Fall 1981

The Federal Economic Recovery Tax Act of 1981

Assembly Revenue and Taxation Committee

Senate Revenue and Taxation Committee

CONFORMITY TO FEDERAL INCOME TAX LAW

Report of the 1981 Federal Conformity Task Force on

THE FEDERAL ECONOMIC RECOVERY TAX ACT OF 1981

A Briefing Book Prepared for
Joint Committee Interim Hearings

ASSEMBLY REVENUE AND TAXATION COMMITTEE

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SENATE REVENUE AND TAXATION COMMITTEE

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FALL 1981

PREFACE

This briefing book represents a comprehensive review of the federal Economic Recovery Tax Act of 1981 and is intended to assist members of the Legislature in understanding the effect of the recent federal legislation and in setting policy with respect to state conformity to federal law changes.

Staff Task Force

This book is the result of the cooperative efforts of staff representatives of over a dozen legislative offices and executive branch departments. The bipartison, broadbased staff Task Force was formed at the direction of Wadie P. Deddeh, Chairman of the Assembly Revenue and Taxation Committee and Robert G. Beverly, Chairman of the Senate Revenue and Taxation Committee. Membership of the Task Force is listed on the following page.

The staff Task Force functioned as follows: The eighty-odd provisions of the federal Economic Reform Tax Act (ERTA) of 1981 were distributed among the Task Force members. Each staff member drafted an analysis describing the federal provision, present comparable state provision, and policy issues of conformity. The Task Force then met as a group to review and comment upon the draft analysis of each ERTA provision.

Estimates of fiscal effect were provided by the Franchise Tax Board or the State Controller's Office, in consultation with the Department of Finance.

Organization of the Briefing Book

This briefing book is divided into four main chapters, which have been coded by page color. Each chapter includes analyses of individual items in the federal ERTA. The Table of Contents lists all items included in the briefing book cross-referenced by ERTA section number and Commerce Clearing House (CCH) paragraph number.

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The first chapter (yellow pages) includes analyses of inheritance/ estate tax provisions.

The second chapter (pink pages) comprises analyses of federal provisions that primarily affect businesses.

The third chapter (buff pages) includes analyses of miscellaneous and administrative provisions in the federal bill.

The final chapter (green pages) consists of analyses of provisions of the federal bill that primarily affect individuals.

Joint Committee Hearing Procedure

Joint hearings of the Assembly and Senate Revenue and Taxation Committees will be held on this subject November 19, November 20, and December 16, 1981.

The hearings are planned to be informal sessions, with brief presentations of each item by staff and testimony from the interested public. If possible, Committee members will give direction to staff to "mark up" a bill comprising the federal conformity items which the Committees favor.

Membership

1981 Federal Conformity Staff Task Force

Steve Archibald, Assembly Office of Research
Dave Brainin, Department of Finance
Larry Counts, Franchise Tax Board
Al Desin, Franchise Tax Board
David Doerr, Assembly Revenue & Taxation Committee
Roy Gill, Inheritance Tax Division, State Controller's Office
Marvin Hanely, Franchise Tax Board
Vance Hansen, Senate Revenue & Taxation Committee
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CHAPTER 1

Economic Recovery Tax Act of 1981

ESTATE TAX PROVISIONS

1.

UNIFIED ESTATE TAX CREDIT INCREASE

Summary of Differences Between State and Federal Law

The federal estate tax is a tax on the right to transfer and, therefore, the estate is taxed as a whole with one exemption, regardless of the number of beneficiaries. The new federal law increases the estate tax unified credit so that it is the equivalent of a $600,000 exemption. However, the increase is phased in over a period of six years as follows: 1982 - $225,000; 1983 - $275,000; 1984 - $325,000; 1985 - $400,000; 1986 - $500,000; 1987 and thereafter - $600,000.

The California tax is an inheritance type tax, which is a tax on the right to receive. Each beneficiary is taxed only on what he or she receives and each gets an exemption, the size of which depends upon the relationship to the decedent. Therefore, the total amount of the exemptions in an estate for California inheritance tax purposes depends upon the number of beneficiaries and their relationship to the decedent.

Fiscal Effect of Conformity

Fiscal effect, as estimated by the State Controller, assuming provision is effective beginning with estates of decedents who die in 1982 and phasing in over six years to conform with the new federal laws, is shown below.

It is assumed that conformity would be achieved by prorating an equivalent inheritance tax exemption among beneficiaries.

	1981-82	1982-83 (in millions)	1983-84
With Insurance Exemption Repeal	-$1.3	-$ 97.7	-$166.5
Without Insurance Exemption Repeal	-$1.4	-$103.7	-$176.2

When full amount of exemptions is phased in, inheritance tax revenue will be reduced by approximately two-thirds. See Attached Table.

Description of Current State Law
R&TC Sections 13801, 13802, 13803

Under current law, exemptions are provided for beneficiaries in varying amounts as follows: minor child - $40,000; adult child, grandchild, parent, grandparent - $20,000; brother, sister, niece, nephew, son-in-law, daughter-in-law - $10,000; all others - $3,000. Spouses are entirely exempt from the inheritance tax.

Description of Federal Law
IRC Section 2010

Provides a unified credit against estate tax which increases in amount depending on the year of death. The exemption equivalents for estates of decedents who die in 1982, 1983, 1984, 1985, 1986 and after 1986 are $225,000, $275,000, $325,000, $400,000, $500,000 and $600,000, respectively.

Policy Issues of Conformity

1. Tax Relief. The expanded exemption would provide substantial tax relief for estate beneficiaries.

2. Administrative Costs. Administrative costs would be reduced by reducing the number of taxable estates.

3. Differences Between California and Federal Law Would Remain. If an exemption amount equivalent to the federal credit is adopted, California would still not be in conformity with federal law due to the existence in California law of the orphan's exemption (which was repealed from the federal estate tax law) and the life insurance exemption (which does not exist in the federal law). If the federal exemption equivalent is enacted without the elimination of the orphan's and life insurance exemptions, the California exemption would be higher than the federal exemption equivalent.

UNIFIED ESTATE TAX CREDIT INCREASE

FISCAL EFFECT TABLES

WITH INSURANCE EXEMPTION REPEAL

Fiscal Year	If Fully Effective	Per-Centage Affected	Per-Centage Revenue Loss	Estimated Revenue Current Law	Revenue Loss If Fully Effective	Revenue Loss
81-2	-15.5%	1.9%	- .3%	$425 Million	$ 65.9 Million	$ 1.3 Million
82-3	-35.5%	62.5%	-22.2%	440 "	156.2 "	97.7 "
83-4	-44.0%	81.4%	-35.8%	465 "	204.6 "	166.5 "
84-5	-51.5%	86.2%	-44.4%	500 "	257.5 "	222.0 "
85-6	-59.0%	88.5%	-52.2%	540 "	318.6 "	281.9 "
86-7	-64.5%	92.7%	-59.8%	580 "	374.1 "	346.8 "
87-8	-66.0%	87.3%	-64.2%	625 "	412.5 "	401.3 "
88-9	-66.0%	100.0%	-66.0%	675 "	445.5 "	445.5 "

WITHOUT INSURANCE EXEMPTION REPEAL

Fiscal Year	If Fully Effective	Per-Centage Affected	Per-Centage Revenue Loss	Estimated Revenue Current Law	Revenue Loss If Fully Effective	Revenue Loss
81-2	-17.5%	1.9%	- .3%	$425 Million	$ 74.4 Million	$ 1.4 Million
82-3	-39.0%	62.5%	-24.4%	440 "	171.6 "	103.7 "
83-4	-46.5%	81.4%	-37.9%	465 "	216.2 "	176.2 "
84-5	-53.5%	86.2%	-46.1%	500 "	267.5 "	230.5 "
85-6	-60.5%	88.5%	-53.5%	540 "	326.7 "	288.9 "
86-7	-65.5%	92.7%	-60.7%	580 "	379.9 "	352.1 "
87-8	-67.0%	97.3%	-65.2%	625 "	418.8 "	407.5 "
88-9	-67.0%	100.0%	-67.0%	675 "	452.3 "	452.3 "

ESTATE TAX: REDUCTION IN MAXIMUM TAX RATE

Summary of Differences Between State and Federal Law

California imposes an inheritance tax, which is a tax on beneficial succession. Each beneficiary is taxed for only that portion of the estate which he or she receives. Those beneficiaries most closely related to the decedent receive a more favorable tax treatment than those more remotely related or unrelated.

The federal government imposes an estate tax, which is a tax upon the transfer of property from the decedent. Except for the spouse of the decedent, the federal estate tax is imposed upon the total estate without regard to the number of beneficiaries or the relationship of the beneficiary to the decedent. There is one schedule of tax rates that applies to the whole taxable estate.

Fiscal Effect of Conformity

Not relevant.

Description of Current State Law
R&TC Sections 13404, 13405, 13406, 15205, 15206, 15207

Under the California inheritance and gift tax, there are three separate tax rate schedules applicable to three classes of beneficiaries. The tax rates are graduated by the amount the beneficiary receives, as follows:

Value of Taxable Inheritance	Tax Rates for Beneficiary Class A	B	C
$ 0 to 25,000	3%	6%	10%
25,000 to 50,000	4	10	14
50,000 to 100,000	6	12	16
100,000 to 200,000	8	14	18
200,000 to 300,000	10	16	20
300,000 to 400,000	12	18	22
over 400,000	14	20	24

Class A = Spouse, lineal ancestor, lineal descendant, certain adopted children and mutually acknowledged children

Class B = Brother, sister, descendant of brother or sister, son-in-law and daughter-in-law

Class C = All others

Description of Federal Law
IRC Sections 2001 (b), (c)

The federal law imposes one schedule of tax rates which applies to the total taxable estate. The tax rates commence at 18% and, prior to the ERTA of 1981, reached a maximum of 70% for transfers in excess of $5,000,000.

The 1981 ERTA provides for a reduction of the maximum rate to 50 percent on transfers in excess of $2,500,000, phased in over a four-year period, as follows:

Year	Maximum Tax Rate
1982	65% on transfers in excess of $4,000,000
1983	60% on transfers in excess of $3,500,000
1984	55% on transfers in excess of $3,000,000
1985 and after	50% on transfers in excess of $2,500,000

Policy Issues of Conformity

The California inheritance tax rates are much lower than the federal estate tax rates. To conform to the actual federal rate would require an increase in the inheritance tax rates. Further, the reduction of the maximum for a single tax rate does not apply to the state law which has three separate tax rate schedules.

ESTATE TAX: UNLIMITED MARITAL DEDUCTION

Summary of Differences Between State and Federal Law

The ERTA of 1981 amends the federal law to eliminate the monetary ceiling on the marital deduction and to modify the terminable interest rule for transfers to a spouse.

Under the state law, all transfers to a spouse are excluded from inheritance and gift tax. The state does not impose the terminable interest limitation on the marital exclusion.

Fiscal Effect of Conformity

According to the State Controller's Office, the fiscal effect of conformity to the federal terminable interest rule cannot be determined.

The terminable interest rule imposes a limitation on the exclusion from tax for transfers to a spouse which is not contained in the state law. However, the ERTA of 1981 modified the rule to provide for a "qualified terminable interest" whereby the tax may be postponed until the death of the surviving spouse. To the extent that transfers to a spouse are of a terminable interest, conformity will <u>increase</u> state revenue by imposing a tax on transfers to a spouse which the state does not currently tax. To the extent that transfers to a spouse are of a "qualified terminable interest", conformity will result in a <u>loss</u> of revenue for the following reasons:

(1) The tax on the transfer of a remainder interest to persons other than the spouse will be postponed until the death of the surviving spouse, or

(2) If the surviving spouse should move from California prior to his/her death, the transfer of the remainder interest will escape California tax altogether.

Description of Current State Law
R&TC Sections 13805 and 15310

All transfers to a spouse are excluded from California inheritance and gift tax. There is no qualification as to the type of interest the spouse takes in order to qualify for the exclusion. If a donor/decedent transfers to the spouse a life estate in property with remainder to others, the value of the life estate is excluded from the tax, and the value of the remainder interest is taxed according to the relationship of the remaindermen to the donor/decedent. In such a case, the property in which the survivor received a life estate is not subject to the tax upon the subsequent death of the surviving spouse.

Description of Federal Law
IRC Section 2056 and 2523

Under the new federal law, except for certain terminable interests, there is no monetary limit on the amount that may be transferred to a spouse free of estate and gift tax. A terminable interest is an interest in property which will terminate or fail upon the lapse of time or upon the occurrence, or failure to occur, of some contingency. Life estates, estates for a term of years and annuities are examples of a terminable interest which ordinarily do not qualify for the federal marital deduction.

Under the 1981 Act, if certain conditions are met, a life interest granted to a spouse (defined as a "qualified terminable interest") will not be treated as a terminable interest. In such a case, the whole of the property is excluded from tax in the estate of the donor/decedent, and the property is subject to tax at the earlier of (1) the date on which the spouse disposes of the property, or (2) the date of the spouse's death.

Policy Issues of Conformity

1. State Already Conforms. The state law already provides for an unlimited marital exclusion. The new federal law partially conforms to existing state law.

2. Terminable Interest Rule Complex. Conformity to federal law would require the state to adopt the federal terminable interest rules, which would introduce complexity to the law, and which rules have been the source of considerable litigation at the federal level.

3. <u>Prior Differences Between State and Federal Law.</u> Prior to ERTA of 1981, the federal law provided for a marital deduction equal to the greater of $250,000 or one-half of the adjusted gross estate if property of that value passed to the decedent/donor's spouse. A terminable interest in property received by the spouse did not qualify for the federal marital deduction.

Effective as to decedents with a date of death on or after January 1, 1981, and gifts made on or after that date, all transfers to a spouse are excluded from state inheritance and gift tax. The state does not impose the terminable interest rule. The state spousal exclusion applies to all transfers to a spouse, including those wherein the spouse receives a terminable interest.

SPECIAL USE VALUE FOR INHERITED PROPERTY

Summary of Differences Between State and Federal Law

Both the state and federal law contain provisions for special use value of real property devoted to farming or a family business. Both laws contain extensive qualifying requirements that must be satisfied before the estate is entitled to special use value, which is less than market value. Both laws place a limit on the amount the value of an estate may be reduced from market value by special use value, both laws provide a special formula method to arrive at special use value, and both laws provide for a recapture of the tax benefit upon the occurrence of certain events. See description of federal law (below) to note the differences.

Fiscal Effect of Conformity

Fiscal effect, as estimated by the State Controller's Office, assuming provisions are effective beginning with estates of decedents who die in 1982 and phasing in over two years to conform with the new federal law, is as follows (in millions):

1981-82	1982-83	1983-84	1984-85
$ 0	-$2.5	-$3.8	-$4

Description of Current State Law
R&TC Section 13311.5

Effective January 1, 1981, the special use value provisions were added to the Inheritance Tax Law. For the most part, the state law was adopted verbatim from the federal and prior to the ERTA of 1981, the state was in full conformity with the federal law.

Description of Federal Law
IRC Section 2032A

The federal law has been amended to change the amount by which value of an estate may be reduced due to special use value from $500,000 to $750,000. The increase in the allowable reduction from market value is phased in, as follows:

Year of Death	Limitation Amount
1981	$600,000
1982	700,000
1983 and after	750,000

The statute provides for a formula method of valuation. Prior to ERTA, the formula method required comparable cash rentals which is extremely difficult, and in some cases impossible, to obtain. The formula method of valuation has been amended to permit comparable annual net share rentals (i.e., crop-share rentals) if cash rentals for comparable land in the same locality are not available.

The law provides for a recapture of the estate tax benefits realized from special use value if the property ceases to be devoted to the qualifying special use or is transferred to non-family members. Prior to ERTA the recapture period was 15 years. If the recapture was triggered within 10 years from the date of death, the full amount of the tax benefit was recaptured; and there was a phase-out if the recapture was triggered between the 10th and the 15th year from the date of death. The law has been amended to reduce the recapture term from 15 years to 10 years. If the recapture is triggered, the full amount of tax savings is recaptured. The phase-out between the 10th and 15th year has been eliminated.

There are additional technical and less significant substantive amendments designed to clarify the law and to ease the requirements to qualify for special use value.

Policy Issues of Conformity

1. Complexity. Should California conform to federal law to avoid imposing upon the taxpayers the burden of dealing with two different sets of rules in a complex, technical area of law? The special use value provisions added to the state law were in full conformity with the provisions of the federal law then in effect.

2. Encouraging Family Farms. Should the provisions for special use value be extended to encourage the continuance of family farms and, to a lesser extent, family businesses?

INSTALLMENT PAYMENTS OF ESTATE TAX

Summary of Differences Between State and Federal Law

California law provides two separate provisions--a 15-year plan and a 10-year plan--for installment payment of inheritance tax attributable to a closely held business. The inheritance tax provisions were patterned after, and were in substantial conformity with, existing federal provisions prior to ERTA of 1981. One major difference between federal and state provisions was a special four percent interest rate on the federal estate tax attributable to the first $1,000,000 of the interest in the closely held business under the federal 15-year plan. The California law did not provide the special four percent interest. Under both of the California provisions, the interest rate on the installment payments is indexed to 90% of the prime rate charged in September and adjusted every two years, with a maximum of 12 percent.

The 1981 Act consolidates the two provisions of the federal law.

Fiscal Effect of Conformity

According to the State Conroller, there would be minor revenue loss due to time lag in payment of tax in greater number of estates that qualify for and elect to make installment payments over a longer period of time.

Description of Current State Law

R&TC Sections 14181 and 14182

Section 14181 provides that where the value of a closely held business owned by the decedent exceeds 65% of the adjusted gross estate, the executor may elect to defer payment of the tax attributable to the business (paying interest only) for five years, and thereafter may pay the tax in up to ten annual installments. The law provides for acceleration of the unpaid balance of tax due if one-third or more of the business is distributed, sold, exchanged, withdrawn or otherwise disposed of.

Section 14182 provides that where the value of a closely held business interest exceeds either 35 percent of the gross estate or 50 percent of the taxable estate, the tax attributable to the interest may be paid in up to 10 annual installments. The unpaid balance due is accelerated under the 10 year plan if 50 percent or more of the business is distributed, sold, exchanged, withdrawn or otherwise disposed of.

Federal Law

IRC Section 6166

The 1981 Act repeals the 10 year federal plan and amends the 15 year plan to provide that where the value of a closely held business interest exceeds 35 percent of the adjusted gross estate, the estate taxes attributable to the business may be deferred for up to 14 years, with an annual interest payment for the first 4 years and thereafter paying the balance in up to 10 annual installments. The new federal law retains the special 4 percent interest on the tax attributable to the first $1,000,000 of the business, but makes certain changes in the rules governing acceleration.

Policy Issues of Conformity

1. Simplification. Consolidating the two provisions for tax deferral provides simplification and clarity. The two different provisions under current state law (and former federal law) are both somewhat complex, and the differences in the two provisions create a considerable amount of confusion.

2. Prior Conformity. The provisions of the current state law, added last year by AB 2092 (Stats. 1980, Ch. 634), were patterned after existing provisions of the federal law (IRC Sections 6166 and 6166A, respectively), and were in substantial conformity with the federal provisions then in effect.

3. Prior Differences Between California and Federal Law. The federal 15 year installment payment plan provided a special 4 percent interest rate on the tax attributable to the first $1,000,000 value of the closely held business. California's 15 year payment provision does not include the special 4 percent interest rate. However, the interest rate on the balance of the unpaid federal tax is indexed to the prime rate, without limitation. The California interest rate on the total of the tax being paid in installments is indexed to 90 percent of the prime rate charged in September, adjusted every two years, with a maximum of 12%. In 1982, the California rate will be 12 percent, whereas the normal rate of interest under the federal law in 1982 will be 20%.

ESTATE TAX DEDUCTION FOR CHARITABLE GIFTS OF ART WORKS

Summary of Differences Between State and Federal Law

The state inheritance tax allows an exemption for transfers to charitable organizations or for charitable uses, regardless of the form in which the transfer is made.

Under the prior federal law, a deduction generally is not allowed where interests in the same property are transferred for both charitable and non-charitable purposes unless the charitable remainder interest is in the form of a charitable remainder annuity, unitrust, or pooled income fund.

ERTA would permit such a deduction.

Fiscal Effect of Conformity

Not applicable.

Description of Current State Law

R&TC Sections 13841, 13842, 15441 and 15442

Under the current state inheritance and gift tax, an exemption is allowed for the value of property, or any interest therein, transferred to charitable organizations or for charitable uses. Therefore, where the same property is transferred for both charitable and non-charitable purposes, the value of the interest transferred for charitable purposes is excluded from the tax, regardless of the form of transfer to the charity or for charitable purpose.

Description of Federal Law

IRC Sections 2055 and 2522

An original work of art and a related copyright are considered interests in the same property. Therefore, under pre-ERTA federal law a deduction is not allowed for the transfer of an original work of art to charity if the copyright is retained or transferred to a non-charity. The ERTA of 1981 amends the federal estate and gift tax law to provide that a work of art and its copyright will be treated as separate properties for purposes of the estate and gift tax charitable deduction. The amendment thereby allows a charitable deduction for transfers to charity of an art work where the copyright is not simultaneously transferred to the charitable organization.

Policy Issues of Conformity

1. Equal Treatment. The purpose of the federal change was to allow a deduction to be taken where a gift of a split interest is made to charity. California law already permits this.

7.

GIFTS MADE WITHIN THREE YEARS OF DEATH

Summary of Differences Between State and Federal Law

Gifts made by a decedent within three years of death (other than gifts of life insurance) are not subject to federal estate tax if the decedent died after 1981. This applies to outright gifts only. Any gifts in which the decedent retained some sort of an interest are still subject to tax. However, gifts made within three years of death will be included for purposes of determining the estate's qualification for special use valuation, deferral of estate tax, special stock redemptions and estate tax liens.

Under California law, transfers made within three years of death are subject to inheritance tax if the transfers are determined to have been made in contemplation of death.

Fiscal Effect of Conformity

According to the State Controller's Office, there would be an estimated annual General Fund revenue loss of $5 million. The estimated revenue loss is not any greater due to the unified treatment of inheritance and gift taxes. Under unification, gifts which are not included in the taxable estate are, however, used to determine the inheritance tax rate. The loss is incurred because gifts less in value than the annual exclusion ($3,000 per donee) are completely ignored and any increase in value between the date of gift and date of death is also not taxed.

Description of Current State Law

R&TC Section 13642

A gift made in contemplation of death is subject to inheritance tax if it was made less than three years prior to the death of the donor.

Description of Federal Law

IRC Section 2035(d)

For estates of decedents who die after 1981, gifts made within three years of death, other than gifts of life insurance and those in which the donor retained some interest, are not subject to estate tax.

Policy Issues of Conformity

1. Tax Relief. Outright gifts may be made without fear that their value will be subject to inheritance tax should the donor die within three years of making the gifts.

2. Background. Prior to 1976, the federal and California laws were almost identical. The Federal Tax Reform Act of 1976 unified the estate and gift taxes and automatically included all gifts made within three years of death in the taxable estate. California partially conformed in 1977, unifying the inheritance and gift taxes. However, rather than making all gifts made within three years of death taxable, California retained its prior law taxing outright gifts only if they were made in contemplation of death. The Federal Economic Recovery Tax Act of 1981 reverses the federal position completely. Instead of gifts made within three years of death being automatically included in the taxable estate, they will automatically be excluded when the decedent died after 1981.

BASIS OF CERTAIN INHERITED PROPERTY

Summary of Differences Between State and Federal Law

With respect to the basis of property acquired by a decedent, current state and federal law are generally the same. After 1981, however, federal law will contain a different rule for property acquired by the decedent as a gift within one year of death.

Fiscal Effect of Conformity

According to FTB, conformity would result in a minor revenue gain, probably less than $500,000 annually.

Description of Current State Law
R&TC Sections 18044-18046

Under existing state law, property acquired from a decedent generally takes a basis in the hands of the recipient equal to its fair market value as of the date of death.

Description of Federal Law
IRC Section 1014(e)

Federal law retains the "fair market value as of the date of death" rule except in the case of property gifted to the decedent within one year of death if such property passes from the decedent to the original donor or the donor's spouse. In such cases the property takes the same basis as it had to the decedent immediately prior to death.

Policy Issues of Conformity

1. Taxpayer Compliance. The provision was put into the law in order to prevent taxpayers from transferring property in contemplation of the decedent's death merely to obtain a stepped-up basis upon receipt of the property from the decedent's estate.

9.

DISCLAIMERS

Summary of Differences Between State and Federal Law

A disclaimer is the refusal to accept the ownership of property rights by inheritance or gift. Under both federal estate and state inheritance and gift taxes, where a valid disclaimer is filed, the property disclaimed is treated as though it passes from the transferor to the person(s) who receive the property by reason of the disclaimer.

Fiscal Effect of Conformity

Not applicable.

Description of Current State Law
R&TC Sections 13409 and 15209

See above.

Description of Federal Law
IRC Section 2518

The disclaimer provision added to the federal law by the Tax Reform Act of 1976 was intended to provide uniformity in the federal law governing disclaimers, regardless of disclaimer requirements imposed by local law. However, the federal law in effect prior to ERTA required that a disclaimer be effective under local law to pass title without direction of the disclaimant in order to be effective for federal estate and gift tax purposes. Because local disclaimer laws vary, the desired uniformity in the federal law has not been obtained.

To obtain the desired uniformity under the federal law, the ERTA of 1981 provides that a timely transfer of property to the person who would have received it under a disclaimer valid under local law is considered an effective disclaimer for federal estate and gift tax purposes, provided all other federal disclaimer requirements are met. Local law will be applicable to determine the identity of the transferee, but the transfer need not satisfy any requirements of the local disclaimer statute.

Policy Issues of Conformity

1. Purpose of Change. The purpose of the new federal provision is to provide uniform treatment of disclaimers under federal estate and gift taxes regardless of the variations in the disclaimer statutes of the several states. The state inheritance and gift taxes are not concerned with the differences in the law among the several states and therefore the new federal provision has no application to the state law.

REPEAL OF ORPHAN'S DEDUCTION

Summary of Differences Between State and Federal Law

The Economic Recovery Tax Act of 1981 repealed the orphan's deduction for federal estate tax purposes. The California inheritance tax law currently provides for an orphan's exemption.

Fiscal Effect of Conformity

Fiscal effect, as estimated by the State Controller's Office, assuming provision is effective for estates of decedents dying on or after January 1, 1982:

1981-82	1982-83	1983-84
$0	+$100,000	+$250,000

Description of Current State Law
R&TC Section 13801(b)

Current state law allows an exemption in an amount equal to ten thousand dollars times the excess of 21 over age in years of a child of the decedent who is under 18 at the date of death of the decedent, provided the decedent does not have a surviving spouse and that the child, immediately after the death of the decedent, has no known living parent.

Description of Federal Law

No comparable provision. Prior to ERTA, federal law did have an orphan's deduction similar to the California provision except that the total amount was $5,000 times the excess of 21 over the age of the child instead of $10,000. Furthermore, the transfer to the child could not consist of a terminable interest. California law has no such restriction.

Policy Issues of Conformity

1. Purpose of Federal Change. The Economic Recovery Act of 1981 increased the estate tax unified credit from the equivalent of a $175,626 exemption to $600,000, phased in over a period of six years. With this very large increase in the exemption equivalent, the federal government felt that the orphan's deduction would no longer be necessary and so repealed it.

GENERATION-SKIPPING TRANSFER TAX

Summary of Differences Between State and Federal Law

The Federal Tax Reform Act of 1976 introduced a new generation-skipping transfer tax. The federal law allows a limited credit for taxes upon generation-skipping transfers paid to a state. The ERTA extends a transitional rule exempting certain trusts from the generation-skipping transfer tax.

In 1977, California adopted a new state generation-skipping transfer tax, imposing a tax on generation-skipping transfers in an amount equal to the credit allowed under the federal law.

Fiscal Effect of Conformity

Not applicable.

Description of Current State Law

R&TC Sections 16700-16950

Current California law imposes a tax upon generation-skipping transfers in an amount equal to the credit for state taxes allowed under the federal generation-skipping transfer tax.

Description of Federal Law

Tax Reform Act of 1976, Section 2006

Under a transitional rule, generation-skipping trusts created by wills or revocable trusts in existence on June 11, 1976, are exempt from the generation-skipping transfer tax if (1) such wills and trusts were not amended after that date to create or increase the amount of the generation-skipping transfer, and (2) the testator or trustor dies before January 1, 1982. The ERTA of 1981 extends the date of death in the transitional rule one year, to January 1, 1983.

Policy Issues of Conformity

1. Credit Against Federal Tax. Inasmuch as the state generation-skipping transfer tax is only an amount equal to the credit allowed under the federal law for state generation-skipping transfer taxes, the state tax is not imposed unless there is first a federal tax. Consequently, the extension in the transitional rule of the federal law will automatically apply to the state law.

ESTATE TAX CREDIT FOR TRANSFER TO SMITHSONIAN

Summary of Differences Between State and Federal Law

The ERTA of 1981 included a special section to provide for a credit against the estate tax imposed upon a specific estate for an anticipated transfer of designated property (i.e., a collection of approximately 7,250 Mathew Brady glass plate negatives and the Alexander Gardener imperial portrait print of Abraham Lincoln) to the Smithsonian Institute.

There is no comparable state law.

Fiscal Effect of Conformity

Not applicable.

Description of State and Federal Laws

ERTA of 1981 Section 429

See above.

Policy Issues of Conformity

1. The estate for which the credit is allowed is not subject to California inheritance tax, and therefore the provision has no application to California law.

13.

GIFT TAX EXCLUSION

Summary of Differences Between State and Federal Law

California provides for an annual gift tax exclusion of $3,000 per donee, while federal law provides for an annual exclusion of $10,000 per donee, plus an unlimited exclusion for the payment of certain expenses.

Fiscal Effect of Conformity

According to the State Controller, conformity would result in an estimated annual General Fund revenue loss of $5-8 million.

This compares with current estimated gift tax revenue of $26.5 million in 1981-82.

Description of Current California Law

R&TC Section 15401

California gift tax law provides for an annual exclusion of $3,000 per donee. However, California law does not permit gift splitting between husband and wife as does federal law.

Description of Federal Law

IRC Section 2503(b),(c)

Effective January 1, 1981, the federal gift tax exclusion is increased from $3,000 to $10,000 per donee per year ($20,000 if spouses elect gift splitting). In addition the new federal law permits an unlimited deduction of amounts paid by a donor on behalf of an individual to an educational institution for tuition or to a medical provider for medical care.

Policy Issues of Conformity

1. Taxpayer Compliance. The present state gift tax exclusion was established as a matter of taxpayer convenience, in that the level was the same as the federal level to preclude the state taxation of gifts not taxed by the federal government.

2. Impact of Inflation. The gift tax exclusion was intended to obviate the necessity of keeping an account of and reporting numerous small gifts. In view of the rate of inflation since the exemption was set at \$3,000 (by SB 556 of 1967, when it was reduced from \$4,000), it is appropriate to increase the level of the exemption.

3. Exemption of Gifts of Tuition and Medical Care. Certain payments of tuition made on behalf of children who have attained their majority, and payment of medical expenses on behalf of elderly relatives, may be technically considered gifts under present law. Such payments should be exempt from gift taxes to avoid the imposition of taxes on unknowing taxpayers for payments which are generally considered family obligations.

ANNUAL PAYMENT OF GIFT TAX

Summary of Differences Between State and Federal Law

California gift tax law requires that gift tax returns be filed and the tax paid on a quarterly basis. The new federal law requires that gift tax returns be filed and the tax paid on an annual basis.

Fiscal Effect of Conformity

Fiscal effect as estimated by the State Controller's Office, assuming the provision is effective for gifts made on or after January 1, 1982 (in millions):

1981-82	1982-83	1983-84
-$5	-$1	-$1

A change in the annual payment of the gift tax would cause a one-time loss in fiscal 1981-82 due to a lag in payments created by the change. The quarterly collections due under current law on May 15, 1982 would not be collected until April 15, 1983. The losses for ensuing years are estimated amounts of interest which would have been earned on the earlier collections.

Description of Current State Law
R&TC Sections 15651 and 15905

Current California law requires that a gift tax return be filed on or before the fifteenth day of the second month following the close of the calendar quarter in which the gift was made. The tax becomes delinquent if not paid by the last day allowed for filing a return.

Description of Federal Law
IRC Sections 2501, 2502, 6019, 6075

The federal law as amended by the Economic Recovery Tax Act of 1981 requires that gift tax returns be filed and gift tax paid on an annual basis. The due date for filing and payment is the fifteenth day of fourth month following the close of the calendar year in which the gift was made (April 15).

Policy Issues of Conformity

1. Administrative Relief for Taxpayers. If several gifts are made within one calendar year, only one return need be filed. Taxpayers have a longer time to file return and pay tax.

2. Administrative Problem for State. Returns will all be filed at one time during the year making work scheduling more difficult.

CHAPTER 2

Economic Recovery Tax Act of 1981

PROVISIONS AFFECTING BUSINESSES

Summary of Differences Between State and Federal Law

Under Federal law, the Class Life Asset Depreciation Range (ADR) system is replaced by the Accelerated Cost Recovery System (ACRS) for property placed in service in 1981 or after. In the Class Life ADR System the depreciation deductions are generally allocated over the period the asset is used in business (i.e., the asset's useful industrywide life). Under ACRS, the depreciation deduction is allowed over a predetermined period generally shorter than the useful life of the asset. The periods are 15, 10, 5, or 3 years.

Existing California law is similar to the prior Federal law, except no variation from the guideline period is allowed.

Fiscal Effect of Conformity

According to FTB, fiscal effect is as follows (in millions):

1981-82	1982-83	1983-84
-$150	-$400	-$600

This estimate also includes the effect of the "election to expense", "recapture of recovery property", "minimum tax", and "earnings and profits" provisions.

Description of Current State Law
R&TC Sections 17208-17213 and 24349-24356.1

Existing state law is patterned after the old Federal law which utilized the Class Life ADR System, except that no range or variance is allowed from the asset guideline period. Under this system, the period of depreciation is related to an asset's expected useful industrywide life. Depreciation may be computed by use of the straight line, declining balance, or sum of the years-digits method. If the declining balance method is used, the rate of depreciation may not exceed twice the rate allowed by the straight line method. In general, the basis for depreciation is the cost of the asset less its salvage value.

Description of Federal Law
IRC Section 168

The new Federal law utilizes the ACRS. Under this system, four predetermined depreciation periods are allowed for all personal property and one predetermined period is allowed for all real property. A flexibility provision allows the use of two longer recovery periods for each of the basic depreciation categories. Depreciation may be computed by the straight line method over the regular or optional longer periods or by a prescribed accelerated method over the regular period. No salvage value shall be taken into account when computing depreciation. The following summarizes the five property classes and the allowable depreciation periods for each class.

Property Type	Optional Time Periods
3-year property: Autos, light-duty trucks, research and experimental machinery, and any machinery having ADR midpoint life of less than 4 years.	3, 5, or 12 years
5-year property: All tangible personal property not included within 15-year, 10-year, or 3-year recovery classes. This class contains most machinery and equipment.	5, 12, or 25 years
10-year property: Public utility property having ADR midpoint life of 18.5 to 25 years, theme park structures, and railroad tank cars.	10, 25, or 35 years
15-year public utility property: Public utility property having ADR midpoint of 25 years or more	15, 35, or 45 years
15-year real property: All real property except theme park structures and certain other real property designated as Section 1245 property.	15, 35, or 45 years

The ERTA also has created a so-called "safe habor lease election" which guarantees that certain three-party financing lease transactions can qualify the nominal lessor to receive investment tax credits and capital cost recovery allowances.

Policy Issues of Conformity

1. Stimulate Investment. Faster depreciation is supposed to encourage additional investment. While the tax benefits of the ACRS provisions at the Federal level may accomplish this goal, it is doubtful similar State provisions would do so. The State tax rates are only about one-fifth of the Federal rates. Furthermore, for national and multi-national corporations only a portion of their income is subject to taxation in California. Therefore, the Federal tax law is the determining factor.

2. Revenue Loss. Adoption of the ACRS provisions at the State level would cause a major reduction in bank and corporation tax and personal income tax revenues. Since the investment decisions are based on the Federal law, the State would not reap any additional benefits for such revenue reduction.

3. Taxpayer Difficulties Because of Different Federal and State Treatment. Clearly, taxpayer bookkeeping needs are more difficult if different depreciation systems are used for State and Federal tax laws. However, under the prior Federal-State situation, a number of taxpayers were already using different depreciation periods for the same assets. It should also be noted that some taxpayers may already have to keep "two sets of books" under federal law; for example, Federal law requires a different depreciation schedule to be used to compute depreciation deductions from the one to be used to compute earnings and profits from which dividends are declared (see "Earning and Profits" section).

ELECTION TO EXPENSE CERTAIN DEPRECIABLE BUSINESS ITEMS

Summary of Differences Between State and Federal Law

Prior Federal law allowed additional first-year depreciation of up to 20% of the cost of certain eligible property. This deduction cannot exceed $2,000 for an individual or $4,000 for a married couple filing a joint return. The new Federal law replaces this provision with an option to expense (i.e., deduct in a single year, rather than over a period of years) the cost of new or used personal property up to $5,000 for 1982 and 1983, up to $7,500 for 1984 and 1985, and up to $10,000 for 1985 and after.

Existing California law is similar to the prior Federal law.

Fiscal Effect of Conformity

Included within ACRS estimate.

Description of Current State Law

R&TC Sections 17213 and 24356

Under California law, any taxpayer may take additional, first-year depreciation of up to 20% of the cost of new or used tangible personal property with a useful life of six years or more. This deduction cannot exceed $2,000 for an individual or $4,000 in the case of husband and wife who file a joint return. The additional depreciation is computed without regard to salvage value. The remaining cost of the property may be depreciated by any other allowable method.

Description of Federal Law

IRC Section 179

Under the new Federal law, taxpayers may expense the cost, within limits (see Summary above), of any property eligible for the investment credit (i.e., most tangible personal property, specified elevators and escalators, single purpose agricultural or horticultural buildings, portions of certain rehabilitated buildings, and portions of certain timber property). Such property must have a useful life of three years of more. The election to expense must be made in the year the property is placed in service and once made may not be revoked without the consent of the Secretary of the Treasury. No investment credit is allowed on the amount of expensed property.

Policy Issues of Conformity

See ACRS discussion.

RECAPTURE ON DISPOSITION OF RECOVERY PROPERTY

Summary of Differences Between State and Federal Law

Prior federal law recognized the gain from the sales of personal property as ordinary income up to the amount of prior depreciation. A gain from the sale of real property (both residential and nonresidential) was considered ordinary income only to the extent that prior depreciation exceeded the amount which would have been allowed under the straight line method. The realization of the gain from both real and personal property could be deferred if it involved the use of an installment sale.

The new federal law eliminated the installment sales deferment provisions for gains arising from the sale of personal property. In addition, when an accelerated method of depreciation is used for nonresidential real property, the gain is considered ordinary income up to the amount of all prior depreciation.

With minor exceptions, the existing California Personal Income Tax Law is similar to the prior federal law. California's Bank and Corporation Tax Law has no provisions for capital gains and losses and, therefore, has no recapture provisions.

Fiscal Effect of Conformity

Included with ACRS estimate.

Description of Current State Law

R&TC Sections 18200, and 18211-18221

Under existing California Personal Income Tax Law, the gain from the sale of property eligible for the Federal investment credit is considered ordinary income to the extent of prior depreciation. (See "Election to Expense Certain Depreciable Business Items" for a listing of such eligible property.) The gain from the sale of real property is considered ordinary income only for the amount of prior depreciation in excess of that which would have been allowed under the straight line method. All or a portion of the gain may be deferred in the case of installment sales of both real and personal property.

There are no capital gain and loss provisions under the Bank and Corporation Tax; all income is considered ordinary income. Thus, there is no need for recapture provisions.

Description of Federal Law

IRC Sections 1245 and 1250

Gain from the sale of personal property is considered ordinary income to the extent of prior depreciation. The gain cannot be deferred by the installment sales provisions for any amount which was deducted under the new expensing option. Gains from the sale of residential real property are counted as ordinary income only on that depreciation allowed in excess of the straight line method (this is the same as prior law). Gains from the sale of nonresidential real property is ordinary income for all prior depreciation, if any accelerated method of depreciation is used. Otherwise the gain is eligible for capital gain treatment. Any gains arising from the sale of real property can be deferred in the case of an installment sale.

Policy Issues of Conformity

See ACRS discussion.

EARNINGS AND PROFITS

Summary of Differences Between State and Federal Law

In computing earnings and profits from which dividends are declared, federal law specifies the recovery period which must be used for depreciable assets. State law merely specifies a straight-line depreciation period.

Fiscal Effect of Conformity

Included within ACRS estimate.

Description of Current State Law

R&TC Section 24491.1

Existing state law provides, in general, that in computing earnings and profits (from which dividends are declared) depreciation is to be computed using the straight-line method.

Description of Federal Law

IRC Section 312(k)

In order to minimize the amount of tax-free distributions, federal law provides that earnings and profits shall be computed by means of the straight-line method using recovery periods that are longer than those allowed under the new "Accelerated Cost Recovery System" (ACRS). For earnings and profits purposes, the extended recovery periods are:

3 year property	5 years
5 year property	12 years
10 year property	25 years
15 year property	35 years

Policy Issues of Conformity

1. Purpose--Limit Tax Free Dividends. Depreciation is considered to be a recovery of capital. Dividends declared from funds derived from a recovery of capital are thus non-taxable. The reason for the provisions in both state and federal law is a recognition of the fact that accelerated depreciation will increase the amount available from which to declare tax-free dividends. Restricting the earnings and profits depreciation computation to the straight-line method reduces the amount of tax-free distributions.

2. Federal Changes Part of ACRS. The recent federal changes were made to ensure that under ARCS corporations would not be permitted excessive tax-free distributions. These changes would be needed in California only if ACRS were adopted.

MINIMUM TAX ON PREFERENCE INCOME

Summary Differences Between State and Federal Law

Federal law and state law both treat excess deductions for accelerated depreciation as an item of preference income. Because of the new ACRS depreciation in the federal law, the ERTA provides for a recovery period (for straight-line depreciation) for computing preference income.

Fiscal Effect of Conformity

Included within ACRS estimates.

Description of Current State Law

R&TC Section 17064

Excess depreciation is a tax preference item for computing the minimum tax on preference income.

Description of Federal Law

IRC Section 57(a)(12)

Excess depreciation for "15-10-5-3" depreciation is computed by taking the difference from straight-line depreciation in accordance with the following schedule:

In the case of:	The recovery period (for straight-line) is:
3 year property	5 years
5 year property	8 years
10 year property	15 years
15 year public utility property	22 years

Policy Issues of Conformity

1. This is an equity adjustment at the federal level to keep high income taxpayers from paying no tax. If California conforms with ACRS, then it should also conform with this definition of preference income.

MAXIMUM TAX RATE ON EARNED INCOME

Summary Differences Between State and Federal Law

Prior federal law had a 50% maximum tax rate on earned income and a 70% maximum rate on unearned income. Since ERTA reduces the maximum tax rate on unearned income to 50% in 1982 and future years, the maximum tax rate of 50% for earned income is moot and has been eliminated.

Fiscal Effect of Conformity

Not applicable.

Description of Current State Law

California treats all income the same, and does not have a maximum tax rate on earned or unearned income.

Description of Federal Law

All income is treated the same for Federal tax rate purposes as a result of changes made by ERTA.

Policy Issues of Conformity

1. Federal law is now conformed to state law in that California does not have different maximum tax rates on different forms of income.

EXTENSION OF CARRYOVER PERIODS

Summary of Differences Between State and Federal Law

This provision extends the carryover period for federal net operating losses, investment credits, work incentive program credits, new employee credits and the alcohol fuels tax credits. The state does not have net operating loss deductions or investment credits, and the similar state credits do not have carryover features.

Fiscal Effect of Conformity

Not applicable.

Description of Current State Law

Existing state law contains provisions granting a number of credits, e.g., solar energy credit, agricultural irrigation equipment credit, targeted jobs tax credit, etc. Some of these credits are refundable and some have carryover features while others have neither. In those cases where there is a carryover provision the credit is allowed to be carried over until entirely used.

Description of Federal Law

IRC Sections 44(e), 46(b), 50A(b), 53(c), 172(b) and (g) 812(b), and 825(d)

In the case of net operating losses arising in tax years ending after 1975, the carryover period is extended from seven to 15 years. This rule also applies to regulated transportation companies (previously a nine-year carryover) and to certain insurance companies (previously an eight-year carryover). In the case of net operating losses arising in tax years ending after 1972, the carryover period for a real estate investment trust is extended to 15 years.

Investment credit and work incentive program credit carryover periods are extended from seven to 15 years for unused credit years ending after 1973.

An extension of the carryover period from seven to 15 years is provided for the new employee credit for unused credit years beginning after 1976.

An extension of the carryover period from seven to 15 years is also provided for the alcohol fuels credit for unused credit years ending after September 30, 1980.

Policy Issues of Conformity

1. Taxpayer Compliance. If California and federal law were the same in the affected areas, taxpayer compliance and simplicity would be enhanced.

2. Taxpayer Benefit. In cases where state credits are allowed to be carried over, California law is more liberal than federal as the carryover period is unlimited.

INVESTMENT TAX CREDIT CHANGES

Summary of Differences Between State and Federal Law

Federal law provides for a tax credit equal to a specified percent (generally 10%) of the cost of new equipment used for business purposes. The ERTA of 1981 makes several changes or additions to the investment tax credit.

State law does not provide for an investment tax credit.

Fiscal Effect of Conformity

Not applicable.

Description of Current State Law

There is no provision for a state investment tax credit.

Description of Federal Law
IRC Sections 46, 47, 48

A credit against the federal tax is allowed for, in most cases, 10% of the cost of qualified investments acquired and placed in service or constructed during the tax year.

Changes made by ERTA include:

a. The credit is extended to rehabilitating qualifying buildings and historic structures.

b. The credit is reduced for property using a 3-year recovery period under ACRS.

c. The credit is not allowed for amounts invested in property to the extent the invested amounts are not "at risk".

d. The cost limitation on used property qualifying for the credit is raised.

e. Tax liability is increased if certain property is disposed of before the close of the recapture period.

Policy Issues of Conformity

1. No Prior Conformity. California has not conformed to the basic concept of the federal investment tax credit. The apparent objective of the federal credit is to increase business investment in capital equipment so as to improve productivity and the international competitive position of the U.S. economy. The reasons for California's prior non-conformity may have included concern that such macro-economic policy-making may not be an appropriate role for the state tax, and concern about the revenue effect of allowing such a credit.

CREDIT FOR INCREASING RESEARCH

Summary of Differences Between State and Federal Law

Federal law provides for a 25% tax credit for expenditures for research above a base level amount made after June 30, 1981 and before July 1, 1986.

California law has no such provision.

Fiscal Effect of Conformity

According to FTB, fiscal effect of conformity based on proration of federal estimates is as follows (in millions):

1981-82	1982-83	1983-84
-$45	-$70	-$85

Description of Current State Law
R&TC Sections 17223, 24365

California law does not have a tax credit for incremental research and experimentation expenditures. However, California law provides for a full deduction of R&E expenditures in the year in which they are made.

Description of Federal Law
IRS Section 44F

Under present law, in general, a taxpayer may elect to deduct currently the amount of research and experimental expenditures incurred in connection with a taxpayer's trade and business.

In addition, the ERTA provides for a special, non-refundable tax credit of 25 percent of "qualified" research and experimentation expenditures made after June 30, 1981 and before January 1, 1986.

To qualify for the credit, the expenditures must meet the following tests:

1. Research must be done in the USA.

2. Research cannot be in social science or humanities.

3. Research must not be paid by government grant.

4. Only that portion of research expenditure which exceeds "base" year research expenditures is eligible for the credit.

For contract research expenditures, only 65 percent are eligible for the credit.

The credit may be carried back for three years and forward for fifteen years.

Policy Issues of Conformity

1. Purpose of the Credit. The purpose of the federal credit is to encourage basic research by the private sector in the U.S.

   Congress believed that a substantial tax credit for incremental research and experimental expenditures will overcome the resistance of many businesses to bear the significant costs of staffing, supplies, and certain computer charges which must be incurred in initiating or expanding research programs. While such costs bear characteristics of investment activity, the relationships between the investment in research and the subsequent earnings often are less directly identifiable, and many businesses are reluctant to a allocate scarce investment funds for uncertain rewards. Research and experimentation are basic activities that must precede (1) the development and application of new techniques and equipment to production, and (2) the development and manufacture of new products.

2. Level of Spending on Research in U.S. Federal and self-financed expenditures for research and development activities performed by business over the 12-year period 1968-1979 remained at a fairly stable level in real terms, fluctuating between $19 and $22.8 billion in constant dollars. Relative to real gross national product, such expenditures declined from 2.01 percent in 1968 to 1.58 percent in 1975, essentially remaining at that level since then.

   Aggregate research and development spending in this country has experienced a similar period of decline. In 1967, total expenditures reached a high of 2.91 percent of GNP before declining over ten years to 2.26 percent in 1977, and then increasing to an estimated 2.30 percent in 1980. If military and space research expenditures are subtracted from the total, the "civilian" research/GNP ratio for the United States is 1.5 percent, compared with 1.9 percent for Japan and 2.3 percent for West Germany.

3. Present Incentives Adquate? With the federal tax credit of 25% and further tax expensing of the costs of research and development, most of the cost of research and redevelopment can be recouped directly in the form of lower taxes. Will any additional incentives at the state level actually produce any additional research or are the present incentives adequate?

4. Role of Government. Is it appropriate for the government to try to influence corporate decisions through tax policy?

   Since present law permits recovery of investment, and business will be the recipient of profits from new inventions, should government help fund private enterprise research activities through a tax credit?

CHARITABLE CONTRIBUTION OF CERTAIN PROPERTY USED FOR RESEARCH OR EXPERIMENTATION PURPOSES

Summary of Differences Between State and Federal Law

This provision allows a corporation (other than a Subchapter S, personal holding or service corporation) a larger deduction than under present law for charitable contributions of new tangible personal property which is of an inventory nature, if contributed to an institution of higher education, and if used by the college or university for research purposes. Under California law, the deduction for the donation of appreciated property is limited to the taxpayer's basis in the property.

Fiscal Effect of Conformity

According to FTB, based on a proration of federal estimates, conformity on this item would result in an annual revenue loss of less than $100,000.

Description of Current State Law
R&TC Section 24357.1

California allows corporations a deduction for charitable contributions to certain organizations, up to 5% of net income. Where a contribution is made in appreciated property, California always reduces the corporate contribution (but not the individual) by the amount of untaxed gain; in effect, the deduction is limited to the basis of the property. An additional, special deduction is allowed for the cost of agricultural products donated to non-profit charitable organizations.

Description of Federal Law
IRC Section 170(e)(4)

Where a charitable contribution is made by a corporation in appreciated property, federal law reduces the deduction for the amount contributed by the amount of any ordinary gain which the taxpayer would have realized had the property been sold for its fair market value, whereas the amount of capital gain property donated is reduced by a portion of the appreciation only if the use of the donated item by the donee is unrelated to the charity's exempt functions, or if the property is given to certain types of private foundations. In 1976, an exception to this general rule was enacted for contributions by corporations of certain types of ordinary income property donated for the care of the needy, the ill, or infants. In the case of such a qualifying charitable contribution of inventory, the exception generally allows a deduction equal to the sum of the taxpayers basis in the property plus one-half of the unrealized appreciation, or twice the basis of the property, whichever is less.

Section 222 of the Economic Recovery Tax Act of 1981 makes this treatment accorded property falling within the 1976 exception applicable to donations of ordinary income property to a college or university which are used by that institution for research purposes. To qualify, the corporate contribution must meet the following requirements:

1. The property must have been constructed by the taxpayer;
2. the donation must be made within two years of substantial completion of construction;
3. the original use of the property is by the donee;
4. substantially all of the use of the property by the donee is for research or experimentation;
5. the property is not transferred by the donee in exchange for money, other property or services; and
6. the donor receives the donee's written statement representing that the use and disposition of the property is in accordance with the last two requirements.

Policy Issues of Conformity

1. Policy Rationale. The federal Conference Committee believed that an additional incentive was desirable to encourage manufacturers to contribute "state-of-the-art" scientific equipment to colleges and universities for use in research activities. The Committee noted that while academic research and development expenditures have increased in constant dollars by three percent each year since 1974 (reversing a spending decline over the prior six years), studies indicate that in equipment-intensive research areas such as physics, chemistry, and electrical engineering, the continuing growth of university expenditures has not kept pace with the rising costs of scientific instrumentation.

   The general deduction limitation rule was enacted in the Tax Reform Act of 1969 to prevent corporations and individual taxpayers in high marginal tax brackets from being better off, after tax, because of donations of highly appreciated property to charity than they would have been had they sold the property and retained all of the proceeds. The rule effectively accomplished this, but also resulted in reduced contributions of the type of property the Conference Committee wished to encourage.

2. Research Expenditures by the University of California System. The master plan for the development of higher education in California, the "Donahue Higher Education Act", defines the responsibility of the three segments of public higher education. The University of California is charged with conducting programs in four major areas, one of which is research directed toward addressing the understanding of the arts and sciences. Research expenditure figures for the California university system, unlike national figures, do not indicate an increase in constant dollars by 3% a year, as shown in the attached table.

3. Incentive Value. The state tax bite is relatively small compared to the federal; to the extent that tax policy influences economic behavior, federal law is more significant. Additionally, any reduction in state tax liability will increase federal liability.

4. Simplicity. Conformity will simplify accounting record-keeping and reporting.

University of California
Research Expenditures By Fund Source
1975-76 Through 1979-80

Fund Source	1975-76 (CCPI Increase: 7.8%) Dollar Amount	1976-77 (CCPI Increase: 6.4%) Dollar Amount	1976-77 % Increase	1977-78 (CCPI Increase: 7.1% Dollar Amount	1977-78 % Increase
General Funds	$ 51,884.008	$ 55,403,421	6.8%	$ 60,266,469	8.8%
Federal Funds	205,049,734	222,940,788	8.7%	236,687,487	6.2%
Special State Appropriations & Contracts	5,879,498	7,381,442	25.5%	9,028,214	22.3%
University Endowments & Private Gifts, Grants & Contracts	34,568,083	38,780,176	12.2%	42,027,555	8.4%
Other Sources	4,164,816	4,876,861	17.1%	5,567,455	14.2%
Total	$301,546,139	$329,382,688	9.2%	$353,577,180	7.3%

1978-79 (CCPI Increase: 9.9%) Dollar Amount	1978-79 % Increase	1979-80 (CCPI Increase: 17.3%) Dollar Amount	1979-80 % Increase
$ 65,702,793	9.0%	$ 77,780,678	18.4%
259,118,048	9.5%	310,045,579	19.7%
9,060,226	0.4%	10,834,302	19.6%
47,192,621	12.3%	54,510,485	15.5%
4,823,707	-13.3%	[illegible],789,259	40.6%
$385,902,395	9.1%	$459,960,303	19.2%

Source:
University of Calif.
Campus
Financial Schedules

MDS
BAP-Budget
10-2-81

RULE FOR ALLOCATING RESEARCH AND DEVELOPMENT EXPENDITURES TO U.S. SOURCE INCOME

Summary of Differences Between State and Federal Law

For a federal taxpayer's first two taxable years beginning within two years after the date of enactment of the Economic Recovery Tax Act of 1981, all research and experimentation expenditures which are paid or incurred for research conducted in the United States will be allocated and apportioned to income from sources within the United States. Under California's unitary method of taxation, if a corporation's business operations conducted both within and without California are determined to be unitary, taxable income is determined by a formula method of apportionment.

Fiscal Effect of Conformity

Not applicable.

Description of Current State Law
R&TC Sections 25101, 25128

California taxes on corporate income are measured by income derived from or attributable to sources within California only. Where a corporation doing business in California derives income from sources within and without the state, or where such a corporation is part of a group of affiliated corporations doing business elsewhere and the operations are determined by the FTB to be a unitary business, the amount of taxable income attributed to California sources is detmined by the application of the apportionment formula to total world-wide income, after allowance for deductions and credits permitted by California law.

Description of Federal Law
IRC Sections 482, 861-864

Under federal law, earnings and dividends of foreign-based affiliates of a U.S. corporation are considered federal taxable income attributable to the U.S. corporation only when repatriated. The law also allows a foreign tax credit for the amount of tax paid abroad by the foreign corporation which paid the dividend. The IRS uses the "separate entity" or "separate accounting" method to allocate income between foreign and domestic operations.

Pursuant to Section 223 of the ERTA, for the next two taxable years, all research and experimentation expenditures which are paid for incurred for research conducted in the United States will be allocated and apportioned to income from sources within the United States. Further, the Secretary of the Treasury is directed to conduct a study on the impact the approach will have on the availability of the foreign tax credit and the research and experimentation expenditures conducted in the United States.

Policy Issues of Conformity

1. Inapplicable Under California's Unitary Method. The purpose of the new federal provision is to prevent taxpayers from losing foreign tax credits on the federal income tax, which may occur as a result of federal rules determining the allocation of expenses between foreign source and U.S. source income. This situation is not relevant in California, as we use the worldwide combination method for unitary businesses. While it would be possible to amend California's unitary system provisions to conform regarding the apportionment of R&D expenditures, it would not have the same purpose as the federal change had, i.e. foreign tax credits.

REDUCTION IN CORPORATE TAX RATE

Summary of Differences Between State and Federal Law

Federal law has a progressive tax rate structure on corporation net income while state law is proportional.

Fiscal Effect of Conformity

Not applicable.

Description of Current State Law

R&TC Section 23151

Corporations pay a minimum tax of $200 or a tax at the rate of 9.6% on net state income, whichever is greater, for the privilege of doing business in California.

Description of Federal Law

IRC Section 11(b)

Prior to the Economic Recovery Tax Act of 1981, corporations paid a progressive tax on net income ranging from 17% on net income less than $25,000 to 46% on net income greater than $100,000.

The ERTA reduces the first bracket tax rate from 17% on net income less than $25,000 to 16% in 1982 and to 15% in 1983. It also reduces the second bracket tax rate on net income between $25,000 and $50,000 from 20% in 1981 to 19% in 1982 and 18% in 1983.

Policy Issues of Conformity

1. Tax Rates Not Conformity Item. Tax rates are a function of expenditure needs and are not relevant for conformity.

2. Proposals For Graduated Corporate Rates. Many small businesses have pushed for a progressive tax rate on corporation net income in California. (See recent report by Employment Development Department titled SMALL BUSINESS POLICY FOR CALIFORNIA, 1981.) If the Legislature wishes to conform with this concept, it should be a separate bill. The revenue consequences of such a provision could be either large, if lower

rates are imposed on small incomes, or neutral, if the top rate is increased along with a progressive structure.

TAX EXEMPTION, MUTUAL INSURANCE COMPANIES

Summary of Differences Between State and Federal Law

Federal law exempts a portion of the net income of Mutual Insurance Companies. Such insurance companies are exempt from state net income taxation by the State Constitution.

Fiscal Effect of Conformity

Not applicable.

Description of Current State Law

California Constitution, Article XIII Section 28(f)

The State Constitution exempts insurance companies from payment of a tax on their net income.

Description of Federal Law

IRC Section 821(a)(2) and (c)(1)(B)

The Internal Revenue Code has special tax rates and exemptions for insurance companies. Small Mutual Insurance Companies also have a $6,000 net income exemption. The ERTA increases this exemption to $12,000.

Policy Issues of Conformity

The State Constitution would have to be changed to implement a policy for the taxation of net income of insurance companies. If such a policy were recommended, it should be pursued with a separate Constitutional Amendment and related statutes to impose a tax on the net income of insurance companies doing business in California.

ACCUMULATED EARNINGS CREDIT

Summary of Differences Between State and Federal Law

Federal law provides a special tax for certain corporations which accumulate earnings instead of paying dividends. California does not have a similar tax.

Fiscal Effect on Conformity

Not applicable.

Description of Current State Law

California's tax on corporations is a net income tax. A minimum franchise tax of $200 is also imposed without regard to income. If a corporation accumulates earnings without paying dividends, there is no special California tax.

Description of Federal Law
IRC Section 531(c)

Federal law contains provisions which assess a tax against corporations retaining excessive earnings instead of paying dividends. In computing the income against which the tax is imposed, a minimum credit is allowed. The new federal law raises the credit from $150,000 to $250,000. The $150,000 credit remains in effect for certain personal service corporations such as law and engineering.

Policy Issues of Conformity

California has not seen the need for an accumulated earnings tax. The federal tax is already effective in this area to "encourage" dividend distributions.

CHANGE IN SUBCHAPTER S CORPORATION RULES

Summary of Differences Between State and Federal Law

Federal law provides that under certain conditions a corporation may elect not to be taxed as a corporation, but to have its shareholders pay tax on the corporation's income instead. The state has no such provision.

Fiscal Effect of Conformity

Not applicable.

Description of Current State Law

California has not enacted a Subchapter S law equivalent to the federal law.

Description of Federal Law
IRC Section 1371

The new law increases from 15 to 25 the maximum number of shareholders that a Subchapter S corporation may have. It also enlarges the rule which allows certain trusts to be shareholders of Subchapter S corporations.

Policy Issues of Conformity

Since California law contains nothing comparable to the federal Subchapter S provisions, these federal changes are not applicable.

BAD DEBTS DEDUCTION OF COMMERCIAL BANKS

Summary of Differences Between State and Federal Law

The method of computing the bad debt deduction for banks differs substantially between state and federal law.

Fiscal Effect of Conformity

According to FTB, conforming with the basic federal provision and the ERTA change for 1982 would produce revenue losses of a few million annually, with the greatest impact in the transitional year when catch-up additions to reserves are made.

Description of Current State Law
R&TC Section 24348

Under existing state law, FTB has the authority to determine, by regulation, computation of banks' bad debt reserve. Under current regulation the addition to a bank's bad debt reserve is computed by means of a six year moving average of actual bad debts as compared to loans outstanding.

Description of Federal Law
IRC Section 585(b)(2)

For 1981, banks are permitted to increase their bad debt reserve to 1.2% of outstanding loans. This percentage was to have been reduced to 0.6% for 1982-1987. After 1987, the bad debt deduction was to be based upon experience only. The new law allows a computation of 1% of outstanding loans for 1982 with the 0.6% rate postponed until 1983.

Policy Issues of Conformity

1. No Prior Conformity. California's law with respect to the bad debt deduction of banks and other financial institutions represents a deliberate departure from the federal method. It was felt that the state method produces a more reasonable result.

2. Done By Regulation. Legislation is not necessary, as this provision is done by FTB by regulation.

FINANCIALLY TROUBLED THRIFT INSTITUTIONS: REORGANIZATIONS

Summary of Differences Between State and Federal Law

Federal law allows tax-free reorganizations of financially troubled thrift institutions without regard to the "continuity of interest" requirement. The reorganization qualifies as a bankruptcy procedure, and tax-free status applies to stock transfers made on or after January 1, 1981.

State law requires the continuity of interest before reorganizations can be considered tax-free.

Fiscal Effect of Conformity

According to FTB, based on proration of federal estimates, conformity to this provision would result in a revenue loss of less than $100,000 annually.

Description of Current State Law
R&TC Section 24531

Mergers, consolidations, and other types of reorganizations are subject to taxation of income gains unless the shareholders of the acquired corporation acquire stock in the acquiring corporation. This latter stipulation is the "continuity of interest" requirement.

Description of Federal Law
IRC Section 368(a)(3)(D)

Prior federal law was unclear concerning the application of the continuity of interest requirement to reorganizations involving mutual thrift institutions.

New federal law allows tax free reorganizations of thrift institutions undertaken in connection with a case under jurisdiction of the federal Home Loan Bank Baord (FHLBB) or the federal Savings and Loan Insurance Corporation (FSLIC) without regard to the continuity of interest requirement.

Policy Issues of Conformity

1. Applicability. Institutions to which this rule applies are savings and loan association, cooperative banks, and mutual savings banks. The latter type of institution does not exist in California.

2. Tax Policy. The purpose of the Act is apparently to "ease" the process of institution reorganization. Mergers and other types of reorganization among financial institutions are expected to increase dramatically in the coming years. However, it may not be good tax policy to exempt particular types of reorganizations without providing the same "ground rules" for reorganizations in other industries. It amounts to a subsidy to the financial community.

CARRYOVERS OF LOSSES FOR FINANCIAL INSTITUTIONS

Summary of Differences Between State and Federal Law

California law does not provide for carryover or carry-back of net operating losses. Federal law permits both carryback and carryover of net operating losses, and provides specific rules in the case of reorganizations with respect to the use of certain carryovers of acquired corporations by acquiring corporations.

Fiscal Effect of Conformity

Not applicable.

Description of Current California Law

None.

Description of Federal Law

IRC Section 382(b)(7)

Certain limitations are imposed on the use of pre-reorganization net operating loss carryovers where the shareholders of the acquired corporation are not shareholders of the surviving corporation. The new law clarifies these limitations by providing that deposits in the acquired corporation which become deposits in the transferee corporation are to be treated as stock in both corporations.

Policy Issues of Conformity

State law does not permit carryovers. Without a carryover system in place, there is nothing to amend.

BAD DEBT RESERVES FOR SAVINGS AND LOAN ASSOCIATIONS

Summary of Differences Between State and Federal Law

Federal law has some special rules on taxation of distributions by a savings and loan association out of excess bad debt reserves.

California does not have a provision comparable to the federal law.

Fiscal Effect of Conformity

According to FTB, conformity would result in minor revenue loss, less than $100,000 annually, based on the federal estimate.

Description of Current State Law

None.

Description of Federal Law

IRC Section 593(e)

Under certain circumstances, distributions by a savings and loan association out of excess bad debt reserves are taxed as ordinary income. Under the new law, this recapture rule does not apply to distributions made to the Federal Savings and Loan Insurance Corporation in redemption of an interest in an association where the FSLIC had received the interest in the association in exchange for financial assistance pursuant to Section 406(f) of the National Housing Act (12U.S.C. Section 1729(f)).

Policy Issues of Conformity

This provision is part of a comprehensive federal scheme with respect to savings and loan bad debt reserves which the state has not adopted. In California, these rules may be established by regulation.

FSLIC FINANCIAL ASSISTANCE

Summary of Differences Between State and Federal Law

Federal law allows a building and loan association to exclude from its income all money and/or property contributed to it under the Federal Savings and Loan Insurance Corporation (FSLIC) financial assistance program, without having to reduce its basis of property.

State law allows this exclusion, but requires basis reduction.

Fiscal Effect of Conformity

According to FTB, the fiscal effect of conformity depends on future financial market conditions relating to housing and building in general. Based on the federal estimate, annual revenue losses would be minor, probably less than $100,000.

Description of Current State Law

These contributions would be excludable for state tax purposes, but the basis of the property would be reduced accordingly.

Description of Federal Law

IRC Section 597

Federal law provides that all money or property contributed to a building and loan association under the FSLIC's assistance program is excludable from the association's income and that the basis of property need not be reduced by the assistance payments, whether or not the association issues a debt or equity instrument in exchange.

Federal law is effective for any assistance payment made on or after January 1, 1981.

Policy Issues of Conformity

1. Tax Relief for the Building and Loan Industry. The purpose of federal law is to provide tax relief to those

associations which require FSLIC assistance. It is argued that these associations are truly needy since the decision to seek assistance reflects the association's financial ill health.

2. Intention of the FSLIC Assistance Program. Providing this tax relief may result in a "tax incentive" for relatively healthy associations to attempt to receive FSLIC financial assistance. In contrast, associations which do not realize a profit during a particular taxable year do not substantially benefit from the income exclusion.

CONVERSION OF MUTUAL SAVINGS BANKS TO STOCK ASSOCIATIONS

Summary of Differences Between State and Federal Law

Federal law:

1. Allows stock associations to compute their bad debt deduction from taxable income in the same manner as that allowed savings and loan associations.

2. Permits stock associations that are regulated as mutual savings banks to separately compute their tax liability on their life insurance business.

3. Clarifies that amounts paid to stock association depositors are deductible to the same degree as that allowed mutual savings banks.

State law does not provide for these situations because there are no mutual savings banks in California. Thus, the issue of conformity is moot.

Fiscal Effect of Conformity

Not applicable.

Description of Current State Law

There is no current state law pertaining to the taxation of such a conversion, since mutual savings banks do not exist in California.

Description of Federal Law
IRC 591(b) and 593

See the summary above. Basically, the new federal law is designed to ease the process of conversion from a mutual savings bank to a stock savings and loan association.

Policy Issues of Conformity

This provision is not applicable to state law, since we do not have mutual savings banks.

INCENTIVE STOCK OPTIONS

Difference Between State and Federal Law

The Economic Recovery Act of 1981 provided for a new type of stock option called an "incentive stock option". California has no such provision.

Fiscal Effect of Conformity

According to FTB, conformity would result in minor net revenue losses over the next few years, followed by slightly larger net revenue gains, perhaps in the $200,000 range annually, reflecting the sale of option stock by employees at a lower basis than otherwise.

Description of Current State Law

R&TC Sections 17122.7, 17531-36, and 24621-22

An "incentive stock option" is an option granted to an indivudal for any reason connected with his or her employment by the employer corporation or by a parent or subsidiary corporation of the employer corporation to purchase stock of any of such corporations.

Under California law, if a stock option has a readily ascertainable fair market value at the time it is granted, the value of the option constitutes ordinary income to the employee at that time and any gain realized at the time the stock is sold is treated as a capital gain.

If the stock option has no readily ascertainable fair market value, it is not income at the time of receipt, but the excess of income over the option price at the time of the sale of the stock is treated as ordinary income.

Description of Current Federal Law

IRC Section 422(a)

The Economic Recovery Tax Act of 1981 provides for a new type of stock option called an "incentive stock option" whereby no tax consequences result from either the granting or the exercising of the stock option by the employee.

However, the employee is taxed at capital gains rates when he sells the stock if the stock is held for at least two years from the option grant date and at least one year from the stock transfer date. The basis of the stock is zero. Several other requirements apply. The employer is not allowed a business expense deduction with respect to an incentive stock option. Applies to options granted on or after January 1, 1976 and exercised on or after January 1, 1981.

The maximum value of stock for which any employee may be granted options in any calendar year generally cannot exceed $100,000. The difference between the option price and the fair market value of the stock at the exercise of the option does not constitute preference income. A corporation with options granted before 1981 can have the option treated as an incentive stock option by making an election. The aggregate value per employee at time of grant under this election cannot exceed $50,000 per calendar year and $200,000 in the aggregate.

Policy Issues of Conformity

1. Purpose of Federal Change. This provision is apparently intended to assist small new business ventures in attracting and motivating employees by allowing corporations to compensate employees by granting them stock options without immediate tax consequences.

2. Prior Conformity. The Federal Tax Reform Act of 1976 phased out the beneficial tax treatment of stock options for options granted after May 20, 1976 or exercised after May 21, 1981 and California conformed to such provisions in 1977.

3. Taxpayer Error/State Administration. Conformity would certainly eliminate taxpayer confusion and error. Without conformity, many taxpayers will assume the incentive stock option is available at the State level. This will cause: (a) increased administrative burdens on the Franchise Tax Board in order to determine the appropriate income from stock options, or (b) reduced tax revenues.

4. Who Benefits. The benefits of this provision will be available to only a limited number of employees of corporations who choose to compensate their employees in this way. Employees from other corporations which, for example, reward their employees with cash payments, would not receive beneficial tax treatment.

PROPERTY TRANSFERRED TO EMPLOYEES

Difference Between State and Federal Law

Federal law provides that stock received pursuant to the insider's trading rule is taxable at the time the restriction lapses rather than at the time of receipt. State law would treat the receipt of such stock as a taxable event.

Fiscal Effect of Conformity

According to the Franchise Tax Board, conformity would result in an unknown, but probably minor, State revenue loss.

Description of Current State Law

R&TC Section 17122.7

Generally, property received by employees as compensation for services is not includable in taxable income at the time of receipt if:

1. the property is subject to a substantial risk of forfeiture, and

2. the employee's interest in the property is non-transferable.

Description of Federal Law

IRC Section 83(c)

Property received by a person who could be subject to suit under Section 16(b) of the Securities Act of 1934 (the insider's trading rule) is subject to a substantial risk of forfeiture and is nontransferable. Therefore, receipt of such stock is not a taxable event.

The employee will include in income, and the employer may deduct, at the time the restriction lapses, the difference between the value of the stock at that time and the amount paid for the stock.

Policy Issues of Conformity

1. Rationale for Federal Provision. Some courts have held that stock received by employees who could be required to pay over to the corporation any profits realized upon the sale of such stock within six months of acquisition (insider's trading rule) is not considered to be subject to a substantial risk of forfeiture and therefore is a taxable event.

2. Substantial Risk of Forfeiture Definition. A person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual.

3. Statute Versus Court Findings. The Federal provisions clarify the intent of Section 83(c) regarding a substantial risk of forfeiture as it relates to the insiders trading rule in light of some recent court decisions to the contrary.

TARGETED JOBS TAX CREDIT

Summary of Differences Between State and Federal Law

Both federal and state law allow employers to claim a credit against tax owed, equal to a portion of wages paid to employees from targeted hard-core unemployed groups. Prior to the 1981 federal tax bill, the laws were generally similar but differed in the following areas: size of the credit, list of qualified employees, cap on amount of credit, and double benefits prohibition (see below). Relevant areas of difference between the two laws resulting from changes made in the ERTA are as follows:

Qualified Employees: The federal law adds laid-off public service CETA employees to the eligible list.

Controls: The new federal law makes rehirees and relatives of the employer ineligible for the credit.

Certification: Retroactive certifications are now prohibited for the federal credit.

Fiscal Impact of Conformity

According to FTB, full conformity to federal law would result in significant revenue loss in income years 1982, 1983 and 1984, in the tens of millions of dollars.

Description of Current State Law

R&TC Sections 17053.7, 24330

California enacted a jobs tax credit in 1979, under which employers are allowed to claim a credit against tax owed equal to a portion of the wages paid to employees from targeted hard-core unemployed groups.

The provisions of the California jobs tax credit are as follows:

Size of the Credit: 10% of the first $3,000 in wages paid in each of the first two years of employment, for a maximum annual credit of $300 per employee (maximum total credit of $600 per employee).

Qualified Employees: WIN program registrants, AFDC recipients not in WIN, SSI recipients, and General Assistance recipients.

Sunset Date: December 31, 1984, except for SSI-SSP and GA recipients the same sunset date as the federal jobs tax credit.

Description of Federal Law
IRC Sections 50, 51

The federal jobs tax provisions were originally enacted in the Tax Reform Act of 1978, and were amended in the Economic Recovery Tax Act of 1981. Current provisions are as follows:

Size of the Credit: 50% of the first $6,000 of wages paid in the first year and 25% of the first $6,000 of wages paid in the second year.

Qualified Employees: WIN registrants, AFDC recipients, handicapped vocational rehabilitation referrals, "economically disadvantaged" youth 18 to 24 years old, SSI recipients, General Assistance recipients, "economically disadvantaged" ex-convicts, "economically disadvantaged" Vietnam-era veterans, and employees laid off from public service employment funded by CETA. Rehirees and relatives of the employer are not eligible for the credit.

Double Benefits Provision: The amount of the credit must be subtracted from the amount of wages the employer deducts for business expenses.

Certification Requirements: Certifications of eligibility issued after the individual begins work are invalid.

Sunset Date: Employees hired on or before December 31, 1982 will qualify (equivalent to a sunset date of December 31, 1984).

Policy Issues of Conformity

1. Prior Non-Conformity. California's jobs tax credit was enacted in 1979 after the federal TJTC was put into place. Presumably, each of California's departures from the federal framework were deliberate. The smaller size of the state credit can be justified by the lower rates of the state tax and the cumulative tax relief resulting from the state are federal credits.

2. Qualifying Employees. The purpose of targeting the federal jobs credit at the specific groups listed above was to encourage creation of jobs for the hard-core unemployed. California's apparent purpose in limiting the state credit to a subset of these was to provide further encouragement to employers to hire persons on state and local public assistance. The rationale was that the state cost of the credit would be at least partially offset by reduced state aid payments to those who became employed.

   State conformity to the broader federal list of qualifying employees would increase the state cost of the program without increasing the potential for offsetting public assistance reductions.

3. Preventing "Bounty-Hunting" and Nepotism. The purpose of the new federal provision preventing retroactive certifications is apparently to put a stop to practices by employers of determining after hiring if employees qualify for the TJTC. There have been reports of consultants who will screen firms' current payrolls to discover any qualifying employees, and take as a "bounty" a portion of the jobs tax credit thereby claimed. Another new federal provision attempts to stop abuses by making rehirees and relatives of the employer ineligible for the credit.

LOW INCOME HOUSING PROVISIONS

Summary of Differences Between State and Federal Law

The Economic Recovery Tax Act made the following changes to tax treatment of low income housing:

1. Permanently exempts low income housing and real property which is not used in a business from the requirement to amortize construction period interest and property taxes. Amortization was already required for all real property, other than low income property. For low income property, amortization was to go into effect in 1982. California law, which is in substantial conformity with former federal law, allows deduction of low income housing construction period costs until December 31, 1981, when amortization would begin. Other property already has amortization requirements.

2. Increased the limit of expenditures for rehabilitation of low-income housing qualified for special 60 month elective amortization from $20,000 to $40,000, under specified conditions for expenditures on or after January 1, 1981. California law, which is in substantial conformity with former federal law, has a $20,000 limit. The current state tax treatment applies only to expenditures incurred before January 1, 1982.

Fiscal Effect of Conformity

According to the Franchise Tax Board, the following estimated revenue losses would occur if California law conformed to federal changes. The estimates are based on a proration of federal estimates.

	1981-82	1982-83	1983-84
Amortization of construction period interest and taxes	-$100,000	-$500,000	-$500,000
Amortization of rehabilitation expenditures	*	-$300,000	-$500,000

*less than $100,000 loss

Description of Current State Law

1. Construction Period Interest and Taxes
R&TC Section 17237

Chapter 1079, Statutes of 1977, provided that no deductions would be allowed for real property construction period interest and taxes, and that pursuant to a specified schedule, such costs would have to be amortized. For low income housing, deductions are allowable for tax years beginning through December 31, 1981. For tax years beginning in 1982, amortization would be required. For other real property, amortization was begun in 1977 and 1978.

2. Rehabilitation Expenditures
R&TC Sections 17211.7 and 24354.2

In the Special Session of 1971, state Personal Income Tax laws and Bank and Corporation Tax laws were amended to provide a special 60 month straight-line write-off of expenditures to rehabilitate low-income rental housing if, over a period of two consecutive years, aggregate expenditures exceed $3,000. The maximum allowed the special treatment was originally $15,000 for any one unit. The special treatment was originally to sunset in 1975. In two subsequent amendments, the program was changed to a $20,000 maximum, with a requirement that the expenditures be incurred before January 1, 1982.

Description of Federal Law

1. Construction Period Interest and Taxes
IRC Section 189(b)(d)

Former federal law prohibited deduction of construction period interest and taxes for low income housing effective taxable year 1982. The law required amortization of such expenses.

ERTA made permanent the deductibility of construction cost for low income housing.

Former federal law also required the amortization of construction period costs for all real property.

ERTA provides that such costs may be deducted for real property that cannot reasonably be expected to be used in a trade or business or in a profit-making activity.

2. Rehabilitation Expenditures
IRC Section 167(k)

Former federal law provided for a special 60-month amortization of up to $20,000 for low-income rehabilitation expenditures. ERTA amendments increase the limit to $40,000 for expenditures made after December 31, 1980 if the rehabilitation is conducted pursuant to a program certified by HUD or a state or federal subdivision, and if: (1) a Certification of the program is made; (2) tenants occupy the units as principal residences; and (3) seller's profit is limited if there is a tenant purchase program.

Policy Issues of Conformity

1. Purpose of the Provision. Congress enacted these provisions to stimulate construction of low-income rental housing to eliminate the shortage of such units. Congress believed that without these incentives, many high risk low-income projects may be curtailed.

2. Past Conformity. California has adopted these incentives as state tax policy by adopting the federal law through 1981.

3. Construction Period Interest and Taxes. The allowance of a deduction for construction period interest and taxes is contrary to the fundamental accounting principle of matching income and expenses.

   In the case of an individual who constructs a building and subsequently receives income in the form of rents from that building, the accounting concept of matching income against expenses should require that the expenses incurred during the construction period be deducted against the rental income which is received over the life of the building, to the extent the expenses are attributable to a depreciable or wasting asset. The general construction costs of the building are treated this way, being capitalized and subsequently deduced as depreciation expenses. (Similarly, certain pre-opening or start-up expenses for a new trade or business are required to be capitalized for tax accounting purposes.)

4. State Incentive Effect. Will the additional state tax deferment benefits which would become available under conformity encourage development of additional low-income housing?

5. Simplicity. If a taxpayer is required to amortize these expenses for state law but can deduct them for federal law, two sets of books must be kept and added complexity will follow.

CHARITABLE CONTRIBUTIONS OF CORPORATIONS: DEDUCTION LIMIT INCREASE

Summary of Differences Between State and Federal Law

For tax years beginning after 1981, the present federal cap limiting charitable deductions of corporations to 5% of its taxable income will be increased to 10%. Under California law, corporations are allowed a deduction for charitable contributions up to a limit of 5% of net income.

Fiscal Effect of Conformity

According to FTB, fiscal effect would be as follows (in millions):

1981-82	1982-83	1983-84
-$ .5	-$2.0	-$2.0

Assembly Revenue and Taxation staff does not believe the fiscal effect will be this significant.

Description of Current State Law

R&TC Section 24358

Corporations are allowed a deduction for contributions paid to certain organizations, up to a limit of 5% of net income, computed without regard to this deduction or to the deductions for dividends received, and certain other special deductions such as building and loan dividends paid, and certain deductions of cooperatives. There is no provision for carrying over excess contributions as there is in the state's Personal Income Tax Law or as there is in federal corporate tax law.

Description of Federal Law

IRC Section 170(b)(2)

The Economic Recovery Tax Act of 1981 increases the allowable deduction for corporate charitable contributions from 5% to 10% of taxable income, computed without regard to that deduction for dividends received, dividends paid on certain preferred stock of public utilities, certain payments to the National Railroad Passenger Corporation, any net operating loss carryback, and any capital loss carryback.

A corporation is permitted to carryover to the five succeeding taxable years contributions which exceed the percentage limitation. The aggregate deductions for taxable years to which an unused contributions deduction is carried are also subject to the percentage limitation.

Policy Issues of Conformity

1. Federal Rationale. According to Gabriel Rudney, Visiting Fellow, Yale University's Institution for Social and Policy Studies, the new limit was not justified as a means of expanding corporate philanthropy, but rather was to prevent the 5% limit from actually decreasing contributions. The accelerated cost recovery and certain other provisions in the 1981 Act are expected to reduce corporate net income so that many corporations would exceed the 5% limit without increasing the amount contributed. The 10% limit would avoid this unintended effect.

   According to Rudney, corporations on the average give about one percent of their net income. About 20 percent of the corporations claimed a deduction according to a study done in the mid-seventies, and only a very small fraction of the corporate donors were at the 5 percent limit.

2. Policy. Deductions for philanthropy are justified as a means to encourage subsidization of cultural and welfare matters for which there might otherwise be pressure for public funding, and as a method of decentralizing decision-making and power in those matters.

3. Incentive Value. There is no clear evidence to help evaluate the impact of a state tax change on charitable giving. However, it does seem reasonable to assume that tax incentives, rather than generosity, are more influential on corporate behavior. To the extent that they are, there is no doubt that the major incentive will come from the deduction allowed against the federal tax, which is much higher. Also, to the extent that state tax liability decreases because of a higher cap, federal tax liability increases because of the lower deduction for state taxes.

4. Simplification Argument. Merely increasing the cap to 10% would not do much in the way of simplifying tax computations for corporate donors. This is because:

   a. there are differences in the adjustments to income for purposes of computing the cap, as indicated above;

b. federal law allows a carryover of contributions, while California law does not;

c. California always reduces a contribution made in appreciated property by a corporation by the amount of the untaxed gain, i.e., to the taxpayer's basis in the property, while federal law makes a similar adjustment only where the property is "ordinary-income" property (with exceptions now for inventory donated to universities for research, and for care of the needy); where the gain would have been long-term capital gain if the property had been sold, federal either makes no adjustment or makes a modified adjustment. The California Bank and Corporation Tax Law has no provision for capital gains and losses.

d. California law allows an additional deduction for the cost of donating agricultural products; and

e. net income for state purposes is different from taxable income for federal purposes, both because of different deductions and in some instances because of the application of the unitary apportionment of income formula by California.

41.

EMPLOYER GIFTS AND AWARDS

Difference Between State and Federal Law

Federal law allows a noncash award ceiling of $400 rather than California's $100. Federal law includes productivity as a reason for an award; California does not. Federal law provides for special treatment for qualified plan awards whereas California does not.

Fiscal Effect of Conformity

According to FTB, conformity would result in annual revenue losses in the $100,000 range, based on proration of the federal estimate.

Description of Current State Law

R&TC Sections 17299.6 and 24445

Employers may deduct an item of tangible personal property awarded to an employee by reason of length of service or for safety achievement when the cost of the item to the employer does not exceed $100.

Description of Federal Law

IRC Section 274(b)

Employers may deduct an item of tangible personal property awarded to an employee by reason of length of service, for safety achievement, or productivity when the cost of the item to the employer does not exceed $400.

Employers may create a permanent written nondiscriminatory plan whereby awards for the above-mentioned reasons may be made to employees. Such awards would be deductible provided the average cost of all items awarded under such plan do not exceed $400. Items that cost in excess of $1600 may not be treated as a qualified plan award.

Policy Issues of Conformity

1. Prior Conformity. Current State law was added by Chapter 1168, Statutes of 1979, to conform to Federal law existing at that time.

2. Taxpayer Error/State Administration. Conformity would certainly eliminate taxpayer confusion and error. Without conformity, many taxpayers will inadvertently deduct the higher Federal amounts. This will either cause:

(a) increased administrative burdens on the Franchise Tax Board in order to determine whether such awards qualify for the deduction, or (b) reduced tax revenues.

3. Productivity Awards. Extending the deduction to noncash items awarded by reason of productivity benefits the employer in two ways: (a) potentially increased profits via increased productivity, and (b) reduced tax liability via the newly created deduction. Should the employer benefit both ways?

4. Qualified Plan Awards. The special treatment for specified qualified plan awards could result in four employees each being awarded $100 noncash gift and one employee being awarded a $1600 noncash gift, thereby resulting in an average cost of all items not exceeding the $400 ceiling. Is this appropriate?

5. Intent of Law Change. If the intent of the Federal law is to increase the value of noncash awards to employees, will this occur, or will it merely provide a windfall tax benefit to employers who would have awarded such items in any event?

MOTOR CARRIER OPERATING AUTHORITIES

Summary of Differences Between State and Federal Law

Prior to ERTA, the state and federal law were the same in that a motor carrier operating under a motor carrier operating authority certificate or permit was not allowed to deduct the diminution in value of such certificate or permit as a loss.

Under ERTA, a motor carrier is allowed to deduct the diminution in value of such certificate or permit over a certain period.

Fiscal Effect of Conformity

According to FTB, conformity to this item would result in rather significant revenue losses, a few million dollars annually.

Description of Current State Law

Although there is no statute specifically disallowing the deduction for diminution in value, the general rule is that no deduction is allowable for diminution in value of intangible property until the intangible is sold or otherwise disposed of.

Description of Federal Law

ERTA Section 266

Due to the deregulation of the trucking industry, motor carrier operating authorities (certificates or permits) may have decreased in value. The law allows taxpayers, for taxable years ending after June 30, 1980, to deduct their adjusted basis in all such authorities. The deduction must be taken ratably over a 60-month period.

Policy Issues of Conformity

1. Equitable Considerations. The diminution in the value of the authorities results from federal governmental action over which the industry had no control. Under such circumstances, it would seem fair to allow deduction of the loss.

2. What About Other Value Decreases? This provision allows a deduction for only one type of value decline, and does not provide for other intangibles which may diminish in value due to governmental action, for example a company's "good will".

3. Administrative Concerns. Confirming the decrease in value would be a very difficult task.

LIFO INVENTORY CHANGES

Summary of Differences Between State and Federal Law

State law requires taxpayers using the last-in, first-out (LIFO) inventory method to value the ending inventory at cost. Under federal law, the Internal Revenue Service is to simplify LIFO inventory valuation by publishing suitable government indexes.

Fiscal Effect of Conformity

According to FTB, based on proration of federal estimates, fiscal effect would be as follows (in millions):

1981-82	1982-83	1983-84
-$1	-$4	-$4

Description of Current State Law
R&TC Sections 17602-17603, 24702-24706

Current state law requires taxpayers to treat goods on hand at the end of the year as having been: first, included in opening inventory and second, as having been acquired during the year. Such goods are inventoried at cost.

Description of Federal Law
IRC Section 472(f)

The Act authorizes the Internal Revenue Service to simplify the so-called dollar value LIFO method by publishing appropriate government indexes. Special rules are provided for the recognition of income in the year of change to LIFO and with respect to the use of a single LIFO pool by small business.

Policy Issues of Conformity

1. Taxpayer Compliance. The LIFO provisions are complex and demanding to apply. If the government indexes do in fact simplify matters, filing the return will be easier.

2. <u>Done By Regulation</u>. Franchise Tax Board has the authority under existing law to conform to the IRS system, if deemed appropriate, without statutory change.

WINDFALL OIL PROFITS TAX

Differences Between State and Federal Law

Federal law imposes a tax on profits derived from domestic crude oil production and provides for specified credits against and exemptions from this tax.

State law does not impose such a tax.

Fiscal Effect of Conformity

Since California does not impose a windfall oil profits tax, the issue of conformity is irrelevant.

Description of Current State Law

There are no state provisions imposing a windfall oil profits tax.

Description of Federal Law

IRC Sections 4987(b)(3), 4991(b), 4994(b), 4994(g), and 6429(c)

The following expanded credits and exemptions are provided to windfall oil profits taxpayers:

1. Royalty holders may claim a credit of $2,500 for income received from 1981 crude oil production, and exempt royalty income received from a portion of production beginning 1982.

2. The value of stripper oil is subject to conditional exemption beginning 1983.

3. Economic interests in crude oil production held by residential child care agencies maintained as a charitable organization is exempt.

In addition, the tax rate levied on newly discovered oil is gradually reduced from its current rate of 30% in 1986.

Policy Issues of Conformity

In absence of state windfall oil profit tax, conformity is not relevant.

COMMODITY STRADDLES

Summary of Differences Between State and Federal Law

California previously conformed with the federal treatment of commodity options. In general the character of any gains or losses (whether capital or ordinary) with respect to option transactions depends on the character of the optioned property. New federal provisions are intended to reduce transactions made for tax advantages only.

Fiscal Effect of Conformity

According to FTB, conformity would result in unknown revenue gains, probably a few million dollars annually.

Description of Current State Law

R&TC Section 18191

Generally the same as prior federal law. No existing provisions comparable to the new federal law.

Description of Federal Law

IRC Section 1092

Provides that with respect to straddle options (situations in which both buy and sell positions are taken on a commodity in order to diminish the taxpayer's risk) losses may be taken only to the extent they exceed realized and unrealized gains involving the straddle. Alternatively, in the case of a straddle which is an "identified straddle", no loss may be recognized until all positions making up the straddle are disposed of.

Disallows losses involving commodity "wash sales"--situations in which a commodity is sold and immediately (within 30 days) repurchased so as to recognize a loss.

IRC Section 263(g)

Disallows deduction of interest and carrying charges with respect to a straddle, and provides for capitalization of such costs.

IRC Section 1256

"Regulated futures contracts" (except "identified straddles"--see Section 1092 above) are to be treated for tax purposes as sold on the last day of the year, and any "gain" or "loss" is to be based on the market value as of that date. If the capital gains or losses are involved, 40% is considered short term and 60% is considered long term.

IRC Section 1212(c)

Losses from a regulated futures contract may be carried back for three years to offset gains on such contracts.

Provides that government bonds sold at a discount and bearing no interest are capital assets.

Provides that gain realized from sale of such bonds shall be treated as ordinary income (interest) up to the "rateable share of the acquisition discount" (based on the number of days the bond is held by the taxpayer divided by the number of days between the acquisition date and the maturity date). Gains in excess of this amount are treated as short-term gains.

IRC Section 1234A

Provides that gains or losses attributable to the lapse or expiration of an option shall be treated as a capital gain if the asset would, if acquired, have been a capital asset. In the past, capital gain provisions have only applied to sale or exchange of assets, but not lapse or expiration of options.

IRC Section 1236(a)

Security dealers must immediately indicate whether securities are purchased for investment or resale to customers. In the past dealers had 30 days in which to so indicate, allowing an opportunity to elect capital status for appreciating securities and ordinary status for securities which were declining in value.

Policy Issues of Conformity

1. Tax Advantages. Commodity futures and options activities have become enormously complex, fraught with circuitous and arcane transactions made for tax advantage only. The new federal greatly reduces the incentive to engage in such transactions.

2. Compliance. If California's law is conformed with the the new federal treatment, compliance, administration and audits relating to these transactions will be far simpler.

PRODUCTION CREDIT FOR CERTAIN GASES

Summary of Differences Between Federal and State Law

Federal law prohibits producers of specified natural gases from nonconventional sources from claiming an income tax credit for such fuel production if they elect the "incentive price" for gas under the Natural Gas Policy Act of 1978.

State law contains no similar provisions.

Fiscal Effect of Conformity

Not applicable.

Description of Current State Law

The state provides neither a credit for production of natural gas from nonconventional sources nor an "incentive" market price for such fuels.

Description of Federal Law

IRC Section 44D(e)

Federal law allows producers of natural gas from non-conventional sources to claim an "alternative fuel" credit against their income tax.

Federal law, under the Natural Gas Policy Act of 1978, allows producers to elect the incentive price for such fuel.

The Economic Recovery Tax Act of 1981 prohibits producers to claim the benefits of both the credit and incentive pricing.

Policy Issues of Conformity

This federal provision is inapplicable to California law.

CHAPTER 3

Economic Recovery Tax Act of 1981

ADMINISTRATIVE AND MISCELLANEOUS PROVISIONS

PRIVATE FOUNDATIONS

Summary of Differences Between State and Federal Law

Although California has conformed in principle to the federal law by creating a special category of organizations classified as private foundations, the state has not conformed to a number of federal excise tax provisions designed as disincentives for violating the rules covering private foundations. Among the excise taxes imposed on private foundations, for federal purposes, is a tax equivalent to 100 percent of specified amounts of a private foundation's defined distributable income which remain undistributed at the close of the taxable year.

Fiscal Effect of Conformity

Not applicable.

Description of Current State Law

California does not provide for punitive taxing sanctions, for the reason that federal discentives are deemed sufficient to discourage private foundations from violating the rules. Accordingly, California does not impose a special excise tax if a private foundation fails to distribute defined distributable income.

Description of Federal Law

IRC Section 4942(d), (j)

For tax years beginning after 1981, the amount of income required to be distributed has been reduced to a minimum investment return, which is generally equal to 5 percent of the private foundation's net investment assets. This means that the 100 percent excise tax will only be imposed on amounts included within the new minimum which are not distributed.

Policy Issues of Conformity

As the state does not have excise tax on private foundations, there is nothing to amend.

STATE LEGISLATORS' EXPENSES

Summary of Differences Between State and Federal Law

Both California and federal law provide that the "tax home" of a member of the Legislature is within the district he represents. The major difference is that California law provides generally that traveling expenses may be deducted while the Legislator is away from home, while the federal law specifies the amount of per diem which may be deducted and defines "legislative days" for which per diem deductions may be taken.

Fiscal Effect of Conformity

According to Franchise Tax Board, conformity to this item would result in a minor revenue loss, less than $100,000 per year.

Description of Current California Law

R&TC Section 17202

California law provides that the "tax home" of a member of the Legislature is within the district he represents. This permits Legislators to deduct traveling expenses while away from home.

Description of Federal Law

IRC Section 162(h)

Federal law provides that the tax home of a member of the Legislature is the residence of such individual within the district he or she represents. Legislators living more than 50 miles from the state capitol are permitted to deduct an amount of per diem received for travel expenses which is the greater of:

(a) the amount of per diem permitted state employees, or

(b) 110% of the amount of per diem permitted for federal employees.

This deduction for per diem is permitted only for legislative days, which are:

(a) days the Legislature is in session,

(b) days the Legislature is in recess for a period of four consecutive days or less, and

(c) days which the Legislature was not in formal Session where a member was formally recorded in attendance at a legislative committee meeting.

The provisions of federal law are retroactive to tax year 1976 and subsequent tax years.

Policy Issues of Conformity

1. Background

The federal Tax Reform Act of 1976 provided an election for the tax treatment of State legislators for taxable years beginning before January 1, 1976. This was extended temporarily **for** one year at a time, for tax years 1978, 1979 and 1980. In the absence of the 1980 congressional action, the tax home of a State legislator, for taxable years beginning after 1980, would have been determined under the general rules for deduction of business expenses.

The State legislator provision of the 1976 Act was construed by the Tax Court in Eugene A. Chappie v. Commissioner (1980). In that case, the Tax Court held that the generally applicable business deduction rules of the Code (Sec. 162) required a California Assemblyman to be away from home overnight in order to be entitled to a business deduction for traveling and living expenses. Because section 604 of the Tax Reform Act of 1976 made no change in this rule for state legislators, the Tax Court held that no such deduction was available as to days when a legislator actually was not away from his tax home (i.e., his place of residence in the district represented) overnight. The Court explained that the present law rules pertaining to business deductions and commuting expenses (Code Secs. 162 and 262) precluded a deduction for expenditures incurred in the legislator's travels to and from Sacramento. Because the legislator did not comply with the generally applicable business deduction rules, he could not be deemed to have expended the per diem amount allowable to electing state legislators as living expenses under the provision of the 1976 Act.

CAMPAIGN FUNDS

Summary of Differences Between State and Federal Law

Both California and federal law impose a tax on the "political organization taxable income" of a tax-exempt political organization. The two laws are generally in conformity, although there are slight differences with respect to capital gains and newsletter funds.

Fiscal Effect of Conformity

No effect.

Description of Current State Law
R&TC Section 23701r

California law provides that "political organization taxable income" in excess of $100 is subject to the 9.6% Bank & Corporation Tax tax rates. This income is generally income from investments by a political organization (less direct expenses incurred in earning that income).

Description of Federal Law
IRC Section 527

Federal law provides that the "political organization taxable income" (POTI), in excess of $100 is subject to the federal graduated corporation tax rates, as follows:

- The POTI of the principal campaign committee, if a candidate is running for Congress, is taxed at the regular tax rate applicable to the income bracket.

- The POTI of committees of candidates for other offices and other political organizations is taxed at the highest federal tax rate applied to corporations.

Prior to the 1981 Act, all political organization taxable income was taxed at the highest tax rate. In the 1981 Act, Congress enacted a lower rate for Congressional candidates only.

Federal law also has special provisions for capital gain income of political organizations and does not extend the $100 deduction to funds for newsletters.

Policy Issues of Conformity

1. 1981 Federal Change Not Relevant to California

   Because California has a single tax rate for corporations (9.6%), the change in the federal law is not relevant to California law. California is in conformity with both prior federal law and new federal law on this point.

2. Other Issues of Conformity

   The differences in state and federal law in the tax treatment of political organization taxable income are minor and pre-existed the 1981 Federal Act.

   These differences have not caused any problems for taxpayers that have been brought to the attention of the Legislature. In addition, POTI of newsletter funds receive a more favorable treatment under California law.

TAX EXEMPT OBLIGATIONS: VOLUNTEER FIRE DEPARTMENTS

Summary of Differences Between State and Federal Law

Federal law, as amended by the Economic Recovery Tax Act of 1981 (ERTA), exempts from taxation interest received from debt instruments of volunteer fire departments. Such interest is not exempt under state law.

Fiscal Effect of Conformity

Very minor annual General Fund revenue losses.

Description of Current State Law

Under Article XIII, Section 26(b), interest on bonds issued by California local governments is exempt from income taxes. This exemption does not apply to volunteer fire departments, which are not political subdivisions of the state.

Description of Federal Law
IRC Section 103

Federal law exempts from taxation interest earned on various obligations of state and local governments. ERTA provides that obligations of volunteer fire departments are also eligible for tax-exempt status. The proceeds from such obligations can be used only for the acquisition, or construction or improvement of firetrucks and firehouses.

Policy Issues of Conformity

1. Purpose of Tax Exemption. The exemption of interest earnings on local government debt instruments lowers the cost to localities of financing capital assets. The state already has a constitutional commitment to subsidize local government obligations. The issue is whether volunteer fire departments, because of their function and responsibilities, should be considered as local governments.

2. Other Quasi-Public Agencies. If volunteer fire departments are granted tax-exempt status, should other groups serving public functions also be granted this status?

3. Incentive of Tax Exemption. It is the federal tax exemption which significantly lowers the cost of capital financing to state and local governments. State tax exemption offers only slight additional benefits.

4. Revenue Impact. Given of the small size of most volunteer fire departments, their capital needs are not large. It is not likely that debt instruments would be used often, even with tax-exempt status.

INDUSTRIAL DEVELOPMENT BONDS: TRANSIT FINANCING

Summary of Differences Between State and Federal Law

Federal law exempts from gross income interest earnings on specified industrial development bonds (IDBs). The Economic Recovery Tax Act of 1981 (ERTA) extended tax exemptions to IDBs used for transit financing.

Under the California Constitution, interest earnings from any bond issue (including IDBs) issued by California or a local government in the state are exempt from income taxation. However, most local governments are not presently authorized to issue IDBs for transit financing.

Fiscal Effect of Conformity

If California local governments are authorized to issue IDBs for transit financing, there would be a minor annual General Fund revenue loss.

Description of Current State Law

Under Article XIII, Section 26(b), "Interest on bonds issued by the state or a local government in the state is exempt from taxes on income". Local governments, however, must have legislative authorization to issue bonds. (This is not necessarily true for charter counties or cities.) Under Title 10 of the Government Code (as added by Chapter 1358, Statutes of 1980), IDBs can be issued only for private industrial uses.

Description of Federal Law

IRC Section 103

Under existing federal law, the interest from most bonds issued by state and local governments is exempt from taxation. With regard to IDBs, however, only the following are exempt:

- Small issues (less than $1 million, with higher limits in certain cases); and

- Issues for specified uses (for example, sports facilities, airports).

ERTA added the category "qualified mass commuting vehicles" to the list of specified exempt uses. This provision would allow public transit districts to work with the private sector in order to lower the cost of financing transit capital purchases.

Policy Issues of Conformity

1. Tax and Policy Conformity. From strictly a tax perspective, the state is already in conformity with the change made by ERTA, as interest on IDBs for transit financing is tax-exempt at both state and federal levels. Practically, however, the general state tax exemption means little, as most local governments cannot issue IDBs for financing transit spending. The conformity policy issue is whether the state should authorize IDB uses which correspond to the uses now provided tax-exempt status by federal law. The Legislature just recently addressed that issue (through Chapter 1358/1980), and established categories of IDB use which differ significantly from those of the federal government. The change made by ERTA merely adds one more difference.

2. Incentive of Tax Exemption. It is the federal tax exemption which significantly lowers the cost of capital financing to state and local governments. State tax exemption offers only slight additional benefits.

PROHIBITION OF DISCLOSURE

Summary of Differences Between State and Federal Law

Prior to ERTA, the Federal Freedom of Information Act (5 USC 552) did not provide for a general or specific exception authorizing the Internal Revenue Service to withhold its audit identification models upon receipt of a disclosure request. The California Public Records Act (Govt. Code 6250 et seq.) permits the nondisclosure of an agency's records (tax audit standards) if the public interest served by not making the record public clearly outweighs the public interest served by such disclosure.

Fiscal Effect of Conformity

No effect.

Description of Current State Law
R&TC Sections 19282 and 26452

Under the Personal Income Tax Law, only the details and particulars shown on an individual's tax return are protected from disclosure. Under the Bank and Corporation Tax Law, the amount of income or particulars relating to the business affairs of the taxpayer are not subject to disclosure. Standards developed for audit purposes are not included as part of the provisions relating to the confidentiality of tax data.

Description of Federal Law
IRC Section 6103(b)(2)

Under the 1981 Act, effective for disclosures after July 19, 1981, the Internal Revenue Code or any other law is not to be construed to require the disclosure of standards used or to be used for audit selection or data used or to be used in setting such standards. This provision is operative if the disclosure of the requested audit criteria would seriously impair tax assessment, collection or enforcement.

Policy Issues of Conformity

1. Public Examination of Audit Criteria. If the general nondisclosure exception contained in the Public Records Act is ever changed, audit criteria could become a record available to anyone for any purpose upon request.

2. Effect on Tax Evasion. The publication of audit standards would not necessarily encourage the filing of accurate tax returns. In fact, such publication could be utilized to increase or even take unearned deductions, credits, etc., with the knowledge that the minimum audit threshold has not been met.

INTEREST RATE ON UNDERPAYMENTS AND OVERPAYMENTS

Summary of Differences Between State and Federal Law

For California purposes, the interest rate for delinquent taxes and refunds is 12% (6% for first year for personal income taxes). The federal interest rate is changed annually to reflect the prime rate.

Fiscal Effect of Conformity

According to Department of Finance, revenue gain from conformity with respect to personal income, bank and corporation, sales and use, and inheritance taxes, assuming a July 1, 1982 effective date, would be as follows (in millions):

1982-83	1983-84	1984-85
+ $125	+ $50	+ $50

Description of Current California Law

R&TC Sections 5763, 6513, 14211, 15961, 18686, 25901, 30202, and 32254

For individual income taxes, the annual interest rate for delinquent taxes and refunds is 6% for the first year and 12% thereafter. For all other state taxes, the interest rate is 12% per annum for delinquencies and refunds.

Description of Federal Law

IRC Section 6621

Federal law makes no distinction between individuals and corporations as to interest rates. After August 13, 1981 the interest rate for delinquencies and refunds is determined annually (by October 15) by reference to 100% of the prime rate paid during September.

Policy Issues of Conformity

1. High Interest Rates. Congress believed that the interest rate applicable to tax refunds and deficiency should coincide more closely with the actual cost of borrowing. Because the tax interest rate historically has exceeded both the prime interest rate and the average interest rate on grade Aaa bonds, taxpayers have been encouraged to compute their taxes

accurately and to pay them promptly, and both taxpayers and the Government have had an incentive to conclude controversies in a timely manner. In recent years, however, the tax interest rate has been significantly lower than the cost of commercial borrowing.

Congress believed that the current disparity between the tax interest rate and the actual cost of borrowing has contributed to the increasing number and value of delinquent tax accounts, and thus modified the rules for determining the tax interest rate to encourage timely refunds and tax payments.

2. Rate Could Be Different From Current Prime. Since the tax interest rate for the whole year is set at the level of September's prime rate, the tax interest rate could be substantially over or under the actual prime rate at the time of delinquency, especially in times when the prime is changing rapidly.

3. Rate Could Fluctuate Annually. Pegging the tax interest rate to reflect the prime rate could cause some confusion among taxpayers, as the rate could change from year to year.

4. Problem With Inheritance Tax Refunds. This interest rate applies to tax refunds paid by Government to taxpayers, as well as to late tax payments. In the case of inheritance tax refunds, use of this prime-linked interest rate could encourage some taxpayers to make a profit at the state's expense. Since the inheritance tax is not self-assessed, but rather is determined by the state upon submission of documents by the estate's representatives, the estate could make a large advance payment to the state when interest rates are high, then delay submitting the needed documents while the interest liability of the state grows.

PENALTIES FOR FALSE WITHHOLDING INFORMATION

Summary of Differences Between State and Federal Law

The federal law provides for both civil and criminal penalties upon employees who file false information with respect to income tax withholding. ERTA increased the amount of both penalties. The state law does not contain any civil penalty for such violation, but contains a monetary criminal penalty in the same amount as the ERTA penalty.

Fiscal Effect of Conformity

According to FTB, conformity would result in a minor increase in penalty collections.

Description of Current State Law

Unemployment Insurance Code Section 13100

State law provides for a criminal penalty of up to $500 upon employees who file false withholding information. No imprisonment penalty is provided. State law does not contain any civil penalty for this violation.

Description of Federal Law

IRC Sections 6682 and 7205

Under ERTA, effective 1982, the civil penalty for false wage withholding information is increased from $50 to $500 and the companion criminal penalty is increased from $500 to $1,000. The potential prison term remains the same at "not more than one year".

Policy Issues of Conformity

1. Deterrent Effect. Congress believed that the penalties for filing false information in connection with wage withholding should be more significant. Events over the past several years indicated that many individuals do not consider the existing monetary penalties to be a significant deterrent to supplying false wage withholding information.

2. <u>Imprisonment, Civil Penalty as Deterrents</u>. The state monetary criminal penalty is currently the same as the ERTA change. However, the state law does not provide for any imprisonment provision. The policy question is whether the inclusion of an imprisonment provision would be effective in reducing the number of persons involved in the movements. Also, the current state law does not currently contain a civil penalty for this violation. Such a penalty would probably assist in discouraging false information.

NEGLIGENCE PENALTY

Summary of Differences Between State and Federal Law

Both laws provide for a 5% penalty. The only difference is that the federal law now augments its 5% penalty with an additional penalty in the amount of 50% of the interest due on the underpayment.

Fiscal Effect of Conformity

According to FTB, conformity would result in a minor increase in penalty collections.

Description of Current State Law
R&TC Section 18684

California law provides for a penalty in the amount of 5% of any deficiency due to negligence or intentional disregard of rules and regulations not amounting to intent to defraud.

Description of Federal Law
IRC Section 6653

Prior to the 1981 Act, the federal law imposing a 5% penalty for negligence or intentional disregard was the same as under the California law. Under the 1981 Act, effective 1982, this 5% penalty is augmented by the amount of 50% of the interest due on the underpayment.

Policy Issues of Conformity

1. Tax Enforcement. This increase in the penalty effectively increases the interest rate to a point that there is no advantageous interest rate in the underpayment of taxes.

2. Penalty Not Deductible. The law allows interest paid on late taxes to be deducted. The new penalty imposed by ERTA, defined as a penalty, is not deductible, and would offset the interest deduction.

PENALTY FOR VALUE OVERSTATEMENTS

Summary of Differences Between State and Federal Law

This is a new provision added to the federal law. There is no similar provision in the state law.

Fiscal Effect of Conformity

According to FTB, conformity should result in minor increase in penalty collections.

Description of Current State Law

None.

Description of Federal Law
IRC Section 6659

Under the 1981 Act, effective for returns filed after 1981, a new penalty is imposed equal to a specified percentage of the underpayment of taxes attributable to certain overstatements of value of property on the return (for example, charitable contributions or basis of property). The basic provisions are as follows:

When penalty applies:

(1) The value or adjusted basis of property claimed on return exceeds 150% of correctly determined amount,

(2) The property was acquired within five years preceding the close of tax year in which the overstatement was made, and

(3) Underpayment of attributable tax amounts to $1,000 or more.

Determination of penalty amount:

Claimed valuation as a percentage of correct valuation:	Penalty as percentage of resulting underpayment:
Under 150%	0%
150% but not more than 200%	10%
Over 200% but not over 250%	20%
Over 250%	30%

Policy Issues of Conformity

1. Tax Enforcement. This additional penalty would assist FTB in the enforcement of the proper valuation of property in the same manner as it assists the IRS; e.g., in abusive tax shelter schemes such as the charitable donation of overvalued property.

2. Tax Administration. Conformity would also assist FTB in its reliance upon federal tax adjustments as it would not then need to back this penalty out.

INFORMATION RETURNS PENALTIES

Summary of Differences Between State and Federal Law

Under ERTA, the penalties for a taxpayer's (1) failure to file information returns with the government and (2) failure to furnish information statements to the persons to whom the payments relate are expanded to cover more types of payments, effective for returns and statements to be filed in 1982. The state, at present, has no similar penalty provisions.

Fiscal Effect of Conformity

According to FTB, conformity would result in minor increases in penalty collections.

Description of Current State Law

The state has no similar penalty provisions.

Description of Federal Law

IRC Sections 6041(d), 6652, 6673

Beginning in 1982, the penalty for failure to file information returns ($10.00 per statement to a maximum of $25,000 per calendar year) is expanded to cover (1) payments of $600 or more of payments made in the course of a trade or business, (2) the catch share of certain fishing boat crews, and (3) failure to provide duplicates of Form W-2, in addition to the present law which pertains to (4) dividends, patronage dividends, and interest payments totaling $10.00 or more, and (5) wage payments in the form of group-term life insurance. The $1.00 penalty per statement ($1,000.00 maximum per calendar year) for failure to file information returns for payments under $10.00 under current law is retained.

Beginning in 1982, the penalty for a taxpayer's failure to furnish information statements to the persons to whom the payments relate ($10.00 per statement to a maximum of $25,000 per calendar year) is expanded to cover (1) catch shares of certain fishing boat crews, (2) windfall profit tax on crude oil, (3) wage statements to employees, and (4) tip statements, in addition to the present law which pertains to (4) dividends, patronage dividends and interest totaling $10.00, (5) wages in the form of group-term life insurance and (6) employee stock options.

Policy Issues of Conformity

1. Enforcement. This would improve FTB's enforcement capabilities.

OVERSTATED DEPOSIT CLAIMS PENALTY

Summary of Differences Between State and Federal Law

Federal and state law impose penalties upon employing units which fail to make required returns or deposits of withheld taxes. The federal penalty is 5% of the amount of the underpayment. The state penalty is 10% of the amount which should have been deposited and the state penalty is 25% if the failure is due to fraud or in intent to evade.

ERTA added a federal penalty for "overstated deposit claims".

Fiscal Effect of Conformity

According to FTB, fiscal effect of conformity is unknown.

Description of Current State Law

Unemployment Insurance Code Section 1126 et seq.

See description above. The Department of Employment Development administers the California income tax withholding and deposit provisions and is responsible for imposing the penalties described above.

Description of Federal Law

IRC Section 6656(b)

The Economic Recovery Tax Act of 1981 adds a new penalty to existing penalties for underpayment of taxes required to be deposited in a government depository. The new penalty applies to "overstated deposit claims" which include claims involving failures to deposit, claims of deposits, and claims for deposits that were not made.

The penalty is equal to 25% of the overstated deposit claim. If the claim was due to reasonable cause and not to willful neglect, the penalty is not imposed.

Policy Issues of Conformity

A recent GAO report estimates that 31% of federal deposit returns fictitiously overstated the amounts deposited in the government depository. The new penalty is added in an attempt to deter underdeposits. Although no statistics are available, the same problem with deposits probably also exists on the state level. Adding another penalty or increasing the current penalties might serve to reduce the number of fictitious returns and underdeposits.

TAX COURT FILING FEE

Summary of Differences Between State and Federal Law

Under ERTA, in the case of petitions filed in the Tax Court after December 31, 1981, the court is authorized to charge a filing fee of up to $60.00 (from the present filing fee of $10.00). The only possible state counterpart, the Board of Equalization hearing of Personal Income Tax and Bank and Corporation Tax appeals, does not charge a filing fee.

Fiscal Effect of Conformity

Based on figures provided by Board of Equalization, imposition of a $60 fee would generate revenues of approximately $60,000 in 1982-83, if appeals filings did not drop due to the fee.

Description of Current State Law

None.

Description of Federal Law

IRC Section 7451

The Tax Court is authorized to impose a fee in the amount not to exceed $60.00, to be fixed by the Tax Court, for the filing of any petition for the redetermination of a deficiency or for declaratory judgment under certain code provisions.

Policy Issues of Conformity

1. Low Income Taxpayers. Would the institution of such fees preclude low income taxpayers from pursuing their right to appeal a FTB determination?

2. Revenue Source. Should the state continue to provide appeal procedures and facilities without specific funding for such?

CORPORATE ESTIMATED TAXES

Summary of Differences Between State and Federal Law

The state and federal law prior to ERTA were the same except that the state did not adopt the federal change made in 1980 which prescribed a special rule for "large" corporations.

ERTA, starting with 1982, increased the percentages of estimated tax required to be paid to avoid the penalty.

Fiscal Effect of Conformity

According to FTB, based on proration of federal estimates, conformity would have the following fiscal effect (in millions):

1981-82	1982-83	1983-84
+$25	+$20	+$22

Description of Current State Law
R&TC Sections 25563 and 25954

Banks and corporations are required to pay estimated tax for the current year. The tax is payable in four equal installments and the sum of such payments must equal at least 80% of the bank's or corporation's tax for the year.

If the above requirement is not met, a penalty of 12% of the underpayment is imposed, unless the bank or corporation satisfies one of three exceptions. One of these exceptions is that the bank's or corporation's estimated tax payments equal or exceed the bank's or corporation's tax liability for the preceding year. As mentioned above, Calfiornia did not adopt the 1980 federal change which required "large" corporations to pay at least 60% of the tax shown on the return for the current year or 60% of the actual tax due if a return is not filed.

Description of Federal Law
IRC Section 6655

ERTA increased the percentages required to be paid by "large" corporations from 60% to 65% in 1982, 75% in 1983, and 80% for 1984 and thereafter, in order to avoid the penalty. A "large" corporation is one that has taxable income of

$1 million or more in any one of its immediately preceding three years. In the case of a group of controlled corporations, a "large" corporation is determined by equally dividing the taxable income to each member unless the members consent to an apportionment plan.

Policy Issues of Conformity

1. Large Corporations. Should a special rule be applied to "large" banks and corporations?

2. Use of Prior Year's Income. Should California depart from its prior policy of relieving "large" banks and corporations from the penalty if they pay estimated taxes based on their preceding year tax liability, which may be considerably less than their estimated tax for the current year? For example, assume a corporation sustained a loss for 1981 and therefore subject to the minimum tax of $200. The corporation estimates its tax liability for 1982 at $100,000. Under current state law, the corporation can escape the penalty if it pays estimated tax of $200 for 1982.

CHAPTER 4

Economic Recovery Tax Act of 1981

PROVISIONS AFFECTING INDIVIDUALS

TAX RATE REDUCTIONS

Summary of Differences Between State and Federal Law

California income tax rates are substantially lower than federal income tax rates. Depending on the level of the California CPI, the reduction of California income taxes through the indexing mechanism could produce proportionately greater tax savings than the reduction in federal tax rates for income years 1981, 1982 and 1983.

Fiscal Effect of Conformity

Not applicable.

Description of Current State Law
R&TC Section 17041

California income tax rates are graduated from 1% to 11%. Tax brackets are indexed by full California CPI for 1981 and by CCPI minus 3% for 1982 and thereafter. Certain credits are fully indexed.

Description of Federal Law
IRC Sections 1, 21(d) and 6428

The ERTA provides for tax rates to be reduced by 1.25% for the 1981 taxable year, followed by 10% reductions in 1982 and 1983. The federal tax rate applicable to the lowest income group will be reduced from 14% to 11% and the rate applicable to the highest income group will be reduced from 70% to 50%.

Policy Issues of Conformity

Conformity is not relevant as tax rates are a policy decision by each level of government on how much revenue it wishes to extract from the income tax.

62.

DEDUCTION TO OFFSET MARRIAGE TAX PENALTY

Summary of Differences Between State and Federal Law

Under federal law, the tax rate schedules are constructed such that two married wage earners pay a higher federal tax than they would pay in combined tax if they were unmarried and filed as single individuals. This has been called a "marriage tax penalty". The 1981 federal tax law provides a phased-in deduction to offset partially this effect for married taxpayers. California tax rate schedules do not result in a marriage tax penalty, and there is no special deduction for married couples.

Fiscal Effect of Conformity

According to FTB, based on proration of federal estimates, conformity would have the following fiscal effect (in millions):

1982-83	1983-84	1984-85	1985-86
-$120	-$250	-$300	-$340

Description of Current State Law

R&TC Section 17041

California has separate tax rate schedules for married and unmarried taxpayers. The tables are based on the "income splitting" concept, which assumes that the joint income of the couple is divided evenly between them. A single individual earning half the income of a married couple will pay half the tax of the married couple. Thus, California cannot be said to have a "marriage penalty".

Description of Federal Law

IRC Sections 62, 85(a), 105(d)(3), and 221

The federal tax rate schedules provide that, at a given income level, the tax liability of a married couple is greater than the combined tax liability of two single individuals. This effect was the result of a provision of the Tax Reform Act of 1969 which was intended to offset a disadvantage previously experienced by single taxpayers.

The 1981 tax act has added a new deduction intended to mitigate the marriage penalty for two-earner married couples. In 1982, two-earner married couples filing joint returns may claim a deduction from the gross income of the lower-earning spouse an amount equal to five percent of the lesser of $30,000 or the amount of the spouse's earned income, for a maximum deduction of $1,500. In 1983 and thereafter, the deduction is 10% of the lesser of $30,000 or the lower-earning spouse's earned income, for a maximum deduction of $3,000.

Policy Issues of Conformity

The deduction for two-earner married couples is not relevant to California law, because our tax rate structure does not result in a marriage tax penalty.

INCOME TAX INDEXING

Summary of Differences Between State and Federal Law

Both state and federal law provide for income tax indexing. Under federal law, the personal income tax will be indexed each year for inflation beginning in 1985, using the U.S. Consumer Price Index. Under existing California law, the personal income tax is already being indexed for inflation, based on the California Consumer Price Index. For income years 1980 and 1981, indexing in California is based on the full change in CCPI. Thereafter, it is based on the CCPI change in excess of 3%.

Fiscal Effect of Conformity

According to FTB, if California were to shift to full indexing of the tax brackets in 1982-83, assuming continuation of use of the current index and the June-to-June time frame, fiscal effect would be as follows (in millions):

1982-83	1983-84
-$240	-$410

Description of Current State Law

R&TC Sections 17041, 17054, 17069, and 17171

Existing state law has provided since 1978 for annual indexing of the personal income tax brackets, and since 1979 for annual indexing of the standard deduction, personal and dependent credits, and special low-income credit. These inflation adjustments are based on the increase in the California Consumer Price Index (CCPI) for all urban consumers, ending in June of each current calendar year. Specifically:

1. The personal and dependent credits are indexed each year by the total increase in the CCPI from 1978, applied to the 1977 values of the credits.

2. The standard deduction and special low-income credit are indexed each year by the cumulative June-to-June increases in the CCPI, applied to the prior year's credits and beginning in 1979.

3. The tax brackets are indexed each year based on the cumulative June-to-June increases in the CCPI, applied to the prior year's brackets and beginning in 1978. However, for all years except 1980 and 1981, the tax bracket indexing uses only the CCPI increase in excess of three percentage points.

Description of Federal Law

IRC Sections 1(f), 21(d), 63(d), 151(f), 6012(a)(1)(D), and 6013(b)(3)(A)

Indexing will begin in 1985 using the percentage change in the U.S. Consumer Price Index for all-urban consumers from October 1983 through September 1984. Items to be adjusted include the zero bracket amount, each tax bracket, and personal and dependent exemptions. Indexing thereafter will always adjust the 1984 base data by the full change in the CPI from 1983.

Policy Issues of Conformity

1. Index. What index should be used to measure inflation for indexing purposes--CCPI (California) versus CPI (federal) versus some other index?

2. Time Frame. What time-frame should be used for measuring inflation--June-to-June (California) versus September-to-September with a one-year lag (federal)?

3. Inflation Adjustment Period. Should tax brackets be adjusted with or without a one-year lag period? If the state conformed to federal indexing in 1985, the lag period would result in the state making a 1985 adjustment similar to the one made in 1984. Depending on the inflation rate in those two years, state taxpayers would receive more or less benefits under federal indexing.

4. Cumulation. What method of accumulating the effects of indexing on tax brackets should be used--constant reapplication of entire change in CPI from base period (federal) versus cumulation of single-year inflation adjustments (California)?

5. Period 1982 to 1985. Prior to 1985 when federal indexing begins, should California's tax brackets, credits and standard deduction be (a) rolled back to their preindexing levels, (b) kept at their current levels, or (c) allowed to be indexed further?

CHILD AND DEPENDENT CARE CREDIT

Summary of Differences Between State and Federal Law

Both laws provide non-refundable credits for employment-related costs of caring for dependents. The major differences are:

Size of the Credit: California allows a 3% credit, which phases down to zero between AGI of $15,000 and $20,000. Federal law allows a 30% credit for AGI of $10,000 and under; a gradually phased down credit for AGI between $10,000 and $28,000; and a 20% credit above $28,000 AGI.

Qualifying Expenses: Federal law permits higher levels of expenses per child to be claimed, and extends the credit to certain out-of-home care for adult and handicapped dependents.

Fiscal Effect of Conformity

According to FTB, total conformity to federal dependent care provisions would result in revenue loss of over $100 million annually. This would be in addition to the revenue loss from our current credit of about $3.5 million annually.

Description of Current California Law

R&TC Section 17052.6

California law was changed in 1977 to substantially conform to the federal child care credit then in effect. The basic state law provisions are as follows:

Size of Credit: 3% of qualifying expenses.

Phase-out of Credit: Credit is reduced by 2% of the amount of the credit for each $100 of AGI over $15,000. Thus, no credit is allowed if AGI is $20,000 or more.

Expenses Not to Exceed: $2,000 for one dependent, $4,000 for two or more dependents. May not exceed earned income of lower-earning spouse.

Qualifying Expenses: Household services and direct-care expenses incurred to enable the taxpayer to be gainfully employed or a full-time student. Out-of-home care permitted only for dependents under age 15.

Eligibility of Dependents: Child under age 15 or dependent or spouse of taxpayer who is physically or mentally incapable of caring for himself.

Description of Federal Law
IRC Section 44A

Under the 1981 act, effective 1982, the federal credit has been modified as follows:

Size of Credit: Varies depending on income, as follows: AGI of $10,000 or less, 30% credit. Above $10,000 AGI, credit reduced by one percentage point for each additional $2,000 AGI. Above AGI of $28,000, 20% credit.

Expenses Not to Exceed: $2,400 for one dependent, $4,800 for two or more dependents. May not exceed earned income of lower-earning spouse.

Qualifying Expenses: Same as state law, except that expenses for out-of-home non-institutional care for disabled dependents who regularly spend at least 8 hours a day in the taxpayer's home are also eligible.

Eligibility of Dependents: Same as state law.

Policy Issues of Conformity

1. Lower Rate Structure, Lower Credit Level. Since California's rate structure (1%-11%) is lower than the federal (14%-50%), lower state credit levels are generally justified to achieve a similar ratio of tax benefits to tax liability. Further, cumulative tax liability is a concern--if California were to conform to the federal credit level, total credit for some taxpayers could be 60% of qualifying expenses.

2. Treatment of Employment-Related Expenses. Federal law allows all taxpayers a credit for some portion of employment-related dependent care costs. This is consistent with the tax principle that expenses of earning income should be deductible for all taxpayers. California now allows no credit to taxpayers with AGI above $20,000.

3. Concentration of Benefits. The phase-out feature in California law concentrates benefits of the credit among lower-income taxpayers, who presumably are less able to afford child care costs than higher income taxpayers. The 1981 federal amendments conformed in concept to California law by increasing the amount of credit available to lower income levels, and retaining the current credit level for all other taxpayers.

4. Costs of Care. The federal increase in maximum claimable expenses (from $2,000 for one dependent to $2,400) presumably was intended to reflect increasing costs of dependent care since 1976 when the previous levels were set. California still has the $2,000 limit.

5. Equity Change for Out-of-Home Care. Prior to the 1981 federal act, both state and federal law allowed out-of-home expenses to be claimed only for child care. Now federal law permits out-of-home costs to be claimed for disabled adults if they still live in the taxpayer's home. This removes a feature that needlessly biases taxpayers' decisions on type of care provided for dependents.

65.

EMPLOYER-PROVIDED DEPENDENT CARE SERVICES

Summary of Differences Between State and Federal Law

The new federal law excludes from an employee's gross income the value of child or dependent care benefits provided by an employer. California has no similar provision.

Fiscal Effect of Conformity

According to FTB, the revenue effect is unknown, but likely would be a negligible loss since virtually no taxpayers are now reporting such benefits as income.

Description of Current State Law
R&TC Section 17071

Under existing law, most types of monetary compensation or benefits provided to employees by employers must be included in the gross income of the employee. However, certain fringe benefits are excluded from employee gross income, such as health, dental and life insurance.

Description of Federal Law
IRC Section 44A

Effective 1982 and thereafter, the value of child or dependent care assistance provided under an employer's written, non-discriminating plan generally will not be includable in the employee's gross income. Amounts excluded under this rule may not be used by the employee to claim any credit or deduction. The value of benefits excluded shall not exceed the earned income of the employee.

Policy Issues of Conformity

1. Equity. The apparent purpose of the new federal provision is to exclude child care fringe benefits in the same way other types of fringe benefits are now excluded from employee gross income.

2. Could Avoid Inconsistent Tax Treatment. Under current state law, employees could be subject to differing tax treatment depending on the way the employer provides child care benefits: where the employer provides an

on-site child care center or pays an independent child care operator directly, the employee is <u>not</u> taxed; however, where the employer pays or reimburses the employee who in turn pays for care, the employee is taxed. The new federal provision guarantees the same tax treatment regardless of how the benefits are provided.

3. <u>Current Law Difficult to Enforce</u>. FTB notes that most taxpayers don't know they should report these kinds of benefits, and it is difficult for FTB to enforce.

CHARITABLE CONTRIBUTIONS FOR NON-ITEMIZERS

Summary of Differences Between State and Federal Law

For tax years 1982 through 1986, federal law will permit taxpayers to take the standard deduction and to deduct a portion of their charitable contributions directly from gross income.

California permits the taxpayer to take the standard deduction or to deduct charitable contributions from adjusted gross income.

Fiscal Effect of Conformity

According to FTB, if all non-itemizers claim the maximum deduction in 1982 and 1983, and claim an average of $300 in 1984 through 1986, the revenue effect would be as follows:

1982-83	1983-84	1984-85	1985-86	1986-87
-$6.7	-$7.0	-$22	-$45	-$95

Description of Current State Law
R&RC Section 17214

Under current state law, charitable contributions are deductible from adjusted gross income, rather than gross income.

Description of Federal Law
IRC Section 170i

For tax years 1982 through 1986, federal law provides that taxpayers who do not itemize and who take the standard deduction may deduct a specific percentage of their charitable contributions from gross income.

The percentage and dollar contribution limits are:

	1982	1983	1984	1985	1986
Percentage	25%	25%	25%	50%	100%
Contribution Limit	$100	$100	$300	50% of AGI	50% of AGI
Maximum Deduction	$25	$25	$75	-	-

After 1986, federal law permits only itemized charitable contribution deduction and would be back in conformity with present California law.

Policy Issues of Conformity

1. Purpose of the Provision. Congress enacted this provision to give taxpayers taking the standard deduction an incentive to increase their charitable contributions.

   Proponents have argued that the private philanthropic sector of our economy is of unique importance. It provides a substantial component to improve the quality of life for millions of American citizens. The decisions of millions of private philanthropists and thousands of philantropic voluntary organizations annually dispense tens of billions of dollars of services in such vital areas as education, science, health, religion, and culture.

   A study by Martin Feldstein and Charles T. Clotfelter found that the deduction of charitable contributions in the calculations of taxable income lowers the "price" of giving and will stimulate increased amounts of giving. The statistical evidence indicates that each 10 percent reduction in the price of giving induces an increase of about 13 percent in the amount of giving. This is referred to as the "price elasticity of giving".

   At a Congressional hearing in 1980, the Treasury contended that the price elasticity of lower- and middle-income taxpayers is lower than that for itemizers--a conclusion that would throw into question Feldstein's belief that nonitemizers would substantially increase their charitable giving if offered a deduction. Feldstein acknowledged that "In the range of incomes over $20,000, these estimates indicated some tendency for higher income groups to have higher price elasticities than lower income groups." However, he cited a number of other studies indicating that lower income groups would respond positively to a charitable deduction.

2. Total Impact of ERTA is Expected to Reduce Charitable Giving. A study by the Urban Institute found that private contributions to churches, universities, hospitals, service organizations and other nonprofit or charitable institutions will decline over the next four years by $18.3 billion in current dollar terms, and $9.9 billion in constant dollar terms, below what they would have been under prior law as a result of the recently enacted Economic Recovery Tax Act of 1981, as follows:

Individual Charitable Giving, Current Dollars (billions)

Year	Pre-1981 Law	1981 Tax Act	Difference
1981	$ 45.0	$ 44.5	-$ 0.5
1982	52.4	49.1	- 3.3
1983	60.2	54.7	- 5.5
1984	70.5	61.5	- 9.0
Total	$228.1	$209.8	-$18.3

This result emerges from a detailed analysis of the potential impact of the 1981 law using a simulation approach that takes account not only of changes in tax rates (and hence in the "price" of giving), but also changes in income levels that affect taxpayer tax brackets, decisions to itemize or not to itemize deductions, and resources available for charitable contributions. The analysis here examines only the 1981 law's impact on individual giving, not its impact on giving by foundations, corporations, or estates.

Because of the expected increase in overall income levels between 1981 and 1984, individual giving even under the new law will be higher in absolute terms than it was in 1980. However, the rate of growth under the 1981 law is projected to be considerably slower than it would have been under the previous law. As a result, private giving is projected to decline as a share of personal income.

The factors in the ERTA which are likely to discourage giving are:

- Reduction in the maximum tax rate on unearned income from 70 percent to 50 percent.

- Across-the-board 25 percent reduction in marginal tax rates over three years.

- Reduction in capital gains tax rate from 28 percent to 20 percent.

- Liberalization of estate taxation.

- Indexation of tax rates and the standard deduction beginning in 1985.

- Modification of foundation payout requirements.

- Reduction in corporate income taxation through liberalization of depreciation provisions.

Factors which are likely to encourage giving are:

- Charitable deductions for non-itemizers.

- Increase in maximum allowable corporate contributions.

In addition to its aggregate impacts, the 1981 tax law will significantly redistribute the burden of giving from the rich to the middle and lower-middle classes. In particular, the share of individual giving provided by the top 15 percent of all taxpayers is projected to decline by 12 percent between 1981 and 1984 under the new law, while the shares accounted for by the bottom 30 percent of all taxpayers and the middle 55 percent will increase by two percent and 11 percent, respectively.

3. Which Charities Benefit? A study by Martin Feldstein in 1975 found that most charitable contributions go to religious organizations, and that lower income persons give a larger percentage of their charitable contributions to such organizations than upper income taxpayers, as shown in the following table:

Types of Charitable Contributions
By Income Class

Adjusted Gross Income ($000)	Religious	Educational	Hospitals	Health and Welfare	Other
0-5	71.0%	0.7%	.03%	11.7%	16%
5-10	67.9	1.3	.4	14.1	16
10-15	67.2	1.7	.6	15.1	15
15-20	60.1	3.6	1.5	16.1	18
20-50	50.7	7.0	3.6	16.6	22
All Incomes	60.1	3.5	1.5	14.1	19

4. Added Complexity. Conformity to this provision would increase the complexity of the personal income tax for taxpayers now taking the standard deduction:

   a. Many taxpayers who now take the standard deduction will have to read through additional income tax instructions and fill out additional lines on the income tax form.

b. Since the deduction is limited by adjusted gross income, this may require further computations of adjusted gross income since state and federal AGI may not be the same.

5. Equity Vis-a-Vis Other Deductions. If this expenditure, which is a personal decision, is put "above the line" and is deductible from gross income, there would be a strong equity argument to permit other itemized deductions, such as medical expenses, taxes, casualty losses, etc., to be deducted from gross income also.

6. Audit Problems. Assistant Treasury Secretary Donald Lubick pointed out in his 1980 Congressional testimony that charitable deductions are already a problem for the IRS. He noted that a downward adjustment occurs in approximately 40% of the returns examined with incomes under $10,000 and in 36% of the returns examined with incomes between $10,000 and $50,000.

   Either through misfeasance or malfeasance, large numbers of taxpayers are apt to take an incorrect charitable deduction. The possibility that the average taxpayer will either not bother to keep records or may in fact fabricate them suggests there could be serious audit and enforcement problems for the FTB. The above-the-line charitable deduction would undoubtedly have a major cost impact on the state in either of two ways:

   Either the FTB will not be able to check a significant number of the additional charitable deductions, which might result in a large revenue loss due to unwarranted deductions, or the Board will have to step up audits drastically to curb fraudulent deductions and to eliminate errors.

   Additional audits, however, are not likely since the cost of policing relatively small deductions would not be commensurate with the additional tax and penalties collected. Furthermore, many of the Board's enforcement problems will involve questions of proof, which cannot be answered by letter but will require a more costly office audit. For taxpayers, this may entail the additional cost of hiring an accountant or attorney.

EXCLUSION OF GAIN ON SALE OF RESIDENCE

Summary of Differences Between State and Federal Law

The federal ERTA of 1981 increased the one-time exclusion of gain from the sale of a principal residence by a taxpayer 55 years of age or older from $100,000 to $125,000. California law allows a one-time $100,000 exclusion for a homeowner, regardless of age.

Fiscal Effect of Conformity

According to the Franchise Tax Board, if California increases its one-time exclusion limits to $125,000, there could be annual revenue losses of approximately $1 million, based on proration of federal estimates. However, state law is out of conformity with federal regarding age limits. If the state were only to limit the benefit to taxpayers over 55 years of age, it is estimated that there would be minor revenue savings. If full conformity were adopted, there could be minor net savings.

Description of Current State Law
R&TC Sections 17154, 17155

Current state law, as amended by Chapter 1168, Statutes of 1979, conformed to then-current federal law in providing a one-time $100,000 exclusion ($50,000 for each married taxpayer filing separately) from the gain on the sale or exchange of a personal residence. However, unlike federal law which limited the benefit to taxpayers who were 55 years of age or older, the state tax exclusion has no age limits.

The state exclusion was first adopted in 1978 in Chapter 569 (AB 3802, Kapiloff), which was an omnibus income tax package (which also established indexing). The original exclusion, applicable only in 1978, allowed a $100,000 for each married taxpayer. The exclusion was in addition to the limited exclusion to individuals of 65 and over. The changes in 1979 removed this former exclusion.

Description of Federal Law
IRC Section 121(b)(1)

In 1979, Congress adopted a one-time exclusion of $100,000 ($50,000 for each married taxpayer filing separately) for individuals 55 years of age and older. ERTA increases that exclusion to $125,000 (or $62,500 for each married taxpayer filing separately) for sales and exchanges after July 20, 1981.

Policy Issues of Conformity

1. Age Limitation. California's tax exclusion preceded the federal one, and has since its inception allowed the benefit to all taxpayers, regardless of age. Total conformity with federal law would mean placing an age limit on the benefit.

   Is the state program intended as a benefit to all taxpayers who are liquidating their housing assets for re-investment elsewhere, or just for those over 55 years of age who presumably are doing so because of budget necessities and/or desire to consume less housing space?

2. Housing Price Inflation. Besides the age limitation issue, there is the issue of just the dollar amount limit. Presumably, the federal law change was intended to reflect the increasing value of housing. Should state law reflect these changes?

GAIN ON SALE OF RESIDENCE: ROLLOVER PERIOD

Summary of Differences Between State and Federal Law

The federal ERTA increased to 24 months from 18 months the period preceeding and following the sale or exchange of a principal place of residence when a taxpayer may reinvest the proceeds without recognition of taxable gain. California law, which is in substantial conformity with former federal law, has an 18 month period.

Fiscal Effect of Conformity

According to the Franchise Tax Board, state conformity with federal law will result in an unknown revenue loss, probably in the $200,000 range annually, based on proration of the federal estimate.

Description of Current State Law
R&TC Sections 18091-18100

Current state law is in substantial conformity with former federal law in providing a nonrecognition of gain on the sale or exchange of a principal residence where the taxpayer replaces the residence with another whose price is equal to or greater than the residence sold. However, the new residence must be acquired within 18 months before or after the sale or transfer of the old residence.

Description of Federal Law
IRC Section 1034

Former federal law provided an 18 month tax-free rollover period for sales or exchanges of principal residences. ERTA provided an extension of the period to 24 months for residences sold or transferred after July 20, 1981. Residences sold before that time are grandfathered into the extended time period if the sale or transfer was made less than 18 months before that date.

Policy Issues of Conformity

1. Tight Housing Market. Presumably, the federal rollover periods were extended to reflect current decreased flexibility in the housing market where it may take a person longer to sell his home after the purchase of a

new one, or where it may take longer to find a suitable financial arrangement for housing after the sale of a former residence.

Increasing the rollover period after the sale of an old home may also allow the person to provide additional short term capital in the economy if he or she invests funds in the interim.

2. Taxpayer Compliance. Having non-conformity would mean taxpayers would have to plan with two different holding periods in mind. This could result in taxpayer confusion and compliance problems.

U.S. CITIZENS WORKING ABROAD

Summary of Differences Between State and Federal Law

Federal law grants a partial exclusion for earned income from sources without the United States and for certain foreign housing costs. It considers certain "camp" lodging furnished for the convenience of the employer to be part of the business expenses of the employer.

California law has nothing comparable to the special Federal provisions for earned income and deductions of Americans living and working abroad.

Fiscal Effect of Conformity

Not applicable.

Description of Current State Law

R&TC Section 17041 et. seq.

California law taxes all income earned by residents of this state, regardless of where it is earned.

Description of Federal Law

IRC Sections 893, 861-4, 911, 913, and 931-933

Under prior federal law, U.S. citizens working abroad could deduct "excess costs" of working overseas. In addition, taxpayers living in certain hardship areas were allowed a special $5,000 deduction. As an exception to these rules, employees who reside in camps in hardship areas could elect to claim a $20,000 earned income exclusion in lieu of the above deductions. Certain eligibility rules apply. The 1981 federal law does the following:

1. Changes residence requirement from 510 days in 18 months to 330 days in 12 months.

2. Replaces the deduction for excess living costs (up to $20,000) with an exclusion of foreign earned income as follows:

1981	$75,000
1982	80,000
1983	85,000
1984	90,000
1985	95,000

3. Retains and expands the provision that lodging and certain meals furnished in a "camp" shall be part of the business expenses of the employer. Defines camp as containing 10 or more units in proximity to work, but need not be in hardship area.

Policy Issues of Conformity

1. Purpose of Federal Change. The change to federal law apparently was based on Congress' belief that, in view of increasing competitive pressures abroad and the nation's continuing trade deficits, it is important to encourage Americans to continue working abroad to help keep American business competitive. The changes are also intended to simplify tax preparation for Americans working abroad.

2. No Prior Conformity. California did not conform to federal legislation in 1976, 1978 and earlier which established special provisions for residents working overseas.

ADOPTION EXPENSES DEDUCTION

Summary of Differences Between State and Federal Law

Both state and federal law now permit an itemized deduction for adoption expenses. The major differences are:

1. Adoptees Covered. California allows a limited deduction for all adoptees, and a larger deduction for adoption costs of "hard to place" children. Federal law permits a deduction only for adoption costs of "children with special needs".

2. Definition of "Special" Child. State and federal law have somewhat different definitions of "hard to place child" and "child with special needs". An adoptee conceivably could qualify under one law and not the other.

3. Maximum Deduction. The maximum California joint deduction is $1,000, while the maximum federal joint deduction is $3,000. (The California deduction for non-special children is for costs in excess of 3% of AGI; federal law has no comparable provision.)

4. Eligible Adoption Costs. California law allows deduction of medical and hospital expenses of the natural mother, while federal law does not. Other deductible expenses are similar.

Fiscal Effect of Conformity

According to FTB, conformity likely would result in a minor increase in revenue.

Description of Current State Law

R&TC Sections 17259, 17259.1

California allows an itemized deduction for expenses paid by a taxpayer or spouse in connection with the adoption of a child. Deductible expenses include any medical and hospital expenses of the mother of an adopted child related to birth, and any welfare agency, legal and other fees or costs relating to the adoption.

Except for "hard to place children" (described below), the deduction is allowed only for adoption expenses in excess of 3% of AGI. The deduction may not exceed $1,000 for joint returns, single returns, or head of household returns, and may not exceed $500 for married-filing-separate returns.

A deduction for the costs of adopting a "hard to place" child is allowed in lieu of the above deduction, without regard to the 3% of AGI threshold. The maximum deduction and eligible expenses are the same as above. A "hard to place" child is defined as "a child who is disadvantaged because of adverse parental background, or a handicapped child, or a child of the age of three years or more".

Description of Federal Law

IRC Section 222

Prior to 1981, there was no federal deduction allowed for adoption expenses.

The new federal law allows an itemized deduction for qualified expenses in connection with the adoption of a "child with special needs". Deductible expenses include reasonable and necessary adoption fees, court costs, attorney fees, and other "directly related" costs. Double benefits are specifically prohibited.

A "child with special needs" is one which the state has determined cannot or should not be returned to his parent's home and who has characteristics (such as ethnic background, age, physical handicap, or other) which make placement without adoption assistance unlikely.

The deduction is limited to $1,500 per individual, allowing a married couple a $3,000 deduction.

Policy Issues of Conformity

1. Federal Deduction Narrower. Conforming to federal law would mean reducing or eliminating California tax benefits for some taxpayers. Adoptive parents of non-hard to place children with costs in excess of 3% of AGI who now would qualify for a state deduction would become ineligible. Some adoptees who would now qualify as "hard to place" (for example, due to "adverse parental background") may not qualify as a "special needs" child. Certain adoption costs now eligible for deduction (such as medical costs of the natural mother) would be ineligible with conformity.

2. Federal Dollar Limit Higher. The maximum federal deduction for a couple could be $3,000, while the maximum is $1,000. Social Service officials note that legal and attendant adoption costs vary consider-

ably by type of adoption process (agency, independent, or inter-country). Costs could vary from $200 to a few thousand dollars.

3. Equity Original Goal of State Law. California originally enacted its deduction for adoption costs in excess of 3% of AGI in 1955 to give equitable treatment to adoptive and natural parents. The rationale was that natural parents may deduct the medical costs of having a child that exceed 3% of AGI, while adoptive parents' costs were not medical costs and thus not deductible. The new federal law does not contain this link to the medical deduction.

4. Incentive or Compensation? It's not explicit whether the intent of the state and federal deductions is to offer an incentive to adopt, particularly to adopt hard to place children, or to compensate parents in part for adoption costs. Since actual adoption-related costs are no different for normal and hard to place children, the higher California benefits and the federal limitation to "special needs" children points to the incentive explanation. Should state tax policy attempt to influence the choices of prospective adoptive parents?

5. Double Benefits Prohibition. The new federal law specifically prohibits deduction of adoption costs that qualify for other deductions or credits or that are reimbursed by government funds. This reduces the potential for abuse or excessive cost. California has no such provision.

SELF-EMPLOYED RETIREMENT SAVINGS (HR 10-KEOGH)

Summary of Differences Between State and Federal Law

Both state and federal law permit deductions, with limits, for contributions to a self-employed retirement plan ("HR 10" or "Keogh" plan).

The laws are substantially similar except the state's contribution deduction is limited to $2,500 and the federal limit is $7,500 ($15,000 for 1982 and thereafter).

Fiscal Effect of Conformity

According to FTB, conforming to the new higher federal limit would result in a revenue loss of about $20 million annually. This would be on top of the cost of the present California provision of $15 million per year.

Description of Current State Law

R&TC Section 17240

The California law generally parallels the prior federal law. However, the state's deduction limits are $2,500 or 10% of earned income, whichever is less, and there are no limits. Also, the amount of compensation which can be taken into account for a deferred benefit plan is $25,000 for the state rather than $50,000. This is because of the inter-relationship with the allowable deduction amounts.

Description of Federal Law

IRC Section 404(e)

Under prior federal law, a self-employed individual could contribute to a qualified plan the lesser of $7,500 or 15% of earned income. The contribution in any given year must be at least the lesser of $750 (even if more than 15% of earned income) or 100% of earned income.

The Act changes the federal law in 1982 and thereafter as follows:

1. The contribution maximum is raised to $15,000 from $7,500. (The 15% of earned income limit was not changed.)

2. The amount of compensation that can be taken into account under a deferred benefit plan to determine annual benefit accruals is increased from $50,000 to $100,000.

3. The amount of compensation that can be taken into account to determine contributions to a plan is raised from $100,000 to $200,000.

4. A participant in a self-employed plan may also be a participant in an individual retirement account (IRA).

5. A new 10% tax penalty is imposed on premature distributions.

6. Loans to all partners are deemed to be distributions. Formerly, only loans to partners with an interest of more than 10% were so treated.

7. Corresponding changes are made to simplified employee pension plans (SEPs): Contribution limit is increased to $7,500 or 15% of income and separate IRA contributions are allowed. Employer can make SEP contributions of $15,000/15%. The basic changes applicable to self retirement plans apply also to retirement plans of a Subchapter S corporation.

Policy Issues of Conformity

1. Equity for Self-Employed. The federal law recognizes that special pension provisions have applied to corporations but not to self-employed. The new changes basically reflect the impact of inflation.

2. Rationale for Prior California Differences. California in the past has generally followed the federal law. The major difference is the lower California deduction limits, which are due to revenue considerations and a recognition that the California tax rates are much lower.

3. Tax When Income Available. A basic theory of tax policy is that income should be taxed only when it is available for beneficial use. Retirement contributions are not available for beneficial use. Both state and federal law have taken a partial approach by allowing limited deductions for Keogh plan contributions.

SIMPLIFIED EMPLOYEE PENSION PLAN

Summary of Differences Between State and Federal Law

A simplified employee pension plan (SEP) is essentially an individual retirement account (IRA) to which both the employer and employee can contribute. The amount the employer can contribute is governed by the Keogh Plan limits and the amount the employee can contribute is governed by the IRA limits. The employee is required to report in his income the employer's contribution but is allowed an offsetting deduction. The employee is allowed a deduction for his contributions, if any, within the prescribed limits.

Prior to ERTA, the state and federal law were the same except that under the state law the limits for the employer's contribution were lower than the federal law because of lower limits allowed for Keogh Plans. Under the federal law, the employee was considered an active participant in a qualified employer plan and was therefore limited in the amount he could contribute to an SEP.

ERTA made the following changes to the federal law relating to SEPs:

1. Increased the limits for employer and employee contributions to SEPs, in line with the increase in limits for Keogh Plans and IRAs.

2. Extended the eligibility of employees to contribute to SEPs in the same manner as in the case of individual retirement accounts; i.e., although the employee is still considered as an active participant of a qualified employer plan and he is now eligible to contribute to an SEP independent of the limits governing the employer's contributions.

3. Increased the compensation limit for antidiscrimination rules consistent with the increase in the employer contribution limits.

Fiscal Effect of Conformity

Included in estimate for Self-Employed Retirement Savings (HR 10 - Keogh) provision.

Description of Current California Law
R&TC Section 17240

California conformed to the basic SEP federal law in 1976, under which an employer may contribute on behalf of the employee an amount up to the limit allowed a self-employed individual under the Keogh Plan or H.R. 10 plan (lesser of $2,500 or 15% of the employee's annual compensation). The employee is required to include the amount of the employer's contribution in his income but is allowed an offsetting deduction. The employee's contributions are limited by the IRA limit (lesser of $1,5000 or 15% of his compensation or actual amount contributed) less the amount contributed by the employer.

Description of Federal Law
IRC Section 219

ERTA, effective 1982, modified the law as follows:

1. Increased the amount of contributions an employer can make to an SEP to the lesser of $15,000 or 15% of the employee's compensation (formerly $7,500 or 15% of compensation). The increase was due to the increase in the amount of contributions allowed in the case of Keogh Plans.

2. The employee covered by an SEP, who is still considered an active participant in a qualified employer plan, is now eligible to make IRA contributions independently to the SEP plan within the new IRA limit (lesser of $2,000 or 100% of annual compensation).

3. Increased the compensation limit for antidiscrimination rules from the first $100,000 to the first $200,000 of compensation.

Policy Issues of Conformity

1. Increased Contributions. Should the increased contribution limits be adopted to adjust for inflation since the initial adoption of IRAs and Keogh Plans?

2. Extension of Eligibility. This depends on whether the extension of eligibility for IRAs to individuals covered by a pension plan is adopted. If adopted, then the extension for SEPs should also be adopted, for consistency of treatment of employees under IRAs and SEPs.

3. Antidiscrimination Rules. The compensation limit increase should be adopted to prevent the disqualification of the plan for state purposes. This can be done even though the increased contribution limits are not adopted.

INDIVIDUAL RETIREMENT ACCOUNTS

Summary of Difference Between State and Federal Law

ERTA changed the provisions relating to individual retirement accounts (IRA) in the following four major areas:

1. Increased the amount of deduction available for contributions to IRAs.

2. Expanded individuals eligible to establish IRAs.

3. Liberalized the rules for spousal IRAs.

4. Allowed voluntary contributions by an employee to a qualified employer plan to qualify for IRA deductions. The state law is similar to the pre-ERTA provisions.

Fiscal Effect of Conformity

According to FTB, based on a 2% proration of federal estimates, conformity will have the following effect (in millions):

1981-82	1982-83	1983-84	1984-85	1985-86
-\$5	-\$30	-\$40	-\$50	-\$60

Description of Current California Law
R&TC Sections 17240, 17241, 17530

In 1976, California conformed its law to the basic federal IRA provisions adopted in 1975. In 1979, California conformed to federal changes made in 1978. The current California law is as follows:

Limitation on Deduction: The lesser of:

a. \$1,500, or

b. 15% of the individual's annual compensation (earned income), or

c. amount actually contributed.

Limitation on Qualification: Limited to individuals who are not active participants of a qualified employer pension plan, tax-sheltered annuity plan, or governmental pension plan.

Spousal IRAs: Individuals who qualify for IRAs are allowed to establish a separate "spousal IRA". Spouse must be a nonworking spouse. Maximum aggregate deduction of an individual's own IRA and spousal IRA is:

a. $1,750, or

b. 15% of individual's annual compensation, or

c. if the contributions to the indivdual's IRA and spousal IRA are not equal, twice the amount of the smaller contribution.

Divorced Spouse: No special provision for continuation of a spousal IRA for a divorced spouse.

Employee Voluntary Contribution to Qualified Employer Plan: No special provision in state law.

Description of Federal Law
IRC Section 219

ERTA, effective 1982, modified the federal law relating to IRAs as follows:

Limitation on Deduction: Increases the limitation on deduction to the lesser of:

a. $2,000 (formerly $1,500), or

b. 100% of individual's annual compensation (formerly 15%).

Limitation on Qualification: Expands individuals eligible for IRAs to include individuals covered by a qualified employer plan, tax-sheltered annuity plan or governmental pension plan. Virtually all employees are now eligible to establish IRAs.

Spousal IRAs: Increases the maximum deduction to the lesser of:

a. $2,250 (formerly $1,750), or

b. 100% of individual's annual compensation (formerly 15%).

The maximum must, however, be reduced by the amount of contributions made to the individual's own IRA and the deduction for the individual's IRA or spousal IRA cannot exceed $2,000.

Divorced Spouse: Allows a divorced spouse to continue a spousal IRA that had been established at least five years prior to the divorce and the former spouse was allowed a deduction for that account in three of the five years. The amount of deduction is limited to the lesser of (a) $1,125 or (b) the sum of the taxpayer's compensation and alimony received during the year.

Voluntary Contribution to Qualified Employer Plan: Allows employees to deduct, as IRA contributions, voluntary contributions to qualified employer plans. The provision is consistent with the qualifications provision in allowing active participants of qualifing employer plans, tax-sheltered annuity plans to independently establish IRAs.

Policy Issues of Conformity

1. Higher Limitations on Deduction: Should the increase be adopted to adjust for inflation since initial adoption of IRAs?

2. Expansion of Qualification: Should employees covered by a pension plan be provided additional tax benefits? This provision would also provide additional long-term deposits to financial institutions offering IRAs. Many state and local government employees are currently entitled to establish deferred compensation plans in addition to being covered under governmental pension plan. Adoption of this provision adds another program to their pension program.

3. Divorced Spouse: This would allow nonworking divorced spouses to provide income for themselves in older years. The tax effect would probably be lower than the tax effect if the deduction was not allowed.

PARTIAL DIVIDEND AND INTEREST EXCLUSION

Summary of Differences Between State and Federal Law

California taxes in full all interest and dividends (except interest from a narrow class of government obligations).

Federal law allows a dividend exclusion of $100 ($200 joint), effective 1982 and thereafter. In addition, in 1985 and thereafter, a special exclusion for "net interest" is allowed, not to exceed $450 per year ($900 joint).

Fiscal Effect of Conformity

Fiscal effect, as estimated by FTB (in millions):

	1982-83	1983-84	1984-85	1985-86	1986-87
Dividend Exclusion	-$15	-$16	-$17	-$18	-$19
"Net Interest" Exclusion	--	--	--	- 75	- 83
	-$15	-$16	-$17	-$93	-$102

Description of Current California Law
R&TC Sections 17071, 17137

Existing California law taxes dividends and <u>most</u> interest in full.

Interest on the following obligations is exempt from California income tax:

1. Bonds and other obligations of the United States, the District of Columbia, territories of the United States, and Puerto Rico.

2. Bonds (not including other obligations) of the State of California or of political subdivisions thereof.

Description of Federal Law
IRC Sections 116, 128

Federal law contains two interest and dividend exclusion provisions:

1. Effective 1982 and thereafter, the former $100 ($200 joint) exclusion for dividends from a domestic corporation is reinstated. (The temporary $200/$400 dividend and interest exclusion is repealed.)

2. Effective 1985 and thereafter, there is a special exclusion from gross income for "net interest". Net interest is defined as interest income reduced by interest deductions (other than business and home mortgage interest deductions).

   The special interest exclusion in any year cannot exceed the lesser of:

   (a) 15% of $3,000 ($6,000 on a joint return), or

   (b) 15% of the taxpayer's net interest for the year.

   Thus, the maximum exclusion is $450 per year ($900 for joint returns).

Six types of interest income qualify for the exclusion. These are:

(a) Interest on deposits with banks, savings and loan associations, and similar financial institutions;

(b) Amounts, whether or not designated as interest, paid on deposits, investment certificates, or withdrawable or repurchasable shares by a mutual savings bank, cooperative bank, domestic building and loan association, industrial loan association or bank, or credit union, provided the deposits or accounts in the institution are insured under federal or state law or are protected and guaranteed under state law;

(c) Interest on evidences of indebtedness (such as bonds, debentures, notes, and certificates) issued by a domestic corporation in registered form and, if specified by regulation, other evidences of indebtedness issued by a domestic corporation of a type offered by corporations to the public;

(d) Interest on federal, state, or local obligations, provided such interest is not exempt from tax under any other Code provision;

(e) Interest attributable to participation shares in a trust established and maintained by a corporation established pursuant to federal law;

(f) Interest paid by insurance companies on prepaid premiums, life insurance policy proceeds that are left on deposit with a company, and under regulations to be prescribed, policyholder dividends left on deposit with a company.

Policy Issues of Conformity

1. California Never Conformed on Dividends. The federal \$100/\$200 dividend exclusion was originally enacted in the 1950's to somewhat mitigate the supposed double taxation of dividends (i.e., at the corporate level as earnings and again at the shareholder level as income). California never conformed to this provision, presumably because the smaller state tax minimizes the importance of the item, and because of revenue considerations.

2. Encouraging Saving, Discouraging Consumer Credit. The "net savings" exclusion in the new federal law effective 1985 is apparently intended to encourage taxpayers to save more than they borrow, since interest income may be excluded only to the extent it exceeds consumer credit interest deducted. This appears consistent with current national policy to promote economic growth by encouraging savings, and to slow inflation with tight money and high interest rates.

3. Incentive Power Uncertain. If California conformed, the maximum benefit possible for joint filers would be a tax reduction of \$99 (\$900 exclusion at 11% marginal rate). It's not clear whether these additional tax savings on top of the federal effect would encourage any further savings. Also, any reduction in state taxes would be partly offset by higher federal taxes for itemizers.

4. Equity Considerations. An exclusion from gross income provides the greatest benefit to taxpayers in the highest income brackets. For example, a \$900 exclusion saves a taxpayer in the 11 percent bracket \$99, while the same exclusion means only \$45 to the taxpayer in the 5 percent bracket.

5. Large Savings Needed to Benefit. In 1978, the average amount of non-mortgage interest deducted by California itemizers was \$1,150. Since only taxpayers with savings greater than interest deductions can benefit from the net interest income exclusion, the typical

taxpayer will have to have to have interest from savings of over $1,000 before he can begin to benefit from the exclusion. Assuming approximately 15% interest could be earned from savings, a deposit of $7,000 would be needed to earn the maximum tax free interest for typical couples.

6. <u>Not Necessary to Conform Now.</u> Regarding the "net savings" provision of federal law, since it will not be operative until 1985, it is not necessary for California to make a decision now about conformity.

QUALIFIED SAVINGS CERTIFICATES

Summary of Differences Between State and Federal Law

California taxes in full all interest and dividends (except interest from a narrow class of government obligations).

Federal law allows a one-time $1,000 ($2,000 for joint returns) exclusion of interest earned on qualified one-year tax-exempt savings certificates issued between October 1, 1981 and December 31, 1982.

Fiscal Effect of Conformity

Fiscal effect, as estimated by FTB (in millions):

1981-82	1982-83	1983-84
-$5	-$40	-$30

Description of Current California Law

R&TC Sections 17071, 17137

Existing California law taxes dividends and most interest in full.

Interest on the following obligations is exempt from California income tax:

1. Bonds and other obligations of the United States, the District of Columbia, territories of the United States, and Puerto Rico.

2. Bonds (not including other obligations) of the State of California or of political subdivisions thereof.

Description of Federal Law

IRC Section 128

The new federal law allows a one-time $1,000 ($2,000 for joint returns) exclusion of interest earned on qualified tax-exempt savings certificates.

Qualified tax-exempt savings certificates are one-year certificates issued by a qualified depository institution. The certificates must have a yield equal to 70 percent of the yield on 52-week Treasury bills. The certificate may be issued only during the period of October 1, 1981 through December 31, 1982 and must have a maturity period of one year. Thus, all of the interest excludable under this provision will be earned before January 1, 1984. Certificates must be available for deposits of $500 or more. Early redemption disqualifies the interest from exclusion.

A qualified depository institution is defined as a bank defined in Section 581, a mutual savings bank, cooperative bank, domestic building and loan association, industrial loan association or bank, credit union, or any other savings or thrift institution chartered and supervised under Federal or State law, if the deposits or accounts of the institution (other than an industrial loan association) are insured under Federal or State law or protected or guaranteed by State law.

The federal law generally requires that a least 75 percent of the proceeds of qualified certificates issued during a calendar quarter by an institution other than a credit union be used to provide residential financing, as defined, by the end of the subsequent calendar quarter.

Policy Issues of Conformity

1. Assistance for Ailing Home Finance Industry. The apparent purpose of this provision of federal law is to promote a short-term infusion of deposits to ailing savings and loan associations and other institutions which finance housing and farm loans.

2. May Simply Cause Shifting. Many analysts agree that this temporary tax benefit for interest earned from depository institutions is likely to cause a drain of funds from other sectors of the economy, without a net gain in the country's savings rate.

3. Detrimental to Municipal Bonds. The tax-free savers certificates are expected to have a serious dampening effect on the market for tax-free state and local bonds, which presently are the only source of tax-free interest.

4. Equity Considerations. Because they pay interest at 70% of Treasury bills, savers certificates are financially attractive only to taxpayers in higher marginal tax brackets. Other factors also make this provision favor the well-to-do: Any exclusion is structured to provide greater tax benefits to higher bracket taxpayers. Further, to take maximum advantage of the exclusion, joint filers would need deposits of about $16,000 (based upon the rate available in October 1981).

5. Incentive Power Uncertain. It's not clear whether a state tax reduction (at maximum 11% of interest earned) would have an effect independent of federal law in encouraging deposits in qualified institutions. It could merely provide additional benefits to taxpayers who would have done so in response to federal law anyway.

6. Inclusion of Banks Questioned. Many observers agree that commercial banks have not exhibited the earnings problems afflicting S&Ls, and question the appropriateness of including them as eligible institutions to issue savers certificates.

CONTRIBUTION "MADE AVAILABLE" RULE

Summary of Differences Between State and Federal Law

Federal and state law are the same in this area--both require that when an employer makes a contribution on behalf of an employee to a qualified pension plan, the employee does not have to include the contribution in his income other than in the tax year in which the contribution is distributed or "made available" to the employee. The ERTA deletes the "made available" provision.

Fiscal Effect of Conformity

According to FTB, conformity to this provision would result in an unknown but likely minor revenue loss.

Description of Current California Law
R&TC Section 17053(a)

California law taxes benefits received under qualified pension or profit-sharing plans to the employee only when actually distributed or made available to the employee. Such distributions are usually taxed as though they were an annuity.

Description of Federal Law
IRC Section 402(a)(1)

The Economic Recovery Tax Act of 1981 deletes the "made available" provision for tax years beginning after 1981.

Policy Issues of Conformity

1. Compliance. Lack of conformity would tend to cause taxpayer confusion. Traditionally, state law has conformed to federal law in this area. Lack of conformity could possibly cause increased administrative costs to the Franchise Tax Board.

2. Ability to Pay. It is a principle of taxation that income should be taxed only when it is actually received and the taxpayer has the ability to pay the tax. An example of benefits that are not distributed but are "made available" would be a pension plan which provides that an employee has the right to withdraw benefits at a certain time, but has not yet exercised that right.

EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

Summary of Differences Between State and Federal Law

Federal law provides for an investment-based tax credit for contributions to an employee stock ownership plan (ESOP), which is to be replaced with a payroll-based tax credit, beginning in 1983. An ESOP is an employee stock bonus plan or a stock pension plan wherein an employer contributes to an employee trust which then acquires stock of the employer.

Through 1982, an employer qualifies for an additional 1% of investment credit (11% rather than 10%) where the additional credit amount is contributed to the plan. An additional ½% is available for matching employee contributions.

Beginning in 1983, the credit is equal to the lesser of employee securities transferred to this plan or a prescribed percentage of the total annual compensation of participating employees.

California has no comparable provision.

Fiscal Effect of Conformity

According to FTB, the estimated revenue effect to California of full conformity to this provision, based upon a proration of federal estimates and assuming adoption of the payroll-based credit effective 1983, is (in millions):

1982-83	1983-84	1984-85	1985-86
-$6	-$60	-$170	-$220

Description of Current California Law

California has not conformed to federal law on the investment-based tax credit for ESOP contributions.

Description of Federal Law

IRC Sections 44G, 46, 401, 404, 409A, 415

Through 1982, an employer qualifies for an additional 1% of investment credit (11% rather than 10%) where the additional credit amount is contributed to the plan. If an employer supplements its contributions by matching employee contributions, an additional ½% of investment credit is available.

Beginning in 1983, the credit is replaced with a payroll-based tax credit. The amount of the new credit is based on the lesser of (1) the total value of employer securities transferred to the plan or (2) a prescribed percentage of the annual compensation of participating employees.

The prescribed percentage is 0.5% for 1983 and 1984, and 0.75% for 1985, 1986 and 1987. The credit expires on January 1, 1988. The credit is limited to the corporation's liability over $25,000. Any unused credit may be carried back three years and forward 15 years.

Policy Issues of Conformity

1. No Investment Credit. Since the ESOP tax credit for 1982 is based on the investment tax credit, as a practical matter it would be difficult to conform to federal law without conformity with the investment tax credit. For 1983-1987, conformity with the new credit would not be difficult.

2. Encourages Productivity. The argument in favor of conformity is that the ESOPs generally provide for additional employee participation in the profit generating potential of their employer, which should increase motivation, and encourage efficiency and higher productivity.

3. Incentive Effect. The arguments against conformity are (1) an additional state credit may not significantly increase participation in ESOPs over and above the participation stimulated by the federal court, (2) the Legislature has considered and rejected conformity to the federal provision when it was introduced in the Tax Reduction Act of 1975.

78.

PUBLIC UTILITY DIVIDEND REINVESTMENT PLAN

Summary of Differences Between State and Federal Law

Prior to ERTA, both state and federal law provided that distribution of property, including stock, by a corporation that is considered a dividend is includable in the recipients' gross income. ERTA makes some exceptions for public utility stock dividend reinvestment plans.

Fiscal Effect of Conformity

According to FTB, the estimated revenue effect to California of conformity to this provision, based upon a proration of federal estimates, is as follows (in millions):

1981-82	1982-83	1983-84	1984-85	1985-86
-$3	-$8	-$9	-$10	-$6

Description of Current California Law
R&C Section 17336

A distribution of property by a corporation, including its stock, that is considered a dividend is includable in the recipient's gross income.

Description of Federal Law
IRC Section 305(e)

Under the 1981 Act, effective for stock distributions after 1981 in tax years ending after 1981, the following is applicable to a domestic public utilities stock dividend reinvestment plan:

1. If an individual elects to receive common stock as a dividend instead of cash or other property, a single taxpayer can exclude up to $750 ($1,500 on a joint return) of the stock dividend.

2. The exclusion privilege applies only to individuals. It does not apply to corporations, trusts, estates, nonresident aliens or persons holding at least 5% of the voting power or value of the stock in the distributing corporation.

3. The stock must be that of a qualifying public utility; must be newly issued common stock that is designated

to qualify for the stock dividend reinvestment plan; and must have a value that is not less than 95% or more than 105% of the stock's value during the period immediately preceding the distribution date.

4. The recipient's basis in the stock dividend is zero. If the stock is sold within one year after distribution, the gain is taxed as ordinary income. Otherwise the gain is capital gain. In addition, if the shareholder disposes of any other of the utility's common stock which he owns within one year of the record date of the dividend stock, he will be deemed to have disposed of this dividend stock (to the extent of the amount of stock disposed of).

5. The stock dividend exclusion terminates for distributions after 1985.

Policy Issues of Conformity

1. Dividends are generally taxed as ordinary income. By electing to receive public utility stock instead of cash or property, an individual, if the stock is held for more than one year, will report its sale as a capital gain.

2. As a policy matter, it is appropriate to use the tax law as a vehicle to provide additional capital to public utilities? Do California utilities, with their present rate structure and regulation, need such capital?

3. Is it fair to all other companies to tax their stock dividends, while exempting stock dividends of public utilities? Does this raise an "equal protection" concern?

GROUP LEGAL SERVICES PLANS

Summary of Differences Between State and Federal Law

Federal law excludes from the income of an employee, his spouse, or his dependents amounts contributed by an employer on their behalf under a qualified group legal services plan.

California has no comparable provision.

Fiscal Effect of Conformity

Assuming these services would be taxed without a specific exclusion, the estimated revenue effect to California of conformity to this provision, based upon a proration of federal estimates, would be a revenue loss of less than $1 million annually. However, it is doubtful that many taxapyers are including such benefits in taxable income now.

Description of Current California Law

California has no specific provisions relating to group legal services plans.

Description of Federal Law
IRC Section 120

Prior to the 1981 Act, the provision excluding from an employee's income amounts paid by an employer to an employee or his dependents under a qualified group legal services plan was due to expire at the end of 1981. The 1982 Act now extends this exclusion through December 31, 1984.

To qualify for exclusion under federal law, the qualified group legal services plan must be a separate written plan for the exclusive benefit of the employees or their dependents. The plan cannot discriminate between classes of employees, except under separate collective bargaining agreements. Not more than 25% of amounts contributed can benefit shareholders or owners who own in excess of 5% of stock, capital, or profit interest of the employer. Legal services must be prepaid or provided for in advance.

Policy Issues of Conformity

1. Purpose of Federal Provision. This item apparently is intended to encourage employers to acquire group plans which would provide legal services to middle income taxpayers who are a generally under-represented economic group because of the substantial costs of legal services.

2. Simplicity. Conformity would be simpler for taxapyers and the state because information regarding the allocable income related to such plans would be difficult to obtain.

3. Enforcement. Inclusion of such amounts in income has been difficult to enforce.

4. Equity. Is it fair for employees benefiting from such plans to obtain an effective tax deduction for legal services which is not available to other taxpayers who pay for legal services directly?

5. Impact on Judicial System. When the cost of a service is paid by other than the party receiving the service, there is no economic incentive to prevent over-utilization of the service: it becomes a "free lunch" for the recipient. The additional legal services provided by such plans would further burden an already overloaded judicial system. The supply and demand implication of such proposals will likely mean higher legal costs generally.

6. No Prior Conformity. The California Legislature considered and rejected conformity to this provision in connection with the 1976 Tax Reform Act.

FRINGE BENEFIT REGULATIONS

Summary of Differences Between State and Federal Law

This provision of the ERTA postpones the issuance of regulations on the taxation of fringe benefits in final form to on or before December 31, 1983, and no proposed or final regulation may be issued if any such regulation has an effective date before January 1, 1984. There are no state regulations in this area. This is not a change in substantive law.

Fiscal Effect of Conformity

Not applicable.

Description of Current California Law
R&TC Sections 17091, 19253

Taxability of fringe benefits would fall within the purview of R&TC Section 17091, which is patterned after IRC Section 61. California presently has no regulations in this area. Under present law, FTB has the authority to issue rules and regulations necessary for the enforcement of the tax laws.

Description of Federal Law
ERTA of 1981, Section 801

See above.

Policy Issues of Conformity

1. Purpose of Federal Provision. There has been substantial public and professional concern about issues related to fringe benefits and their taxability under the income tax. In 1978, Congress first enacted a provision to prohibit the Treasury from issuing regulations on this subject. Congress' purpose in this act was to provide additional time for study and testimony on this subject.

2. No Prior Conformity. California did not conform to the 1978 federal legislation postponing fringe benefit regulations.

3. <u>FTB Authority</u>. Should FTB be left with the authority to enact regulations on this subject if and when it deems necessary, or through conformity should FTB be kept from acting for another two years?

ESTIMATED INCOME TAXES FOR INDIVIDUALS

Summary of Differences Between State and Federal Law

With a few exceptions, federal law and state law were similar with respect to the payment of estimated taxes by individuals. The basic requirement was that estimate payments must be paid if the tax for the current year is $100 or more.

Under the new federal law the $100 tax threshold is increased to $200 in 1982, $300 in 1983, $400 in 1984, and $500 in 1985 and thereafter.

Fiscal Effect of Conformity

According to FTB, adoption of the federal threshold amounts would have the following revenue effect (in millions):

1981-82	1982-83	1983-84	1984-85	1985-86
-$8	-$18	-$29	-$41	-$43

Description of Current State Law

R&TC Sections 18415 and 18685-18688

Estimated taxes by individuals must be paid if the tax for either the current or prior year is more than $100 (joint returns, single returns) or $50 (separate returns). The amount which must be paid in quarterly installments is the lesser of the current or prior year's tax. If 80% of the actual tax for the preceding year or the tax for the current year is covered by withholding, estimates are not required. If 80% of the adjusted gross income of the current year's adjusted gross income is subject to withholding, then estimates are not required.

The penalty for underpayment or nonpayment of estimated taxes is 12%. However, this penalty is not imposed if:

1) estimate payments for the current year equal or exceed the prior years tax,
2) estimate payments for the current year equal or exceed the amount of tax computed on prior year's income, but current year's rates,

3) estimate payments equal or exceed 80% of taxes due,
4) estimate payments equal 90% of the tax on taxable income for periods starting prior the first of the year to the end of the month preceding each month in which an installment must be paid.

Description of Federal Law
IRC Sections 6015(a)-6654(d)

Former federal law was similar to current state law except estimate payments were required if various gross income thresholds were exceeded:

1) $500 or more income not subject to withholding,
2) gross income exceeds $20,000 (single), $10,000 (joint return), or $5,000 (married not entitled to file joint returns).

The penalty was 12% (6% prior to February 1, 1980). The exceptions to the penalties are essentially similar to state law.

The new federal law increases the $100 tax threshold from $100 to $200 (1982), $300 (1983), $400 (1984) and $500 (1985 and thereafter). In addition, the penalty is increased to the prime rate as determined by the Internal Revenue Service.

Policy Issues of Conformity

1. Inflation. The $100 threshold has been in the state law since 1971 and in the federal law since 1971 ($40 prior). The federal increase may be viewed as a recognition of the impact of inflation. The federal threshold increases continue annually to 1985 when federal indexing will go into effect. As California has had indexing since 1978, the impact of inflation has already been taken into account.

2. Simplicity. Conforming to the federal change will reduce taxpayer confusion and if the change is not made, some taxpayers will erroneously assume that the state threshold is the same as federal and then will be assessed penalties.

3. Collections. Some taxes which would have been paid by estimates will become collection accounts.

4. Administrative. The federal change would reduct the number of quarterly estimates. While this may result in minor administrative savings, such savings may be offset by costs associated with collection accounts for those who do not pay the tax with the return.

REAL ESTATE INSTALLMENT SALES BETWEEN RELATED PARTIES

Summary of Differences Between State and Federal Law

Both state and federal law impute an interest rate to the seller with respect to installment sales of land between related parties. The state rate is the former federal rate of 10%. With respect to sales of less than $500,000, the new federal rate is 7%.

Fiscal Effect of Conformity

According to FTB, conformity would result in a revenue loss of less than $100,000 per year, based on proration of federal estimates.

Description of Current State Law
R&TC Section 17617

Current state law, which is the same as the former federal law, provides for the imposition of a minimum interest rate of 10% on installment contracts for the sale of land that are entered into after June 30, 1981, and that do not provide for at least 9% interest. What this means is that the seller realizes taxable interest income of at least the imputed rate amount. The buyer's interest deduction is whatever actual interest paid.

Description of Current Federal Law
IRC Section 483(g)

For land installment sales of up to $500,000 to spouses, siblings, ancestors and lineal descendants, a maximum imputed interest rate of 7% is used, effective with respect to payments made after June 30, 1981.

Policy Issues of Conformity

1. Benefit to Restricted Class of Persons. The legislation would appear to encourage real property sales between relatives.

2. Taxpayer Compliance. Having only one set of rules for both state and federal law should reduce taxpayer confusion and aid compliance.

3. <u>Affects Only Certain Sales</u>. If the interest rate charged in an installment sale of land between related parties is less than 7%, it should make no difference for imputation purposes as to whether the sales price was less than $500,000. Why should such sales be given a lower imputed rate?