the tax treatment of S corporations and their shareholders, as of the "specified date" of January 1, 2009, with modifications.

<sup>1512</sup> Public Law 103-66.

<sup>1513</sup> The targeted areas are those that have pervasive poverty, high unemployment, and general economic distress, and that satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

("USDA"). The Taxpayer Relief Act of 1997<sup>1514</sup> authorized the designation of two additional Round I urban empowerment zones, and 20 additional empowerment zones ("Round II empowerment zones"). The Community Renewal Tax Relief Act of 2000 ("2000 Community Renewal Act")<sup>1515</sup> authorized a total of ten new empowerment zones ("Round III empowerment zones"), bringing the total number of authorized empowerment zones to 40.<sup>1516</sup> In addition, the 2000 Community Renewal Act conformed the tax incentives that are available to businesses in the Round I, Round II, and Round III empowerment zones, and extended the empowerment zone incentives through December 31, 2009.<sup>1517</sup>

The tax incentives available within the designated empowerment zones include a federal income tax credit for employers who hire qualifying employees, accelerated depreciation deductions on qualifying equipment, tax-exempt bond financing, deferral of capital gains tax on sale of qualified assets sold and replaced, and partial exclusion of capital gains tax on certain sales of qualified small business stock.

The following is a description of the tax incentives.

#### Employment 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 is a resident of the empowerment zone and performs substantially all employment services within the empowerment zone in a trade or business of the employer.<sup>1518</sup>

The wage credit rate applies to qualifying wages paid before January 1, 2010. Wages paid to a qualified employee who earns more than \$15,000 are eligible for the wage credit (although only

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<sup>1514</sup> Public Law 105-34.

<sup>1515</sup> Public Law 106-554.

<sup>1516</sup> The urban part of the program is administered by the HUD and the rural part of the program is administered by the USDA. The eight Round I urban empowerment zones are Atlanta, GA; Baltimore, MD; Chicago, IL; Cleveland, OH; Detroit, MI; Los Angeles, CA; New York, NY; and Philadelphia, PA/Camden, NJ. Atlanta relinquished its empowerment zone designation in Round III. The three Round I rural empowerment zones are Kentucky Highlands, KY; Mid-Delta, MI; and Rio Grande Valley, TX. The 15 Round II urban empowerment zones are Boston, MA; Cincinnati, OH; Columbia, SC; Columbus, OH; Cumberland County, NJ; El Paso, TX; Gary/Hammond/East Chicago, IN; Ironton, OH/Huntington, WV; Knoxville, TN; Miami/Dade County, FL; Minneapolis, MN; New Haven, CT; Norfolk/Portsmouth, VA; Santa Ana, CA; and St. Louis, Missouri/East St. Louis, IL. The five Round II rural empowerment zones are Desert Communities, CA; Griggs-Steele, ND; Oglala Sioux Tribe, SD; Southernmost Illinois Delta, IL; and Southwest Georgia United, GA. The eight Round III urban empowerment zones are Fresno, CA; Jacksonville, FL; Oklahoma City, OK; Pulaski County, AR; San Antonio, TX; Syracuse, NY; Tucson, AZ; and Yonkers, NY. The two Round III rural empowerment zones are Aroostook County, ME; and Futuro, TX.

<sup>1517</sup> If an empowerment zone designation were terminated prior to December 31, 2009, the tax incentives would cease to be available as of the termination date.

<sup>1518</sup> IRC section 1396. The \$15,000 limit is annual, not cumulative such that the limit is the first \$15,000 of wages paid in a calendar year which ends with or within the taxable year.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

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 empowerment zone may claim the wage credit, regardless of whether the employer meets the definition of an "enterprise zone business."<sup>1519</sup>

An employer's deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year.<sup>1520</sup> 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.<sup>1521</sup> 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.<sup>1522</sup> The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.<sup>1523</sup>

#### Increased IRC section 179 Expensing Limitation

An enterprise zone business is allowed an additional \$35,000 of IRC section 179 expensing (for a total of up to \$285,000 in 2009)<sup>1524</sup> for qualified zone property placed in service before January 1, 2010.<sup>1525</sup> 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 \$500,000.<sup>1526</sup> The term "qualified zone property" is defined as depreciable tangible property (including buildings) provided that (i) the property is acquired by the taxpayer (from an unrelated party) after the designation took effect, (ii) the original use of the property in an empowerment zone commences with the taxpayer, and (iii) substantially all of the use of the property is in an empowerment zone in the active conduct of a trade or business by the

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<sup>1519</sup> IRC sections 1397C(b) and 1397C(c). However, the wage credit is not available for wages paid in connection with certain business activities described in IRC section 144(c)(6)(B), including a golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack, or liquor store, 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.

<sup>1520</sup> IRC section 280C(a).

<sup>1521</sup> IRC sections 1396(c)(3)(A) and 51A(d)(2).

<sup>1522</sup> IRC sections 1396(c)(3)(B) and 51A(d)(2).

<sup>1523</sup> IRC section 38(c)(2).

<sup>1524</sup> For each of 2010 and 2011, the IRC section 179 expensing limitation will be a total of up to \$535,000. The Small Business Jobs Act of 2010, Public Law 111-240.

<sup>1525</sup> IRC sections 1397A and 1397D.

<sup>1526</sup> IRC sections 1397A(a)(2), 179(b)(2), (7). For 2008 and 2009, the limit is \$800,000.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

taxpayer. Special rules are provided in the case of property that is substantially renovated by the taxpayer.

An enterprise zone business means any qualified business entity and any qualified proprietorship. A qualified business entity means, any corporation or partnership if for such year: (1) every trade or business of such entity is the active conduct of a qualified business within an empowerment zone; (2) at least 50 percent of the total gross income of such entity is derived from the active conduct of such business; (3) a substantial portion of the use of the tangible property of such entity (whether owned or leased) is within an empowerment zone; (4) a substantial portion of the intangible property of such entity is used in the active conduct of any such business; (5) a substantial portion of the services performed for such entity by its employees are performed in an empowerment zone; (6) at least 35 percent of its employees are residents of an empowerment zone; (7) less than five percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to collectibles other than collectibles that are held primarily for sale to customers in the ordinary course of such business; and (8) less than five percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property.<sup>1527</sup>

A qualified proprietorship is any qualified business carried on by an individual as a proprietorship if for such year: (1) at least 50 percent of the total gross income of such individual from such business is derived from the active conduct of such business in an empowerment zone; (2) a substantial portion of the use of the tangible property of such individual in such business (whether owned or leased) is within an empowerment zone; (3) a substantial portion of the intangible property of such business is used in the active conduct of such business; (4) a substantial portion of the services performed for such individual in such business by employees of such business are performed in an empowerment zone; (5) at least 35 percent of such employees are residents of an empowerment zone; (6) less than 5 percent of the average of the aggregate unadjusted bases of the property of such individual which is used in such business is attributable to collectibles other than collectibles that are held primarily for sale to customers in the ordinary course of such business; and (7) less than five percent of the average of the aggregate unadjusted bases of the property of such individual which is used in such business is attributable to nonqualified financial property.<sup>1528</sup>

A qualified business is defined as any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license or any business prohibited in connection with the employment credit.<sup>1529</sup> In addition, the leasing of real property that is located within the empowerment zone is treated as a qualified business only if the leased property is not residential property and at least 50 percent of the gross rental income from the real property is from enterprise zone businesses. The rental of tangible personal property is

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<sup>1527</sup> IRC section 1397C(b).

<sup>1528</sup> IRC section 1397C(c).

<sup>1529</sup> IRC section 1397C(d). Excluded businesses include any private or commercial golf course, country club, massage parlor, hot tub facility, sun tan facility, racetrack, or other facility used for gambling or any store the principal business of which is the sale of alcoholic beverages for off-premises consumption. IRC section 144(c)(6).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

not a qualified business unless at least 50 percent of the rental of such property is by enterprise zone businesses or by residents of an empowerment zone.

#### Expanded Tax-Exempt Financing for Certain Zone Facilities

States or local governments can issue enterprise zone facility bonds to raise funds to provide an enterprise zone business with qualified zone property.<sup>1530</sup> These bonds can be used in areas designated enterprise communities as well as areas designated empowerment zones. To qualify, 95 percent (or more) of the net proceeds from the bond issue must be used to finance qualified zone property whose principal user is an enterprise zone business, and certain land functionally related and subordinate to such property.

The term enterprise zone business is the same as that used for purposes of the increased IRC section 179 deduction limitation (discussed above) with certain modifications for start-up businesses. First, a business will be treated as an enterprise zone business during a start-up period if: (1) at the beginning of the period, it is reasonable to expect the business to be an enterprise zone business by the end of the start-up period; and (2) the business makes bona fide efforts to be an enterprise zone business. The start-up period is the period that ends with the start of the first tax year beginning more than two years after the later of: (1) the issue date of the bond issue financing the qualified zone property; and (2) the date this property is first placed in service (or, if earlier, the date that is three years after the issue date).<sup>1531</sup>

Second, a business that qualifies as at the end of the start-up period must continue to qualify during a testing period that ends three tax years after the start-up period ends. After the three-year testing period, a business will continue to be treated as an enterprise zone business as long as 35 percent of its employees are residents of an empowerment zone or enterprise community.

The face amount of the bonds may not exceed \$60 million for an empowerment zone in a rural area, \$130 million for an empowerment zone in an urban area with zone population of less than 100,000, and \$230 million for an empowerment zone in an urban area with zone population of at least 100,000.

#### Elective Rollover of Capital Gain from the Sale or Exchange of any Qualified Empowerment Zone Asset Purchased after December 21, 2000

Taxpayers can elect to defer recognition of gain on the sale of a qualified empowerment zone asset<sup>1532</sup> held for more than one year and replaced within 60 days by another qualified

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<sup>1530</sup> IRC section 1394.

<sup>1531</sup> IRC section 1394(b)(3).

<sup>1532</sup> The term "qualified empowerment zone asset" means any property that would be a qualified community asset (as defined in IRC section 1400F, relating to certain tax benefits for renewal communities) if in IRC section 1400F: (i) references to empowerment zones were substituted for references to renewal communities, (ii) references to enterprise zone businesses (as defined in IRC section 1397C) were substituted for references to renewal community businesses, and (iii) "December 17, 2010" were substituted for "December 31, 2001" each place it appears. IRC section 1397B(b)(1)(A).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

empowerment zone asset in the same zone.<sup>1533</sup> The deferral is accomplished by reducing the basis of the replacement asset by the amount of the gain recognized on the sale of the asset.

#### Partial Exclusion of Capital Gains on Certain Small Business Stock

Individuals generally may exclude 50 percent (60 percent for certain empowerment zone businesses) of the gain from the sale of certain small business stock acquired at original issue and held for at least five years.<sup>1534</sup> The amount of gain eligible for the exclusion by an individual with respect to any corporation is the greater of: (1) ten times the taxpayer's basis in the stock; or (2) \$10 million. To qualify as a small business, when the stock is issued, the gross assets of the corporation may not exceed \$50 million. The corporation also must meet certain active trade or business requirements.

The portion of the gain includible in taxable income is taxed at a maximum rate of 28 percent under the regular tax.<sup>1535</sup> A percentage of the excluded gain is an alternative minimum tax preference;<sup>1536</sup> the portion of the gain includible in alternative minimum taxable income is taxed at a maximum rate of 28 percent under the alternative minimum tax.

Gain from the sale of qualified small business stock generally is taxed at effective rates of: (i) 14 percent under the regular tax<sup>1537</sup> and 14.98 percent under the alternative minimum tax for dispositions before January 1, 2011; (ii) 19.88 percent under the alternative minimum tax for dispositions after December 31, 2010, in the case of stock acquired before January 1, 2001; and (iii) 17.92 percent under the alternative minimum tax for dispositions after December 31, 2010, in the case of stock acquired after December 31, 2000.<sup>1538</sup>

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A "qualified community asset" includes: (1) qualified community stock (meaning original-issue stock purchased for cash in an enterprise zone business), (2) a qualified community partnership interest (meaning a partnership interest acquired for cash in an enterprise zone business), and (3) qualified community business property (meaning tangible property originally used in a enterprise zone business by the taxpayer) that is purchased or substantially improved after December 17, 2010.

<sup>1533</sup> IRC section 1397B.

<sup>1534</sup> IRC section 1202.

<sup>1535</sup> IRC section 1(h).

<sup>1536</sup> IRC section 57(a)(7). In the case of qualified small business stock, the percentage of gain excluded from gross income that is an alternative minimum tax preference is (i) seven percent in the case of stock disposed of in a taxable year beginning before 2011; (ii) 42 percent in the case of stock acquired before January 1, 2001, and disposed of in a taxable year beginning after 2010; and (iii) 28 percent in the case of stock acquired after December 31, 2000, and disposed of in a taxable year beginning after 2010.

<sup>1537</sup> The 50 percent of gain included in taxable income is taxed at a maximum rate of 28 percent.

<sup>1538</sup> The amount of gain included in alternative minimum tax is taxed at a maximum rate of 28 percent. The amount so included is the sum of (i) 50 percent (the percentage included in taxable income) of the total gain and (ii) the applicable preference percentage of the one-half gain that is excluded from taxable income.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

### Temporary Increases in Exclusion

The percentage exclusion for qualified small business stock acquired after February 17, 2009, and on or before September 27, 2010, is increased to 75 percent.

The percentage exclusion for qualified small business stock acquired after September 27, 2010, and before January 1, 2011, is increased to 100 percent.<sup>1539</sup>

The temporary increases in the exclusion percentage apply for all qualified small business stock, including stock of empowerment zone businesses.<sup>1540</sup>

### Other Tax Incentives

Other incentives not specific to empowerment zones but beneficial to these areas include the work opportunity tax credit for employers based on the first year of employment of certain targeted groups, including empowerment zone residents (up to \$2,400 per employee), and qualified zone academy bonds for certain public schools located in an empowerment zone, or expected (as of the date of bond issuance) to have at least 35 percent of its students receiving free or reduced lunches.

### New Federal Law (IRC sections 1202 and 1391)

The provision extends for two years, through December 31, 2011, the period for which the designation of an empowerment zone is in effect, thus extending for two years the empowerment zone tax incentives, including the wage credit, accelerated depreciation deductions on qualifying equipment, tax-exempt bond financing, and deferral of capital gains tax on sale of qualified assets sold and replaced. In the case of a designation of an empowerment zone the nomination for which included a termination date which is December 31, 2009, termination shall not apply with respect to such designation if the entity which made such nomination amends the nomination to provide for a new termination date in such manner as the Secretary may provide.

The provision extends for two years, through December 31, 2016, the period for which the percentage exclusion for qualified small business stock (of a corporation which is a qualified business entity) acquired on or before February 17, 2009, is 60 percent. Gain attributable to periods after December 31, 2016, for qualified small business stock acquired on or before February 17, 2009, or after December 31, 2011, is subject to the general rule which provides for a percentage exclusion of 50 percent.

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<sup>1539</sup> Section 760 of the act extends the January 1, 2011, date to January 1, 2012.

<sup>1540</sup> IRC sections 1202(a)(3)(B) and 1202(a)(4)(B).

### Effective Date

The provision relating to the designation of an empowerment zone and the provision relating to the exclusion of gain from the sale or exchange of qualified small business stock held for more than five years applies to periods after December 31, 2009.

California Law (R&TC sections 17053.33, 17053.45, 17053.46, 17053.47, 17053.70, 17053.74, 17053.75, 18152, 18152.5, 23612.2, 23622.7, 23622.8, 23633, 23644, and 23646)

### Federal Empowerment Zones

California does not conform to the federal empowerment-zone tax incentives. Instead, California provides its own tax incentives for taxpayers conducting business activities within geographically targeted economic development areas, including Enterprise Zones,<sup>1541</sup> Manufacturing Enhancement Areas,<sup>1542</sup> Targeted Tax Areas,<sup>1543</sup> and Local Agency Military Base Recovery Areas.<sup>1544</sup> Thus, the two-year federal extension of empowerment zone designations is not applicable under California law.

### Small Business Stock

California specifically does not conform to the federal exclusion for gain on qualified small business stock,<sup>1545</sup> and instead provides its own exclusion.<sup>1546</sup> Under California law, noncorporate taxpayers may exclude from income 50 percent of gain from the sale or exchange of California qualified small business stock acquired at original issue and held for more than five years. The amount of gain eligible for the exclusion with respect to any corporation is the greater of (1) ten times the taxpayer's basis in the stock or (2) \$10 million.

California qualified small business stock generally means stock in a C corporation<sup>1547</sup> that: (1) has gross assets of \$50 million or less; (2) has at least 80 percent of its payroll attributable to

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<sup>1541</sup> R&TC sections 17053.70, 17053.74, 17053.75, 23612.2 and 233622.7.

<sup>1542</sup> R&TC sections 17053.47 and 23622.8.

<sup>1543</sup> R&TC sections 17053.33, 23633 and 23644.

<sup>1544</sup> R&TC sections 17053.45, 17053.46, 23644 and 23646.

<sup>1545</sup> R&TC section 18152.

<sup>1546</sup> R&TC section 18152.5. The California exclusion generally parallels the federal exclusion under IRC section 1202.

<sup>1547</sup> The stock must be that of a domestic C corporation that is not a DISC or former DISC, a regulated investment company, a real estate investment trust, a real estate mortgage investment conduit, or a cooperative.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

employment located in California; and (3) uses at least 80 percent of the value of its assets in the active conduct of one or more qualified trades or businesses in California.

Unlike federal law, California does not apply a different tax rate to gains on qualified small business stock. However, similar to federal law, the exclusion is a California AMT preference item—fifty percentage of the excluded gain is a California AMT preference item;<sup>1548</sup> and, the portion of the gain includible in alternative minimum taxable income is taxed at a maximum rate of seven percent under the California AMT.

Additionally, although California has its own stand-alone exclusion, any regulation issued by the Secretary of Treasury relating federal qualified small business stock applies for California purposes to the extent that California incorporates the federal qualified-small-business-stock rules.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
754	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," or "DC Zone," within which businesses and individual residents are eligible for special tax incentives. The census tracts that comprise the District of Columbia Enterprise 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 of Columbia); and (2) all additional census tracts within the District of Columbia where the poverty rate is not less than 20 percent. The District of Columbia Enterprise Zone designation remains in effect for the period from January 1, 1998, through December 31, 2009.

The following tax incentives are available for businesses located in an empowerment zone and the District of Columbia Enterprise Zone is treated as an empowerment zone for this purpose: (1) 20-percent wage credit; (2) an additional \$35,000 of IRC section 179 expensing for qualified zone property; and (3) expanded tax-exempt financing for certain zone facilities. In addition, a zero-percent capital gains rate applies to capital gains from the sale of certain qualified DC Zone assets held for more than five years.

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<sup>1548</sup> R&TC section 17062(e).

Present law also provides for a nonrefundable tax credit for first-time homebuyers of a principal residence in the District of Columbia.

#### Employment 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 is a resident of the District of Columbia and performs substantially all employment services within an empowerment zone in a trade or business of the employer.

The wage credit rate applies to qualifying wages paid after December 31, 2001, and before January 1, 2010. 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 empowerment zone may claim the wage credit, regardless of whether the employer meets the definition of an "enterprise zone business," as defined below.

An employer's deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year. 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. 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. The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.

#### Increased IRC section 179 Expensing Limitation

An enterprise zone business is allowed an additional \$35,000 of IRC section 179 expensing (for a total of up to \$285,000 in 2009)<sup>1549</sup> for qualified zone property placed in service after December 31, 2001, and before January 1, 2010. 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 \$500,000. The term "qualified zone property" is defined as depreciable tangible property (including buildings) provided that: (i) the property is acquired by the taxpayer (from an unrelated party) after the designation took effect; (ii) the original use of the property in an empowerment zone commences with the taxpayer; and (iii) substantially all of the use of the property is in an empowerment zone in the active conduct of a trade or business by the taxpayer. For this purpose, special rules are provided in the case of property that is substantially renovated by the taxpayer.

An enterprise zone business means any qualified business entity and any qualified proprietorship. A qualified business entity means, any corporation or partnership if for such year: (1) every trade

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<sup>1549</sup> For each of 2010 and 2011, the IRC section 179 expensing limitation will be a total of up to \$535,000. The Small Business Jobs Act of 2010, Public Law 111-240.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

or business of such entity is the active conduct of a qualified business within an empowerment zone; (2) at least 50 percent of the total gross income of such entity is derived from the active conduct of such business; (3) a substantial portion of the use of the tangible property of such entity (whether owned or leased) is within an empowerment zone; (4) a substantial portion of the intangible property of such entity is used in the active conduct of any such business; (5) a substantial portion of the services performed for such entity by its employees are performed in an empowerment zone; (6) at least 35 percent of its employees are residents of an empowerment zone; (7) less than five percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to collectibles other than collectibles that are held primarily for sale to customers in the ordinary course of such business; and (8) less than five percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property.

A qualified proprietorship is any qualified business carried on by an individual as a proprietorship if for such year: (1) at least 50 percent of the total gross income of such individual from such business is derived from the active conduct of such business in an empowerment zone; (2) a substantial portion of the use of the tangible property of such individual in such business (whether owned or leased) is within an empowerment zone; (3) a substantial portion of the intangible property of such business is used in the active conduct of such business; (4) a substantial portion of the services performed for such individual in such business by employees of such business are performed in an empowerment zone; (5) at least 35 percent of such employees are residents of an empowerment zone; (6) less than five percent of the average of the aggregate unadjusted bases of the property of such individual which is used in such business is attributable to collectibles other than collectibles that are held primarily for sale to customers in the ordinary course of such business; and (7) less than five percent of the average of the aggregate unadjusted bases of the property of such individual which is used in such business is attributable to nonqualified financial property.

A qualified business is defined as any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license or any business prohibited in connection with the employment credit. In addition, the leasing of real property that is located within the empowerment zone is treated as a qualified business only if: (1) the leased property is not residential property; and (2) at least 50 percent of the gross rental income from the real property is from enterprise zone businesses. The rental of tangible personal property is not a qualified business unless at least 50 percent of the rental of such property is by enterprise zone businesses or by residents of an empowerment zone.

#### Expanded Tax-Exempt Financing for Certain Zone Facilities

An enterprise zone business is permitted to borrow proceeds from the issuance of tax-exempt enterprise zone facility bonds (as defined in IRC section 1394, without regard to the employee residency requirement) issued by the District of Columbia. To qualify, 95 percent (or more) of the net proceeds must be used to finance: (1) qualified zone property whose principal user is an enterprise zone business, and (2) certain land functionally related and subordinate to such property. Accordingly, most of the proceeds have to be used to finance certain facilities within the DC Zone. The aggregate face amount of all outstanding qualified enterprise zone facility bonds

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

per enterprise zone business may not exceed \$15 million and may be issued only while the DC Zone designation is in effect, from January 1, 1998 through December 31, 2009.

The term enterprise zone business is the same as that used for purposes of the increased IRC section 179 deduction limitation with certain modifications for start-up businesses. First, a business will be treated as an enterprise zone business during a start-up period if: (1) at the beginning of the period, it is reasonable to expect the business to be an enterprise zone business by the end of the start-up period; and (2) the business makes bona fide efforts to be an enterprise zone business. The start-up period is the period that ends with the start of the first tax year beginning more than two years after the later of: (1) the issue date of the bond issue financing the qualified zone property; and (2) the date this property is first placed in service (or, if earlier, the date that is three years after the issue date).

Second, a business that qualifies as at the end of the start-up period must continue to qualify during a testing period that ends three tax years after the start-up period ends. After the three-year testing period, a business will continue to be treated as an enterprise zone business as long as 35 percent of its employees are residents of an empowerment zone or enterprise community.

#### Zero-Percent Capital Gains

A zero-percent capital gains rate applies to capital gains from the sale of certain qualified DC Zone assets held for more than five years. In general, a "qualified DC Zone asset" means stock or partnership interests held in, or tangible property held by, a DC Zone business. For purposes of the zero-percent capital gains rate, the DC Zone is defined to include all census tracts within the District of Columbia where the poverty rate is not less than ten percent.

In general, gain eligible for the zero-percent tax rate is that from the sale or exchange of a qualified DC Zone asset that is a capital asset or property used in a trade or business, as defined in IRC section 1231(b). 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 DC Zone business. However, no gain attributable to periods before January 1, 1998, and after December 31, 2014, is qualified capital gain.

#### District of Columbia Homebuyer Tax Credit

First-time homebuyers of a principal residence in the District of Columbia qualify for a tax credit of up to \$5,000. The \$5,000 maximum credit amount applies both to individuals and married couples. The credit phases out for individual taxpayers with adjusted gross income between \$70,000 and \$90,000 (\$110,000 and \$130,000 for joint filers). The credit is available with respect to purchases of existing property as well as new construction.

A "first-time homebuyer" means any individual if such individual (and, if married, such individual's spouse) did not have a present ownership interest in a principal residence in the District of Columbia during the one-year period ending on the date of the purchase of the principal residence to which the credit applies. A taxpayer will be treated as a first-time homebuyer with respect to only one residence—i.e., a taxpayer may claim the credit only once. A taxpayer's basis in a

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

property is reduced by the amount of any homebuyer tax credit claimed with respect to such property.

The first-time homebuyer credit is a nonrefundable personal credit and may offset the regular tax and the alternative minimum tax. Any credit in excess of tax liability may be carried forward indefinitely. The homebuyer credit is generally available for property purchased after August 4, 1997, and before January 1, 2010. However, the credit does not apply to the purchase of a residence after December 31, 2008 to which the national first-time homebuyer credit under IRC section 36 applies.

New Federal Law (IRC sections 1400, 1400A, 1400B and 1400C)

The provision extends for two years, through December 31, 2011, the designation of the District of Columbia Enterprise Zone. The provision also extends for two years through December 31, 2011, the special \$15 million per-user bond limitation and the relief from resident and employee requirements for certain tax-exempt bonds issued in the District of Columbia Enterprise Zone.

The provision extends for two years the zero-percent capital gains rate applicable to capital gains from the sale or exchange of any DC Zone asset held for more than five years (and, as amended, acquired or substantially improved before January 1, 2012). The provision also extends for two years the period to which the term "qualified capital gain" refers. As amended, the term "qualified capital gain" shall not include any gain attributable to periods before January 1, 1998, or after December 31, 2016.

The provision extends the first-time D.C. homebuyer credit for two years (as amended, to apply to property purchased before January 1, 2012).

Effective Date

The provision extending the period of designation of the District of Columbia Enterprise Zone and the provision extending the period for which the term "qualified capital gain" refers applies to periods after December 31, 2009. The provision extending tax-exempt financing for certain zone facilities applies to bonds issued after December 31, 2009. The provision amending the definitions of DC Zone business stock, DC Zone partnership interest, and DC Zone business property applies to property acquired or substantially improved after December 31, 2009. The provision extending the first-time homebuyer credit applies to homes purchased after December 31, 2009.

California Law (None)

California does not conform to special incentives for the D.C. Zone.

Impact on California Revenue

Not applicable.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

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<u>Section</u>	<u>Section Title</u>
755	Temporary Increase in Limit on Cover over Rum Excise Taxes to Puerto Rico and the Virgin Islands

Background

A \$13.50 per proof gallon<sup>1550</sup> excise tax is imposed on distilled spirits produced in or imported into the United States.<sup>1551</sup> 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).<sup>1552</sup>

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.<sup>1553</sup> The amount of the cover over is limited under IRC section 7652(f) to \$10.50 per proof gallon (\$13.25 per proof gallon before January 1, 2010).

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 Virgin Islands are divided and covered over to the two possessions under a formula.<sup>1554</sup> 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.<sup>1555</sup> 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 limitation of \$13.25 per proof gallon is extended for rum brought into the United States

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<sup>1550</sup> A proof gallon is a liquid gallon consisting of 50 percent alcohol. See IRC section 5002(a)(10) and (11).

<sup>1551</sup> IRC section 5001(a)(1).

<sup>1552</sup> IRC sections 5214(a)(1)(A), 5002(a)(15), 7653(b) and (c).

<sup>1553</sup> 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).

<sup>1554</sup> IRC section 7652(e)(2).

<sup>1555</sup> IRC sections 7652(a)(3), (b)(3), and (e)(1).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

after December 31, 2009 and before January 1, 2012. After December 31, 2011, the cover over amount reverts to \$10.50 per proof gallon.

Effective Date

The provision is effective for distilled spirits brought into the United States after December 31, 2009.

California Law

The FTB does not administer excise taxes. Defer to the Board of Equalization (BOE).

Impact on California Revenue

Defer to the BOE.

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<u>Section</u>	<u>Section Title</u>
756	American Samoa Economic Development Credit

Background

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 corporation's economic activity-based limitation with respect to American Samoa. The credit is not part of the IRC but is computed based on the rules of IRC sections 30A and 936. The credit is allowed for the first four taxable years of a corporation that begin after December 31, 2005, and before January 1, 2010.

A corporation was an existing credit claimant with respect to a American Samoa if: (1) the corporation was engaged in the active conduct of a trade or business within American Samoa on October 13, 1995; and (2) the corporation elected the benefits of the possession tax credit<sup>1556</sup> in

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<sup>1556</sup> 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. IRC sections 27(b), 936. This credit offset the U.S. tax imposed on certain income related to operations in the U.S. possessions. Subject to certain limitations, discussed 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. 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.

Under the economic activity-based limit, the amount of the credit could not 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

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

an election in effect for its taxable year that included October 13, 1995.<sup>1557</sup> 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 claimant as of the close of the taxable year ending before the date on which that new line of business was added.

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 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 IRC section 936 does not apply with respect to the credit allowed by the provision.

The credit applies to the first four taxable years of a taxpayer which begin after December 31, 2005, and before January 1, 2010.

New Federal Law (Uncodified act section 756 affecting section 119 of division A of the Tax Relief and Health Care Act of 2006)

The provision allows the credit to apply to the first six taxable years of a taxpayer beginning after December 31, 2005, and before January 1, 2012.

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allowances with respect to long-life qualified tangible property, and (3) in certain cases, a portion of the taxpayer's possession income taxes. A taxpayer could elect, instead of the economic activity-based limit, a limit equal to the applicable percentage of the credit that otherwise would have been allowable with respect to possession business income, beginning in 1998, the applicable percentage was 40 percent.

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. IRC section 936(a)(2). The IRC section 936 credit generally expired for taxable years beginning after December 31, 2005.

<sup>1557</sup> 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.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Effective Date

The provision is effective for taxable years beginning after December 31, 2009.

California Law (None)

California does not conform to the American Samoa economic development credit.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
757	Work Opportunity Credit

Background

In General

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of nine targeted groups. The amount of the credit available to an employer is determined by the amount of qualified wages paid by the employer. Generally, qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer (two years in the case of an individual in the long-term family assistance recipient category).

Targeted Groups Eligible for the Credit

Generally, an employer is eligible for the credit only for qualified wages paid to members of a targeted group.

*(1) Families receiving TANF*

An eligible recipient is an individual certified by a designated local employment agency (e.g., a state employment agency) as being a member of a family eligible to receive benefits under the Temporary Assistance for Needy Families Program ("TANF") for a period of at least nine months part of which is during the 18-month period ending on the hiring date. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for the TANF.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

*(2) Qualified veteran*

There are two subcategories of qualified veterans related to eligibility for food stamps and compensation for a service-connected disability.

Food stamps

A qualified veteran is a veteran who is certified by the designated local agency as a member of a family receiving assistance under a food stamp program under the Food Stamp Act of 1977 for a period of at least three months part of which is during the 12-month period ending on the hiring date. For these purposes, members of a family are defined to include only those individuals taken into account for purposes of determining eligibility for a food stamp program under the Food Stamp Act of 1977.

Entitled to compensation for a service-connected disability

A qualified veteran also includes an individual who is certified as entitled to compensation for a service-connected disability and: (1) having a hiring date that is not more than one year after having been discharged or released from active duty in the Armed Forces of the United States; or (2) having been unemployed for six months or more (whether or not consecutive) during the one-year period ending on the date of hiring.

Definitions

For these purposes, being entitled to compensation for a service-connected disability is defined with reference to section 101 of Title 38, U.S. Code, which means having a disability rating of 10 percent or higher for service-connected injuries.

For these purposes, a veteran is an individual who has served on active duty (other than for training) in the Armed Forces for more than 180 days or who has been discharged or released from active duty in the Armed Forces for a service-connected disability. However, any individual who has served for a period of more than 90 days during which the individual was on active duty (other than for training) is not a qualified veteran if any of this active duty occurred during the 60-day period ending on the date the individual was hired by the employer. This latter rule is intended to prevent employers who hire current members of the armed services (or those departed from service within the last 60 days) from receiving the credit.

*(3) Qualified ex-felon*

A qualified ex-felon is an individual certified as: (1) having been convicted of a felony under any state or federal law; and (2) having a hiring date within one year of release from prison or the date of conviction.

*(4) Designated community residents*

A designated community resident is an individual certified as being at least age 18 but not yet age 40 on the hiring date and as having a principal place of abode within an empowerment zone, enterprise community, renewal community or a rural renewal community. For these purposes, a rural renewal county is a county outside a metropolitan statistical area (as defined by the Office of Management and Budget) that had a net population loss during the five-year periods 1990-1994 and 1995-1999. Qualified wages do not include wages paid or incurred for services performed after the individual moves outside an empowerment zone, enterprise community, renewal community or a rural renewal community.

*(5) Vocational rehabilitation referral*

A vocational rehabilitation referral is an individual who is certified by a designated local agency as an individual who has a physical or mental disability that constitutes a substantial handicap to employment and who has been referred to the employer while receiving, or after completing: (a) vocational rehabilitation services under an individualized, written plan for employment under a state plan approved under the Rehabilitation Act of 1973; (b) under a rehabilitation plan for veterans carried out under Chapter 31 of Title 38, U.S. Code; or (c) an individual work plan developed and implemented by an employment network pursuant to subsection (g) of section 1148 of the Social Security Act. Certification will be provided by the designated local employment agency upon assurances from the vocational rehabilitation agency that the employee has met the above conditions.

*(6) Qualified summer youth employee*

A qualified summer youth employee is an individual: (1) who performs services during any 90-day period between May 1 and September 15; (2) who is certified by the designated local agency as being 16 or 17 years of age on the hiring date; (3) who has not been an employee of that employer before; and (4) who is certified by the designated local agency as having a principal place of abode within an empowerment zone, enterprise community, or a renewal community. As with designated community residents, no credit is available on wages paid or incurred for service performed after the qualified summer youth moves outside of an empowerment zone, enterprise community, or a renewal community. If, after the end of the 90-day period, the employer continues to employ a youth who was certified during the 90-day period as a member of another targeted group, the limit on qualified first-year wages will take into account wages paid to the youth while a qualified summer youth employee.

*(7) Qualified food stamp recipient*

A qualified food stamp recipient is an individual at least age 18 but not yet age 40 certified by a designated local employment agency as being a member of a family receiving assistance under a food stamp program under the Food Stamp Act of 1977 for a period of at least six months ending on the hiring date. In the case of families that cease to be eligible for food stamps under section 6(o) of the Food Stamp Act of 1977, the six-month requirement is replaced with a requirement that the family has been receiving food stamps for at least three of the five months ending on the date of hire. For these purposes, members of the family are defined to include only those

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

individuals taken into account for purposes of determining eligibility for a food stamp program under the Food Stamp Act of 1977.

*(8) Qualified SSI recipient*

A qualified SSI recipient is an individual designated by a local agency as receiving supplemental security income ("SSI") benefits under Title XVI of the Social Security Act for any month ending within the 60-day period ending on the hiring date.

*(9) Long-term family assistance recipients*

A qualified long-term family assistance recipient is an individual certified by a designated local agency as being: (1) a member of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) a member of a family that has received such family assistance for a total of at least 18 months (whether or not consecutive) after August 5, 1997 (the date of enactment of the welfare-to-work tax credit)<sup>1558</sup> if the individual is hired within two years after the date that the 18-month total is reached; or (3) a member of a family who is no longer eligible for family assistance because of either federal or state time limits, if the individual is hired within two years after the federal or state time limits made the family ineligible for family assistance.

*(10) Unemployed veterans and disconnected youth hired in 2009 and 2010*

Unemployed veterans and disconnected youth who begin work for the employer in 2009 or 2010 are treated as a targeted category under section 1221(a) of the American Recovery and Reinvestment Act of 2009.<sup>1559</sup>

An unemployed veteran is defined as an individual certified by the designated local agency as someone who: (1) has served on active duty (other than for training) in the Armed Forces for more than 180 days or who has been discharged or released from active duty in the Armed Forces for a service-connected disability; (2) has been discharged or released from active duty in the Armed Forces during the five-year period ending on the hiring date; and (3) has received unemployment compensation under state or federal law for not less than four weeks during the one-year period ending on the hiring date.

A disconnected youth is defined as an individual certified by the designated local agency as someone: (1) at least age 16 but not yet age 25 on the hiring date; (2) not regularly attending any secondary, technical, or post-secondary school during the six-month period preceding the hiring date; (3) not regularly employed during the six-month period preceding the hiring date; and (4) not readily employable by reason of lacking a sufficient number of skills.

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<sup>1558</sup> The welfare-to-work tax credit was consolidated into the work opportunity tax credit in the Tax Relief and Health Care Act of 2006, for qualified individuals who begin to work for an employer after December 31, 2006.

<sup>1559</sup> Public Law 111-5.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

### Qualified Wages

Generally, qualified wages are defined as cash wages paid by the employer to a member of a targeted group. The employer's deduction for wages is reduced by the amount of the credit.

For purposes of the credit, generally, wages are defined by reference to the FUTA definition of wages contained in IRC section 3306(b) (without regard to the dollar limitation therein contained). Special rules apply in the case of certain agricultural labor and certain railroad labor.

### Calculation of the Credit

The credit available to an employer for qualified wages paid to members of all targeted groups except for long-term family assistance recipients equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, qualified first-year wages are qualified wages (not in excess of \$6,000) attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is \$2,400 (40 percent of the first \$6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is \$1,200 (40 percent of the first \$3,000 of qualified first-year wages). Except for long-term family assistance recipients, no credit is allowed for second-year wages.

In the case of long-term family assistance recipients, the credit equals 40 percent (25 percent for employment of 400 hours or less) of \$10,000 for qualified first-year wages and 50 percent of the first \$10,000 of qualified second-year wages. Generally, qualified second-year wages are qualified wages (not in excess of \$10,000) attributable to service rendered by a member of the long-term family assistance category during the one-year period beginning on the day after the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is \$9,000 (40 percent of the first \$10,000 of qualified first-year wages plus 50 percent of the first \$10,000 of qualified second-year wages).

In the case of a qualified veteran who is entitled to compensation for a service-connected disability, the credit equals 40 percent of \$12,000 of qualified first-year wages. This expanded definition of qualified first-year wages does not apply to the veterans qualified with reference to a food stamp program, as defined under present law.

### Certification Rules

An individual is not treated as a member of a targeted group unless: (1) on or before the day on which an individual begins work for an employer, the employer has received a certification from a designated local agency that such individual is a member of a targeted group; or (2) on or before the day an individual is offered employment with the employer, a pre-screening notice is completed by the employer with respect to such individual, and not later than the 28th day after the individual begins work for the employer, the employer submits such notice, signed by the employer and the individual under penalties of perjury, to the designated local agency as part of a written request for certification. For these purposes, a pre-screening notice is a document (in such form as the Secretary may prescribe) that contains information provided by the individual on the basis of which the employer believes that the individual is a member of a targeted group.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

### Minimum Employment Period

No credit is allowed for qualified wages paid to employees who work less than 120 hours in the first year of employment.

### Other Rules

The work opportunity tax credit is not allowed for wages paid to a relative or dependent of the taxpayer. No credit is allowed for wages paid to an individual who is a more than fifty-percent owner of the entity. Similarly, wages paid to replacement workers during a strike or lockout are not eligible for the work opportunity tax credit. Wages paid to any employee during any period for which the employer received on-the-job training program payments with respect to that employee are not eligible for the work opportunity tax credit. The work opportunity tax credit generally is not allowed for wages paid to individuals who had previously been employed by the employer. In addition, many other technical rules apply.

### Expiration

The work opportunity tax credit is not available for individuals who begin work for an employer after August 31, 2011.

### New Federal Law (IRC section 51)

The provision extends the work opportunity tax credit for four months (for individuals who begin work for an employer after August 31, 2011 before January 1, 2012).<sup>1560</sup>

### Effective Date

The provisions are effective for individuals who begin work for an employer after August 31, 2011.

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<sup>1560</sup> The rule to allow unemployed veterans and disconnected youth who begin work for the employer in 2009 or 2010 to be treated as members of a targeted group is not extended.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

California Law (R&TC sections 17053.46, 17053.47, 17053.74, 23622.7, 23622.8, and 23646)

California does not conform to the federal work opportunity credit; however, the following California hiring credits<sup>1561</sup> are reduced by the amount of the federal work opportunity credit: (1) the enterprise zone credit;<sup>1562</sup> (2) the manufacturing enhancement area credit;<sup>1563</sup> and (3) the Local Agency Base Recovery Area credit.<sup>1564</sup> Because California conforms to IRC section 51 as of the “specified date” of January 1, 2009, there is no IRC section 51 reduction to the CA hiring credits with respect to federal work opportunity credits allowed for individuals hired after August 31, 2011.

Impact on California Revenue

Estimated Revenue Impact of Work Opportunity Credit For Taxable Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
\$380,000	\$270,000	\$70,000

Estimates are based on a proration of federal estimates developed by the Joint Committee on Taxation.

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<sup>1561</sup> California law provides hiring credits for taxpayers conducting business activities within geographically targeted economic development areas (EDAs). EDAs include Enterprise Zones (EZs), Manufacturing Enhancement Areas (MEAs), Targeted Tax Areas (TTAs), and Local Agency Military Base Recovery Areas (LAMBRAs).

An employer located in an EDA is eligible for a hiring credit equal to a percentage of wages paid to individuals from targeted groups (i.e. qualified employees). To some extent, the definition of qualified employees for the EDA hiring credits is similar to the definition of qualified employees for purposes of the federal work opportunity tax credit.

<sup>1562</sup> R&TC sections 17053.74(b)(4)(A)(iv)(XI) and 23622.7(b)(4)(A)(iv)(XI).

<sup>1563</sup> R&TC sections 17053.47(f) and 23622.8(e).

<sup>1564</sup> R&TC sections 17053.46(g) and 23646(g).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

<u>Section</u>	<u>Section Title</u>
758	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. These can include tax-exempt bonds that finance public schools.<sup>1565</sup> An issuer must file with the IRS certain information about the bonds issued in order for that bond issue to be tax-exempt.<sup>1566</sup> 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.<sup>1567</sup> 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.<sup>1568</sup> 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."<sup>1569</sup> A total of \$400 million of qualified zone academy bonds is authorized to be issued annually in calendar years 1998 through 2008. That is increased to \$1,400 million in 2009 and 2010. Each calendar year's bond limitation is allocated 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.

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<sup>1565</sup> IRC section 103.

<sup>1566</sup> IRC section 149(e).

<sup>1567</sup> IRC section 103(a) and (b)(2).

<sup>1568</sup> IRC section 148.

<sup>1569</sup> IRC sections 54E and 1397E.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

A taxpayer holding a qualified zone academy bond on the credit allowance date is entitled to a credit. The credit is includible in gross income (as if it were a taxable interest payment on 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.<sup>1570</sup> The Secretary determines credit rates for tax credit bonds based on general assumptions about credit quality of the class of potential eligible issuers and such other factors as the Secretary deems appropriate. The Secretary may determine credit rates based on general credit market yield indexes and credit ratings. The maximum term of the bond is determined by the Treasury Department, so that the present value of the obligation to repay the principal on the bond is 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 IRC, 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 arbitrage requirements that generally apply to interest-bearing tax-exempt bonds also generally apply to qualified zone academy bonds. In addition, an issuer of qualified zone academy bonds must reasonably expect to and actually spend 100 percent or more of the proceeds of such bonds on qualified zone academy property within the three-year period that begins on the date of issuance. To the extent less than 100 percent of the proceeds are used to finance qualified zone academy property during the three-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 three-year period to redeem any nonqualified bonds. The three-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.

Two special arbitrage rules apply to qualified zone academy bonds. First, available project proceeds invested during the three-year period beginning on the date of issue are not subject to

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<sup>1570</sup> Given the differences in credit quality and other characteristics of individual issuers, the Secretary cannot set credit rates in a manner that will allow each issuer to issue tax credit bonds at par.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

the arbitrage restrictions (i.e., yield restriction and rebate requirements). Available project proceeds are 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 three-year spending period may be invested at unrestricted yields, but the earnings on such investments must be spent on qualified zone academy property. Second, 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.

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.

For bonds originally issued after March 18, 2010, an issuer of qualified zone academy bonds may make an irrevocable election on or before the issue date of such bonds to receive a payment under IRC section 6431 in lieu of providing a tax credit to the holder of the bonds. The payment to the issuer on each payment date is equal to the lesser of (1) the amount of interest payable on such bond by such issuer with respect to such date or (2) the amount of the interest that would have been payable under such bond on such date if such interest were determined at the applicable tax credit bond rate.

New Federal Law (IRC section 54E)

In General

The provision extends the qualified zone academy bond program for one year. The provision authorizes issuance of up to \$400 million of qualified zone academy bonds for 2011.

The issuer election to receive a payment in lieu of providing a tax credit to the holder of the qualified zone academy bond is not available for bonds issued with the 2011 national limitation. The provision has no effect on bonds issued with limitation carried forward from 2009 or 2010.

Effective Date

The provision applies to obligations issued after December 31, 2010.

California Law (R&TC sections 17143 and 24272)

In General

California does not conform to federal tax-credit bonds, and income from such bonds is not includible in California gross income.

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.

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 (subdivision (b) of section 26 of Article XIII). The R&TC further provides 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

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

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 federal 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 as the measure of the tax for the privilege of exercising the corporate franchise.

#### Impact on California Revenue

Not applicable.

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TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

<u>Section</u>	<u>Section Title</u>
759	Mortgage Insurance Premiums

Background

In General

Present law provides that qualified residence interest is deductible notwithstanding the general rule that personal interest is nondeductible.<sup>1571</sup>

Acquisition Indebtedness and Home Equity Indebtedness

Qualified residence interest is interest on acquisition indebtedness and home equity indebtedness with respect to a principal and a second residence of the taxpayer. The maximum amount of home equity indebtedness is \$100,000. The maximum amount of acquisition indebtedness is \$1 million. Acquisition indebtedness means debt that is incurred in acquiring, constructing, or substantially improving a qualified residence of the taxpayer, and that is secured by the residence. Home equity indebtedness is debt (other than acquisition indebtedness) that is secured by the taxpayer's principal or second residence, to the extent the aggregate amount of such debt does not exceed the difference between the total acquisition indebtedness with respect to the residence, and the fair market value of the residence.

Private Mortgage Insurance

Certain premiums paid or accrued for qualified mortgage insurance by a taxpayer during the taxable year in connection with acquisition indebtedness on a qualified residence of the taxpayer are treated as interest that is qualified residence interest and thus deductible. The amount allowable as a deduction is phased out ratably by 10 percent for each \$1,000 by which the taxpayer's adjusted gross income exceeds \$100,000 (\$500 and \$50,000, respectively, in the case of a married individual filing a separate return). Thus, the deduction is not allowed if the taxpayer's adjusted gross income exceeds \$110,000 (\$55,000 in the case of married individual filing a separate return).

For this purpose, qualified mortgage insurance means mortgage insurance provided by the Veterans Administration, the Federal Housing Administration,<sup>1572</sup> or the Rural Housing Administration, and private mortgage insurance (defined in section 2 of the Homeowners Protection Act of 1998 as in effect on the date of enactment of the provision).

Amounts paid for qualified mortgage insurance that are properly allocable to periods after the close of the taxable year are treated as paid in the period to which they are allocated. No deduction is allowed for the unamortized balance if the mortgage is paid before its term (except in

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<sup>1571</sup> IRC section 163(h).

<sup>1572</sup> The Veterans Administration and the Rural Housing Administration have been succeeded by the Department of Veterans Affairs and the Rural Housing Service, respectively.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

the case of qualified mortgage insurance provided by the Department of Veterans Affairs or Rural Housing Service).

The provision does not apply with respect to any mortgage insurance contract issued before January 1, 2007. The provision terminates for any amount paid or accrued after December 31, 2010, or properly allocable to any period after that date.

Reporting rules apply under the provision.

New Federal Law (IRC section 163)

The provision extends the deduction for private mortgage insurance premiums for one year (only with respect to contracts entered into after December 31, 2006). Thus, the provision applies to amounts paid or accrued in 2011 (and not properly allocable to any period after 2011).

Effective Date

The provision is effective for amounts paid or accrued after December 31, 2010.

California Law (R&TC section 17225)

California specifically does not conform to the federal deduction for private mortgage insurance premiums.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
760	Temporary Exclusion of 100 Percent of Gain on Certain Small Business Stock

Background

In General

Individuals generally may exclude 50 percent (60 percent for certain empowerment zone businesses) of the gain from the sale of certain small business stock acquired at original issue and held for at least five years.<sup>1573</sup> The amount of gain eligible for the exclusion by an individual with respect to any corporation is the greater of: (1) ten times the taxpayer's basis in the stock; or (2) \$10 million. To qualify as a small business, when the stock is issued, the gross assets of the

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<sup>1573</sup> IRC section 1202.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

corporation may not exceed \$50 million. The corporation also must meet certain active trade or business requirements.

The portion of the gain includible in taxable income is taxed at a maximum rate of 28 percent under the regular tax.<sup>1574</sup> A percentage of the excluded gain is an alternative minimum tax preference;<sup>1575</sup> the portion of the gain includible in alternative minimum taxable income is taxed at a maximum rate of 28 percent under the alternative minimum tax.

Gain from the sale of qualified small business stock generally is taxed at effective rates of: (i) 14 percent under the regular tax<sup>1576</sup> and 14.98 percent under the alternative minimum tax for dispositions before January 1, 2011; (ii) 19.88 percent under the alternative minimum tax for dispositions after December 31, 2010, in the case of stock acquired before January 1, 2001; and (iii) 17.92 percent under the alternative minimum tax for dispositions after December 31, 2010, in the case of stock acquired after December 31, 2000.<sup>1577</sup>

#### Temporary Increases in Exclusion

The percentage exclusion for qualified small business stock acquired after February 17, 2009, and on or before September 27, 2010, is increased to 75 percent. As a result of the increased exclusion, gain from the sale of this qualified small business stock held at least five years is taxed at effective rates of seven percent under the regular tax<sup>1578</sup> and 12.88 percent under the alternative minimum tax.<sup>1579</sup>

The percentage exclusion for qualified small business stock acquired after September 27, 2010, and before January 1, 2011, is increased to 100 percent and the minimum tax preference does not apply.<sup>1580</sup>

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<sup>1574</sup> IRC section 1(h).

<sup>1575</sup> IRC section 57(a)(7). In the case of qualified small business stock, the percentage of gain excluded from gross income that is an alternative minimum tax preference is (i) seven percent in the case of stock disposed of in a taxable year beginning before 2011; (ii) 42 percent in the case of stock acquired before January 1, 2001, and disposed of in a taxable year beginning after 2010; and (iii) 28 percent in the case of stock acquired after December 31, 2000, and disposed of in a taxable year beginning after 2010. Section 102 of the act extends the 2010 and 2011 dates by two years.

<sup>1576</sup> The 50 percent of gain included in taxable income is taxed at a maximum rate of 28 percent.

<sup>1577</sup> The amount of gain included in alternative minimum tax is taxed at a maximum rate of 28 percent. The amount so included is the sum of (i) 50 percent (the percentage included in taxable income) of the total gain and (ii) the applicable preference percentage of the one-half gain that is excluded from taxable income.

<sup>1578</sup> The 25 percent of gain included in taxable income is taxed at a maximum rate of 28 percent.

<sup>1579</sup> The 46 percent of gain included in alternative minimum tax is taxed at a maximum rate of 28 percent. Forty-six percent is the sum of 25 percent (the percentage of total gain included in taxable income) plus 21 percent (the percentage of total gain which is an alternative minimum tax preference).

<sup>1580</sup> IRC section 1202(a)(4)(A) and (C).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

New Federal Law (IRC section 1202)

The provision extends the 100-percent exclusion and the exception from minimum tax preference treatment for one year (for stock acquired before January 1, 2012).

Effective Date

The provision is effective for stock acquired after December 31, 2010.

California Law (R&TC sections 17062, 18152, and 18152.5)

California specifically does not conform to the federal exclusion for gain on qualified small business stock,<sup>1581</sup> and instead provides its own exclusion.<sup>1582</sup> Under California law, noncorporate taxpayers may exclude from gross income 50 percent of gain from the sale or exchange of California qualified small business stock acquired at original issue and held for more than five years. The amount of gain eligible for the exclusion with respect to any corporation is the greater of: (1) ten times the taxpayer's basis in the stock; or (2) \$10 million.

California qualified small business stock generally means stock in a C corporation<sup>1583</sup> that: (1) has gross assets that do not exceed \$50 million; (2) has at least 80 percent of its payroll attributable to employment located in California; and (3) uses at least 80 percent of the value of its assets in the active conduct of one or more qualified trades or businesses in California.

Unlike federal law, California does not apply a different tax rate to gains on qualified small business stock. However, like federal law, the exclusion is a California alternative minimum tax (AMT) preference item—50 percent of the excluded gain is a California AMT preference;<sup>1584</sup> the portion of the gain includible in alternative minimum taxable income is taxed at a maximum rate of seven percent under the California AMT.

Additionally, although California has its own stand-alone exclusion, any regulation issued by the Secretary of Treasury relating federal qualified small business stock applies for California purposes to the extent that California incorporates the federal qualified-small-business-stock rules.

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<sup>1581</sup> R&TC section 18152.

<sup>1582</sup> R&TC section 18152.5. The California exclusion generally parallels the federal exclusion under IRC section 1202, with modifications.

<sup>1583</sup> The stock must be that of a domestic C corporation that is not a DISC or former DISC, a regulated investment company, a real estate investment trust, a real estate mortgage investment conduit, or a cooperative.

<sup>1584</sup> R&TC section 17062(e).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
761	Tax-Exempt Bond Financing

Background

An aggregate of \$8 billion in tax-exempt private activity bonds is authorized for the purpose of financing the construction and repair of infrastructure in New York City ("Liberty Zone bonds"). The bonds must be issued before January 1, 2010.

New Federal Law (IRC section 1400L)

The provision extends authority to issue Liberty Zone bonds for two years (through December 31, 2011).

Effective Date

The provision is effective for bonds issued after December 31, 2009.

California Law (R&TC section 17143)

The PITL specifically does not conform to federal law regarding private activity bonds. The California Constitution provides an exemption from income taxation for all interest from bonds issued by this state or a local government of this state. Federal law, other than the IRC, prohibits state taxation of interest on federal bonds if the interest on state obligations is exempt from tax. Taxpayers subject to the corporate franchise tax must include in the measure of franchise tax all interest received including interest on governmental obligations that is exempt from income tax. Interest received from federal obligations and California obligations or its political subdivisions is excluded from income subject to the corporation and personal income tax.

Impact on California Revenue

Not applicable.

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TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

<u>Section</u>	<u>Section Title</u>
762	Increase in Rehabilitation Credit

Background

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.

Present law increases 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, 2010. The provision is effective for expenditures incurred on or after August 28, 2005, for taxable years ending on or after August 28, 2005.

New Federal Law (IRC section 1400N)

The provision extends for two additional years the increase in the rehabilitation credit from 20 to 26 percent and from 10 to 13 percent, respectively, with respect to any certified historic structure or qualified rehabilitated building located in the Gulf Opportunity Zone. Thus, the increase applies for qualified rehabilitation expenditures with respect to such buildings or structures incurred before January 1, 2012.

Effective Date

The provision is effective for amounts paid or incurred after December 31, 2009.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

California Law (None)

California does not conform to the federal rehabilitation credit.

Impact on California Revenue

Not applicable.

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Section

Section Title

763

Low-Income Housing Credit Rules for Buildings in GO Zones

Background

In General

The low-income housing credit may be claimed over a 10-year period for the cost of rental housing occupied by tenants having incomes below specified levels. 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.

The credit percentage for newly constructed or substantially rehabilitated housing that is not federally subsidized is adjusted monthly by the IRS so that the 10 annual installments have a present value of 70 percent of the total qualified basis. The credit percentage for newly constructed or substantially rehabilitated housing that is federally subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value of 30 percent of qualified basis. These are referred to as the 70-percent credit and 30-percent credit, respectively.

Volume Limit

Generally, 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. Each state has a limited amount of low-income housing credit available to allocate. This amount is called the aggregate housing credit dollar amount (or the "state housing credit ceiling"). For each state, the state housing credit ceiling is the sum of four components: (1) the unused housing credit ceiling, if any, of such state from the prior calendar year; (2) the credit ceiling for the year (either a per-capital amount or the small state minimum annual cap); (3) any returns of credit ceiling to the state during the calendar year from previous allocations; and (4) the state's share, if any, of the national pool of unused credits from other states that failed to use them (only states that allocated their entire credit ceiling for the preceding calendar year are eligible for a share of the national pool. For calendar year 2010, each state's credit ceiling is \$2.10 per resident, with a

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

minimum annual cap of \$2,430,000 for certain small population states.<sup>1585</sup> These amounts are indexed for inflation. These limits do not apply in the case of projects that also receive financing with proceeds of tax-exempt bonds issued subject to the private activity bond volume limit.

Under IRC section 1400N(c), the otherwise applicable state housing credit ceiling is increased for each of the states within the Gulf Opportunity Zone. This increase applies to calendar years 2006, 2007, and 2008. The additional volume for each of the affected states equals \$18.00 times the number of such state's residents within the Gulf Opportunity Zone. This amount is not adjusted for inflation. This additional volume limit expires unless the applicable low-income buildings are placed in service before January 1, 2011.

New Federal Law (IRC section 1400N)

The provision extends the placed-in-service deadline (for one year) to December 31, 2011.

Effective Date

The provision is effective on December 17, 2010.

California Law (R&TC sections 17057.5, 17058, 23610.4, and 23610.5)

In General

California conforms by reference to IRC section 42, relating to the low-income housing credit, as of the "specified date" of January 1, 2009, with modifications. In order to qualify for the California low-income housing credit, the housing project must be located in California. Additional California modifications are discussed below.

*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 percent and the sum of the credit percentages for the first three years.

For new buildings that are federally subsidized, and for existing buildings that are at risk of conversion to market rental rates, the percentage of creditable costs in the first three years is the

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<sup>1585</sup> Rev. Proc. 2009-50.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

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.<sup>1586</sup> 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 may be allocated to the partners of a partnership owning the project based on the partnership agreement, regardless of 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.<sup>1587</sup>

Impact on California Revenue

Not applicable.

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<sup>1586</sup> IRC section 42(f)(3).

<sup>1587</sup> R&TC section 23610.5(b)(1)(C).

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

<u>Section</u>	<u>Section Title</u>
764	Tax-Exempt Bond Financing

Background

In General

Under present law, gross income does not include interest on state or local bonds. 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"). The definition of a qualified private activity bond includes an exempt facility bond and a qualified mortgage bond.

Exempt Facility Bonds

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)).

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").

Qualified Mortgage Bonds

Qualified mortgage bonds are tax-exempt bonds issued to make mortgage loans to eligible mortgagors for the purchase, improvement, or rehabilitation of owner-occupied residences. The IRC imposes several limitations on qualified mortgage bonds, including income limitations for eligible mortgagors, purchase price limitations on the home financed with bond proceeds, and a "first-time homebuyer" requirement. In addition, bond proceeds generally only can be used for new mortgages, i.e., proceeds cannot be used to acquire or replace existing mortgages.

Exceptions to the new mortgage requirement are provided for the replacement of construction period loans, bridge loans, and other similar temporary initial financing. In addition, qualified

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

rehabilitation loans may be used, in part, to replace existing mortgages. A qualified rehabilitation loan means certain loans for the rehabilitation of a building if there is a period of at least 20 years between the date on which the building was first used (the "20-year rule") and the date on which the physical work on such rehabilitation begins and the existing-walls and basis requirements are met. The existing-walls requirement for a rehabilitated building is met if 50 percent or more of the existing external walls are retained in place as external walls, 75 percent or more of the existing external walls are retained in place as internal or external walls, and 75 percent or more of the existing internal structural framework is retained in place. The basis requirement is met if expenditures for rehabilitation are 25 percent or more of the mortgagor's adjusted basis in the residence, determined as of the later of the completion of the rehabilitation or the date on which the mortgagor acquires the residence.

Qualified mortgage bonds also may be used to finance qualified home-improvement loans. Qualified home-improvement loans are defined as loans to finance alterations, repairs, and improvements on an existing residence, but only if such alterations, repairs, and improvements substantially protect or improve the basic livability or energy efficiency of the property. Qualified home-improvement loans may not exceed \$15,000, and may not be used to refinance existing mortgages.

As with most qualified private activity bonds, issuance of qualified mortgage bonds is subject to annual State volume limitations (the "State volume cap").

#### Gulf Opportunity Zone Bonds

The Gulf Opportunity Zone Act of 2005 authorizes Alabama, Louisiana, and Mississippi (or any political subdivision of those states) to issue qualified private activity bonds to finance the construction and rehabilitation of residential and nonresidential property located in the Gulf Opportunity Zone ("Gulf Opportunity Zone Bonds"). Gulf Opportunity Zone Bonds are not subject to the state volume cap. Rather, the maximum aggregate amount of Gulf Opportunity Zone Bonds that may be issued in any eligible state is limited to \$2,500 multiplied by the population of the respective state within the Gulf Opportunity Zone.

Depending on the purpose for which such bonds are issued, Gulf Opportunity Zone Bonds are treated as either exempt facility bonds or qualified mortgage bonds. Gulf Opportunity Zone Bonds are treated as exempt facility bonds if 95 percent or more of the net proceeds of such bonds are to be used for qualified project costs located in the Gulf Opportunity Zone. Qualified project costs include the cost of acquisition, construction, reconstruction, and renovation of nonresidential real property (including buildings and their structural components and fixed improvements associated with such property), qualified residential rental projects (as defined in IRC section 142(d) with certain modifications), and public utility property. Bond proceeds may not be used to finance movable fixtures and equipment.

Rather than applying the 20-50 and 40-60 test from IRC section 142, a project is a qualified residential rental project under the provision if 20 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 or if 40 percent or more of the residential units in such project are occupied by individuals whose income is 70 percent or less of area median gross income.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

Gulf Opportunity Zone Bonds issued to finance residences located in the Gulf Opportunity Zone are treated as qualified mortgage bonds if the general requirements for qualified mortgage bonds are met. The IRC also provides special rules for Gulf Opportunity Zone Bonds issued to finance residences located in the Gulf Opportunity Zone. For example, the first-time homebuyer rule is waived and the income and purchase price rules are relaxed for residences financed in the GO Zone, the Rita GO Zone, or the Wilma GO Zone. In addition, the IRC increases from \$15,000 to \$150,000 the amount of a qualified home-improvement loan with respect to residences located in the specified disaster areas.

Also, a qualified GO Zone repair or reconstruction loan is treated as a qualified rehabilitation loan for purposes of the qualified mortgage bond rules. Thus, such loans financed with the proceeds of qualified mortgage bonds and Gulf Opportunity Zone Bonds may be used to acquire or replace existing mortgages, without regard to the existing walls or 20 year rule under present law. A qualified GO Zone repair or reconstruction loan is any loan used to repair damage caused by Hurricane Katrina, Hurricane Rita, or Hurricane Wilma to a building located in the GO Zones (or reconstruction of such building in the case of damage constituting destruction) if the expenditures for such repair or reconstruction are 25 percent or more of the mortgagor's adjusted basis in the residence. For these purposes, the mortgagor's adjusted basis is determined as of the later of (1) the completion of the repair or reconstruction or (2) the date on which the mortgagor acquires the residence.

Gulf Opportunity Zone Bonds must be issued before January 1, 2011.

New Federal Law (IRC section 1400N)

The provision extends authority to issue Gulf Opportunity Zone Bonds for one year (through December 31, 2011).

Effective Date

The provision is effective on the December 17, 2010.

California Law (R&TC sections 17143 and 24272)

California does not conform to federal tax-credit bonds, and income from such bonds is not includable in California gross income.

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.

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,

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

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 (subdivision (b) of section 26 of Article XIII). The R&TC further provides 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 federal 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 as the measure of the tax for the privilege of exercising the corporate franchise.

### Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
765	Bonus Depreciation Deduction Applicable to the GO Zone

### Background

#### In General

An additional first-year depreciation deduction is allowed equal to 50 percent of the adjusted basis of qualified property placed in service during 2008, 2009, and 2010 (2009, 2010, and 2011 for certain longer-lived and transportation property).<sup>1588</sup> The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes, but is not allowed for purposes of computing earnings and profits. 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 are no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum

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<sup>1588</sup> IRC section 168(k). The additional first-year depreciation deduction is subject to the general rules regarding whether an item must be capitalized under IRC section 263 or IRC section 263A.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

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.

Property qualifying for the additional first-year depreciation deduction 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)).<sup>1589</sup> Second, the original use<sup>1590</sup> of the property must commence with the taxpayer after December 31, 2007.<sup>1591</sup> 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, 2011. An extension of the placed in service date of one year (i.e., to January 1, 2012) is provided for certain property with a recovery period of 10 years or longer and certain transportation property.<sup>1592</sup> Transportation property is defined as tangible personal property used in the trade or business of transporting persons or property.

The applicable time period for acquired property is (1) after December 31, 2007, and before January 1, 2011, 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, 2011.<sup>1593</sup> 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, 2011. Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the

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<sup>1589</sup> The additional first-year depreciation deduction is not available for any property that is required to be depreciated under the alternative depreciation system of MACRS. The additional first-year depreciation deduction is also not available for qualified New York Liberty Zone leasehold improvement property as defined in IRC section 1400L(c)(2).

<sup>1590</sup> 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.

<sup>1591</sup> 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.

If property is originally placed in service by a lessor (including by operation of IRC section 168(k)(2)(D)(i)), such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of such sale.

<sup>1592</sup> Property qualifying for the extended placed in service date must have an estimated production period exceeding one year and a cost exceeding \$1 million.

<sup>1593</sup> 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.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

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, 2011 ("progress expenditures") is eligible for the additional first-year depreciation.<sup>1594</sup>

#### Gulf Opportunity Zone Additional Depreciation

Present law provides an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of specified qualified Gulf Opportunity Zone extension property. To qualify, property generally must be placed in service on or before December 31, 2010. 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),<sup>1595</sup> 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 is eligible for the additional first-year depreciation.

The specified portions of the Gulf Opportunity Zone are defined as those portions of the Gulf Opportunity Zone which 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).

#### New Federal Law (IRC section 1400N)

The provision extends for one year through December 31, 2011, the date by which specified Gulf Opportunity Zone extension property must be placed in service to be eligible for the additional first-year depreciation deduction. In the case of nonresidential real property or residential rental property, the adjusted basis of such property attributable to manufacture, construction, or production before January 1, 2012 is eligible for the additional first-year depreciation.

#### Effective Date

The provision applies to property placed in service after December 31, 2009.

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<sup>1594</sup> 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, apply.

<sup>1595</sup> Generally, property described in IRC section 168(k)(2)(A)(i) is (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)), or (4) certain leasehold improvement property.

TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010  
Public Law 111-312, December 17, 2010

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

This provision is not applicable under California law.

The PITL generally conforms to MACRS as of the “specified date” of January 1, 2009, but specifically does not conform to additional first-year depreciation under IRC section 168(k),<sup>1596</sup> and does not conform to the additional first-year depreciation deduction of specified qualified Gulf Opportunity Zone extension property under IRC section 1400N(d).

The CTL did not adopt pre-1986 accelerated cost recovery system (ACRS) depreciation, does not adopt MACRS, and does not adopt the additional first-year depreciation deduction of specified qualified Gulf Opportunity Zone extension property under IRC section 1400N(d). Instead, the CTL generally provides the pre-1981 federal asset depreciation range (ADR) deduction.<sup>1597</sup> The ADR is based on the “useful life” of depreciable property.

Impact on California Revenue

Not applicable.

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<sup>1596</sup> R&TC section 17250(a)(4).

<sup>1597</sup> R&TC section 24349.

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

Overview of Regulated Investment Companies

In general, a regulated investment company (“RIC”) is an electing domestic corporation that either meets (or is excepted from) certain registration requirements under the Investment Company Act of 1940,<sup>1598</sup> that derives at least 90 percent of its ordinary income from specified sources considered passive investment income,<sup>1599</sup> that has a portfolio of investments that meet certain diversification requirements,<sup>1600</sup> and meets certain other requirements.<sup>1601</sup>

Many RICs are “open-end” companies (mutual funds) that have a continuously changing number of shares that are bought from and redeemed by the company, and that are not otherwise available for purchase or sale in the secondary market. Shareholders of open-end RICs generally have the right to have the company redeem shares at “net asset value.” Other RICs are “closed-end” companies, which have a fixed number of shares that are normally traded on national securities exchanges or in the over-the-counter market and are not redeemable upon the demand of the shareholder.

In the case of a RIC that distributes at least 90 percent of its net ordinary income and net tax-exempt interest to its shareholders, a deduction for dividends paid is allowed to the RIC in computing its tax.<sup>1602</sup> Thus, no corporate income tax is imposed on income distributed to its shareholders. Dividends of a RIC generally are includible in the income of the shareholders; a RIC can pass through the character of: (1) its long-term capital gain income, by paying “capital gain dividends;” and (2) in certain cases, tax-exempt interest, by paying “exempt-interest dividends.” A RIC may also pass through certain foreign tax credits and credits on tax-credit bonds, as well as the character of certain other income received by the RIC.

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<sup>1598</sup> IRC sections 851(a) and (b)(1).

<sup>1599</sup> IRC section 851(b)(2).

<sup>1600</sup> IRC section 851(b)(3).

<sup>1601</sup> IRC sections 851 and 852.

<sup>1602</sup> IRC section 852(a) and (b).

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

<u>Section</u>	<u>Section Title</u>
101	Capital Loss Carryovers of Regulated Investment Companies

Background

Limitation on Capital Losses

Losses from the sale or exchange of capital assets are allowed only to the extent of the taxpayer's gains from the sale or exchange of capital assets plus, in the case of a taxpayer other than a corporation, \$3,000.<sup>1603</sup>

Carryover of Net Capital Losses

*RICs*

If a RIC has a net capital loss (i.e., losses from the sale or exchanges of capital assets in excess of gains from sales or exchanges of capital assets) for any taxable year, the amount of the net capital loss is a capital loss carryover to each of the eight taxable years following the loss year, and is treated as a short-term capital loss in each of those years.<sup>1604</sup> The entire amount of a net capital loss is carried over to the first taxable year succeeding the loss year and the portion of the loss which may be carried to each of the next seven years is the excess of the net capital loss over the net capital gain income<sup>1605</sup> (determined without regard to any net capital loss for the loss year or taxable year thereafter) for each of the prior taxable years to which the loss may be carried.

*Corporations other than RICs*

In the case of a corporation other than a RIC, a net capital loss generally is treated as a capital loss carryback to each of the three taxable years preceding the loss year and a capital loss carryover the each of the five taxable years following the loss year and is treated as a short-term capital loss in each of those years.<sup>1606</sup> The carryover amount is reduced in a manner similar to that described above applicable to RICs. A net capital loss may not be carried back to a taxable year for which a corporation is a RIC.<sup>1607</sup>

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<sup>1603</sup> IRC section 1211.

<sup>1604</sup> IRC section 1212(a)(1)(C)(i).

<sup>1605</sup> Capital gain net income is the excess of gains from the sale or exchange of capital assets over losses from such sales or exchanges. IRC section 1222(9).

<sup>1606</sup> IRC section 1212(a)(1)(A).

<sup>1607</sup> IRC section 1212(a)(3)(A).

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

*Individual taxpayers*

If a taxpayer other than a corporation has a net capital loss for any taxable year, the excess (if any) of the net short-term capital loss over the net long-term capital gain is treated as a short-term capital loss in the succeeding taxable year, and the excess (if any) of the net long-term capital loss over the net short-term capital gain is treated as a long-term capital loss in the succeeding taxable year.<sup>1608</sup> There is no limitation on the number of taxable years that a net capital loss may be carried over.

New Federal Law (IRC sections 1212 and 1222)

In General

The provision provides capital loss carryover treatment for RICs similar to the present-law treatment of net capital loss carryovers applicable to individuals. Under the provision, if a RIC has a net capital loss for a taxable year, the excess (if any) of the net short-term capital loss over the net long-term capital gain is treated as a short-term capital loss arising on the first day of the next taxable year, and the excess (if any) of the net long-term capital loss over the net short-term capital gain is treated as a long-term capital loss arising on the first day of the next taxable year.<sup>1609</sup> The number of taxable years that a net capital loss of a RIC may be carried over under the provision is not limited.

Coordination with Present-Law Carryovers

The provision provides for the treatment of net capital loss carryovers under the present law rules to taxable years of a RIC beginning after December 22, 2010. These rules apply to: (1) capital loss carryovers from taxable years beginning on or before December 22, 2010; and (2) capital loss carryovers from other taxable years prior to the taxable year the corporation becoming a RIC.

Amounts treated as a long-term or short-term capital loss arising on the first day of the next taxable year under the provision are determined without regard to amounts treated as a short-term capital loss under the present-law carryover rule. In determining the amount by which a present-law carryover is reduced by capital gain net income for a prior taxable year, any capital loss treated as arising on the first day of the prior taxable year under the provision is taken into account in determining capital gain net income for the prior year.

The following example illustrates these rules:

Assume a calendar year RIC has no net capital loss for any taxable year beginning before 2010, a net capital loss of \$2 million for 2010; a net capital loss of \$1 million for 2011, all of which is a

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<sup>1608</sup> IRC section 1212(b). Adjustments are made to take account of the \$3,000 amount allowed against ordinary income.

<sup>1609</sup> For earnings and profits treatment of a RIC's net capital loss, see section 302 of the Act.

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

long-term capital loss; and \$600,000 gain from the sale of a capital asset held less than one year on July 15, 2012.

For 2012, the RIC has: (1) a \$600,000 short-term capital gain from the July 15 sale; (2) a \$2 million carryover from 2010 which is treated as a short-term capital loss;<sup>1610</sup> and (3) a \$1 million long-term capital loss from 2011 treated as arising on January 1, 2012. The capital loss allowed in 2012 is limited to \$600,000, the amount of capital gain for the taxable year.

For purposes of determining the amount of the \$2 million net capital loss that may be carried over from 2010 to 2013, there is no capital gain net income for 2012 because the \$600,000 gain does not exceed the \$1 million long-term loss treated as arising on January 1, 2012; therefore the entire 2010 net capital loss is carried over to 2013 and treated as a short-term capital loss in 2013. Four-hundred thousand dollars (\$400,000), the excess of the \$1 million long-term capital loss treated as arising on January 1, 2012, over the \$600,000 short-term capital gain for 2012, is treated as a long-term capital loss on January 1, 2013. The 2010 net capital loss may continue be carried over through 2018, subject to reduction by capital gain net income; no limitation applies on the number of taxable years that the 2011 net capital loss may be carried over.

#### Effective Date

The provision generally applies to net capital losses for taxable years beginning after December 22, 2010. The provision relating to the treatment of present-law carryovers applies to taxable years beginning after December 22, 2010.

#### California Law (R&TC sections 18151, 18155, 24990, and 24990.5)

Under the PITL and the CTL, California conforms to the federal rules for capital loss carryovers as of the “specified date” of January 1, 2009, with modifications.<sup>1611</sup> As a result, California does not conform to this provision (that allows RICs to have unlimited capital loss carryovers, provides that a RIC’s net long-term capital loss retains its character when carried forward (instead of being treated as a short-term capital loss), and provides coordination rules for present-law RIC capital loss carryovers).

Under California law, if a RIC has a net capital loss for any taxable year, the amount of the net capital loss is a capital loss carryover to each of the eight taxable years following the loss year, and is treated as a short-term capital loss in each of those years. The entire amount of a net capital loss is carried over to the first taxable year succeeding the loss year and the portion of the loss which may be carried to each of the next seven years is the excess of the net capital loss over

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<sup>1610</sup> The present-law treatment of net capital losses arising in taxable years beginning before December 22, 2010, continues to apply.

<sup>1611</sup> For taxable years beginning on or after January 1, 2010, R&TC sections 18151 and 24990 conform to Subchapter P of Chapter 1 of Subtitle A of the IRC, containing IRC sections 1201 to 1298, as of the “specified date” of January 1, 2009, with modifications. The PITL and the CTL specifically do not allow capital loss carrybacks; see R&TC sections 18155 and 24990(b).

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

the net capital gain income (determined without regard to any net capital loss for the loss year or taxable year thereafter) for each of the prior taxable years to which the loss may be carried.

Impact on California Revenue

Estimated Revenue Impact of Capital Loss Carryovers of Regulated Investment Companies For Taxable Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
\$0	\$250,000	\$450,000

Estimates are based on a proration of federal estimates developed by the Joint Committee on Taxation.

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<u>Section</u>	<u>Section Title</u>
201	Savings Provisions for Failures of Regulated Investment Companies to Satisfy Gross Income and Asset Tests

Background

Asset Tests

In general, at the close of each quarter of the taxable year, at least 50 percent of the value of a RIC's total assets must be represented by: (1) cash and cash items (including receivables), government securities and securities of other RICs; and (2) other securities, generally limited in respect of any one issuer to an amount not greater in value than five percent of the value of the total assets of the RIC and to not more than 10 percent of the outstanding voting securities of such issuer.<sup>1612</sup>

In addition, at the close of each quarter of the taxable year, not more than 25 percent of the value of a RIC's total assets may be invested in: (1) the securities (other than government securities or the securities of other RICs) of any one issuer; (2) the securities (other than the securities of other RICs) of two or more issuers which the taxpayer controls and which are determined, under regulations prescribed by the Secretary, to be engaged in the same or similar trades or businesses or related trades or businesses; or (3) the securities of one or more qualified publicly traded partnerships (as defined in IRC section 851(h)).<sup>1613</sup>

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<sup>1612</sup> IRC section 851(b)(3)(A).

<sup>1613</sup> IRC section 851(b)(3)(B).

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

A RIC meeting both asset tests at the close of any quarter will not lose its status as a RIC because of a discrepancy during a subsequent quarter between the value of its various investments and the asset test 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.<sup>1614</sup> This rule protects a RIC against inadvertent failures of the asset tests that may be caused by fluctuations in the relative values of its assets. A second rule (the “30-day rule”) gives a RIC 30 days following the end of a quarter in which it fails an asset test to cure the failure, if the failure is by reason of a discrepancy, between the value of its various investments and the asset test requirements, that exists immediately after the acquisition of any security or other property which is wholly or partly the result of such acquisition during such quarter. Failure of any asset test (except where the failure is cured pursuant to the 30-day rule) will prevent a corporation from qualifying as a RIC.

#### Gross Income Test

A RIC must derive 90 percent of its gross income from qualifying income. Thus, a RIC meets the gross income test provided its gross income that is not qualifying income does not exceed one-ninth of the portion of its gross income that is qualifying income. For example, a RIC with \$90x of gross income from qualifying income can have up to \$10x of gross income from other sources without failing the test. Failure to meet the gross income test for a taxable year prevents a corporation from qualifying as a RIC for that year.

#### New Federal Law (IRC sections 851 and 852)

##### Saving Provision for Asset Test Failures

The provision provides a special rule for *de minimis* asset test failures and a mechanism by which a RIC can cure other asset test failures and pay a penalty tax. The rule for *de minimis* asset test failures applies if a RIC fails to meet one of the asset tests in IRC section 851(b)(3) due to the ownership of assets the total value of which does not exceed the lesser of one percent of the total value of the RIC's assets at the end of the quarter for which the assets are valued or \$10 million. Where the *de minimis* rule applies, the RIC shall nevertheless be considered to have satisfied the asset tests if, within six months of the last day of the quarter in which the RIC identifies that it failed the asset test (or such other time period provided by the Secretary) the RIC disposes of assets in order to meet the requirements of the asset tests or the RIC otherwise meets the requirements of the asset tests.

In the case of other asset test failures, a RIC shall nevertheless be considered to have met the asset tests if: (1) the RIC sets forth in a schedule filed in the manner provided by the Secretary a description of each asset that causes the RIC to fail to satisfy the asset test; (2) the failure to meet the asset tests is due to reasonable cause and not due to willful neglect; and (3) within six months of the last day of the quarter in which the RIC identifies that it failed the asset test (or such other time period provided by the Secretary) the RIC (a) disposes of the assets which caused the asset test failure, or (b) otherwise meets the requirements of the asset tests. In cases of asset test failures other than *de minimis* failures, the provision imposes a tax in an amount equal

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<sup>1614</sup> IRC section 851(d).

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

to the greater of: (1) \$50,000; or (2) the amount determined (pursuant to regulations promulgated by the Secretary) by multiplying the highest rate of tax specified in section 11 (currently 35 percent) by the net income generated during the period of asset test failure by the assets that caused the RIC to fail the asset test. For purposes of Subtitle F of the IRC, the tax imposed for an asset test failure is treated as excise tax with respect to which the deficiency procedures apply.

These provisions added by the bill do not apply to any quarter in which a corporation's status of a RIC is preserved under the provision of present law.

#### Saving Provision for Gross Income Test Failures

The provision provides that a corporation that fails to meet the gross income test shall nevertheless be considered to have satisfied the test if, following the corporation's failure to meet the test for the taxable year, the corporation: (1) sets forth in a schedule, filed in the manner provided by the Secretary, a description of each item of its gross income; and (2) the failure to meet the gross income test is due to reasonable cause and is not due to willful neglect.

In addition, under the provision, a tax is imposed on any RIC that fails to meet the gross income test equal to the amount by which the RIC's gross income from sources which are not qualifying income exceeds one-ninth of its gross income from sources which are qualifying income. For example, if a RIC has \$90x of gross income of sources which are qualifying income and \$15x of gross income from other sources, a tax of \$5x is imposed. The tax is the amount by which the \$15x gross income from sources which are not qualifying income exceeds the \$10x permitted under present law.

#### Calculation of Investment Company Taxable Income

Taxes imposed for failure of the asset or income tests are deductible for purposes of calculating investment company taxable income.

#### Effective Date

The provision is effective to taxable years for with respect to which the due date (determined with regard to any extensions) of the return of tax is due after December 22, 2010.

#### California Law (R&TC section 24870)

Under the CTL, California conforms to the federal RIC asset and gross income tests as of the "specified date" of January 1, 2009, with modifications.<sup>1615</sup> Thus, California does not conform to this provision (that provides savings provisions for failures of RICs to satisfy the asset and gross income tests).

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<sup>1615</sup> For taxable years beginning on or after January 1, 2010, R&TC section 24870 conforms to Subchapter M of Chapter 1 of Subtitle A of the IRC, consisting of IRC sections 851 to 860G, as of the "specified date" of January 1, 2009, with modifications.

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

Impact on California Revenue

Estimated Revenue Impact of Savings Provisions for Failures of Regulated Investment Companies to Satisfy Gross Income and Asset Tests For Taxable Years with Respect to which the Due Date (Determined without Regard to Extensions) of the Return of Tax is On or After January 1, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
\$3,000	\$3,000	\$3,000

Estimates are based on a proration of federal estimates developed by the Joint Committee on Taxation.

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<u>Section</u>	<u>Section Title</u>
301	Modification of Dividend Designation Requirements and Allocation Rules for Regulated Investment Companies

Background

Capital Gain Dividends – In General

In general, a capital gain dividend paid by a RIC is treated by the RIC's shareholders as long-term capital gain.<sup>1616</sup> In addition, a RIC is allowed a dividend paid deduction for its capital gain dividends in computing the tax imposed on its net capital gain.<sup>1617</sup>

A capital gain dividend is any dividend, or part thereof, which is designated by the RIC as a capital gain dividend in a written notice mailed to the RIC's shareholders not later than 60 days after the close of the RIC's taxable year,<sup>1618</sup> except that in the event a RIC designates an aggregate amount

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<sup>1616</sup> IRC section 852(b)(3)(B). This provision applies only with respect to RICs which meet the requirements of IRC section 852(a) for the taxable year.

<sup>1617</sup> IRC section 852(b)(3)(A).

<sup>1618</sup> IRC section 852(b)(3)(C). If there is an increase in the amount by which a RIC's net capital gain exceeds the deduction for dividends paid (determined with reference to capital gain dividends only) as a result of a "determination," the RIC has 120 days after the date of the determination to make a designation with respect to such increase. A determination is defined in IRC section 860(e) as: (1) a decision by the Tax Court, or a judgment, decree, or other order by any court of competent jurisdiction, which has become final; (2) a closing agreement made under IRC section 7121; (3) under regulations prescribed by the Secretary, an agreement signed by the Secretary and by, or on behalf of, the qualified investment entity relating to the liability of such entity for tax; or (4) a statement by the

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

of capital gain dividends for a taxable year that exceeds the RIC's net capital gain, the portion of each distribution that is a capital gain dividend is only that proportion of the designated amount that the RIC's net capital gain bears to the total amount so designated by the RIC. For example, assume a RIC makes quarterly distributions of \$30, designated entirely as capital gain dividends. If the RIC has only \$100 of net capital gain for its taxable year, only \$25 of each quarterly distribution is a capital gain dividend (i.e.,  $\$30 \times (\$100/\$120) = \$25$ ).

#### Other Designated Items

##### *Exempt-interest dividends*

A RIC may designate any portion of a dividend (other than a capital gain dividend) as an "exempt-interest dividend," if at least half of the RIC's assets consist of tax-exempt state and local bonds. The shareholder treats an exempt-interest dividend as an item of tax-exempt interest.<sup>1619</sup>

Exempt-interest dividends are defined as any dividend, or part thereof, which is designated by the RIC as an exempt-interest dividend in a written notice mailed to the RIC's shareholders not later than 60 days after the close of the RIC's taxable year,<sup>1620</sup> except that in the event a RIC designates an aggregate amount of exempt-interest dividends for a taxable year that exceeds the RIC's tax-exempt interest (net of related deductions disallowed under IRC sections 265 and 171(a)(2) by reason of the interest being tax exempt), the portion of each distribution that will be an exempt-interest dividend is only that proportion of the designated amount that net exempt interest bears to the amount so designated.

##### *Foreign tax credits; credits for tax-credit bonds; dividends received by RIC*

RICs may pass through to shareholders certain foreign tax credits, credits for tax-credit bonds, and dividends received by the RIC that qualify, in the case of corporate shareholders, for the dividends received deduction, or, in the case of individual shareholders, the capital gain rates in effect for dividends received in taxable years beginning before January 1, 2011. In each case the qualifying amount must be designated in a written notice mailed to its shareholders not later than 60 days after the close of the RIC's taxable year.

##### *Dividends paid to certain foreign persons*

Certain dividends paid to nonresident alien individuals and foreign corporations in taxable years of the RIC beginning before January 1, 2010, retain their character as interest or short term-capital gain.<sup>1621</sup> These dividends must be designated in a written notice mailed to its shareholders not

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taxpayer attached to its amendment or supplement to a return of tax for the relevant tax year. See Rev. Proc. 2009-28, 2009-20 I.R.B. 1011.

<sup>1619</sup> IRC section 852(b)(5)(B).

<sup>1620</sup> IRC section 852(b)(5)(A).

<sup>1621</sup> IRC sections 871(k) and 881(e).

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

later than 60 days after the close of the RIC's taxable year. Rules similar to the rules described above relating to capital gain dividends and exempt-interest dividends apply to designated amounts in excess of actual amounts.

New Federal Law (IRC section 852)

Capital Gain Dividends

*Reporting requirements*

The provision replaces the present-law designation requirement for a capital gain dividend with a requirement that a capital gain dividend be *reported* by the RIC in written statements furnished to its shareholders. A written statement furnishing this information to a shareholder may be a Form 1099.

*Allocation by fiscal-year RICs*

The provision provides a special rule allocating the excess reported amount<sup>1622</sup> for taxable year RICs in order to reduce the need for RICs to amend Form 1099s and shareholders to file amended income tax returns. This special allocation rule applies to a taxable year of a RIC which includes more than one calendar year if the RIC's post-December reported amount<sup>1623</sup> exceeds the excess reported amount for the taxable year.

For example, assume a RIC for its taxable year ending June 30, 2012, makes quarterly distributions of \$30,000 on September 30, 2011, December 31, 2011, March 31, 2012, and June 30, 2012, and reports the amounts as capital gain dividends. If the RIC has only \$100,000 net capital gain for its taxable year, the excess reported amount is \$20,000. Because the post-December reported amount (\$60,000) exceeds the excess reported amount (\$20,000), the excess reported amount is allocated among the post-December reported capital gain dividends in proportion to the amount of each such distribution reported as a capital gain dividend. Thus, one-half of the excess reported amount (i.e., 1/2 of \$20,000 = \$10,000) is allocated to each post-December distribution, reducing the amount of each post-December distribution treated as a capital gain dividend from \$30,000 to \$20,000. Because no excess reported amount is allocated to either of the quarterly distributions made on or before December 31, 2011, the entire \$30,000 of each of the distributions retains its character as a capital gain dividend.

If, in the above example, the RIC has only \$40,000 net capital gain for its taxable year, the excess reported amount is \$80,000. Because the post-December reported amount (\$60,000) does not exceed the excess reported amount (\$80,000), the excess reported amount is allocated among all the reported capital gain dividends for the taxable year in proportion to the amount of each

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<sup>1622</sup> The "excess reported amount" is the excess of the aggregate amount reported as capital gain dividends for the taxable year over the RIC's net capital gain for the taxable year.

<sup>1623</sup> The "post-December reported amount" is the aggregate amount reported with respect to items arising after December 31 of the RIC's taxable year.

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

distribution reported as a capital gain dividend. Thus, one-fourth of the excess reported amount (i.e., 1/4 of \$80,000 = \$20,000) is allocated to each distribution, reducing the amount of each distribution treated as a capital gain dividend from \$30,000 to \$10,000.

#### Other Designated Items

The provision replaces the other designation requirements described under present law with a requirement that amounts be *reported* by the RIC in written statements furnished to its shareholders.<sup>1624</sup>

The provision also provides allocation rules for excess reported amounts of exempt-interest dividends and certain dividends paid to nonresident alien individuals and foreign corporations by fiscal year RICs similar to the rule described above applicable capital gain dividends.

#### Effective Date

The provision applies to taxable years beginning after December 22, 2010.<sup>1625</sup>

#### California Law (R&TC sections 17088, 24870, and 24871)

##### Capital Gain Dividends – In General

Under the PITL and the CTL, California conforms to the federal RIC capital gain dividend designation requirements and allocation rules as of the “specified date” of January 1, 2009, with modifications.<sup>1626</sup> The PITL conforms to the federal rule that provides a capital gain dividend paid by a RIC is treated by the RIC’s shareholders as long-term capital gain;<sup>1627</sup> however, the CTL specifically does not conform to the federal tax imposed on a RIC’s net capital gain.<sup>1628</sup>

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<sup>1624</sup> The Act does not change the method of designation of undistributed capital gain taken into account by shareholders under IRC section 852(b)(3)(D)(i).

<sup>1625</sup> Each amendment to a provision relating to qualified dividends of individual shareholders will sunset when the provision to which the amendment was made sunsets pursuant to section 303 of the Jobs and Growth Tax Relief Reconciliation Act. Under present law, these provisions sunset in taxable years beginning after December 31, 2010.

<sup>1626</sup> For taxable years beginning on or after January 1, 2010, R&TC sections 17088 and 24870 conform to Subchapter M of Chapter 1 of Subtitle A of the IRC, consisting of IRC sections 851 to 860G, as of the “specified date” of January 1, 2009, with modifications. R&TC section 17088(b) modifies the federal definition of exempt interest to mean interest that is exempt for state purposes under R&TC section 17145.

<sup>1627</sup> For taxable years beginning on or after January 1, 2010, R&TC section 17088 conforms to IRC section 852(b)(3)(B) as of the “specified date” of January 1, 2009.

<sup>1628</sup> R&TC section 24871(b)(1).

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

*Reporting requirements*

California generally conforms to the capital-gain-dividend designation requirements as of the “specified date” of January 1, 2009, and therefore does not conform to the reporting-requirement part of the provision (that replaces the designation requirement for a capital gain dividend with a requirement that a capital gain dividend be *reported* by the RIC in written statements furnished to its shareholders).

*Allocation by Fiscal-Year RICs*

California conforms to the federal definition of a capital gain dividend as of the “specified date” of January 1, 2009, and thus does not conform to this provision’s new special rule allocating the excess reported amount for taxable year RICs.

*Other Designated Items*

*Exempt-interest dividends*

The PITL specifically does not conform to the federal exempt-interest dividend deduction rules,<sup>1629</sup> and instead provides a stand-alone exempt-interest dividend deduction that generally parallels the federal deduction, including the 60-day shareholder designation rules that existed under federal law prior to this provision, modified to provide that exempt interest means interest that is exempt for state purposes.<sup>1630</sup> Thus, the PITL does not conform to or parallel this provision’s special allocation rule for exempt-interest dividends. And, the CTL specifically does not conform to federal rules relating to exempt-interest dividends,<sup>1631</sup> and instead provides that the deduction for dividends paid is modified to allow exempt-interest dividends, to the extent that interest is includable in the franchise or the income tax income under the CTL, to be included in the computation of the deduction.

*Foreign tax credits; credits for tax-credit bonds; dividends received by RIC*

This provision’s special allocation rules for foreign tax credits and federal tax credit bonds are not applicable under California law because California does not conform to foreign tax credits or to federal tax credit bonds.

The CTL conforms to the dividends received deduction as of the “specified date” of January 1, 2009, modified to provide that interest may be included in the computation of deductible dividends to the extent the interest is included in gross income for franchise or income

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<sup>1629</sup> R&TC section 17088(b).

<sup>1630</sup> R&TC section 17145.

<sup>1631</sup> R&TC section 24871(d).

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

tax purposes.<sup>1632</sup> Thus, the CTL does not conform to the changes made by this provision to the special allocation rules that apply to the dividends received deduction.

*Dividends paid to certain foreign persons*

California does not conform to the federal rules for certain dividends paid to nonresident alien individuals and foreign corporations in taxable years of the RIC beginning before January 1, 2010.

Impact on California Revenue

Estimated Revenue Impact of Modification of Dividend Designation Requirement and Allocation Rules for Regulated Investment Companies For Taxable Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
-\$1,000	-\$500	-\$500

Estimates are based on a proration of federal estimates developed by the Joint Committee on Taxation.

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<u>Section</u>	<u>Section Title</u>
302	Earnings and Profits of Regulated Investment Companies

Background

The current earnings and profits of a RIC are not reduced by any amount that is not allowable as a deduction in computing taxable income for the taxable year.<sup>1633</sup>

Application to Net Capital Loss

Thus, under the general rule, the current earnings and profits of a RIC are not reduced by a net capital loss either in the taxable year the loss arose or any taxable year to which the loss is carried.<sup>1634</sup> The accumulated earnings and profits are reduced in the taxable year the net capital loss arose.

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<sup>1632</sup> R&TC section 24871(b)(4).

<sup>1633</sup> IRC section 852(c)(1). The provision applies to a RIC without regard to whether it meets the requirements of IRC section 852(a) for the taxable year.

<sup>1634</sup> See section 101 of the Act for the treatment of carryovers of a net capital loss under present law and as amended by the Act.

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

### Application to Exempt-Interest Expenses

Because the general rule denies deductions in computing current earnings and profits for amounts disallowed for expenses, interest, and amortizable bond premium relating to tax-exempt interest,<sup>1635</sup> the current earnings and profits of a RIC with tax-exempt interest may exceed the amount which the RIC can distribute as exempt-interest dividends.<sup>1636</sup> Thus, distributions by a RIC with only tax-exempt interest income may result in taxable dividends to its shareholders. For example, assume a RIC has \$1 million gross tax-exempt interest and \$10,000 expenses disallowed under IRC section 265 (and no accumulated earnings and profits and no other item of current earnings and profits). If the RIC were to distribute \$1 million to its shareholders during its taxable year (which is \$10,000 more than its economic income for the year), \$990,000 may be designated as exempt-interest dividends, and the remaining \$10,000 is taxable as ordinary dividends.

### New Federal Law (IRC section 852)

#### Net Capital Loss

The rules applicable to the taxable income treatment of a net capital loss of a RIC apply for purposes of determining earnings and profits (both current earnings and profits and accumulated earnings and profits). Thus, a net capital loss for a taxable year is not taken into account in determining earnings and profits, but any capital loss treated as arising on the first day of the next taxable year is taken into account in determining earnings and profits for the next taxable year (subject to the application of the net capital loss rule for that year).

#### Exempt-Interest Expenses

The deductions disallowed in computing investment company taxable income relating to tax-exempt interest are allowed in computing current earnings and profits of a RIC.

In the example under present law, the provision reduces the RIC's current earnings and profits from \$1 million to \$990,000 and if the RIC were to distribute \$1 million to its shareholders during the taxable year, \$990,000 may be reported as exempt-interest dividends and the remaining \$10,000 is treated as a return of capital (or gain to the shareholder).

### Effective Date

The provision applies to taxable years beginning after December 22, 2010.

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<sup>1635</sup> IRC sections 171(a)(2) and 265.

<sup>1636</sup> For a description of exempt-interest dividends, see explanation of section 301 of the Act.

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

California Law (R&TC sections 17088, 17145, and 24870)

Under the PITL and the CTL, California conforms to the federal treatment of net capital loss and exempt-interest expense for purposes of computing earnings and profits of a RIC as of the “specified date” of January 1, 2009, with modifications.<sup>1637</sup> The PITL modifies the federal definition of exempt interest to mean interest that is exempt for state purposes, and provides its own exempt-interest dividend rules that generally parallel the federal rules.<sup>1638</sup>

The CTL conforms to the federal rules to determine the earnings and profits of a RIC as of the “specified date” of January 1, 2009, modified to provide that California disallowed amounts are used for purposes of the interest and expense deductions that are denied in the computation of earnings and profits.<sup>1639</sup> Additionally, the CTL specifically does not conform to federal rules relating to exempt-interest dividends,<sup>1640</sup> and instead provides that the deduction for dividends paid is modified to allow certain capital gain dividends and exempt-interest dividends, to the extent that interest is includable in the franchise or the income tax income under the CTL, to be included in the computation of the deduction.

Impact on California Revenue

Estimated Revenue Impact of Earnings and Profits of Regulated Investment Companies For Taxable Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
-\$3,000	-\$2,000	-\$2,000

Estimates are based on a proration of federal estimates developed by the Joint Committee on Taxation.

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<sup>1637</sup> For taxable years beginning on or after January 1, 2010, R&TC sections 17088 and 24870 conform to Subchapter M of Chapter 1 of Subtitle A of the IRC, consisting of IRC sections 851 to 860G, as of the “specified date” of January 1, 2009, with modifications. The PITL modifies the federal definition of exempt interest to mean interest that is exempt for state purposes under R&TC section 17145.

<sup>1638</sup> R&TC section 17145.

<sup>1639</sup> R&TC section 24871(b)(3).

<sup>1640</sup> R&TC section 24871(d).

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

<u>Section</u>	<u>Section Title</u>
303	Pass-Thru of Exempt-Interest Dividends and Foreign Tax Credits in Fund of Funds Structure

Background

In a so-called “fund of funds” structure, one RIC (“upper-tier fund”) holds stock in one or more other RICs (“lower-tier funds”). Generally, the character of certain types of income and gain, such as capital gain and qualified dividends, of a lower-tier fund pass through from the lower-tier RIC to the upper-tier RIC and then pass through to the shareholders of the upper-tier RIC.

Exempt-interest dividends and foreign tax credits may be passed through by a RIC only if at least 50 percent of the value of the total assets of a RIC consist of tax-exempt obligations (in the case of exempt-interest dividends) or more than 50 percent of the value of the total assets consist of stock or securities in foreign corporations (in the case of the foreign tax credit).

Because an upper-tier RIC holds stock in other RICs, it does not meet the 50-percent asset requirements. As a result, it may not pass through these items to its shareholders, even though the items were passed through to it by a lower-tier RIC meeting these requirements.

New Federal Law (IRC section 852)

Under the provision, in the case of a qualified fund of funds, the RIC may: (1) pay exempt-interest dividends without regard to the requirement that at least 50 percent of the value of its total assets consist of tax-exempt state and local bonds; and (2) elect to allow its shareholders the foreign tax credit without regard to the requirement that more than 50 percent of the value of its total assets consist of stock or securities in foreign corporations. For this purpose, a qualified fund of funds means a RIC at least 50 percent of the value of the total assets of which (at the close of each quarter of the taxable year) is represented by interests in other RICs.

Effective Date

The provision applies to taxable years beginning after December 22, 2010.

California Law (R&TC sections 17088 and 24870)

Under the PITL and the CTL, California conforms to the federal rules that applied to a RIC’s pass through of exempt-interest dividends as of the “specified date” of January 1, 2009, with modifications.<sup>1641</sup>

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<sup>1641</sup> For taxable years beginning on or after January 1, 2010, R&TC sections 17088 and 24870 conform to Subchapter M of Chapter 1 of Subtitle A of the IRC, consisting of IRC sections 851 to 860G, as of the “specified date” of January 1, 2009, with modifications.

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

The PITL modifies the federal definition of exempt interest to mean interest that is exempt for state purposes.<sup>1642</sup> The CTL specifically does not conform to federal rules relating to exempt-interest dividends, and instead provides that the deduction for dividends paid is modified to allow certain capital gain dividends and exempt-interest dividends (to the extent that interest is includible in the franchise or the income tax base under the CTL) to be included in the computation of the deduction.

Thus, to the extent that the 50-percent-of-RIC-asset-value threshold applies to income that is exempt for California purposes, California does not conform to the change made under this provision that allows the asset-value test to be disregarded.

California does not conform to the foreign tax credit; thus, that part of the provision is not applicable under California law.

Impact on California Revenue

Estimated Revenue Impact of Pass-Thru of Exempt-Interest Dividends and Foreign Tax Credits in Fund of Funds Structure For Taxable Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
-\$100,000	-\$80,000	-\$70,000

Estimates are based on a proration of federal estimates developed by the Joint Committee on Taxation.

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<u>Section</u>	<u>Section Title</u>
304	Modification of Rules for Spillover Dividends of Regulated Investment Companies

A RIC may elect to have certain dividends paid after the close of a taxable year considered as having been paid during that year for purposes of the RIC distribution requirements and determining the taxable income of the RIC.<sup>1643</sup> These dividends are referred to as “spillover dividends.” In order to qualify as a spillover dividend, the dividend must be declared prior to the time prescribed for filing the tax return for the taxable year (determined with regard to extensions) and the distribution must be made in the 12-month period following the close of the taxable year and not later than the date of the first dividend payment made after the declaration.

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<sup>1642</sup> R&TC section 17088(b).

<sup>1643</sup> IRC section 855.

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

New Federal Law (IRC section 855)

The time for declaring a spillover dividend is the later of the 15th day of the 9th month following the close of the taxable year or the extended due date for filing the return. Also, the requirement that the distribution be made not later than the date of the first dividend payment after the declaration is changed. The provision provides that the distribution must be made not later than the date of the first dividend payment of the same type of dividend (for example, an ordinary income dividend or a capital gain dividend) made after the declaration. For this purpose, a dividend attributable to short-term capital gain with respect to which a notice is required under the Investment Company Act of 1940 shall be treated as the same type of dividend as a capital gain dividend.<sup>1644</sup>

Effective Date

The provision applies to distributions in taxable years beginning after December 22, 2010.

California Law (R&TC sections 17088 and 24870)

Under the PITL and the CTL, California conforms to the RIC spillover dividend rules as in effect on the “specified date” of January 1, 2009.<sup>1645</sup> Thus, California does not conform to this provision’s modification to the spillover dividend rules.

Impact on California Revenue

Negligible—the Joint Committee on Taxation estimates that this provision will result in negligible revenue losses; thus, the California revenue losses as a result of conforming to this provision would also be negligible.

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<sup>1644</sup> See section 19 of the Investment Company Act of 1940, as amended, for rules requiring notice to shareholders identifying source of distribution.

<sup>1645</sup> For taxable years beginning on or after January 1, 2010, R&TC sections 17088 and 24870 conform to Subchapter M of Chapter 1 of Subtitle A of the IRC, consisting of IRC sections 851 to 860G, as of the “specified date” of January 1, 2009, with modifications.

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

<u>Section</u>	<u>Section Title</u>
305	Return of Capital Distributions of Regulated Investment Companies

A dividend is a distribution of property by a corporation: (1) out of its earnings and profits accumulated after February 28, 1913 (“accumulated earnings and profits”); and (2) out of its earnings and profits of the taxable year (“current earnings and profits”).<sup>1646</sup> The current earnings and profits are prorated among current-year distributions.<sup>1647</sup> Distributions of property that are not a dividend reduce the adjusted basis of a shareholder’s stock and are treated as gain to the extent in excess of the stock’s adjusted basis.<sup>1648</sup>

For example, assume a RIC, with a taxable year ending June 30 and with no accumulated earnings and profits, has current earnings and profits of \$4 million and distributes \$3 million to its shareholders on September 15 and \$3 million on March 15. Under present law, \$2 million of each distribution is out of current earnings and profits and is treated as dividend income to its shareholders. The remaining amounts are applied against the adjusted basis of the each shareholder’s stock or taken into account as gain by the shareholders.

New Federal Law (IRC section 316)

In the case of a non-calendar year RIC that makes distributions of property with respect to the taxable year in an amount in excess of the current and accumulated and earnings and profits, the current earnings and profits are allocated first to distributions made on or before December 31 of the taxable year.

Thus, under the provision, in the above example, all \$3 million of the distribution made on September 15 is out of current earnings and profits and thus treated as dividend income. Only \$1 million of the distribution made on March 15 is out of current earnings and profits and treated as dividend income. The remaining \$2 million of the March 15 distribution is applied against the adjusted basis of each shareholder’s stock or taken into account as gain by the shareholders.

In the case of a RIC with more than one class of stock, the provision applies separately to each class of stock.<sup>1649</sup>

Effective Date

The provision applies to distributions made in taxable years beginning after December 22, 2010.

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<sup>1646</sup> IRC section 316.

<sup>1647</sup> Treas. Reg. section 1.316-2(b).

<sup>1648</sup> IRC section 301(c).

<sup>1649</sup> See Rev. Rul. 69-440.

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

California Law (R&TC section 24451)

California conforms to the federal rules relating to RIC return of capital distributions as of the “specified date” of January 1, 2009.<sup>1650</sup> Thus, California does not conform to the earnings and profits allocation changes made by this provision.

Impact on California Revenue

Negligible—the Joint Committee on Taxation estimates that this provision will result in negligible revenue gains; thus, the California revenue gains as a result of conforming to this provision would also be negligible.

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<u>Section</u>	<u>Section Title</u>
306	Distributions in Redemption of Stock of a Regulated Investment Company

Background

Exchange Treatment

The redemption of stock by a corporation is treated as an exchange of stock if the redemption fits into one of four categories of transactions.<sup>1651</sup> If the redemption does not fit into one of these categories, the redemption is treated as a distribution of property. One of the four categories of transactions is that the redemption “is not essentially equivalent to a dividend.”<sup>1652</sup> A redemption “is not essentially equivalent to a dividend” if the redemption results in a “meaningful reduction in the shareholder’s proportionate ownership in the corporation.”<sup>1653</sup> Other categories include a substantially disproportionate redemption, a redemption that terminates the shareholder’s interest in the corporation, and a partial liquidation (if the redeemed shareholder is not a corporation).<sup>1654</sup>

The IRC provides no specific rule regarding the application of the “not essentially equivalent to a dividend” test in the case of an open-end RIC whose shareholders “sell” their shares by having

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<sup>1650</sup> For taxable years beginning on or after January 1, 2010, R&TC section 24451 conforms to Subchapter C of Chapter 1 of Subtitle A of the IRC, relating to corporate distributions and adjustments, as of the “specified date” of January 1, 2009.

<sup>1651</sup> IRC section 302.

<sup>1652</sup> IRC section 302(b)(1).

<sup>1653</sup> *United States v. Davis*, 397 U.S. 301 (1970).

<sup>1654</sup> IRC section 302(b)(2)-(4).

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

them redeemed by the issuing RIC and where multiple redemptions by different shareholders may occur daily.

#### Loss Deferral

Any deduction in respect of a loss from the sale or exchange of property between members of a controlled group of corporation is deferred until the transfer of the property outside the group.<sup>1655</sup> In the case of a fund of funds, a lower-tier fund may be required to redeem shares in an upper-tier fund when the upper-tier fund shareholders demand redemption of their shares. Because the upper-tier fund and lower-tier fund may be members of the same controlled group of corporations, any loss by the upper-tier fund on the disposition of the lower-tier fund shares may be deferred.

#### New Federal Law (IRC sections 267 and 302)

##### Exchange Treatment

The provision provides that, except to the extent provided in regulations, the redemption of stock of a publicly offered RIC is treated as an exchange if the redemption is upon the demand of the shareholder and the company issues only stock which is redeemable upon the demand of the shareholder. A publicly offered RIC is a RIC the shares of which are: (1) continuously offered pursuant to a public offering; (2) regularly traded on an established securities market; or (3) held by no fewer than 500 persons at all times during the taxable year.

##### Loss Deferral

The provision provides that, except to the extent provided in regulations, the loss deferral rule does not apply to any redemption of stock of a RIC if the RIC issues only stock which is redeemable upon the demand of the shareholder and the redemption is upon the demand of a shareholder that is another RIC.

#### Effective Date

The provision applies to distributions after December 22, 2010.

#### California Law (R&TC sections 17201, 17321, 24427, and 24451)

##### Exchange Treatment

The PITL and the CTL conform to the federal exchange-of-stock treatment rules that were in effect as of the “specified date” of January 1, 2009, with modifications.<sup>1656</sup> Thus, California does not conform to the RIC stock-redemption changes made by this provision.

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<sup>1655</sup> IRC section 267(f).

<sup>1656</sup> For taxable years beginning on or after January 1, 2010, R&TC sections 17321 and 24451 conform to Subchapter C of Chapter 1 of Subtitle A of the IRC, relating to corporate distributions and adjustments, as of the “specified date” of January 1, 2009, with modifications.

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

Loss Deferral

The PITL and the CTL conform to the federal loss deferral rules as of the “specified date” of January 1, 2009, with modifications.<sup>1657</sup> Thus, California does not conform to the RIC loss-deferral-rule changes made by this provision.

Impact on California Revenue

Estimated Revenue Impact of Distributions in Redemption of Stock of a Regulated Investment Company For Taxable Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
-\$450,000	-\$350,000	-\$350,000

Estimates are based on a proration of federal estimates developed by the Joint Committee on Taxation.

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<u>Section</u>	<u>Section Title</u>
307	Repeal of Preferential Dividend Rule for Publicly Offered Regulated Investment Companies

Background

RICs are allowed a deduction for dividends paid to their shareholders. In order to qualify for the deduction, a dividend must not be a “preferential dividend.”<sup>1658</sup> For this purpose, a dividend is preferential unless it is distributed pro rata to shareholders, with no preference to any share of stock compared with other shares of the same class, and with no preference to one class as compared with another except to the extent the class is entitled to a preference. A distribution by a RIC to a shareholder whose initial investment was \$10 million or more is not treated as preferential if the distribution is increased to reflect reduced administrative cost of the RIC with respect to the shareholder.

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<sup>1657</sup> For taxable years beginning on or after January 1, 2010, (1) R&TC section 17201(c) conforms to Part IX of Subchapter B of Chapter 1 of Subtitle A of the IRC, relating to items not deductible, as of the “specified date” of January 1, 2009, with modifications, and (2) R&TC section 24427 conforms to IRC section 267, relating to losses, as of the “specified date” of January 1, 2009.

<sup>1658</sup> IRC section 562(c).

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

Securities law, administered by the Securities Exchange Commission, provides strict limits on the ability of RICs to issue shares with preferences.<sup>1659</sup>

New Federal Law (IRC section 562)

The provision repeals the preferential dividend rule for publicly offered RICs. For this purpose, a RIC is publicly offered if its shares are: (1) continuously offered pursuant to a public offering; (2) regularly traded on an established securities market; or (3) held by no fewer than 500 persons at all times during the taxable year.

Effective Date

The provision applies to distributions in taxable years beginning after December 22, 2010.

California Law (R&TC sections 24870 and 24871)

The CTL conforms to the federal rules for the deduction for dividends paid (and the preferential dividend rule) as of the “specified date” of January 1, 2009;<sup>1660</sup> thus, the CTL does not conform to this provision (that repeals the preferential dividend rules for publicly offered RICs).

Impact on California Revenue

Negligible—the Joint Committee on Taxation estimates that this provision will result in negligible revenue losses; thus, the California revenue losses as a result of conforming to this provision would also be negligible.

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<sup>1659</sup> See, for example, section 18 of the Investment Company Act of 1940.

<sup>1660</sup> For taxable years beginning on or after January 1, 2010, R&TC section 24870 conforms to Subchapter M of Chapter 1 of Subtitle A of the IRC, as of the “specified date” of January 1, 2009 (consisting of IRC sections 851 to 860G), with RIC modifications in R&TC section 24871. The preferential dividend rules under IRC section 562 apply to the deduction for dividends paid as defined in IRC section 561, and IRC section 852 allows the deduction for dividends paid as defined in IRC section 561. As a result, for taxable years beginning on or after January 1, 2010, the CTL conforms to the preferential dividend rules as of the “specified date” of January 1, 2009.

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

<u>Section</u>	<u>Section Title</u>
308	Elective Deferral of Certain Late-Year Losses of Regulated Investment Companies

Background

Capital Gains and Losses

*In general*

In general, a RIC may pay a capital gain dividend to its shareholders to the extent of the RIC's net capital gain for the taxable year. The shareholders treat capital gain dividends as long-term capital gain.<sup>1661</sup>

Under present law, an excise tax is imposed on a RIC for a calendar year equal to four percent of the excess (if any) of the required distribution over the distributed amount. The required distribution is the sum of 98 percent of the RIC's ordinary income for the calendar year and 98 percent of the capital gain net income for the one-year period ending October 31 of such calendar year. The distributed amount is the sum of the deduction for dividends paid during the calendar year and the amount on which a corporate income tax is imposed on the RIC for taxable years ending during the calendar year.<sup>1662</sup>

*Deferral of net capital losses and long-term capital losses*

Under present law, for purposes of determining the amount of a net capital gain dividend, the amount of net capital gain for a taxable year is determined without regard to any net capital loss or net long-term capital loss attributable to transactions after October 31 of the taxable year, and the post-October net capital loss or net long-term capital loss is treated as arising on the first day of the RIC's next taxable year.<sup>1663</sup>

Present law provides that to the extent provided in regulations, the above rules relating to post-October net capital losses also apply for purposes of computing taxable income of a RIC.<sup>1664</sup> Regulations have been issued allowing RICs to elect to defer all or part of any net capital loss (or if there is no such net capital loss, any net long-term capital loss) attributable to the portion of the taxable year after October 31 to the first day of the succeeding taxable year.<sup>1665</sup>

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<sup>1661</sup> See explanation of section 301 of the Act.

<sup>1662</sup> IRC section 4982.

<sup>1663</sup> IRC section 852(b)(3)(C). Certain RICs with taxable years ending with the month of November or December are not subject to this rule.

<sup>1664</sup> The last sentence of IRC section 852(b)(3)(C).

<sup>1665</sup> Treas. Reg. section 1.852-11.

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

The following example illustrates the application of the post-October capital loss rules:

Assume a RIC with a taxable year ending June 30, 2011, recognizes a long-term capital gain of \$1,000,000 on September 15, 2010. In order to avoid the excise tax, the RIC distributes \$980,000 on December 15, 2010, which it designates as a capital gain dividend. On January 15, 2011, the RIC recognizes a \$600,000 long-term capital loss. The RIC has no other income or loss during 2010 and 2011, and has no accumulated earnings and profits.

Absent the post-October loss rule, the RIC would have a net capital gain (and current earnings and profits) of only \$400,000 for the taxable year ending June 30, 2011. Only \$400,000 of the December 15, 2010, distribution would be a capital gain dividend; the remaining \$580,000 of the \$980,000 distributed on December 15 would be a return of capital. Because the “distributed amount” for excise tax purposes takes into account only those distributions for which a dividend paid deduction is allowed, the RIC's distributed amount for calendar year 2010 would be \$400,000, which is less than the distributed amount required to avoid the excise tax. In addition, the shareholders may have improperly reported the distribution as a capital gain dividend on the 2010 income tax returns.

By “pushing” the post-October long-term capital loss to July 1, 2011, in the above example, the entire \$980,000 paid on December 15, 2010, is a capital gain dividend. The distribution is fully deductible in computing the excise tax. No excise tax is imposed for 2010 because the RIC has no undistributed income.

#### Short-Term Capital Losses Not Deferred

No special rule applies to short-term capital losses arising after October 31 of the taxable year for purposes of defining a capital gain dividend.

The following example illustrates the present-law treatment of a RIC with a post-October 31 short-term capital loss:

Assume a RIC with a taxable year ending June 30, 2011, recognizes a short-term capital gain of \$1 million on September 15, 2010. In order to avoid the excise tax, the RIC distributes \$980,000 on December 15, 2010. On May 15, 2011, the RIC recognizes a \$1 million long-term capital gain and \$1 million short-term capital loss. The RIC has no other income or loss during 2010, 2011, or 2012 (and has no accumulated earnings and profits).

Under present law, the shareholders receive Forms 1099 for 2010 reporting the dividends as other than capital gain dividends and they report the dividends accordingly on their 2010 income tax returns. Because the RIC has only \$1 million of current earnings and profits for its taxable year, the RIC may not pay an additional distribution designated as a capital gain dividend for its taxable year in order to be allowed a dividend paid deduction in computing the RIC's tax on net capital gain. Instead, the RIC could designate the December 15 distribution as a capital gain dividend, but that would require shareholders to file amended income tax returns for 2010.

### Deferral Partly Elective

Under present law, for purposes of determining capital gain dividends, the “push” forward of post-October capital losses is automatic, rather than elective; in contrast the push forward of these losses is elective for RIC taxable income purposes. Assume for example that a RIC has no net capital gain for the portion of its taxable year on or before October 31, and makes no distributions before January 1 of the taxable year. For the remainder of its taxable year, the RIC has a \$1 million short-term capital gain and a \$1 million long-term capital loss. Under present law, for purposes of determining the amount of capital gain dividends, the \$1 million long-term capital loss is automatically pushed forward to the next taxable year. But for purposes of determining its taxable income, the capital loss is pushed forward only if the RIC elects. If no election is made and the RIC has a \$1 million long-term capital gain in the next taxable year and pays a \$1 million dividend, the dividend may not be designated a capital gain dividend, although the RIC had \$1 million long-term capital gain that year. If an election is made, the RIC must distribute the \$1 million of short-term capital gain as an ordinary dividend in the current taxable year although the gains were economically offset by the long-term capital loss.

### Ordinary Gains and Losses

#### *Net foreign currency losses and losses on stock in a passive foreign investment company*

In applying the excise tax described above, net foreign currency losses and gains and ordinary loss or gain from the disposition of stock in a passive foreign investment company (“PFIC”) properly taken into account after October 31 are “pushed” to the following calendar year for purposes of the tax.<sup>1666</sup>

Under present law, to the extent provided in regulations, a RIC may elect to push the post-October net foreign currency losses and the net reduction in the value of stock in a PFIC with respect to which an election is in effect under IRC section 1296(k) forward to the next taxable year.<sup>1667</sup> Regulations have been issued allowing RICs to elect to defer all or part of any post-October net foreign currency losses for the portion of the taxable year after October 31 to the first day of the succeeding taxable year.<sup>1668</sup>

#### *Other ordinary losses*

Other ordinary losses of a RIC may not be “pushed” forward. As a result, in the event that a RIC has net ordinary losses for the portion of the taxable year after December 31 (other than a net foreign currency loss or loss on stock of a PFIC), the RIC may have insufficient earnings and profits

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<sup>1666</sup> IRC section 4982(e)(5) and (6).

<sup>1667</sup> IRC section 852(b)(8) and (10).

<sup>1668</sup> Treas. Reg. section 1.852-11.

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

to pay a dividend during the calendar year ending in the taxable year in order to reduce or eliminate the excise tax.

For example, assume a RIC for its taxable year ending June 30, 2012, has ordinary income of \$1 million for the portion of its taxable year ending on December 31, 2011. In order to avoid the excise tax, the RIC distributes \$980,000 on December 15, 2011. The RIC has no accumulated earnings and profits. For the period beginning January 1, 2012, and ending on June 30, 2012, the RIC has a net ordinary loss of \$1 million. Because the RIC has no earnings and profits, the distribution in 2011 is not a dividend, the distributed amount for calendar year 2011 is zero, and an excise tax is imposed.

New Federal Law (IRC section 852)

Post- October Capital Losses

Under the provision, except to the extent provided in regulations, a RIC may elect to “push” to the first day of the next taxable year part or all of any post-October capital loss. The post-October capital loss means the greatest of the RIC’s net capital loss, net long-term capital loss, or the net short-term capital loss (attributable to the portion of the taxable year after October 31).<sup>1669</sup>

The election<sup>1670</sup> applies for all purposes of the IRC, including determining taxable income, net capital gain, net short-term capital gain, and earnings and profits.

The application of the provision to short-term capital losses may be illustrated by the following example:

Assume a RIC for its taxable year ending June 30, 2012, recognizes a short-term capital gain of \$1 million on September 15, 2011. In order to avoid the excise tax, the RIC distributes \$980,000 on December 15, 2011. On May 15, 2012, the RIC recognizes a \$1 million long-term capital gain and \$1 million short-term capital loss. The RIC has no other income or loss during 2011, 2012, or 2013 (and has no accumulated earnings and profits).

The RIC may elect to treat the short-term capital loss as arising on July 1, 2012. If the RIC so elects and makes an additional \$1 million distribution before July 1, 2012, it may report the distribution as a capital gain dividend and be allowed a dividends paid deduction in computing the tax on its net capital gain for the 2011-2012 taxable year. No amended federal Forms 1099 and no amended tax returns by the shareholders are required.

Late-Year Ordinary Losses

Under the provision, except to the extent provided in regulations, a RIC may elect to “push” to the first day of the next taxable year part or all of any qualified late-year ordinary loss. The qualified

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<sup>1669</sup> Special rules apply to certain RICs with taxable years ending with the month of November or December.

<sup>1670</sup> The principles of Treasury Regulation section 1.852-11 are to apply to a qualified late-year loss for which an election is made under this provision, subject to any subsequent change in the regulations.

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

late year ordinary loss is the excess of: (1) the sum of the specified losses attributable to the portion of the taxable year after October 31 and other ordinary losses attributable to the portion of the taxable year after December 31; over (2) the sum of the specified gains attributable to the portion of the taxable year after October 31 and other ordinary income attributable to the portion of the taxable year after December 31. Specified losses and gains have the same meaning as used for purposes of the excise tax under IRC section 4982.<sup>1671</sup>

The election applies for all purposes of the IRC.

Effective Date

The provision applies to taxable years beginning after December 22, 2010.

California Law (R&TC sections 17088 and 24871)

Deferral (Post-October “Push”) Rules

Under the PITL and the CTL, California conforms to the federal RIC ordinary and capital gain and loss rules, including the post-October “push” forward rules, as of the “specified date” of January 1, 2009, with modifications.<sup>1672</sup> Thus, California does not conform to this provision (that allows a RIC to elect to “push” forward (i.e. to the first day of the next taxable year) part or all of post-October ordinary and capital losses).

Excise Tax on Excess Distributions

California does not conform to the excise tax on undistributed income of RICs.

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<sup>1671</sup> See explanation of section 402 of the Act.

<sup>1672</sup> For taxable years beginning on or after January 1, 2010, R&TC sections 17088 and 24870 conform to Subchapter M of Chapter 1 of Subtitle A of the IRC, consisting of IRC sections 851 to 860G, as of the “specified date” of January 1, 2009, with modifications.

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

Impact on California Revenue

Deferral (Post-October "Push") Rules

Estimated Revenue Impact of Elective Deferral of Certain Late-Year Losses of Regulated Investment Companies For Taxable Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
-\$1,000	-\$1,000	-\$1,000

Estimates are based on a proration of federal estimates developed by the Joint Committee on Taxation.

Excise Tax on Excess Distributions

Not applicable.

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<u>Section</u>	<u>Section Title</u>
309	Exception to Holding Period Requirement for Certain Regularly Declared Exempt-Interest Dividends

Background

If a shareholder receives an exempt-interest dividend with respect to a share of RIC stock held for six months or less, any loss on the sale or exchange of the stock, to the extent of the amount of the exempt-interest dividend, is disallowed. To the extent provided by regulations, the loss disallowance rule does not apply to losses on shares which are sold or exchanged pursuant to a plan which involves the periodic liquidation of the shares. In the case of a RIC that regularly distributes at least 90 percent of its net tax-exempt interest, the Secretary may, by regulations, prescribe a shorter holding period not shorter than the greater of 31 days or the period between the regular distributions.

New Federal Law (IRC section 852)

The provision makes the loss disallowance rule inapplicable, except as otherwise provided by regulations, with respect to a regular dividend paid by a RIC that declares exempt-interest dividends on a daily basis in amount equal to at least 90 percent of its net tax-exempt interest and distributes the dividends on a monthly or more frequent basis.

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

Effective Date

The provision applies to stock for which the taxpayer's holding period begins after December 22, 2010.

California Law (R&TC sections 17088 and 24871)

Under the PITL and the CTL, California conforms to the federal holding period requirement for certain regularly declared exempt-interest dividends as of the "specified date" of January 1, 2009, with modifications.<sup>1673</sup> However, the PITL and the CTL modify exempt-interest dividends to mean interest dividends that are exempt for state purposes. Specifically, the PITL provides a state exempt-interest dividend deduction that generally parallels the federal deduction,<sup>1674</sup> and the CTL provides that interest may be included in the computation of deductible dividends to the extent the interest is included in gross income for franchise or income tax purposes.<sup>1675</sup>

Thus, to the extent that dividends are exempt-interest dividends for state purposes, California does not conform to this provision's changes to the loss disallowance rule.

Impact on California Revenue

Negligible—the Joint Committee on Taxation estimates that this provision will result in negligible revenue losses; thus, California revenue losses as a result of conforming to this provision would also be negligible.

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<u>Section</u>	<u>Section Title</u>
401	Capital Loss Carryovers of Regulated Investment Companies

Background

An excise tax is imposed on a RIC for a calendar year equal to four percent of the excess (if any) of the required distribution over the distributed amount. The required distribution is the sum of 98 percent of the RIC's ordinary income for the calendar year and 98 percent of the capital gain net income for the one-year period ending October 31 of such calendar year.

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<sup>1673</sup> For taxable years beginning on or after January 1, 2010, R&TC sections 17088 and 24870 conform to Subchapter M of Chapter 1 of Subtitle A of the IRC, consisting of IRC sections 851 to 860G, as of the "specified date" of January 1, 2009, with modifications. R&TC section 17088(b) modifies the federal definition of exempt interest to mean interest that is exempt for state purposes under R&TC section 17145.

<sup>1674</sup> R&TC section 17088(b).

<sup>1675</sup> R&TC section 24871(b)(4).

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

The distributed amount is the sum of the deduction for dividends paid during the calendar year and the amount on which a corporate income tax is imposed on the RIC for taxable years ending during the calendar year.<sup>1676</sup>

The excise tax does not apply to a RIC for any calendar year if at all times during the calendar year each shareholder in the RIC is either a qualified pension plan exempt from tax or a segregated asset account of a life insurance company held in connection with variable contracts.

New Federal Law (IRC section 4982)

The provision adds tax-exempt entities whose ownership of beneficial interests in the RIC would not preclude the application of IRC section 817(h)(4) (regarding segregated asset accounts of a variable annuity or life insurance contract) to the list of persons who may hold stock in a RIC that is exempt from the excise tax. These persons include qualified annuity plans described in IRC section 403, IRAs, including Roth IRAs, certain government plans described in IRC section 414(d) or 457, and a pension plan described in IRC section 501(c)(18).<sup>1677</sup> Also, another RIC to which IRC section 4982 does not apply may hold stock in a RIC exempt from the excise tax.

Effective Date

The provision applies to calendar years beginning after December 22, 2010.

California Law (None)

California does not conform to the excise tax on undistributed income of RICs.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
402	Deferral of Certain Gains and Losses of Regulated Investment Companies for Excise Tax Purposes

Background

Special rules apply to certain items of income and loss in computing the excise tax under IRC section 4982.<sup>1678</sup> Any foreign currency gains and losses attributable to an IRC section 988 transaction properly taken into account after October 31 of any calendar year generally are

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<sup>1676</sup> IRC section 4982.

<sup>1677</sup> See Rev. Rul. 94-62, 1994-2 C.B. 164, as supplemented by Rev. Rul. 2007-58, I.R.B. 2007-37 (Sept. 10, 2007).

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

“pushed” to the following calendar year.<sup>1679</sup> Any post-October positive or negative adjustments, and income or loss, on contingent payment debt instruments is treated in the same manner as foreign currency gain or loss from an IRC section 988 transaction.<sup>1680</sup> Any gain recognized under IRC section 1296 (relating to mark-to-market for marketable stock in a passive foreign investment company (“PFIC”)) generally is determined as if the RIC’s taxable year ends October 31, and any gain or loss from an actual disposition of stock in an electing PFIC after October 31 generally is “pushed” to the following calendar year.<sup>1681</sup>

To the extent provided in regulations, any net foreign currency loss of a RIC and any net reduction in the value of the stock of a PFIC held by a RIC attributable to transactions after October 31 of the taxable year may be “pushed” to the first day of the following taxable year for purposes of computing taxable income.<sup>1682</sup> Similar rules apply for purposes of computing earnings and profits in order to allow a RIC a distribution deduction for purposes of the excise tax.<sup>1683</sup>

New Federal Law (IRC section 4982)

Under the provision, the present-law excise tax “push” rules applicable to foreign currency gains and losses are expanded to include all “specified gains and losses,” i.e., ordinary gains and losses from the sale, exchange, or other disposition of (or termination of a position with respect to) property, including foreign currency gain and loss, and amounts marked to market under IRC section 1296. Thus, these post-October 31 gains and losses are “pushed” to the next calendar year.<sup>1684</sup>

The provision also provides that, for purposes of determining a RIC’s ordinary income, the present-law rule treating PFIC stock as disposed of on October 31 is made applicable to all property held by a RIC which under any provision of the IRC (including regulations thereunder) is treated as disposed of on the last day of the taxable year.

Finally, for purposes of the excise tax, the provision allows a taxable year RIC, except as provided in regulations, to elect to “push” any net ordinary loss (determined without regard to ordinary gains and losses which are automatically “pushed” to the next calendar year) attributable to the

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<sup>1678</sup> See section 401 of the Act for a description of the tax.

<sup>1679</sup> IRC section 4982(e)(5).

<sup>1680</sup> See Treas. Reg. section 1.1275-4(b)(9)(v).

<sup>1681</sup> IRC section 4982(e)(6).

<sup>1682</sup> IRC section 852(b)(8) and (10). See Treas. Reg. section 1.852-11 for rules relating to the treatment of losses attributable to periods after October 31 of a taxable year.

<sup>1683</sup> IRC section 852(c)(2).

<sup>1684</sup> For treatment of these losses for income tax purposes, see IRC section 852(b)(8), as amended by section 308 of the Act.

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

portion of the calendar year after the beginning of the taxable year that begins in the calendar year to the first day of the next calendar year.

For example, assume a RIC for its taxable year ending June 30, 2012, has ordinary loss of \$1 million for the portion of its taxable year ending on December 31, 2011, and \$1 million ordinary income for the remainder of the taxable year. The RIC has no other items of income or loss in 2011, 2012, or 2013. The RIC must distribute \$980,000 in 2012 to avoid the excise tax, notwithstanding that it has no taxable income (or earnings and profits) for a taxable year that includes any portion of 2012. Under the provision, if the RIC makes an election, the \$1 million ordinary loss will be treated as arising on January 1, 2012, for purposes of the excise tax and the RIC will not be required to make a distribution in 2012 to avoid the excise tax.

Effective Date

The provision applies to calendar years beginning after December 22, 2010.

California Law (None)

California does not conform to the excise tax on undistributed income of RICs.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
403	Distributed Amount for Excise Tax Purposes Determined on Basis of Taxes Paid by Regulated Investment Company

Background

In computing the excise tax under IRC section 4982,<sup>1685</sup> a RIC is treated as having distributed amounts on which a tax is imposed on the RIC during the calendar year in which the taxable year of the RIC ends, regardless of the calendar year in which estimated tax payments are made.<sup>1686</sup>

New Federal Law (IRC section 4982)

Under the provision, a RIC making estimated tax payments of the taxes imposed on investment company taxable income and undistributed net capital gain for a taxable year beginning (but not ending) during any calendar year may elect to increase the distributed amount for that calendar

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<sup>1685</sup> See section 401 of the Act for a description of the tax.

<sup>1686</sup> IRC section 4982(c)(1)(B).

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

year by the amount on which the estimated tax payments of these taxes are made during that calendar year. The distributed amount for the following calendar year is reduced by the amount of the prior year's increase.

Effective Date

The provision applies to calendar years beginning after December 22, 2010.

California Law (None)

California does not conform to the excise tax on undistributed income of RICs.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
404	Increase in Required Distribution of Capital Gain Net Income

Background

An excise tax is imposed on a RIC for a calendar year equal to four percent of the excess (if any) of the required distribution over the distributed amount. The required distribution is the sum of 98 percent of the RIC's ordinary income for the calendar year and 98 percent of the capital gain net income for the one-year period ending October 31 of such calendar year. The distributed amount is the sum of the deduction for dividends paid during the calendar year and the amount on which a corporate income tax is imposed on the RIC for taxable years ending during the calendar year.<sup>1687</sup>

New Federal Law (IRC section 4982)

The provision increases the required distribution percentage of the capital gain net income from 98 percent to 98.2 percent.

Effective Date

The provision applies to calendar years beginning after December 22, 2010.

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<sup>1687</sup> IRC section 4982.

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

California Law (None)

California does not conform to the excise tax on undistributed income of RICs.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
501	Repeal of Assessable Penalty with Respect to Liability for Tax of Regulated Investment Company

Background

If there is a determination that a RIC has a tax deficiency with respect to a prior taxable year, the RIC can distribute a “deficiency dividend.”<sup>1688</sup> A deficiency dividend is treated by the RIC as a dividend paid with respect to the prior taxable year. As a result, the deficiency dividend increases the RIC’s deduction for dividends paid for that year and eliminates the deficiency. A RIC making a deficiency dividend is subject to an interest charge as if the entire amount of the deficiency dividend were the amount of the tax deficiency. An additional penalty is also imposed equal to the lesser of: (1) the amount of the interest charge; or (2) one-half of the amount of the deficiency dividend.<sup>1689</sup>

New Federal Law (IRC section 6697)

The provision repeals the additional penalty with respect to deficiency dividends.

Effective Date

The provision applies to taxable years beginning after December 22, 2010.

California Law (None)

California does not conform to the assessable penalty with respect to liability for tax of regulated investment companies.

Impact on California Revenue

Not applicable.

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<sup>1688</sup> IRC section 860.

<sup>1689</sup> IRC section 6697.

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

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<u>Section</u>	<u>Section Title</u>
502	Modification of Sales Load Basis Deferral Rule for Regulated Investment Companies

Background

If a taxpayer incurs a load charge in acquiring stock in a RIC and by reason of incurring the charge or making the acquisition, acquires a reinvestment right, the stock is disposed of within 90 days of the acquisition, and the taxpayer subsequently acquires stock in a RIC and the otherwise applicable load charge is reduced by reason of the reinvestment right, then the load charge (to the extent it does not exceed the reduction) is not taken into account in determining gain or loss of the original stock but is treated as incurred in acquiring the subsequently acquired stock.<sup>1690</sup>

New Federal Law (IRC section 852)

The provision limits the applicability of the provision described under present law to cases where the taxpayer subsequently acquires stock before January 31 of the calendar year following the calendar year the original stock is disposed of.

Effective Date

The provision applies to charges incurred in taxable years beginning after December 22, 2010.

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<sup>1690</sup> IRC section 852(f).

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010  
Public Law 111-325, December 22, 2010

California Law (R&TC sections 17088 and 24871)

Under the PITL and the CTL, California generally conforms to sales load basis deferral rule for RICs as of the “specified date” of January 1, 2009;<sup>1691</sup> thus, California does not conform to this provision’s modification to that rule.

Impact on California Revenue

Estimated Revenue Impact of Modification of Sales Load Basis Deferral Rule for Regulated Investment Companies For Taxable Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
-\$370,000	-\$200,000	-\$100,000

Estimates are based on a proration of federal estimates developed by the Joint Committee on Taxation.

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<sup>1691</sup> For taxable years beginning on or after January 1, 2010, R&TC sections 18151 and 24990 conform to Subchapter P of Chapter 1 of Subtitle A of the IRC, containing IRC sections 1201 to 1298, as of the “specified date” of January 1, 2009, with modifications.

**EXHIBIT A – 2010 MISCELLANEOUS FEDERAL ACTS IMPACTING THE IRC NOT REQUIRING A CALIFORNIA RESPONSE**

- 1. Public Law 111-153, the Federal Aviation Administration Extension Act of 2010.** This Act amends the IRC to extend through April 30, 2010: (1) excise taxes on aviation fuels and air transportation of persons and property; and (2) the expenditure authority for the Airport and Airway Trust Fund. Additionally, the Act amends the IRC to extend through April 30, 2010, the authorization of appropriations for (1) Federal Aviation Administration operations; (2) air navigation facilities and equipment; and, (3) research, engineering, and development.

IRC Section	Public Law Number	Act Section Number	124 Stat. Page
1	111-153	1	1084
4081	111-153	2(a) and 2(c)	1084
4261	111-153	2(b)(1)	1084
4271	111-153	2(b)(2)	1084
9502	111-153	3(a), 3(b), and 3(c)	1084

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- 2. Public Law 111-159, the TRICARE Affirmation Act.** This Act amends the IRC to provide that health care coverage provided by the TRICARE program<sup>1692</sup> and the Non-appropriated Fund Health Benefits Program of the Department of Defense shall constitute minimal essential health care coverage as required by the Patient Protection and Affordable Care Act.

IRC Section	Public Law Number	Act Section Number	124 Stat. Page
1	111-159	1	1123
5000A	111-159	2(a)	1123
5000A	111-159	2(b)	1123

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<sup>1692</sup> TRICARE is the name of the Department of Defense's managed health care program for active duty military, active duty service families, retirees and their families, and other beneficiaries. Under TRICARE, there are generally three options for health care: TRICARE Standard (formerly called CHAMPUS), TRICARE Extra, and TRICARE Prime. TRICARE Standard is the basic TRICARE health care program.

**EXHIBIT A – MISCELLANEOUS FEDERAL ACTS IMPACTING THE IRC NOT REQUIRING  
A CALIFORNIA RESPONSE**

- 3. Public Law 111-161, the Airport and Airway Extension Act of 2010.** This Act amends the IRC to extend through July 3, 2010: (1) increased excise taxes on aviation fuels and the excise tax on air transportation of persons and property; and (2) the expenditure authority for the Airport and Airway Trust Fund.

IRC Section	Public Law Number	Act Section Number	124 Stat. Page
1	111-161	1	1126
4081	111-161	2(a)	1126
4261	111-161	2(b)(1)	1126
4271	111-161	2(b)(2)	1126
4081	111-161	2(c)	1126
9502	111-161	3(a) and 3(b)	1126
9502	111-161	3(c)	1126

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- 4. Public Law 111-171, the Haiti Economic Lift Program Act of 2010.** This Act amends the Corporate Estimated Tax Shift Act of 2009<sup>1693</sup> to increase estimated tax payments of corporations with at least \$1 billion in assets in the third quarter of 2014 by 0.75 percent to 101.00 percent of such amount.

IRC Section	Public Law Number	Act Section Number	124 Stat. Page
6655	111-171	12(a)	1207
6655	111-171	12(b)	1207

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- 5. Public Law 111-173, an Act to clarify that health care provided by the Secretary of Veterans Affairs constitutes minimal essential coverage under the Patient Protection and Affordable Care Act.**<sup>1694</sup>

IRC Section	Public Law Number	Act Section Number	124 Stat. Page
5000A	111-173	1(a)	1215
5000A	111-173	1(b)	1215

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<sup>1693</sup> Public Law 111-42.

<sup>1694</sup> Public Law 111-148.

**EXHIBIT A – MISCELLANEOUS FEDERAL ACTS IMPACTING THE IRC NOT REQUIRING  
A CALIFORNIA RESPONSE**

- 6. Public Law 111-197, the Airport and Airway Extension Act of 2010, Part II.** This Act amends the IRC to extend through August 1, 2010: (1) increased excise taxes on aviation fuels and the excise tax on air transportation of persons and property; and, (2) the expenditure authority of the Airport and Airway Trust Fund.

IRC Section	Public Law Number	Act Section Number	124 Stat. Page
1	111-197	1	1353
4081	111-197	2(a)	1353
4261	111-197	2(b)(1)	1353
4271	111-197	2(b)(2)	1353
4081	111-197	2(c)	1353
9502	111-197	3(a) and (b)	1353
9502	111-197	3(c)	1353

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- 7. Public Law 111-198, the Homebuyer Assistance and Improvement Act of 2010.** This Act amends the IRC to: (1) extend eligibility for the first-time homebuyer credit until September 30, 2010, for taxpayers who entered into a binding contract to purchase a principal residence before May 1, 2010; (2) extend the penalty for tendering a bad check to the IRS to tendering any instrument in payment, by any commercially acceptable means; and (3) authorize the Secretary of the Treasury to disclose prisoner tax return information to state agencies charged with the responsibility of administration of prisons.

IRC Section	Public Law Number	Act Section Number	124 Stat. Page
1	111-198	1	1356
36	111-198	2(a) and 2(b)	1356
36	111-198	2(c)	1356
6657	111-198	3(a)	1356
6657	111-198	3(b)	1356
6103	111-198	4(a) – (d)	1356 and 1357
6103	111-198	4(e)	1357

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- 8. Public Law 111-205, the Unemployment Compensation Extension Act of 2010.** This Act amends the Supplemental Appropriations Act, 2008 with respect to the state-established individual emergency unemployment compensation account (EUCA). This Act extends the final date for entering a federal-state agreement under the Emergency Unemployment Compensation (EUC) program through November 30, 2010, and postpones the termination of the program until April 30, 2011.

**EXHIBIT A – MISCELLANEOUS FEDERAL ACTS IMPACTING THE IRC NOT REQUIRING  
A CALIFORNIA RESPONSE**

This Act amends the Assistance for Unemployed Workers and Struggling Families Act to extend until December 1, 2010, requirements that federal payments to states cover 100 percent of EUC.

This Act amends the Unemployment Compensation Extension Act of 2008 to exempt weeks of unemployment between July 22, 2010, and April 30, 2011, from the prohibition in the Federal-State Extended Unemployment Compensation Act of 1970 against federal matching payments to a state for the first week in an individual’s eligibility period for which extended compensation or sharable regular compensation is paid if the state law provides for payment of regular compensation to an individual for his or her first week of otherwise compensable unemployment. (Thus allows temporary federal matching for the first week of extended benefits for states with no waiting period.)

This Act amends the Supplemental Appropriations Act, 2008, to apply to claims for EUC payments the terms and conditions of state unemployment compensation law relating to availability of work, active search for work, and refusal to accept work.

This Act requires a state to determine whether an individual is to be paid EUC or regular compensation for a week of unemployment by using one of four specified methods if: (1) an individual has been determined to be entitled to EUC for a benefit year; (2) that benefit year has expired; and (3) such individual has remaining entitlement to EUC for that benefit year, and would qualify for a new benefit year in which the weekly benefit amount of regular compensation is at least either \$100 or 25 percent less than the individual’s weekly benefit amount in such benefit year.

This Act declares that federal-state agreements under which the state agency makes EUC payments to certain individuals shall not apply (or shall cease to apply) with respect to a state whose method of computing regular compensation under such state’s law has been modified in a manner that reduces the average weekly benefit amount of regular compensation payable on or after June 2, 2010, to less than the average weekly benefit amount of regular compensation otherwise payable under the state law as in effect on such date. (Thus prohibits states from reducing regular compensation in order to be eligible for federal funds under the EUC program.)

IRC Section	Public Law Number	Act Section Number	124 Stat. Page
1	111-205	1	2236
3304	111-205	2(a)(1)	2236
3304	111-205	2(a)(2)	2236
3304	111-205	2(a)(3)	2236
3304	111-205	2(b) and 2(c)	2236
3304	111-205	2(d)	2237
3304	111-205	3(a)	2237
3304	111-205	3(b)	2238
3304	111-205	4	2238

**EXHIBIT A – MISCELLANEOUS FEDERAL ACTS IMPACTING THE IRC NOT REQUIRING  
A CALIFORNIA RESPONSE**

**9. Public Law 111-210**, an Act to renew certain import restrictions contained in the Burmese Freedom and Democracy Act of 2003, and to amend the Consolidated Omnibus Budget Reconciliation Act of 1985 to extend from August 17, 2018, to August 24, 2018, certain customs user fees, including those for certain commercial or private vessels, commercial trucks, railroad cars, commercial or private aircraft, barges or other bulk carriers from Canada or Mexico, dutiable mail, and customs broker permits.

This Act also amends the Hiring Incentives to Restore Employment Act<sup>1695</sup> to increase required estimated tax payments of corporations with at least \$1 billion in assets in the third quarter of 2015 by 0.25 percent to 121.75 percent of such amount.

IRC Section	Public Law Number	Act Section Number	124 Stat. Page
6655	111-210	3	2256

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**10. Public Law 111-216, the Airline Safety and Federal Aviation Administration Extension Act of 2010.** This Act amends the IRC to extend through September 30, 2010: (1) excise taxes on aviation fuels and air transportation of persons and property; and (2) the expenditure authority for the Airport and Airway Trust Fund.

IRC Section	Public Law Number	Act Section Number	124 Stat. Page
4081	111-216	101(a)	2349
4261	111-216	101(b)(1)	2349
4271	111-216	101(b)(2)	2349
4081	111-216	101(c)	2349
9502	111-216	102(a) and 102(b)	2349
9502	111-216	102(c)	2349

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**11. Public Law 111-227, the United States Manufacturing Enhancement Act of 2010.** This Act amends the Hiring Incentives to Restore Employment Act<sup>1696</sup> to increase required estimated tax payments of corporations with at least \$1 billion in assets in the third quarter of 2015 by 0.5 percent to 122.0 percent of such amount.

IRC Section	Public Law Number	Act Section Number	124 Stat. Page
6655	111-227	4002	2480

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<sup>1695</sup> Public Law 111-147.

<sup>1696</sup> Public Law 111-147.

**EXHIBIT A – MISCELLANEOUS FEDERAL ACTS IMPACTING THE IRC NOT REQUIRING  
A CALIFORNIA RESPONSE**

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**12. Public Law 111-237, the Firearms Excise Tax Improvement Act of 2010.** This Act amends the IRC to require: (1) excise taxes on recreational equipment be due and payable on the date for filing the return for such taxes (i.e., quarterly); and (2) the Secretary of the Treasury to assess and collect, in the same manner as delinquent taxes are assessed and collected, mandatory orders of restitution for victims of crime. This Act also amends the Hiring Incentives to Restore Employment Act<sup>387</sup> to increase required estimated tax payments of corporations with at least \$1 billion in assets in the third quarter of 2015 by 0.25 percent to 122.25 percent of such amount.

IRC Section	Public Law Number	Act Section Number	124 Stat. Page
1	111-237	1	2497
6302	111-237	2(a)	2497
6302	111-237	2(b)	2497
6201	111-237	3(a)	2497
6213	111-237	3(b)(1)	2498
6501	111-237	3(b)(2)	2498
6201	111-237	3(c)	2498
6655	111-237	4(a)	2498

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**13. Public Law 111-249, the Airport and Airway Extension Act of 2010, Part III.** This act amends the IRC to extend through December 31, 2010: (1) increased excise taxes on aviation fuels and the excise tax on air transportation of persons and property; and (2) the expenditure authority for the Airport and Airway Trust Fund.

IRC Section	Public Law No.	Act Section No.	124 Stat. Page
4081	111-249	2(a)	2627
4261	111-249	2(b)(1)	2627
4271	111-249	2(b)(2)	2627
4081	111-249	2(c)	2627
9502	111-249	3(a) and 3(b)	2627
9502	111-249	3(c)	2627

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**EXHIBIT A – MISCELLANEOUS FEDERAL ACTS IMPACTING THE IRC NOT REQUIRING  
A CALIFORNIA RESPONSE**

**14. Public Law 111-322 Continuing Appropriations and Surface Transportation Extensions Act, 2011.** This act amends the IRC to extend through March 5, 2011, authorities for expenditures from the (1) HTF Highway and Mass Transit Accounts; and, (2) Sport Fish Restoration and Boating Trust Fund.

IRC Section	Public Law No.	Act Section No.	124 Stat. Page
9503	111-322	2401(a)	3531
9504	111-322	2401(b)	3531
9503	111-322	2401(c)	3531

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**15. Public Law 111-329, the Airport and Airway Extension Act of 2010, Part IV.** This act amends the IRC to extend through March 31, 2011: (1) increased excise taxes on aviation fuels and the excise tax on air transportation of persons and property; and (2) the expenditure authority for the Airport and Airway Trust Fund.

IRC Section	Public Law No.	Act Section No.	124 Stat. Page
1	111-329	1	3566
4081	111-329	2(a)	3566
4261	111-329	2(b)(1)	3566
4271	111-329	2(b)(2)	3566
4081	111-329	2(c)	3566
9502	111-329	3(a), (b)	3566
9502	111-329	3(c)	3566

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**EXHIBIT A – MISCELLANEOUS FEDERAL ACTS IMPACTING THE IRC NOT REQUIRING  
A CALIFORNIA RESPONSE**

**16. Public Law 111-344, the Omnibus Trade Act of 2010.** This act amends the IRC to extend the 80 percent tax credit for health insurance costs (including advance payments) for TAA recipients for eligible coverage months beginning before July 1, 2012. The act also amends the IRC, the Employee Retirement Income Security Act of 1974 (ERISA), and the Public Health Service Act (PHSA) to extend until July 1, 2012, the TAA pre-certification period rule disregarding any 63-day lapse in creditable health care coverage for TAA workers. The act extends the continued eligibility for the credit for qualifying family members and certain qualified TAA-eligible individuals and Pension Benefit Guaranty Corporation (PBGC) recipients for COBRA premium assistance through June 30, 2012, and extends until July 1, 2012, coverage under an employee benefit plan funded by a voluntary employees' beneficiary association established pursuant to an order of a bankruptcy court, or by agreement with an authorized representative.

IRC Section	Public Law No.	Act Section No.	124 Stat. Page
35	111-344	111(a)	3614
7527	111-344	111(b)	3615
35	111-344	111(c)	3615
7527	111-344	112(a)	3615
7527	111-344	112(b)	3615
35	111-344	113(a)	3615
35	111-344	113(b)	3615
9801	111-344	114(a)	3615
9801	111-344	114(d)	3615
35	111-344	115(a)	3615
35	111-344	115(c)	3615
4980B	111-344	116(b)	3616
4980B	111-344	116(d)	3616
35	111-344	117(a)	3616
35	111-344	117(b)	3616
7527	111-344	118(a)	3616
7527	111-344	118(b)	3616
6655	111-344	302	3617

**EXHIBIT B – EXPIRING TAX PROVISIONS**

<b>California Sunset<sup>1697</sup></b>	<b>California Section</b>	<b>Federal Section</b>	<b>Federal Sunset</b>	<b>Description</b>
See footnote <sup>1698</sup>	17059	36	12/01/09	Credit: Principal Residence
12/31/10	18750 - 18753	N/A	N/A	Voluntary Contribution: California Sea Otter 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 <sup>1699</sup>	17059.1	N/A	N/A	Credit: First Time Homebuyer and New Home
12/31/12	18711 - 18716	N/A	N/A	Voluntary Contribution: State Children's Trust Fund
12/31/12	18741 - 18744	N/A	N/A	Voluntary Contribution: Fish and Game Preservation Fund
12/31/12	18791 - 18796	N/A	N/A	Voluntary Contribution: Designations to California Breast Cancer Research Fund
12/31/12	18861 - 18864	N/A	N/A	Voluntary Contribution: California Cancer Research Fund
12/31/13	19551.1	N/A	N/A	City Business Tax/License Information Mandate
12/31/13	17501 - 24601	420	12/31/13	Transfer of Excess Pension Assets to Retiree Health Accounts

<sup>1697</sup> In general, this is the last taxable year to which the provision applies. Fiscal years beginning within this taxable year are also generally covered by the provision.

<sup>1698</sup> This provision is repealed on December 1, 2013; however, the \$100 million limitation on the amount of total credit allowable was reached on July 2, 2009.

<sup>1699</sup> This provision allocated \$100 million to the First Time Homebuyer credit and \$100 million to the New Home credit. The First Time Homebuyer credit cap was reached during August 2010, and therefore expired in 2010. The cap for the New Home credit required a contract to be in place for purchase of the new home by December 31, 2010, with completion of the contract by August 1, 2011. The New Home credit will expire December 31, 2011, whether the cap is reached or not.

**EXHIBIT B – EXPIRING TAX PROVISIONS**

<b>California Sunset</b>	<b>California Section</b>	<b>Federal Section</b>	<b>Federal Sunset</b>	<b>Description</b>
12/31/13	18851 - 18855	N/A	N/A	Voluntary Contribution: Emergency Food Assistance Program Fund
12/31/14	18721 - 18724	N/A	N/A	Voluntary Contribution: California Fund for Senior Citizens
12/31/14	18761 - 18766	N/A	N/A	Voluntary Contribution - California Alzheimer's Disease and Related Research Fund
12/31/14	18815	N/A	N/A	Voluntary Contribution: California Veterans Home Fund
12/31/14	18856	N/A	N/A	Voluntary Contribution: California Police Activities League (CALPAL)
12/31/14	18887	N/A	N/A	Voluntary Contribution: Safely Surrendered Babies Fund
12/31/14	18891	N/A	N/A	Voluntary Contribution: Arts Council Fund
12/31/15	18801 - 18804	N/A	N/A	Voluntary Contribution: California Firefighter's Memorial Fund
12/31/15	18805 - 18808	N/A	N/A	Voluntary Contribution: California Peace Officer's Memorial Foundation Fund
12/31/17	17053.62 & 23662	45H	Permanent	Credit: Environmental Credit for Production of Ultra Low Sulfur Diesel Fuel
See footnote <sup>1700</sup>	17053.80 & 23623	N/A	N/A	Credit: New Jobs
See footnote <sup>1701</sup>	17131.3 & 24303	48(d)	12/31/12	Grants for Specified Energy Property in Lieu of Tax Credits

<sup>1700</sup> This credit is repealed on December 1 of the year in which the total amount of the credit allocated reaches \$400 million. As of December 31, 2010, less than \$40 million had been allocated.

<sup>1701</sup> The eligible property must be placed in service in calendar years 2009, 2010, or 2011, or its construction must begin during that period and must be completed prior to 2013 (in the case of wind facility property), 2014 (in the case of other renewable power facility property eligible for credit under IRC section 45), or 2017 (in the case of any specified energy property described in IRC section 48).

**EXHIBIT C – REVENUE TABLES**

Assumed Enactment after June 30, 2011

<b>Table 1 – Temporary Extension Act of 2010</b> (Public Law 111-144)				
<b>Act Section</b>	<b>Provision</b>	<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>
2	Extension of Unemployment Insurance Provisions	Defer to the EDD	Defer to the EDD	Defer to the EDD
3	Extension and Improvement of Premium Assistance for COBRA Benefits	Baseline and Defer to the EDD	Baseline and Defer to the EDD	Baseline and Defer to the EDD

<b>Table 2 – Hiring Incentives to Restore Employment (HIRE) Act</b> (Public Law 111-147)				
<b>Act Section</b>	<b>Provision</b>	<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>
101	Payroll Tax Forgiveness for Hiring Unemployed Workers	Baseline and Defer to the EDD	Baseline and Defer to the EDD	Baseline and Defer to the EDD
102	Business Credit for Retention of Certain Newly Hired Individuals in 2010	N/A	N/A	N/A
201	Increase in Expensing of Certain Depreciable Business Assets	N/A	N/A	N/A
301	Issuer Allowed Refundable Credit for Certain Qualified Tax Credit Bonds	N/A	N/A	N/A
441-445	Revenue Provisions Relating to the Highway Trust Fund	Defer to the BOE	Defer to the BOE	Defer to the BOE
501	Reporting on Certain Foreign Accounts	N/A	N/A	N/A
502	Repeal of Certain Foreign Exceptions to Registered Bond Requirements	Defer to the BOE	Defer to the BOE	Defer to the BOE

**EXHIBIT C – REVENUE TABLES**

<b>Table 2 – Hiring Incentives to Restore Employment (HIRE) Act (Public Law 111-147)</b>				
<b>Act Section</b>	<b>Provision</b>	<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>
511	Disclosure of Information with Respect to Foreign Financial Assets	\$1,000,000	\$800,000	\$800,000
512	Penalties for Underpayments Attributable to Undisclosed Foreign Financial Assets	\$500,000	\$400,000	\$400,000
513	Modification of Statute of Limitations for Significant Omission of Income in Connection with Foreign Assets	Baseline	Baseline	Baseline
521	Reporting of Activities with Respect to Passive Foreign Investment Companies	N/A	N/A	N/A
522	Secretary Permitted to Require Financial Institutions to File Certain Returns Related to Withholding on Foreign Transfers Electronically	N/A	N/A	N/A
531	Clarifications with Respect to Foreign Trusts which are Treated as Having a United States Beneficiary	N/A	N/A	N/A
532	Presumption that Foreign Trust has United States Beneficiary	N/A	N/A	N/A
533	Uncompensated Use of Trust Property	N/A	N/A	N/A
534	Reporting Requirement of United States Owners of Foreign Trusts	N/A	N/A	N/A
535	Minimum Penalty with Respect to Failure to Report on Certain Foreign Trusts	N/A	N/A	N/A
541	Substitute Dividends and Dividend Equivalent Payments Received by Foreign Persons Treated as Dividends	N/A	N/A	N/A
551	Delay in Application of Worldwide Allocation of Interest	N/A	N/A	N/A

**EXHIBIT C – REVENUE TABLES**

<b>Table 2 – Hiring Incentives to Restore Employment (HIRE) Act</b> (Public Law 111-147)				
<b>Act Section</b>	<b>Provision</b>	<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>
561	Time for Payment of Corporate Estimated Taxes	N/A	N/A	N/A

<b>Table 3 – Patient Protection and Affordable Care Act</b> (Public Law 111-148)				
<b>Act Section</b>	<b>Provision</b>	<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>
1322	Federal Program to Assist Establishment and Operation of Nonprofit, Member-Run Health Insurance Issuers	Defer to the BOE	Defer to the BOE	Defer to the BOE
1401	Refundable Tax Credit for Providing Premium Assistance for Coverage Under a Qualified Health Plan	N/A	N/A	N/A
1414	Disclosures to Carry out Eligibility Requirements for Certain Programs	N/A	N/A	N/A
1421	Credit for Employee Health Insurance Expenses of Small Businesses	N/A	N/A	N/A
1501	Requirement to Maintain Minimum Essential Coverage	Defer to the BOE	Defer to the BOE	Defer to the BOE
1502	Reporting of Health Insurance Coverage	Baseline	Baseline	Baseline
1513	Shared Responsibility for Employers	Defer to the BOE	Defer to the BOE	Defer to the BOE
1514	Reporting of Employer Health Insurance Coverage	Baseline	Baseline	Baseline
1515	Offering of Exchange-Participating Qualified Health Plans Through Cafeteria Plans	Negligible Loss	Negligible Loss	Negligible Loss
1562	Conforming Amendments	Defer to the BOE	Defer to the BOE	Defer to the BOE

**EXHIBIT C – REVENUE TABLES**

<b>Table 3 – Patient Protection and Affordable Care Act (Public Law 111-148)</b>				
<b>Act Section</b>	<b>Provision</b>	<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>
3308	Reducing Part D Premium Subsidy for High-Income Beneficiaries	N/A	N/A	N/A
6301	Patient-Centered Outcomes Research	Defer to the BOE	Defer to the BOE	Defer to the BOE
9001	Excise Tax on High-Cost Employer-Sponsored Health Coverage	Defer to the BOE	Defer to the BOE	Defer to the BOE
9002	Inclusion of Cost of Employer-Sponsored Health Coverage on W-2	Baseline	Baseline	Baseline
9003	Distributions for Medicine Qualified Only if for Prescribed Drug or Insulin	Baseline	Baseline	Baseline
9004	Increase in Additional Tax on Distributions from HSAs and Archer MSAs Not Used for Qualified Medical Expenses	\$200,000	\$150,000	\$150,000
9005	Limitation on Health Flexible Spending Arrangements Under Cafeteria Plans	Baseline	Baseline	Baseline
9006	Expansion of Information Reporting Requirements	Baseline	Baseline	Baseline
9007	Additional Requirements for Charitable Hospitals	Baseline and Defer to the EDD	Baseline and Defer to the EDD	Baseline and Defer to the EDD
9008	Imposition of Annual Fee on Branded Prescription Pharmaceutical Manufacturers and Importers	Defer to the BOE	Defer to the BOE	Defer to the BOE
	Denial of Deduction for Annual Fee on Branded Prescription Pharmaceutical Manufacturers and Importers	\$17,000,000	\$15,000,000	\$15,000,000
9009	Imposition of Annual Fee on Medical Device Manufacturers and Importers	N/A	N/A	N/A

**EXHIBIT C – REVENUE TABLES**

<b>Table 3 – Patient Protection and Affordable Care Act (Public Law 111-148)</b>				
<b>Act Section</b>	<b>Provision</b>	<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>
9010	Imposition of Annual Fee on Health Insurance Providers	Defer to the BOE	Defer to the BOE	Defer to the BOE
9012	Elimination of Deduction for Expenses Allocable to Medicare Part D Subsidy	N/A	N/A	N/A
9013	Modification of Itemized Deduction for Medical Expenses	\$0	\$25,000,000	\$44,000,000
9014	Limitation on Excessive Remuneration Paid by Certain Health Insurance Providers	Defer to the BOE	Defer to the BOE	Defer to the BOE
9015	Additional Hospital Insurance Tax on High-Income Taxpayers	Defer to the EDD	Defer to the EDD	Defer to the EDD
9016	Modification of Section 833 Treatment of Certain Health Organizations	Defer to the BOE	Defer to the BOE	Defer to the BOE
9017	Excise Tax on Elective Cosmetic Medical Procedures	N/A	N/A	N/A
9021	Exclusion of Health Benefits Provided by Indian Tribal Governments	-\$150,000	-\$80,000	-\$80,000
9022	Establishment of Simple Cafeteria Plans for Small Businesses	Negligible Loss	Negligible Loss	Negligible Loss
9023	Qualifying Therapeutic Discovery Project Credit	-\$2,600,000	-\$1,700,000	-\$800,000
10105	Amendments to Subtitle E	N/A	N/A	N/A
10108	Free Choice Vouchers	No Impact	No Impact	-\$55,000,000
10907	Excise Tax on Indoor Tanning Services in Lieu of Elective Cosmetic Medical Procedures	Defer to the BOE	Defer to the BOE	Defer to the BOE

**EXHIBIT C – REVENUE TABLES**

<b>Table 3 – Patient Protection and Affordable Care Act</b> (Public Law 111-148)				
<b>Act Section</b>	<b>Act Section</b>	<b>Act Section</b>	<b>Act Section</b>	<b>Act Section</b>
10908	Exclusion for Assistance Provided to Participants in State Student Loan Repayment Programs for Certain Health Professionals	-\$500,000	-\$350,000	-\$350,000
10909	Expansion of Adoption Credit and Adoption Assistance Programs	-\$1,200,000	No Impact	No Impact

<b>Table 4 – Health Care and Education Reconciliation Act of 2010</b> (Public Law 111-152)				
<b>Act Section</b>	<b>Provision</b>	<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>
1004	Income Definitions	Statutes of 2011, Ch. 17	Statutes of 2011, Ch. 17	Statutes of 2011, Ch. 17
1402	Unearned Income Medicare Contribution	N/A	N/A	N/A
1405	Excise Tax on Medical Device Manufacturers	Defer to the BOE	Defer to the BOE	Defer to the BOE
1408	Elimination of Unintended Application of Cellulosic Biofuel Producer Credit	N/A	N/A	N/A
1409	Codification of Economic Substance Doctrine and Penalties	Baseline	Baseline	Baseline
1410	Time for Payment of Corporate Estimated Taxes	N/A	N/A	N/A

<b>Table 5 – Continuing Extension Act of 2010</b> (Public Law 111-157)				
<b>Act Section</b>	<b>Provision</b>	<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>
2	Extension of Unemployment Insurance Provisions	Defer to the EDD	Defer to the EDD	Defer to the EDD
3	Extension and Improvement of Premium Assistance for COBRA Benefits	Baseline and Defer to the EDD	Baseline and Defer to the EDD	Baseline and Defer to the EDD

**EXHIBIT C – REVENUE TABLES**

<b>Table 6 – Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010 (Public Law 111-192)</b>				
<b>Act Section</b>	<b>Provision</b>	<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>
103	Establish a CMS-IRS Data Match to Identify Fraudulent Providers	N/A	N/A	N/A
201	Extended Period for Single-Employer Defined Benefit Plans to Amortize Certain Shortfall Amortization Bases	Baseline	Baseline	Baseline
202	Application of Extended Amortization Period to Plans Subject to Prior Law Funding Rules	Baseline	Baseline	Baseline
203	Lookback for Certain Benefit Restrictions	Baseline	Baseline	Baseline
204	Lookback for Credit Balance Rule for Plans Maintained by Charities	Baseline	Baseline	Baseline
211	Adjustments to Funding Standard Account Rules	Baseline	Baseline	Baseline

<b>Table 7 – Dodd-Frank Wall Street Reform and Consumer Protection Act (Public Law 111-203)</b>				
<b>Act Section</b>	<b>Provision</b>	<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>
501 - 542	Nonadmitted and Reinsurance Reform Act of 2010	Baseline	Baseline	Baseline
1601	Certain Swaps, etc., not Treated as Section 1256 Contracts	No Impact	No Impact	No Impact

**EXHIBIT C – REVENUE TABLES**

<b>Table 8 – State Fiscal Relief and Other Provisions; Revenue Offsets</b> (Public Law 111-226)				
<b>Act Section</b>	<b>Provision</b>	<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>
211	Rules to Prevent Splitting Foreign Tax Credits from the Income to Which they Relate	N/A	N/A	N/A
212	Denial of Foreign Tax Credit with Respect to Foreign Income not Subject to United States Taxation by Reason of Covered Asset Acquisitions	N/A	N/A	N/A
213	Separate Application of Foreign Tax Credit Limitation, etc., to Items Resourced Under Treaties	N/A	N/A	N/A
214	Limitation on the Amount of Foreign Taxes Deemed Paid with Respect to Section 956 Inclusions	N/A	N/A	N/A
215	Special Rule with Respect to Certain Redemptions by Foreign Subsidiaries	\$600,000	\$400,000	\$400,000
216	Modification of Affiliation Rules for Purposes of Rules Allocating Interest Expense	Baseline	Baseline	Baseline
217	Termination of Special Rules for Interest and Dividends Received from Persons Meeting the 80-Percent Foreign Business Requirements	Baseline	Baseline	Baseline
218	Limitation on Extension of Statute of Limitations for Failure to Notify Secretary of Certain Foreign Transfers	Baseline	Baseline	Baseline
219	Elimination of Advance Refundability of Earned Income Credit	N/A	N/A	N/A

**EXHIBIT C – REVENUE TABLES**

<b>Table 9 – Small Business Jobs Act of 2010</b> (Public Law 111-240)				
<b>Act Section</b>	<b>Provision</b>	<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>
2011	Temporary Exclusion of 100 Percent of Gain on Certain Small Business Stock	N/A	N/A	N/A
2012	General Business Credits of Eligible Small Businesses for 2010 Carried Back 5 Years	N/A	N/A	N/A
2013	General Business Credits of Eligible Small Businesses in 2010 not Subject to Alternative Minimum Tax	N/A	N/A	N/A
2014	Temporary Reduction in Recognition Period for Built-in Gains Tax	-\$850,000	-\$300,000	\$0
2021	Increased Expensing Limitations for 2010 and 2011; Certain Real Property Treated as Section 179 Property	N/A	N/A	N/A
2022	Additional First-Year Depreciation for 50 Percent of the Basis of Certain Qualified Property	N/A	N/A	N/A
2023	Special Rule for Long-Term Contract Accounting	N/A	N/A	N/A
2031	Increase Amount Allowed as Deduction for Start-Up Expenditures in 2010	N/A	N/A	N/A
2041	Limitation on Penalty for Failure to Disclose Reportable Transactions Based on Resulting Tax Benefits	-\$400,000	-\$400,000	-\$400,000
2042	Deduction for Health Insurance Costs in Computing Self-Employment Taxes in 2010	Defer to the EDD	Defer to the EDD	Defer to the EDD
2043	Removal of Cellular Telephones and Similar Telecommunications Equipment from Listed Property	-\$1,200,000	-\$1,000,000	-\$1,000,000
2101	Information Reporting for Rental Property Expense Payments	Baseline	Baseline	Baseline
2102	Increase in Information Return Penalties	\$10,000	\$10,000	\$10,000

**EXHIBIT C – REVENUE TABLES**

<b>Table 9 – Small Business Jobs Act of 2010</b> (Public Law 111-240)				
<b>Act Section</b>	<b>Provision</b>	<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>
2103	Report on Tax Shelter Penalties and Certain Other Enforcement Actions	N/A	N/A	N/A
2104	Application of Continuous Levy to Tax Liabilities of Certain Federal Contractors	N/A	N/A	N/A
2111	Participants in Government Section 457 Plans Allowed to Treat Elective Deferrals as Roth Contributions	Baseline	Baseline	Baseline
2112	Rollovers from Elective Deferral Plans to Designated Roth Accounts	Baseline	Baseline	Baseline
2113	Special Rules for Annuities Received from Only a Portion of a Contract	\$900,000	\$1,200,000	\$1,800,000
2121	Crude Tall Oil Ineligible for Cellulosic Biofuel Producer Credit	N/A	N/A	N/A
2122	Source Rules for Income on Guarantees	Baseline	Baseline	Baseline
2131	Time for Payment of Corporate Estimated Taxes	N/A	N/A	N/A

**EXHIBIT C – REVENUE TABLES**

<b>Table 10 – Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010</b> (Public Law 111-312)				
<b>Act Section</b>	<b>Provision</b>	<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>
101 - 103	Temporary Extensions of 2001, 2003 and 2009 Tax Relief	See A through K, below		
A	Marginal Individual Income Tax Rate Reductions	N/A	N/A	N/A
B	Overall Limitation on Itemized Deductions and the Personal Exemption	N/A	N/A	N/A
C	Child Tax Credit	N/A	N/A	N/A
D	Marriage Penalty Relief and Earned Income Tax Credit Simplification	N/A	N/A	N/A
E	Education Incentives	Baseline and Defer to the EDD	Baseline and Defer to the EDD	Baseline and Defer to the EDD
F	Other Incentives for Families and Children	Baseline	Baseline	Baseline
G	Alaska Native Settlement Trusts	N/A	N/A	N/A
H	Reduced Rate on Dividends and Capital Gains	N/A	N/A	N/A
I	Extend American Opportunity Tax Credit	N/A	N/A	N/A
J	Child Tax Credit	N/A	N/A	N/A
K	Increase in the Earned Income Tax Credit	N/A	N/A	N/A
201 - 202	Extension of Alternative Minimum Tax Relief for Nonrefundable Personal Credits and Increased Alternative Minimum Tax Exemption Amount	N/A	N/A	N/A

**EXHIBIT C – REVENUE TABLES**

<b>Table 10 – Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010</b> (Public Law 111-312)				
<b>Act Section</b>	<b>Provision</b>	<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>
301 - 304	Modify and Extend the Estate, Gift, and Generation Skipping Transfer Taxes After 2009	Defer to the State Controller	Defer to the State Controller	Defer to the State Controller
401	Extension of Bonus Depreciation; Temporary 100 Percent Expensing for Certain Business Assets	N/A	N/A	N/A
402	Temporary Extension of Increased Small Business Expensing	N/A	N/A	N/A
501	Temporary Extension of Unemployment Insurance Provisions	Defer to the EDD	Defer to the EDD	Defer to the EDD
502	Temporary Modification of Indicators Under the Extended Benefit Program	Defer to the EDD	Defer to the EDD	Defer to the EDD
503	Technical Amendment Relating to Collection of Unemployment Compensation Debts	Defer to the EDD	Defer to the EDD	Defer to the EDD
601	Temporary Employee Payroll Tax Cut	-\$33,000,000	\$0	\$0
701	Incentives for Biodiesel and Renewable Diesel	Defer to the BOE	Defer to the BOE	Defer to the BOE
702	Credit for Refined Coal Facilities	N/A	N/A	N/A
703	New Energy Efficient Home Credit	N/A	N/A	N/A
704	Excise Tax Credits and Outlay Payments for Alternative Fuel and Alternative Fuel Mixtures	Defer to the BOE	Defer to the BOE	Defer to the BOE
705	Special Rule for Sales or Dispositions to Implement FERC or State Electric Restructuring Policy for Qualified Electric Utilities	N/A	N/A	N/A
706	Suspension of Limitation on Percentage Depletion for Oil and Gas from Marginal Wells	N/A	N/A	N/A

**EXHIBIT C – REVENUE TABLES**

<b>Table 10 – Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (Public Law 111-312)</b>				
<b>Act Section</b>	<b>Provision</b>	<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>
707	Extension of Grants for Specified Energy Property in Lieu of Tax Credits	Baseline	Baseline	Baseline
708	Extension of Provisions Related to Alcohol Used as Fuel	Defer to the BOE	Defer to the BOE	Defer to the BOE
709	Energy Efficient Appliance Credit	N/A	N/A	N/A
710	Credit for Nonbusiness Energy Property	N/A	N/A	N/A
711	Alternative Fuel Vehicle Refueling Property	N/A	N/A	N/A
721	Deduction for Certain Expenses of Elementary and Secondary School Teachers	N/A	N/A	N/A
722	Deduction for State and Local Taxes	N/A	N/A	N/A
723	Contributions of Capital Gain Real Property Made for Conservation Purposes	-\$1,500,000	No Impact	No Impact
724	Above-the-Line Deduction for Qualified Tuition and Related Expenses	N/A	N/A	N/A
725	Tax-Free Distributions from Individual Retirement Plans for Charitable Purposes	Baseline	Baseline	Baseline
726	Look- Thru of Certain Regulated Investment Company Stock in Determining Gross Estate of Non-Residents	Defer to the State Controller	Defer to the State Controller	Defer to the State Controller
727	Parity for Exclusion from Income for Employer-Provided Mass Transit and Parking Benefits	Baseline	Baseline	Baseline
728	Refunds Disregarded in the Administration of Federal Programs and Federally Assisted Programs	N/A	N/A	N/A

**EXHIBIT C – REVENUE TABLES**

<b>Table 10 – Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (Public Law 111-312)</b>				
<b>Act Section</b>	<b>Provision</b>	<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>
731	Research Credit	N/A	N/A	N/A
732	Indian Employment Tax Credit	N/A	N/A	N/A
733	New Markets Tax Credit	N/A	N/A	N/A
734	Railroad Track Maintenance Credit	N/A	N/A	N/A
735	Mine Rescue Team Training Credit	N/A	N/A	N/A
736	Employer Wage Credit for Employees Who Are Active Duty Members of the Uniformed Services	N/A	N/A	N/A
737	15-Year Straight-Line Cost Recovery for Qualified Leasehold Improvements, Qualified Restaurant Building Improvements, and Qualified Retail Improvements	N/A	N/A	N/A
738	7-Year Recovery Period for Motorsports Entertainment Complexes	N/A	N/A	N/A
739	Accelerated Depreciation for Business Property on an Indian Reservation	N/A	N/A	N/A
740	Enhanced Charitable Deduction for Contributions of Food Inventory	N/A	N/A	N/A
741	Enhanced Charitable Deduction for Contributions of Book Inventory to Public Schools	N/A	N/A	N/A
742	Enhanced Charitable Deduction for Corporate Contributions of Computer Inventory for Educational Purposes	N/A	N/A	N/A
743	Election to Expense Mine Safety Equipment	N/A	N/A	N/A

**EXHIBIT C – REVENUE TABLES**

<b>Table 10 – Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (Public Law 111-312)</b>				
<b>Act Section</b>	<b>Provision</b>	<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>
744	Special Expensing Rules for Certain Film and Television Productions	N/A	N/A	N/A
745	Expensing of Environmental Remediation Costs	N/A	N/A	N/A
746	Deduction Allowable with Respect to Income Attributable to Domestic Production Activities in Puerto Rico	N/A	N/A	N/A
747	Modification of Tax Treatment of Certain Payments to Controlling Exempt Organizations	-\$800,000	-\$100,000	\$10,000
748	Treatment of Certain Dividends of Regulated Investment Companies	N/A	N/A	N/A
749	RIC Qualified Investment Entity Treated Under FIRPTA	N/A	N/A	N/A
750	Exceptions for Active Financing Income	Baseline	Baseline	Baseline
751	Look-Thru Treatment of Payments Between Related Controlled Foreign Corporations Under Foreign Holding Company Rules	Baseline	Baseline	Baseline
752	Basis Adjustment to Stock of S Corps Making Charitable Contribution of Property	-\$1,300,000	-\$100,000	-\$70,000
753	Empowerment Zone Tax Incentives	N/A	N/A	N/A
754	Tax Incentives for Investment in the District of Columbia	N/A	N/A	N/A
755	Temporary Increase in Limit on Cover over Rum Excise Taxes to Puerto Rico and the Virgin Islands	Defer to the BOE	Defer to the BOE	Defer to the BOE
756	American Samoa Economic Development Credit	N/A	N/A	N/A

**EXHIBIT C – REVENUE TABLES**

<b>Table 10 – Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (Public Law 111-312)</b>				
<b>Act Section</b>	<b>Provision</b>	<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>
757	Work Opportunity Credit	\$380,000	\$270,000	\$70,000
758	Qualified Zone Academy Bonds	N/A	N/A	N/A
759	Mortgage Insurance Premiums	N/A	N/A	N/A
760	Temporary Exclusion of 100 Percent of Gain on Certain Small Business Stock	N/A	N/A	N/A
761	Tax-Exempt Bond Financing	N/A	N/A	N/A
762	Increase in Rehabilitation Credit	N/A	N/A	N/A
763	Low-Income Housing Credit Rules for Buildings in GO Zones	N/A	N/A	N/A
764	Tax-Exempt Bond Financing	N/A	N/A	N/A
765	Bonus Depreciation Deduction Applicable to the GO Zone	N/A	N/A	N/A

**EXHIBIT C – REVENUE TABLES**

<b>Table 11 – Regulated Investment Company Modernization Act of 2010</b> (Public Law 111-325)				
<b>Act Section</b>	<b>Provision</b>	<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>
101	Capital Loss Carryovers of Regulated Investment Companies	\$0	\$250,000	\$450,000
201	Savings Provisions for Failures of Regulated Investment Companies to Satisfy Gross Income and Asset Tests	\$3,000	\$3,000	\$3,000
301	Modification of Dividend Designation Requirements and Allocation Rules for Regulated Investment Companies	-\$1,000	-\$500	-\$500
302	Earnings and Profits of Regulated Investment Companies	-\$3,000	-\$2,000	-\$2,000
303	Pass-Thru of Exempt-Interest Dividends and Foreign Tax Credits in Fund of Funds Structure	-\$100,000	-\$80,000	-\$70,000
304	Modification of Rules for Spillover Dividends of Regulated Investment Companies	Negligible Loss	Negligible Loss	Negligible Loss
305	Return of Capital Distributions of Regulated Investment Companies	Negligible Gain	Negligible Gain	Negligible Gain
306	Distributions in Redemption of Stock of a Regulated Investment Company	-\$450,000	-\$350,000	-\$350,000
307	Repeal of Preferential Dividend Rule for Publicly Offered Regulated Investment Companies	Negligible Loss	Negligible Loss	Negligible Loss
308	Elective Deferral of Certain Late-Year Losses of Regulated Investment Companies	-\$1,000	-\$1,000	-\$1,000
309	Exception to Holding Period Requirement for Certain Regularly Declared Exempt-Interest Dividends	Negligible Loss	Negligible Loss	Negligible Loss
401	Capital Loss Carryovers of Regulated Investment Companies	N/A	N/A	N/A
402	Deferral of Certain Gains and Losses of Regulated Investment Companies for Excise Tax Purposes	N/A	N/A	N/A

**EXHIBIT C – REVENUE TABLES**

<b>Table 11 – Regulated Investment Company Modernization Act of 2010 (Public Law 111-325)</b>				
<b>Act Section</b>	<b>Provision</b>	<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>
403	Distributed Amount for Excise Tax Purposes Determined on Basis of Taxes Paid by Regulated Investment Company	N/A	N/A	N/A
404	Increase in Required Distribution of Capital Gain Net Income	N/A	N/A	N/A
501	Repeal of Assessable Penalty with Respect to Liability for Tax of Regulated Investment Company	N/A	N/A	N/A
502	Modification of Sales Load Basis Deferral Rule for Regulated Investment Companies	-\$370,000	-\$200,000	-\$100,000